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OCTOBER 2021

THE INVESTMENT LIFE CYCLE OF A HOTEL

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In light of the coronavirus (COVID-19) pandemic and the effect it has had on lending and new development in the hospitality industry, it may be beneficial to review the basics and walk through the investment life cycle of a hospitality asset. This guide is intended to be a helpful reference for a seasoned hospitality professional, a student looking to break into the industry, and anyone in between. Furthermore, HVS has leading experts for each stage of the process, ready to help you with any of your hotel investment needs from conception to disposition.

Hotels are handled by a myriad of different entities during the investment life cycle. Some participants include the developer with the initial idea, investors, lenders, management companies, brands, architects, and designers. Each one can make or break a successful hotel investment. They must all be aligned for the investment, whether it is a new construction or an acquisition with repositioning, to be successful.

The life cycle model begins with conceptual planning and ends with the disposal of the hotel either at the end of the hotel's economic life or when the investor's investment goal is reached.

The remainder of this article will focus on the development of a new hotel, but much of the information applies to acquisitions as well.

Conceptual Planning

Conceptual planning is part of pre-planning that occurs before a hotel project is underway. The pre-planning phases are crucial for a project to get off the ground, literally and figuratively. Conceptual planning includes assessing the market, deciding on the size and type of hotel, and assembling a team of experts and professionals who can help design and estimate the cost of the vision and assess the feasibility.

Feasibility & Underwriting

After the initial concept of the project is identified, a feasibility study must be conducted in order to determine if the concept will be able to make a sufficient return on investment. In other words, will it be worth the risk and expense of carrying out the project? Sometimes the feasibility study indicates that, while the initial concept most likely would not have a strong return, tweaking some element could result in a successful investment. Changes could include the number of rooms, the quality level, the facilities and amenities, or any number of other elements.

One critical step in underwriting the project is a detailed analysis of the estimated development costs and future benefits to compare the potential return on investment for this project with alternative projects or investments. Decisions and choices require information. Estimating the costs can be challenging because construction and material costs change daily and because of the long delay between performing the analysis and incurring those costs. The difference between the assumptions in the underwriting analysis and the actual costs incurred could be substantial enough to change the decision. Therefore, the decision tools in the analysis must include a sensitivity component to account for future cost variances.

There are consulting firms, like HVS, that produce these studies for interested developers. Having a third-party report provides developers and financing partners critical information about the market and the hotel's potential operating profit so they can be confident in the consultant's feasibility opinion. Developers/owners and the brands also often have their own internal feasibility teams to determine whether their projects make financial sense.

Brand & Operator Selection

If the project is deemed feasible, then it is critical for the developer to select a management company (operator) if they do not have hotel operational expertise in-house and to select an appropriate hotel brand if branding is part of the concept. Finding the right brand and operating partners that fit into the hotel's vision is essential to a successful hotel investment. The contracts for both brand and management are long and expensive to terminate, so vetting and selecting the right operator and brand require expertise from knowledgeable advisors to avoid making a costly mistake. Additionally, the contracts themselves should be negotiated with the assistance of knowledgeable and experienced advisors because operator-centric or missing provisions can result in extra liability and costs for owners.

Financing

After having the operator and brand on board, at least with signed letters of intent, and a feasibility study completed, it is time to secure financing. Capital will be needed to cover the costs of the land; construction; furniture, fixtures, and equipment (FF&E); soft costs, such as consulting fees and pre-opening costs; and working capital. Hotels are rarely financed with 100% equity because the most cost-effective approach is to leverage the investment with both equity and debt. Lenders for the mortgage loan can be traditional banks, debt funds, life-insurance companies, CMBS/conduit lenders, or government-subsidized lenders that offer a single tranche of debt. However, we note that there is also more complicated financing available with a multi-layered capital stack or securitizations. (Complex financing strategies are beyond the scope of this article.) Any financing structure will require the development of a sophisticated financial package to present to lenders and investors. The package should focus on demonstrating the hotel's strong potential for success, including mitigating the downside, as well as the stability, credibility, assets, and track record of the team.

Approvals

A variety of external approvals will be necessary for the project to proceed. Entitlements, permits, and approvals by different jurisdictional entities must be secured, depending on the site and the range of local controls in place. Examples of agencies that may issue local permits and approvals for a hotel project include zoning and land use planning authorities, city or town water/sewer authorities, building departments, and tribal and/or state gaming commissions (for casino properties).

Professional Services & Project Consultants Selection

To seek approvals, developers will need special design and engineering consultants to create plans and renderings to help detail the development to the local authorities.

