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Hotel Investments Handbook

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HVS International has provided consulting services for thousands of clients in all 50 states and more than 60 foreign countries. Its professional staff of more than 150 industry specialists offers a wide range of services, including market feasibility studies, valuations, strategic analyses, development planning, and litigation support. Through its divisions, HVS supplies unique hotel consulting expertise in the areas of executive search, food and beverage operations, gaming, technology, hotel operations, asset management, marketing, interior design, parking, golf, and investment counseling. HVS International is the industry's primary source of hotel sales information. Its databases contain information on more than 10,000 hotel transactions and thousands of financial statements. HVS is also the most comprehensive source of hotel compensation data.

As a leading authority and prolific author on the topic of hotel feasibility studies and appraisals, Mr. Rushmore has written all five textbooks and two seminars for the Appraisal Institute covering this subject. He has also authored three reference books on hotel investing and has published more than 300 articles. He writes a monthly column for *Hotels* magazine and is widely quoted by major business and professional publications. Mr. Rushmore lectures extensively on hotel trends and has taught hundreds of classes and seminars to more than 20,000 industry professionals. He is on the faculty of the Cornell Hotel School's professional development program.

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Preface

Investing in hotels and motels is considered by many to be a high-risk use of time and capital. The investor not only acquires an interest in a volatile form of real property but also participates in the highly specialized business of operating a service-oriented going concern. Where the lodging facility includes food, beverage, banquet, and recreational facilities, the risk and accompanying aggravation are often multiplied tenfold. Yet, despite the sometimes dire consequences associated with such investments, investors continue to be drawn to the status and glamour of hotels as well to the potential for gain.

Hotel Investments Handbook—2002 has been written as a guidebook for those who want to participate in the lodging industry while keeping their risk exposure to a minimum. Its coverage is equally designed for all three types of investors associated with hotel projects: (1) owners, who invest equity capital and assume the major portion of the risk; (2) lenders, who invest debt capital; and (3) hotel operators, who invest considerable time and effort. The book provides an investor with the basic tools for making a hotel investment: a complete understanding of the U.S. and international hotel industries; the steps for planning the investment; a procedure for determining the economic feasibility of the investment; criteria for choosing a management company and a franchise affiliation along with tips for drafting sound agreements to define these relationships; and the fundamentals of developing, acquiring, and financing a lodging facility. The book is intended to be useful to a first-time hotel investor, while at the same time offering valuable insights to experienced investors.

Hotel Investments Handbook—2002 brings together in one easy-to-use volume all the information needed to make a successful hotel investment. The book is organized in a step-by-step manner that describes hotel investing from a "how-to" perspective and that follows the actual sequence of events in the development of an investment. It includes numerous charts and tables that convey information in a simple, straightforward manner, as well as case studies that illustrate the various procedures used in evaluating hotel investments in a real-world setting.

Since hotel investing is a dynamic process and the hotel industry is constantly changing, *Hotel Investment Handbook* will be updated yearly with a new edition.

STEPHEN RUSHMORE

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CHAPTER 1

Overview of the U.S. Lodging Industry

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» 1.01 THE LODGING INDUSTRY

An investment in the lodging industry, whether it be for the purpose of acquiring an existing facility or developing a completely new one, requires a certain amount of research regarding both the industry as a whole and the investment itself. *Hotel Investments Handbook* presents the necessary information and analytical methods in the sequence in which they are used in order to make a prudent investment. Before embarking on a hotel investment, a prudent investor gains a general knowledge of the hotel industry and the ways in which it works. Chapters 1 through 4 provide an overview of the industry and discuss the forces that affect it.

[1] History

The evolution of the lodging industry in the United States is, of course, closely related to the economic history of the country. Usually, the health of the industry can be gauged by the condition of the economy as a whole. Prosperous times for the nation typically mean increased room and occupancy rates and the construction of more lodging facilities. When the economy falters, leisure and business travelers tend to stay home or spend less on accommodations when travel is necessary. Internal industry cycles also have a strong effect on the lodging industry. The most important of these is the continually changing relationship between room demand and room supply. For example, hotel construction is fueled by several factors other than simple demand. The availability of funds is often a determining factor. Oversupply, often the result of periods of increased construction activity, has meant stagnation for the industry, even when the economy as a whole performs well. This was the case in the late 1980s.

