What Lenders Should Know About Extended-Stay Hotels

Rod Clough

Extended-stay hotels blur the line between apartments and hotels. In this article, Rod Clough describes the characteristics of these hotels, and explains what lenders should keep in mind when considering extensions of credit to this industry.

When it comes to hotel financing, lenders and consultants typically review a hotel's performance relative to its defined competitive set to evaluate the asset's strengths and weaknesses in its market. This is normally the best approach, and allows the interested party to see the performance direction of the market and the hotel's position in that trend. Market demand factors are typically well defined, with close-by corporations, convention centers, airports, and tourist attractions serving as important indicators for growth or decline in the market. However, what happens to this methodology when it is compromised by a fundamental difference in where the demand for the hotel under study is generated and ultimately housed?

A case in point is the budget, extended-stay hotel. For the most part, these hotels do not capture demand from the typical sources lenders and consultants are most accustomed to, such as convention centers, corporate travel, or tourist attractions. Moreover, these properties do not compete only with other hotels; apartment complexes are important competitors for this class of property. The budget, extended-stay hotel is truly in a class by itself: it is a hybrid between the apartment and the hotel.

Upon detailed inspection, the budget, extended-stay hotel even feels a bit like a small apartment complex. When a person checks in, these hotels typically require payment up-front for a week-long stay. Only limited housekeeping service is offered, so, like an apartment, the person is, for the most part, in charge of maintaining his or her own cleanliness standard. Although nightly rates are offered, rates are primarily marketed on a weekly basis. There is typically no restaurant, gift shop, meeting room, concierge, or recreational amenities

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to use during a person's stay. The front desk and lobby is more like the apartment manager's office; it is small, normally sparsely furnished, and open during limited hours only. The lobby of this type of hotel is not a place for lounging, meeting friends, or inquiring at the front desk about restaurant reservations.

How in the world can a hotel with no pool, no whirlpool, no meeting space, no free continental breakfast, a front office that is only open limited hours, and guestrooms furnished with such a basic package survive? The answer is this: it is not really a typical hotel; if it was, it would likely require those amenities to capture its demand. These brands have found a niche market for that sector of demand looking for something somewhere in between a hotel and apartment, and the expectations of this group are different than the sector of demand seeking typical hotel accommodations.

Temporary Housing

The group within this niche – those seeking this product type – is certainly varied within itself – but there is one common thread that prevails. These individuals are seeking temporary housing. What "temporary" means to one individual to the next may vary, but it is being sought nonetheless. And, the budget, extended-stay has entered to fill that request.

The reasons for requiring this type of temporary housing are many.

For example, the guest may need to stay in the budget, extended-stay hotel for purely financial reasons. The guest may not have the funds required to sign an apartment lease, such as first and last months' rent plus deposit. These funds can be substantial. With rents increasing quickly, the total funds required at lease signing may exceed $2,000 – versus the ability to check-in with only one week prepaid at a budget, extended-stay hotel for around $200, a tenth of the cost. (If a person pays in cash instead of with a credit card, a small deposit may be required at the budget, extended-stay hotel.)

Second, the guest may have a poor credit history, and may be unable to qualify for an apartment lease. Most apartment managers will run a credit check prior to issuing a lease – no credit check is obtained when a guest checks in to a budget, extended-stay hotel. Even if the individual has the money for the first and last months' rent and deposit, the person may not be able to afford utilities. Utility companies normally require hefty set-up and installation charges, along with ongoing monthly usage fees that can reach substantial proportions during times of extreme temperatures. The budget extended-stay hotel normally offers a room with free local phone calls, cable service, heating, cooling, water, and electricity – all paid for.

