

FEASIBILITY FIRST AND FOREMOST

By Daniel H. Lesser

*Everything you wanted to know - and must know -
before deciding to build a hotel or resort.*

My recent review of major hotel markets throughout the nation indicates that many cities have too many hotels and just about as many others are well on their way to becoming saturated. With this general overbuilding of all types of lodging facilities, the industry may be faced with a shakeout of marginal operations. Much care must be given to the criteria upon which to base a decision to build or expand.

Lodging facilities - both the number of facilities and their occupancy - in a given area typically display cyclical trends over extended periods of time. They follow classic supply-and-demand patterns: demand for rooms increases interest in building; new facilities are put up; eventually overbuilding reduces occupancy rates to unprofitable levels; marginal operations fail and, eventually, growth in demand causes occupancy levels to rise again and the whole cycle is repeated.

During the mid 1970's, numerous foreclosures resulted from unsound appraisals and feasibility studies that led owners to spend more than they should have in developing lodging facilities. More recently, debt and equity investors have learned the importance of accurate feasibility studies for new projects. This article highlights the major steps to be followed in determining economic and market feasibility, and offers some points and arithmetic in assessing whether or not to build.

1. Site Analysis - Obviously the suitability of the site for the development and operation of a lodging facility is important. Size, topography, access, visibility and availability of utilities have a direct impact on the desirability of a particular hostelry site. (These are such standard points, and so specific to the facility, that we need not go into them further.)

2. Area and Neighborhood Economic and Demographic Analysis. - The economic vitality of both the immediately surrounding area and the general neighborhood encompassing a lodging facility is essential in forecasting future lodging demand and income

potential. Historic economic and demographic trends of transient visitation are the starting point for any projections.

reviews all available historic and projected economic and demographic data to determine whether the local market area and neighborhood will experience future economic growth, stability or decline, as well as the rate of any trends. Local Chambers of Commerce are one source for this data.

These trends are then correlated and weighted to forecast the amount of growth or decline in transient visitation by individual market segments (e.g., commercial, meeting and convention, vacationer).

The following table summarizes some of the economic and demographic data that should be considered when analyzing a hotel market area.

Economic and Demographic Data

Population
Retail Sales
Total Employment
Manufacturing Employment
Construction Employment
Non-Residential Building
TCPU Employment
FIRE Employment
Wholesale Employment
Service Employment
Government Employment
Occupied Office Space
Available Office Space
Freeway Traffic
Airport Passengers
Airport Cargo
Convention Center Delegates
Tourist Visitation

3. Market Analysis for Transient Accommodations - The market for transient accommodations is an all-encompassing terminology relating to the many types of travelers utilizing lodging facilities within a market area. The overall transient market is subdivided into three primary classifications: commercial, meeting and convention, and vacationer.

Market segmentation is a useful procedure because individual classifica-

tions generally exhibit different characteristics on such factors as future growth potential, seasonality of demand, average length of stay, double occupancy, facility requirements, price sensitivity and so forth. By quantifying the room-per-night demand by market segment and defining the individual characteristics of each segment, the future market for transient accommodations can be more accurately forecast.

4. Competition Analysis - To evaluate an area's competitive hostelry environment, the following steps should be taken: (A) Identify all area lodging facilities and determine which are directly and indirectly competitive with the property you have in mind. (B) Determine whether additional lodging units will be added to the market within the foreseeable future. (C) Quantify the number of existing and proposed rooms available within the market area. (D) Review the current rate structure, historic occupancy levels, market orientation, facilities and amenities of each individual competitive hotel and motel. (Note: Getting hold of all these statistics and analyzing them, is a very tough job -but we have shown over and over again that it must be done to avoid calamitous decisions.)

5. Quantifying a Hotel's Demand - The percentage of occupancy - i.e., the room revenue - is one of the key factors that affects a property's bottom line. To analyze a proposed property with no track record, a model to quantify the local demand for accommodations and to allocate this demand among the competitive properties, including your proposed facility, should be developed.

This type of market study, known as a room-night analysis, quantifies the expected market share per property, additions and deletions to supply, changes in the room-night demand base, and forecast occupancy levels.

A room-night is a unit of hotel/motel demand, representing one room occupied for one night by one or more people. Totalling the room nights within a defined market area produces an estimate of the total demand for transient

accommodations. There are two approaches for quantifying a market's room-night demand: (A) the build-up approach based on analysis of demand generators and (B) the build-up approach based on analysis of lodging activity.