Along with the evolution of lodging products and the identification and pursuit of specific segments of the lodging market, the ownership and management of lodging facilities have undergone many changes. The industry, which began with entrepreneurs who owned and managed individual properties, has come to be dominated by national and international chains. At one time, the chains built and owned the properties on which their names were displayed, but the trend in the

industry is for many of the major hotel chains to develop and manage properties for outside investors. This fundamental change has dramatically increased the number of individuals and corporate entities involved in hotel projects.

Chapter 2 traces the development of the lodging industry in the United States from colonial days to the present. Along the way, it points out the major developments that have affected the industry, such as franchising, new financing methods, and product and market segmentation. This chapter also introduces the reader to the hotel industry as it exists today.

[2] National Supply and Demand

In addition to a familiarity with the basic elements of the lodging industry and the economic trends that affect it, an understanding of the nature of the national supply of lodging and the national demand for lodging is essential in order to correctly make the crucial decisions affecting an investment, such as the choice of a particular market or product. Chapter 3 describes the various types, classes, and locations of facilities that make up the national supply of lodging as well as the characteristic operating results of the various kinds of facilities. Chapter 4 identifies the sources of data by which present demand can be quantified and future demand projected.

» 1.02 PLANNING A HOTEL INVESTMENT

Whether a hotel investment entails the development of a new property or the acquisition of an existing facility, proper planning is necessary for success. The following lists outline the steps that must be taken to acquire or develop a lodging facility. Some of the steps are appropriate for both the development and acquisition process, while others are unique to only one. The order of the various steps is not fixed and some may be performed concurrently.

Hotel Acquisition:

- *Planning stage:*
  - —Select a region of the United States.
  - —Narrow the selection to several cities or market areas.
  - —Look for a market niche.
  - —Look for a product (i.e., available properties).
  - —Perform a preliminary economic market study and appraisal.

- *Implementation stage:*
  - —Tie up the property with a letter of intent, option, or contract.
  - —Negotiate the terms of the sale.
  - —Go to contract on the property.
  - —Line up an operator.
  - —Line up a franchise.
  - —Commission a formal economic market study and appraisal.
  - —Line up mortgage financing.
  - —Line up equity financing.

Hotel Development:

- *Planning stage:*
  - —Select a region of the United States.
  - —Narrow the selection to several cities or market areas.
  - —Look for a market niche.
  - —Look for a product (i.e., available sites).
  - —Perform a preliminary economic market study and appraisal.
- *Implementation stage:*
  - —Tie up the property with a letter of intent, option, or contract.
  - —Obtain zoning and permits.
  - —Assemble the project team.
  - —Line up an operator and franchise.
  - —Prepare architectural plans and estimate project costs.
  - —Commission a formal economic market study and appraisal.
  - —Line up a mortgage.
  - —Line up equity capital.

Chapters 5 through 13 describe the essential steps in planning a hotel investment, particularly the evaluation of markets, sites, and products in order to determine a viable location; the type and class of facility that would best utilize the attributes of the location and opportunities afforded by the local market area; and the financial results that can be expected from the proposed facility. Appendix 1 contains a data collection checklist covering many of the topics described in these chapters.

Chapters 5 through 13 feature case studies developed to illustrate the concepts presented in the text. A proposed hotel (as opposed to an existing facility) was selected as the subject in order to demonstrate how a market study and appraisal can be performed without the benefit of historical operating data. The case studies are designed to be realistic, but the data is hypothetical.

[1] Selecting a Lodging Market

The first step in both hotel acquisition and development planning is to determine where to begin the search for suitable hotels to acquire or sites to develop. Chapter 5 shows how investors should evaluate various regions of the country, using data and analytical techniques to determine whether they should be considered further

or rejected. Some of the important factors that investors should consider are the following:

- *Proximity to home office.* Hotels are labor-intensive businesses that require constant supervision and direction. When acquiring or developing a lodging facility, investors are well-advised to keep it close to home so that it can be given their full attention. Supervising lodging operations scattered over a wide geographic area is of course possible, but to do so requires a level of expertise that can be gained only through significant industry experience.
- *Signs of economic growth.* Regions of the country exhibiting strong growth trends are generally better suited for hotel investing than are regions that are economically stagnant.
- *Competitive environment.* The hotel investor should carefully evaluate the regional supply of competitive lodging facilities in conjunction with his study of economic growth. Even if economic trends are favorable, an adverse competitive environment brought about by the oversupply of hotel rooms can make a region an undesirable location for acquiring or developing a lodging facility.