Third, the guest may be in the market for a temporary, work-related assignment. During this assignment, the guest typically maintains a residence in his or her hometown and will likely return home on weekends or for periodic visits. During this return trip home, the room remains "occupied" in the person's name, even though the person may not physically be present for a few days. Examples of these types of assignments include the following: store managers, assistant managers, or supervisors sent to specific markets to assist in the opening of a new store or staff retraining; construction workers in a market during a specific building season, or specialized craftspeople in the market to handle a specific project; insurance company staff sent to the market to handle claims in a specific region or in an area affected by a natural disaster; representatives targeting a specific geographic region for the sales of manufactured goods; and government employees on assignment in the area or training at nearby government facilities.

Fourth, the guest may be relocating, either within the market, to the market, or away from the market. In each case, the guest may not have the move-out of one residence perfectly timed with the move-in of the next residence. The interim period may last a week to months, depending on the situation, and alternatives (such as staying with friends or signing an interim 6-month or 12-month apartment lease) may be less desirable options.

Finally, the guest may be temporarily unable to use his or her residence due to an insurance related factor. If a guest's home is victim of fire, flood, or any other condition rendering it unlivable, alternate housing is necessary while the condition is remedied. The budget, extended-stay hotel becomes an attractive alternative in the weeks to months that may be required to return the home to a livable condition. People found in these circumstances are accordingly drawn to the budget, extended-stay hotel.

Limitations Of The Budget, Extended-Stay Hotel

If it sounds so good, why aren't more apartment dwellers moving into the budget extended-stay hotel? There are certain key differences that still make this property class a hotel, and not a true apartment. For example, the total living area of the budget, extended-stay hotel room is quite small, when compared to a typical one bedroom apartment. The living area is generally one large room in the hotel, while the apartment typically offers a large living area and separate bedroom. Secondly, kitchens are generally not full kitchens with cooking stoves (cook-tops are typical) and generally do not have dishwashers. Thirdly, the hotel offers a centralized pay laundry facility; individual units do not have clothes washers and dryers, typical of many apartment units.

Other limiting factors include the following: guests typically can not put decorations on the walls in the hotel; guests normally cannot have pets (but pet lovers don't have it so easy in a typical apartment either – most charge a hefty pet cleaning fee at lease signing, some as much as one month's rent on top of other deposits); rooms normally do not have any outside living area, such as a balcony or patio, or outside common area (this limits guests' "breathing area." Apartment complexes typically offer some type of outside park area, a pool, and balconies or patios); the hotel may be located along a highway, which may be relatively noisy at all hours, while many apartment complexes are set-back from highways or offer many units not directly on a major thoroughfare.

These factors render the budget, extended-stay hotel a bit more physically constricting than the apartment; however, these aspects are sacrificed to have more flexibility in the chosen lease term and up-front financial obligations.

The Brands

Although the extended-stay hotel has been around for quite some time, spearheaded by the establishment of the Residence Inn chain in the early 1980s, the emergence of the budget extended-stay sector is a relatively more recent occurrence. These properties have typically been developed near busy intersections or along major thoroughfares in suburban neighborhoods experiencing expansion. Their primary development has occurred in the southeastern United States, spearheaded first by Atlanta's Suburban Lodges of America. Major brands are listed and described below:

- **Budget Suites of America**The Budget Suites concept differs from the typical budget, extended-stay property in many respects. The hotel has a design most similar to an apartment complex, with a sprawling physical plant containing many guestroom buildings and one central building for management functions. While priced similarly to other brands, with standard suites starting at roughly $180 per week (equating to roughly $26 per night for weekly stays), the rate is not inclusive of kitchenware, linen, and maid service. These services are provided at an additional cost. Guestrooms do feature kitchens with ovens, which is not typical for this product class. Budget Suites offers a total of 18 locations, including two locations in Phoenix, seven locations in Las Vegas, and nine locations in the Dallas/Fort Worth Metroplex. The company also offers two more upscale "Suites of America" hotels which are priced at $230 per week; these hotels are located in their Texas and Arizona markets.