- **Civil Engineer:** The civil engineer runs the zoning and site-plan approval process that begins with researching zoning ordinances, height limits, setbacks and parking requirements, topography, stormwater management, and utilities. The information is coordinated with the architect so that the civil engineer can submit a site plan that includes placement of the building, parking, driveway, lighting, and utility connections. The civil engineer works closely with the developer, architect, and a land-use zoning attorney while navigating through the various planning departments and authorities to obtain zoning and site-plan approval. The civil engineer also works with the developer and zoning attorney to investigate whether any zoning waivers and special exceptions are required and to pursue them if necessary.
- **Architect:** Hospitality architecture is a specialty unlike other building architecture. Therefore, having an architect and design team that specializes in hospitality is a must, as the specialized professionals understand brand and guest expectations, as well as hotel design and planning. At the onset, a developer needs the architect to prepare conceptual site and building plans to confirm the required

building size and height based on the project's program and to illustrate that it fits on a property, that the desired number of keys can be met, and/or that the renovation desired is achievable. As the concept design evolves, the architect coordinates with the civil engineer related to the building, parking, and guest-arrival placement to confirm that the proposed building will meet zoning requirements. A hospitality architect may work with a brand for a prototype project or may design a soft-branded or independent custom hotel, as appropriate. The architect prepares complete building plans through the conceptual design, schematic design development, and construction document phases to create drawings and specifications needed for the building permit application, as well as bidding and construction. Through these phases, the architect designs the building while coordinating along the way with the developer's team; project manager; brand; interior designer; structural engineer; mechanical, electrical, and plumbing (MEP) engineer; and consultants for lighting, food service, low voltage wiring, and audiovisual components. The architect confirms the project meets applicable codes and accessibility (ADA) requirements and can advise on sustainability.

- **Engineers and Consultants:** Depending on the complexity of the hotel project, a structural and MEP engineer are most likely part of the basic architecture and design team. The structural engineer can investigate various structural systems, as well as unique site-specific elements such as wind and earthquake loads. The MEP engineer considers energy consumption and the building requirements for power, lighting, water, sewer, stormwater, gas, sprinklers, and fire alarms. These items are coordinated with the interior designer and architect. Other consultants are brought into the project as needed for food service and laundry equipment design and for low voltage wiring, including designing placement and risers for data, cable television, phones, and Wi-Fi. In hotels with meeting space, an audiovisual consultant is brought on board.
- **Interior Designers:** An iconic and memorable guest experience begins and ends with interior design. The designers creatively bring the developer's vision to life, integrate brand requirements and standards, and develop the narrative regarding the area's unique history or neighborhood story. This translates to materials, color, art, softgood and case good design, and branding. A boutique or soft-branded property gives the designers even more creative license, and these projects are more involved for an interior designer than a branded project. Along the way, the interior designer assists the developer through the brand design-approval process; prepares furniture, fixture, and equipment (FF&E) specifications and budgets; and coordinates with a purchasing agent. While selecting a creative design team is important, it is equally important that the design team has the hospitality knowledge and ability to design practical solutions to meet the developer's FF&E budget. An interior designer may also bring on a consultant for lighting and artwork.

Hotel developers will often consult with seasoned hotel operators in a process called programming, where the needs of the hotel operation are considered at each stage of project planning so that the designed spaces in the building are suitable and safe for day-to-day hotel operations. Everything from ensuring the hallways are wide enough for housekeeping carts to fire and life safety issues must be considered.

Land Acquisition

While most developers have already secured the land at this stage, at the very least, it is best to identify which site they would like to develop and the associated cost. Incurring additional development costs without controlling the site is very risky. It is important at this stage that the land be secured either by obtaining an option (with extensions) or closing on title. Given that land is difficult to finance, developers may have to acquire the land all-cash and then use the land as equity as part of the capital stack.

Procurement & Construction

Once the land and approvals are secured, the construction plans are completed and filed, and all financing has been obtained, then construction can commence. All the materials must be sourced and procured, the building envelope completed, and then the fit-out completed (e.g., IT and FF&E installation). A new-build premium select-service hotel can take roughly 18 to 24 months to construct in normal conditions. Monitoring construction and the various installations is the responsibility of a project manager, who ensures that the work is proceeding according to plan and budget, coordinates lender inspections, manages FF&E procurement and installation, and undertakes a myriad of other oversight tasks. Some developers have a project manager on staff, while others retain third parties for this very important role.

Pre-Opening

Well before opening, the operator will begin a process known as pre-opening. This can begin as early as 24 months before opening for a large and complicated hotel and as late as four to six months before opening for a limited-service hotel with no dining outlets or meeting space. During pre-opening, the operator will undertake a number of planning and implementation steps to ensure a successful opening by creating a critical path plan that extends through opening.