Once the investor has selected a particular region, he should use similar criteria to choose specific market areas in which to focus his investigations. The demand for transient accommodations and the competitive supply are once again the key factors to be considered when analyzing potential market areas.

After the market area has been determined, the next step is to find a market niche, which is a unique market position or a particular market for which a product may be suited. When evaluating a market area, the hotel investor first looks for situations that exhibit a need for a specific hotel product. At the same time, consideration is also given to protective characteristics known as barriers to entry, which might include restrictive zoning or license approval processes, limited suitable land or acquisition opportunities, rapidly escalating construction costs, and the unavailability of an appropriate chain affiliation or management company. A unique market position may quickly change to an overbuilt position if no barriers to entry exist and other competitive products can enter the market without much difficulty.

Finding the appropriate market niche not only is an important consideration for a proposed hotel development but can be equally critical when it becomes necessary to reposition an existing property. A hotel can be repositioned through a renovation or upgrading, change of franchise affiliation, or the introduction of new management.

[2] Property and Site Selection

Once the type of hotel has been determined on the basis of the evaluation of market niches, the investor must start to look for available hotels if an existing property is desired, or suitable sites if a new development is desired.

Real estate brokers are the best source of information regarding the availability of property for sale. When looking for an existing hotel, investors often use the services of a broker whose practice is concentrated in the lodging industry. A knowledgeable hotel broker can save considerable time and effort by showing only properties that meet the investor's particular criteria. When looking for potential hotel sites, it is best to use a land broker familiar with the local area—particularly the zoning regulations, building codes, and related laws. One of the most difficult aspects of accomplishing a hotel development is obtaining the necessary zoning changes and

variances. A knowledgeable land broker understands these issues and can direct the developer to suitable sites requiring minimal zoning changes and approvals. Brokers are compensated by the seller with commissions based on a percentage of the sales price—generally 1 percent to 4 percent for existing hotels and 4 percent to 10 percent for vacant land.

Real estate brokers are agents for the seller; as such, they work for, are loyal to, and are paid by the property owner. Sometimes buyers of existing hotels or developable sites find it advantageous to employ either a broker or a property search firm to research potential investment opportunities. This alternative is sometimes effective, because a search firm is often able to obtain leads on hotels for sale before they actually go on the market. The same hotel knowledge and experience is necessary for a hotel search firm as a hotel broker. The fee arrangement for a hotel search depends largely on the area covered; sometimes fees are based on an hourly or per diem rate, a flat fee, or some formula related to the number of hotels actually acquired by the client.

Buyers can also research the market and successfully locate potential products on their own, but usually only if the buyer is familiar with the local area and knows all the property owners and potential sellers or if the buyer is a major, well-known buyer of lodging facilities and is likely to receive solicitations directly from potential sellers. By dealing directly with the seller, the buyer can avoid paying a fee to a broker or a search firm, and thus eliminate a considerable expense, which is ultimately reflected in the purchase price of the property.

[3] Preliminary Market Study and Appraisal

Before any money is committed to the purchase of the property, prudent investors perform or commission a thorough preliminary economic market study and appraisal. The information yielded by this analysis is used to determine the type of hotel and facilities best suited to the location and the type of management and franchise affiliation (if any) that would be the most effective. Another important product of a market study is a forecast of the revenues and expenses that the subject property can be expected to realize. This information is vital to the buyer during the negotiation of the sale of the property, because it can be used to determine the value of the facility.

The first step in evaluating a proposed investment is to analyze the site of the proposed or existing property. The suitability of the site for hotel operations is one of the most important determinants of the success of an investment. The site analysis involves such factors as the physical suitability of the land, access and visibility, the availability of utilities and other services, and the applicable zoning regulations. Chapter 6 examines all of these concerns and shows how they are to be weighed in the evaluation of a proposed site.

Once a particular site has been selected, the area in which it is located must be evaluated. Generally, this evaluation includes both the immediate neighborhood of the site and its market area. The extent of the relevant neighborhood can usually be determined by simple observation of the surrounding area, including roads and land-use patterns. The market area, on the other hand, is often harder to identify because it involves a larger area and depends on more abstract factors (e.g., competition and travel patterns). Chapter 7 explains how both the neighborhood and the market area can be determined and evaluated for suitability.