- **Extended Stay America, Inc.**This Spartanburg, South Carolina-based company offers three different three different brands within the budget, extended-stay segment. The company does not offer franchising opportunities. The Studio Plus brand is the most expensive brand, and offers larger rooms sized between 400 and 500 square feet with a queen-size bed, extras such as a sofa sleeper, and an on-site pool and exercise room. Rates for this brand start at roughly $300 per week, or $43 a day for weekly stays. Extended StayAmerica is the mid-level offering, with rates starting at roughly $250 a week (roughly $36 per day for weekly stays). This brand offers a smaller room, at roughly 300 square feet with a queen-size bed, and does not have recreational amenities. Crossland is the cheapest offering, and is available to rates starting at roughly $180 per week, which equates to roundly $26 per night for weekly stays. Crossland has smaller rooms yet, averaging 225 square feet, and guestrooms feature one double bed, no premium cable service, and a mini-refrigerator. Up to four guests are permitted at Studio Plus, accommodated by its guestrooms, which offer sofa sleepers, while the other two brands offer accommodations for up to 2 persons.

- **Hearthside Extended Stay Suites**This brand offers 10 locations, with nine in Texas and one in Nevada, with additional hotels under development in Colorado, Louisiana, Arizona, Nevada, and Texas. This product is similar in scope to the Crosslands product. Unlimited local phone calls are included in the room rate. Hearthside properties offer an exercise room, which is not typical of this property type. Rates averaged near $200 per week at the beginning of this year, with rates ranging from roughly $180 to $210 in most locations; the $200 average equates to roundly $29 a day for weekly stays.

- **InTown Suites**InTown Suites is a brand represented by 47 hotels primarily in southeastern United States, but also has representation in Indiana, Texas, Oklahoma, Utah, and Arizona. Primary states include Texas, with 16 properties, Florida, with seven properties, and Georgia, with five. These hotels are also simple in scope, and offer typical amenities and guestrooms for this product type. This Atlanta-based company is led by CEO David Vickers. InTown Suites offers the some of the best values of the brands surveyed, with weekly rates ranging between $150 and $170 and nightly rates bracketing $50.

- **Studio 6**This Accor brand offers 37 locations, mainly in the South and Midwest; primary states include Texas (16 hotels), Georgia (4 hotels), Arizona (3 hotels), and Florida (3 hotels). As of early 2002, rates averaged near $210 per week, which equates to roundly $30 a day for weekly stays. Guestrooms are normally modestly sized, with one bed with nightstands, one or two overstuffed chairs, a dresser, and a small dining table with two chairs. In-room features include a telephone with voicemail and free local phone calls, remote controlled televisions, and a coffee maker. Guests may purchase prepaid phone cards for long distance calls. Cable television service is offered, with HBO as the primary premium channel. To cut down on the potential of theft or breakage, lighting is typically mounted on the wall or ceiling, televisions are bolted to dressers, and microwaves are wall mounted.

- **Suburban Lodges of America**This 127-hotel chain is the largest of this brand sector, spanning 19 states. The Atlanta-based company has greatest representation in its home state, with 31 hotels, and also has significant representation in Florida (16 hotels) and Texas (15 hotels). Suburban Lodges of America road to becoming the most represented budget, extended-stay brand began with its early launch in 1987 and the opening of its first hotel in 1988. As a result of this longevity, it has grown into the largest brand in this category. This company is traded on the NASDAQ and offers franchise opportunities.

- **SuiteOne**SuiteOne offers rooms that range in size from 280 to 350 square feet. The company currently offers 7 locations, with 4 in Georgia, 2 in South Carolina, and 1 in Alabama. This company is also based in Atlanta and offers franchising opportunities. Rates ranged between $179 and $250 per week as of early 2002, and generally bracketed the $200 per week mark (this averages roughly $29.00 per day for weekly stays).