The build-up approach based on **analysis of demand generators** utilizes interviews and statistical sampling of market research to estimate an area's lodging demand by totaling the room-nights generated from local sources of transient visitation. The approach starts with a review of various generators of transient visitation in your defined market area. Drawing from a sample of the major transient generators, (vacation attractions, major corporations and the like) interviews and surveys are conducted to determine the amount of demand each source attracts on a weekly or monthly basis, along with other important visitor characteristics, such as length of stay, number in party and spending habits. By employing statistical sampling techniques, an area's room-night demand can be quantified based on the samples.

The build-up approach based on **analysis of lodging activity** recognizes that an area's transient demand can be estimated by totaling the rooms actually occupied. Through interviews of hostelry operators, investors and other knowledgeable hotel people, occupancy levels and trends for individual lodging operations can be established.

Multiplying the percentage of occupancy for each property by its available number of rooms by 365 produces the total number of room-nights actually occupied on an annual basis. After combining the room-nights occupied for each property within the market area, and adding a factor for the demand that cannot be accommodated during periods of peak occupancy levels, one arrives at an area's total room-night lodging demand.

Of the two alternative methods - demand generators or lodging activity - I find the latter to yield the better results (provided of course you can extract the data from local sources). The analysis of demand generators incorporates the possibility of inadvertently omitting one or more transient generators and thereby misjudging the actual size of the local lodging market.

6. Forecast Net Operating Income-

Lodging facilities are unique forms of real estate with several unusual characteristics, such as an intensive use of labor, expense categories directly related to cost-of-goods-sold, and a retail product

identity. Special knowledge and data are required for an accurate estimate of a property's net operating income.

For proposed hotels with no operating history, assemblage of sufficient market and comparable data assists in formulating an estimate of occupancy and average room rate. Once these two factors are established, rooms revenue and other sources of income may be computed. An analysis of operating ratios from existing comparable properties or national averages provide a basis for estimating departmental and undistributed operating expense. It is important to note that to determine economic feasibility, the forecast net operating income must consider the fixed charges of property taxes, insurance and reserves for replacement of furniture, fixtures and equipment.

Analyzing A Project's Feasibility

The feasibility and general economics

	<u>YEAR 1</u>	<u>YEAR 2</u>	<u>STABILIZED</u>
Number of Rooms	350	350	350
Occupancy %	65%	70%	73%
Average Rate:	\$75.00	\$81.00	\$87.50
Rooms Revenue	6,228,000	7,243,000	8,158,000
(% of Gross Rev.)	58.2%	59.4%	60.2%
Gross Revenue	10,697,000	12,196,000	13,546,000
Net Operating Inc.	2,179,000	2,839,000	3,383,000
(% of Gross Rev.)	20.4%	23.2%	24.9%

Mortgages for such projects are currently written for 30 years at 12.5% interest, resulting in a mortgage constant of .1280; most lenders are willing to finance up to 75 percent of appraised

of a hotel investment are tied directly to a developer's ability to adequately capitalize the project with a combination of reasonably priced mortgage and equity financing. A hotel investment is typically composed of a large amount of mortgage money (60 to 75 percent of value) and a smaller amount of equity capital.

The weighted cost of both of these sources of funds results in an overall capitalization rate which, when applied to a forecast net operating income stream, produces an estimate of property value. Fairly obviously, if a hotel's value based on anticipated income is greater than the cost to build, the project would be justified from a market and economic point of view. Let us follow the arithmetic via an example.

Consider the hypothetical new 350-room hotel. A thorough market analysis yields the following forecast operating statistics:

<u>WEIGHTED COST OF INVESTED CAPITAL</u>		
MORTGAGE	.75 x .1280	=.0960
EQUITY	.25 x .1150	=.0288
Overall Capitalization Rate (Rounded)		.1250

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To value this project, the net operating income for Years One and Two is discounted to the present value using the present-value-of-a-reversion-of-one (dollar) factor for the second year. The sum of the present values equals the property's market value. Derivation of the property value is illustrated below.

Year	Forecast Operating Income Before Interest & Depreciation		Present Value of A Reversion of 1 (Dollar)	2 12.5%	Present Value
1	\$2,179,000	x	.8889	=	\$1,937,000
2	2,839,000	x	.7901	=	2,243,000
Stabilized*	27,064,000	x	.7901	=	21,384,000
Total (Rounded)					\$25,500,000

If this 350-room hotel can be constructed for less than \$25,000,000, the project would appear to be feasible. To further test feasibility, a computer program should be utilized to perform a sensitivity analysis. Various scenarios should consider best, worst, and most likely assumptions about occupancy, average room rate, net operating income, and debt/equity financial structure.

The example illustrates a traditional approach for determining the feasibility of a proposed hotel. A true feasibility study should thoroughly address each of the previously described components. Anything less could lead a development team to the rude awakening that the value of their completed project is less than the cost of construction, and essentially not feasible. •



About the Author

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