

How Much Should I Pay for the Land ?

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As we enter 1996, the specter of new hotel development looms closer. While the construction of mid-level and first-class full-service hotels will still not be feasible in most markets for a few years to come, we are now seeing some seeds planted for new development. The entire development process typically takes three to four years, so hotels that will open upon the dawn of the next millennium are being planned now. Common questions being asked of us today are "how much should I pay for the land?" ... or "how much is this hotel site worth?" The traditional method of estimating land value, through the review and analysis of comparable land sales, is only applicable if enough relevant and recent data is available. Due to the real estate depression of the early 1990s, we have seen few transactions within the past

seven years of commercial sites that were purchased for hotel development. Land sales from the mid- to late 1980s will likely be irrelevant in estimating land value, due to the dramatic change in market conditions. The fact that land is only worth something to someone when it can be put to use explains why land values generally decline by a greater proportion than values of improved properties during a real estate downturn. In the absence of land sales, three alternate approaches are useful in evaluating what a hotel site is worth.

1. Allocation Method

The allocation method is based upon the principles of balance and of contribution, which suggest that there is a normal or typical ratio of land value to total property value for specific use

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categories. Land generally represents 10% to 20% of a hotel's total development cost, depending upon project and local market characteristics. Due to the challenging economics of new full-service hotel development, it is likely that land values will fall toward the lower end of this range in the next development cycle. By looking at what existing hotels are transacting for in a specific market, one can estimate a preliminary range of land value. Let's use an example in which a developer wants to buy a site for a proposed upper mid-tier, full-service hotel. Table 1 sets forth a preliminary range of land value in a market where similar hotels have transacted over the past two years, ranging from a low of \$55,000 per room to a high of \$70,000 per room.

The indicated range of land value, based upon the allocation method is \$5,500 to \$10,500 per room, based upon a land contribution percentage range of 10% to 20%.

2. Ground Lease Approach

The ground lease approach is supported by numerous self-adjusting comparables, as well as by the overall economics of the individual project. Over the past 25 years, hotels have been routinely constructed on leased land. While the terms differ somewhat from hotel to hotel, the basis for rent calculation is generally tied to a percentage of revenue formula. Recalculating the lease formulas as a percentage of only rooms revenue results in a range of 3% to 4% for areas in the U.S. outside of California and Hawaii, and 4% to 7% within desirable areas of these two states. Some local sub-markets will fall outside

Table 1: Land Allocation Method

Range of Sales Price Per Room - Existing Hotels	\$ 55,000	\$ 70,000
Land Contribution Ratio	10%	15%
Preliminary Range of Land Value	\$ 5,500	\$ 10,500

of these norms, due to specific market conditions. Applying the ground rental percentage to an estimate of rooms revenue results in the net income attributable to the land. Applying an overall capitalization rate of 7% to 11%, depending upon the market and location, results in a land value estimate.

In our example, let us assume that the proposed hotel, were it open and stabilized today, could be expected to achieve an \$80 average rate. However, the hotel's

ground rental percentage, and a 9% capitalization rate.

3. Land Residual Approach

The final method of estimating a hotel site's value is the land residual approach. This method, if utilized with accurate variables, is the most appropriate for determining what you can afford to pay for the land for a specific project. A market feasibility study is performed to estimate what the economic value of the hotel will be, once it is open and

Table 2: Ground Lease Approach

Stabilized Average Rate (\$96)	\$ 85
Number of Days in the Year	365
Stabilized Occupancy	74%
Projected Rooms Revenue per Room	\$ 22,959
Ground Rent Percentage	4%
Projected Income Attributable to the Land	\$ 918
Capitalization Rate	9%
Estimated Land Value Per Room	\$ 10,204

deflated future stabilized average rate, expressed in 1996 dollars, equates to \$95, because average rates in the market are increasing faster than inflation. An estimate of the current land value warrants recognition of some – but not all – of the future upside in room rates, due to the risk in the increases being achieved. The buyer's anticipation of higher average rates in the future may provide some room for negotiation, however. Table 2 sets forth a land estimate using the ground lease approach, an average rate of \$85 (in 1996 dollars), a 4%

operational. The development costs of the hotel, including all soft costs, such as interest and pre-opening expenses, are estimated. A developer's profit is added to the estimated costs to compensate the developer for undertaking the project. However, the actualization of a developer's profit should be added to the estimated costs to compensate the developer for undertaking the project. The amount by which the economic value of the hotel, based upon projected future cash flow, exceeds the hotel's estimated development cost determines the net residual value

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to the land. In our example, let's assume that the developer's consultants have estimated that the hotel will be worth \$120,000 per room, once it is open and operational in the Year 2000. The developer estimates that the total development cost of the hotel, exclusive of land costs and a developer's profit, will be \$105,000. The residual value to the land equates to the future value of \$120,000, less the project's development cost of \$105,000, or \$10,000 per room. Since the value and cost figures are estimated in future dollars, the land value can be discounted to the date of purchase by either a deflation rate or safe rate of return. Discounting the land value for four years at 6% per year results in a land value of \$11,881 per room.

The three approaches applied to our example result in an estimate of land value ranging from \$10,000 to \$12,000, or 9.5% to 11.4% of total cost. Once the hotel is developed, the value of the land component may rise to represent a greater proportion of total value. However, the challenging economics of hotel development will likely reduce land values to below the traditional range for the near term. While the choice of variables utilized in such an analysis is subjective, a careful consideration of the attributes of the market, proposed project, and site can lead to a prudent analysis and conclusion. Developers attempting to build new hotels should be careful not to pay too much for the land component in this new economic environment of low inflation and slim profit margins. □

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