- **Sun Suites**Sun Suites offers 20 locations, mainly in the Southeast and Southwest; primary states include Georgia (7 hotels) and Texas (8 hotels). This product is similar in scope to the Studio 6 product. This company is based in Atlanta. Unlimited local phone calls come at an expense of $2.00 daily, or guests may choose not to have phone access. Again, as of January 2002, rates averaged near $170 per week, although a range of rates is advertised from $150 to $350; the $170 per week rate equates to $24 a day for weekly stays.

Financial Considerations

Several special considerations should be made when reviewing financial statements and forecasting future revenues and expenses of these types of hotels. Unique revenue and expense factors to this type of hotel property exist.

The rooms revenue category is, of course, the most important for this type of hotel, which lacks such revenue sources as restaurants, meeting and banquet space, and retail stores. Rooms revenue should be analyzed similar to a typical hotel's rooms revenue: on the basis of occupancy and average room rate. If the budget, extended-stay sector has been well represented in a neighborhood for a time long enough to discern a reasonable trend, a review of competitors' occupancy levels is the most important step in gauging the strength of the market. The additional step of reviewing occupancy trends of neighborhood apartment complexes is also necessary; this process is even more important if the budget, extended-stay sector is not well represented in the neighborhood or if it is newly established.

As previously mentioned, this property type is a hybrid between the apartment and the hotel. Hence, occupancy levels for this type of property typically trend somewhere between the occupancy trends of nearby apartment complexes and typical, limited-service hotels. For example, in a market with positive demand attributes for an appropriately-sized hotel of this type, occupancy levels may fall between

85% and 95%. When compared to the national average in the 60-percent range for hotels, this seems quite high. But, when compared to neighborhood apartment complexes, which may run practically at capacity in expanding population areas, the 85% to 95% level appears reasonable and even low in some instances. Therefore, occupancy is highly influenced by supply and demand factors – of similar budget, extended-stay hotels and modestly-priced apartment housing.

Keeping a high occupancy level is predicated on staying true to the extended-stay nature of the property – not necessarily striving for a perfect fill every night. For example, say a budget, extended-stay hotel sells its last room available one night for a three-night stay; then, on the next night, a person inquires about a room for a two-month stay. Unfortunately, the hotel is unable to satisfy the request because the room that was available is now occupied for two more days by the short-term guest. This example illustrates that careful management of the room inventory is required to obtain the highest occupancy possible along with the highest percentage of extended-stay customers possible.

Average rate trends should be reviewed on a basis of length of stay. For this type of property, the rate changes if you stay for less than a week, or if you stay for weeks at a time. A typical limited-service hotel property segments demand by the corporate, leisure, and group customer. The budget, extended-stay hotel's demand should be segmented by the following three categories: stays of 1 to 6 nights, stays of one to three weeks, and stays of four weeks or more. Because the "four weeks or more" category represents an occupied room night for at least 28 days or more, this category usually represents up to 80% or more of the budget, extended-stay hotel's demand mix.

The lowest room rates are typically offered for the longest stays, to entice this type of preferred customer to the hotel. The highest room rates are obtained for the short-term stay, on a nightly basis of typically $50 to $60 per night. Despite the higher room rate obtained for the short-term guest, this customer base is neither appropriate nor sought after for this type of property. If management seeks to increase its one- to six-night stay capture, it efforts to increase its average rate for the property, inevitably occupancy will be sacrificed. It is more effective for this property to sell one room to a single customer for a four-week stay, than to try to sell the room to twenty-eight different customers for a one-night stay each. Moreover, catering to the single-night customer also cuts into the valuable profit margin of the hotel, by requiring greater staffing requirements in the front office and housekeeping, in particular.