An important step in any hotel investment is an examination of the supply of lodging facilities in the subject area. Before the success of the proposed hotel investment can be determined, the appraiser must first determine the degree to which

other hotels in the area would compete with the subject property. Chapter 8 discusses how this analysis should be performed. It explains how operating information for competitive hotels can be obtained or projected and shows how data obtained from competitors can be adjusted to eliminate any bias that they might contain.

After the supply of hotels has been evaluated, the existing demand must be quantified to determine its ability to support a new hotel or the acquisition of an existing facility. The demand analysis can be performed using one of two methods:
the demand generator build-up approach or the lodging activity build-up approach. Chapter 9 explains these two methods and shows how the data necessary to use them can be obtained.

In conjunction with the analyses of local supply and demand, the appraiser must determine the competitive positions of all the local facilities and how the subject property would fit into this picture. Generally, this task involves determining the current market share, average room rate, and occupancy rate of the existing competition. Once this determination has been made, the appraiser can forecast these variables for the subject property. Chapter 10 shows how this analysis is accomplished.

One of the final steps in the preliminary appraisal is to forecast the income and expenses of the proposed hotel investment. The income projection focuses on a hotel's main categories of revenue, such as rooms, food and beverage, and telephone income. The expense projection examines a hotel's main items of expense, such as rooms, food and beverage, telephone, administrative, management, and marketing costs. Chapter 11 discusses the various categories of revenue and shows how a revenue forecast is made. Chapter 12 does the same for expenses.

A property valuation, along with the forecasts of revenue and expense, allows the appraiser to make a recommendation regarding the feasibility of a proposed hotel investment. The first step in a property valuation is to determine the overall worth of the subject property. This step entails appraising an existing hotel or forecasting the value of a proposed property. This value is contrasted against the cost of the property, which is either the cost of acquisition or of construction. Chapter 13 explains the three basic methods for performing a property valuation: the cost approach, the sales comparison approach, and the income capitalization approach.

» 1.03 DEVELOPMENT, ACQUISITION, AND FINANCING

Once the necessary planning for a hotel project has been completed, the actual process of development or acquisition, as outlined in Chapters 14 through 17, can begin. Chapter 14 discusses hotel investment, offering reasons to invest in hotels, a historical perspective for the investor, and finally key strategies for and insights into the investment process.

Chapter 15 discusses important considerations for those who wish to own a hotel property. The form of hotel ownership is a very important decision that is usually based on tax, legal, or business considerations. For example, an owner might choose to form a corporation instead of individual ownership in order to limit his personal liability.

In this chapter, the following business entities are discussed:

1. Individual ownership
2. Concurrent ownership (by two or more individuals)
3. Partnership (general and limited)
4. Regular corporation (C Corporation)
5. S Corporation
6. Limited liability company (LLC)

7. Trust

8. Real estate investment trust (REIT)

Chapter 16 explores the various financing techniques and sources of capital commonly used in the hotel industry, along with the mortgage loan process and what the hotel developer should consider when obtaining a mortgage.

Chapter 16 divides equity and debt sources into the following two categories:

1. Institutions that originate mortgages and maintain portfolios of both mortgages and real estate equities, including:

—Commercial banks;

—Life insurance companies;

—Private credit companies; and

—Pension funds.

2. Investment conduits, which are primarily entities that invest in hotel real estate mortgages and pass through income and gain to investors (both private individuals and institutions), including:

—Real estate limited partnerships (RELPs);

—Real estate investment trusts (REITs); and

—Commercial mortgage-backed securities (CMBS).

3. Mortgage financing, which is how most hotels are financed. Topics covered include:

—Types of Mortgage loans; and

—Obtaining a hotel mortgage.

Chapter 17 focuses on two issues related to the buying and selling of hotel properties. The first is the importance of hiring a professional broker when selling a hotel property. The second is the like-kind exchange. An exchange of hotels, or an exchange of business property for a desired hotel property, is a creative means of acquiring a new property. This method can offer unique planning opportunities for the hospitality or business owner who wishes to relocate to another market. It can also provide significant tax savings for a new owner, because appreciated property can be exchanged without incurring any tax on the appreciated gain.

