Hotel Investment Strategies

Replacement Cost Crucial Investment Factor

After the events of 9/11, coupled with the general downturn of the global economy, hotel values in many markets around the world have declined over the last 12 months. The generally used benchmark to measure the severity of such a decline is the hotel's replacement cost. Let's see why so many investors, including Wall Street, recently have focused on replacement cost and its relationship with the decision-making process of buying, selling or developing hotels.

According to the Appraisal Institute, replacement cost is defined as the cost of constructing, at current prices, a building having the same utility using modern materials and according to current standards, design and layout. In other words, what would it cost today to totally replace a hotel developed one or more years ago. There are many sources of replacement cost estimates, including construction cost manuals, architects, builders and construction managers.

In today's climate of full investor disclosure, I challenge public hotel companies to annually disclose the market value of their hotels along with their estimates of replacement cost.

The San Francisco office of HVS International tracks current replacement costs for different types of hotels, and according to their 2001 survey, the total average cost on a per room basis for developing various types of hotels is as follows:

	Total Development (Replacement Cost) Average Per Room
Budget/Economy	US$48,000
Mid-scale without food and beverage	US$81,000
Extended Stay	US$91,000
Mid-scale with food and beverage	US$97,000
Full Service	US$160,000
Luxury and Resort	US$353,000

The replacement cost benchmark is important because it influences a number of investment decisions. For example, in a number of markets around the world where the market value of an existing, well-maintained hotel is 10% to 25% below its replacement cost, there is no incentive to develop new hotels. Why would someone build a new mid-scale hotel without food and beverage facilities for US$81,000 per room if upon completion it would be worth only US$65,000 per room? Wouldn't it be more prudent to acquire an existing hotel, hold on to it for a while and capture the upside when values increase? Investors should buy when values of existing hotels are below replacement costs and build new hotels when values of existing hotels are above replacement costs.

Today is a good time to be a buyer of existing hotels. Not only are you apt to be able to acquire an asset at a price below its replacement cost, but you also should benefit from a period of slow supply growth because it is not financially feasible to build new hotels based on this replacement cost benchmark. In the five cycles I have experienced in the last 30 years, investors always made money when they acquired good quality, well-maintained hotels at a price 10% or more below its replacement cost. A similar opportunity is available today in many hotel markets.

Public hotel companies also use replacement cost estimates in an attempt to demonstrate the underlying value of their assets compared to the overall stock value of their companies. While this replacement cost comparison is fairly simple to calculate, a more meaningful benchmark would be a market value estimate on a property-by-property basis contrasted with the overall stock value of the company. In today's climate of full investor disclosure, I challenge public hotel companies to annually disclose the market value of their hotels along with their estimates of replacement cost.

For more information on hotel replacement costs contact esahlins@hvsinternational.com.

By Stephen Rushmore, *MAI, CHA, president and founder of HVS International, a global hotel consulting firm with offices in New York, Miami, Denver, San Francisco, Vancouver, Mexico City, London, New Delhi, Singapore, São Paulo and Toronto. Mr. Rushmore can be contacted at 1.516.248.8828 Ext. 204.*