As noted previously, room rates for this type of property bracketed the $200 per week mark as of the beginning of 2002. A property running 90% occupancy at a $200 per week average room rate, generates $9,360 in rooms revenue per unit for the year. Other revenues will be minimal, given the limited services available to generate that revenue. Local telephone service is typically free and long-distance calls are typically charged-through to guests' personal calling cards. This leaves vending and guest laundry revenues as the only other considerable revenue sources for the hotel; these are important, but minimal when compared to the level of rooms revenue collections. These collections may bracket $0.50 per occupied room night, or roundly $200 in additional revenue per room for the year. This provides our example hotel with total income of roundly $9,600 per room.

On the expense side, the greatest savings is in the streamlined staffing needs to operate a property of this type. Normally, a budget, extended-stay property may be operated with roughly 10 employees, including a manager to handle administration and sales, a maintenance person, and a mix of room attendants and front desk agents. Some locations may require a security patrol person, although security service is normally contracted-out and assisted by an automated camera security function offered by many brands. Accounting and regional marketing functions are normally centralized and not completed on-site. On the whole, fewer front desk agents are needed than at a typical hotel, as the hotel experiences fewer check-ins and check-outs with extended-stays and front office hours are limited, particularly on weekends.

Fewer housekeepers are also needed because rooms receive only weekly service. However, as the rooms are used as temporary residences, the rooms tend to get significant wear and tear over the course of a hotel stay. After a guest checks-out, this guest may have been staying in the room non-stop over the course of months. In this time, the room may have been utilized for storage of personal belongings, and extensive food preparation. Because only limited housekeeping services are throughout the extended-stay, this can contribute to greater wear and tear. After check-out, a greater level of service is typically required. A room may need to be repainted, and new carpet installation may be necessary. Therefore, the check-out room is normally jointly handled by both a housekeeper and a maintenance staff person.

Administrative and general costs are also scaled back. The greatest expenditures in this category are payroll for a manager, central office accounting charges, and credit card commissions. Sales and marketing costs should be very minimal, and may include some billboard advertising or targeted sales efforts, the allocation for a shared sales and marketing manager, and franchise fees if applicable.

If the property is maintained appropriately, the reserve for replacement should be adequate to keep the property in good shape. Given the extended-stay patterns of the property, full-scale renovations are not appropriate for a property of this type. Rather, upon check-out, rooms should receive necessary renovations in order to maintain their competitive quality. This periodic renovation of room to room should keep the hotel competitive.

Well-managed, budget, extended-stay hotels in healthy markets should achieve net income that averages in the 30-percent range, and towards the upper end of this range if the market is particularly strong. For the example noted previously, a profit ratio of 35% provides $3,360 of income per room for the year.

Weighing the Risks and Rewards

Risk factors for this type of property are more closely tied to the shifts in population and housing trends that exist within the pertinent market area. As a neighborhood follows a normal development cycle, change which occurs through growth, stability, and decline leads to concurrent changes in demand for the budget, extended-stay sector. This direction and pace of change should be analyzed and incorporated into the asset's cash flow projection.

In the example provided, the rewards were illustrated at $3,360 per year, per room. Capitalizing this reward by rates ranging from 11% to 13% indicates a value range of roundly $25,800 to $30,500 per room for this example. Therefore, total development costs must fall within this range for this type of hotel, which in turn necessitates a reasonable developer's profit expectation and relatively cheap land. It simply does not pencil to develop this type of property on an expensive site or with an unusually high developer's profit expectation. Moreover, if developers seek to draw more dollars to the bottom line through a greater contribution of short-term stays – profit is eroded through higher staffing requirements. Finally, the competitive nature of the business has kept the range of rates offered for this product type very tight, as noted previously, closely bracketing the $200 rate per week.

Carefully balancing all aspects of the budget, extended-stay operation is essential. The property type's low room rates leave management with a very low margin for error and require successful capture of the right market mix and scheduling of the minimal needed staff, among other factors. One wrong turn can quickly cut into valuable profitability. With such distinct qualities, lenders should pay special consideration to these assets, and feel comfortable with the management, location, and property quality as it fits into the market for this unique, hybrid property type. ■