» 1.04 FRANCHISE AFFILIATIONS AND HOTEL MANAGEMENT

Two of the most important steps in the hotel investment process are obtaining a franchise affiliation and selecting a hotel management company, as described in Chapters 18 through 21. The choice of a franchise affiliation is an important decision in a hotel investment that should be made as early in the acquisition or development process as possible. Even more so than a management company, a franchise company will want the opportunity to participate in decisions regarding designs and specifications for a lodging facility, because most have companywide standards that must be met by each of their properties. An early decision also enables the property owner to accurately determine the cost of the franchise affiliation and use the information when analyzing the economics of the project.

Chapter 18 discusses the major concerns in choosing a franchise affiliation, including the advantages and disadvantages of franchises, the services offered by franchisors, and the fees charged by franchisors. The chapter also examines the process for selecting a franchise affiliation and the agreements between franchisors and franchisees.

[1] Property Management

Whether the project in question is a development or an acquisition, a management company should be retained as early as possible in the process. In the case of a development, a management company should be brought in before any significant amount of time is spent on architectural drawings, so that the management company will have the opportunity to provide suggestions regarding the layout and general design of the facility. Securing a management company early on is even more important for a hotel acquisition, because the company will often be able to generate valuable information regarding the projected operating performance of the property, which can be a critical factor for the purchaser during the negotiation of the sale of the property. In addition, the management company will indicate what changes must be made to the property if improvements are required in order to meet the company's operating standards. This input will also have an effect on the negotiating position of the buyer.

Chapter 19 describes the two basic types of management companies: first-tier operators and second-tier operators. It examines all of the important considerations in choosing a management company and looks at the actual contract negotiation process. It also compares the hiring of individual managers to the hiring of a management company.

[2] Management Contracts

The proper execution of the management contract is a vital step for the successful development of the hotel investment. This document spells out the basic relationship between the owner and the operator. Each party must be able to negotiate the contract with a full understanding of the consequences of including or disallowing a particular provision. If either party is permitted to include provisions that are disproportionately favorable to its position, the working relationship between the parties can be severely damaged.

Chapter 20 provides an in-depth analysis of operating agreements between hotel owners and management companies. It describes the basic provisions found in management contracts, ranging from fee structures, financial reporting, and budgeting to terminations, assignment of employees, and indemnification. Appendix 3 contains a wide assortment of clauses, taken from actual management agreements, that can be used to assemble a working contract. The clauses are labeled to show their orientation—owner, operator, or neutral.

Chapter 21 steps back a bit to discuss the essential steps in the coordination and execution of a hotel's development. The actual process of construction is not discussed, but the phases that a hotel development project typically goes through and the roles of the main contributors to a development project are explained in detail.

» 1.05 OTHER ISSUES

Chapters 22 through 24 discuss other timely issues of interest to hotel developers. The focus in Chapter 22 is on international markets. The chapter includes a discussion of the benefits of investing in developed countries versus developing ones. It also

includes country-by-country descriptions of the hotel markets in Europe and the Middle East. For each country, the state of the current hotel market and its potential for growth is discussed.

Chapter 23 focuses on a particular market within the hotel industry—the casino gaming industry. Casino-style gaming is currently legal in twenty-two states, in a variety of forms such as on riverboats, at riverside docks, and in saloons, and on various sites including Indian reservations, public parcels and waterways, and privately owned land. A combination of consumer acceptance and the local municipalities' need to increase revenue has resulted in an array of new jurisdictions and gaming venues. This chapter provides a detailed analysis of the current state of the industry as well as its future.

Chapter 24 offers practical advice about the selection of a consulting and appraisal firm to perform an economic market study and appraisal of property. The chapter includes an analysis of the major changes that have taken place in the appraisal industry since the passage of the Financial Institutions Reform and Recovery Enforcement Act (FIRREA) in 1990.

» 1.06 INDUSTRY SOURCES AND CONTACTS

The directories at the back of *Hotel Investments Handbook* offer information about companies currently involved in the hotel industry, such as hotel developers, lenders, management companies, and franchise companies. Each entry includes the name, address, and telephone number of the firm along with the person to contact. Once an investment has reached the planning stages, these directories can provide investors with invaluable leads as to the people and firms to contact to make their project a reality.