The operator will recruit, hire, and train new employees to prepare the hotel for opening day and manage it after opening. The General Manager (GM) is usually the first position to be filled so that this individual can execute and coordinate the pre-opening process. The GM, in conjunction with ownership, creates a pre-opening budget, which includes the costs of hiring and training new associates, temporary office space, equipment, marketing and public relations, travel for corporate staff, and any other needs. Hiring key personnel in a timely manner is critical for a strong opening. A good Director of Sales, for instance, can be difficult to find in some markets, and waiting too long to recruit can affect the hotel's performance into the future. Website development also occurs at this stage, along with collateral design and field marketing. Sales activities are crucial here, as well, to develop group room-night business and start to negotiate rates for potential top accounts. The pre-opening staff will also create the specifications and quantities for operating supplies and small equipment (OS&E) to ensure enough inventory and supplies are on hand to satisfy expected demand upon opening. The GM also creates a partial-year operating budget to predict expense and staffing levels during the first months of operations.

Operations & Maintenance

From opening day going forward, it is important that the management team and asset manager operate and maintain the hotel to maximize operating profit, maximize asset value, and achieve any unique owner goals. Together, their responsibilities include profitable revenue generation, human resources, physical asset management, financial administration, and reporting and budgets. The management team focuses on reaching certain important metrics such as average daily rate (ADR) targets and profitable revenue per available room (RevPAR) levels at various milestones. Management must also control costs and keep an adequate reserve for owner-driven renovations and/or brand-mandated property improvement plans (PIPs). Hotel maintenance is critical to make sure the future PIPs or renovations are not overly costly, that the hotel remains clean and safe for guests and staff, and that the facilities enhance rather than detract from the guest experience.

For larger, more complicated, or unique hotels, the owner retains both an operator and another company as asset manager. An asset manager makes sure that the owner's goals and vision are achieved via revenue maximization, expense management, maintenance, service quality, and capital reinvestment projects throughout the hotel's operation.

Disposition

Ultimately, the building may have a finite economic life, where the cost to maintain the operation exceeds the value of the asset and where rehabilitation or adaptive reuse should be considered in order to optimize the investment. Alternatively, some investors have a predetermined investment time period that dictates selling the hotel to maximize the composite returns of their portfolio. Hotels for sale are typically marketed by a commercial brokerage firm through an exclusive listing, which creates an offering (marketing) package and distributes these marketing materials to known potential buyers. The broker can run either a targeted/quiet marketing process to a small group of buyers or a broad/public marketing process to a large audience. Both processes are followed by a call-for-offer date when all prospective buyers submit an offer to acquire the hotel. The typical marketing timeline prior to the call-for-offer date is 30 to 60 days, and it may take up to another 30 days to select the final buyer through additional rounds of offers and negotiations. Once the buyer is elected, then a purchase and sale agreement (PSA) is executed, and the buyer conducts a thorough due diligence, secures financing (debt and equity), and secures franchise transfer (if applicable). The total disposition timeline for hotels varies, especially amid the COVID-19 recovery, but six months to one year is the typical amount of time a hotel will sit on the market. After closing, the new owner is in charge of maintenance and upkeep of the hotel property until it is sold again. The hotel eventually reaches the end of its economic life, when it could be torn down and rebuilt or converted to an entirely different purpose, if the highest and best use of the land has changed since conception.

Conclusion & Assistance

The hotel investment life cycle is a complicated process that requires the help of many professionals working in tandem to provide a feasible and successful real estate investment. HVS has experts in most categories of the hotel investment life cycle who can assist you in this process. We have a **consulting and valuation division** that conducts appraisals, market studies, and feasibility studies. We have a **design division** to handle all aspects of project design, developing plans, and project management. We have an **asset management and hotel management division** to oversee hotel operations and negotiate brand and operator contracts. We have an **executive search division** to find key operating personnel. We have a **brokerage division** to market and sell your hotel. We also have **other special divisions** that focus on specific hospitality product types, such as gaming; shared ownership; and convention, sports, and entertainment. When you need any of these services, please feel free to reach out to Michael Farbman with HVS Boston, who can get you in touch with the right professional for your hotel business needs.





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About HVS

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About the Author



Michael Farbman, a Project Manager with the HVS Boston office, graduated from The School of Hotel Administration at Cornell University in May 2015. Prior to joining HVS in 2019, Michael worked as an

Associate for Cushman & Wakefield, evaluating hotels in the New York City area for their Valuation & Advisory group. Before that, he worked as a Hotel Development Analyst for High Hotels Ltd., where he played a role in the acquisition of the Courtyard Ewing/Princeton. Michael also worked as an Acquisitions and Asset Management Analyst at Urban American Management, where he analyzed and prepared bids for some of the largest and most high-profile NYC multifamily deals of 2016, analyzed the eventual acquisition of 515 W 168th Street, and asset-managed 386 Manhattan Avenue.

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