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HOTEL VALUATION FACTORS MORGANTOWN, WEST VIRGINIA

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Morgantown Introduction

With a population of approximately 30,000 permanent residents, Morgantown is the county seat of Monongalia County, West Virginia. At the crossroads of Interstate 68 and Interstate 79, Morgantown is considered the medical, cultural, and commercial hub of the region. Morgantown is home to West Virginia University, the largest institution of higher education in the state of West Virginia. West Virginia University (WVU) boasts a student population of approximately 29,000 full-time students, nearly doubling the population of Morgantown during the academic school year. In 2010, Morgantown was ranked in the top ten on Forbes' list of Best Places for Business and Careers, along with being named one of the top eight college football towns in the country by Budget Travel. Formerly a transportation and shipping hub, Morgantown has become more diversified with recent growth in several industries such as education, health care, natural gas exploration, and tourism. As a more recent source of economic activity, the Morgantown area is situated within the Marcellus Shale region, where there is an abundance of the Marcellus Shale rock that is used to extract natural gas through a process called hydraulic fracturing. This natural gas exploration has been a booming industry in the Morgantown region and throughout the state of West Virginia where Marcellus Shale is present.

The Morgantown hotel market includes a broad range of upscale, midscale, and economy hotels. We have recently evaluated a sample of these hotels in Morgantown. This article will discuss factors that influence hotel values and metrics used to determine hotel values. The article will focus primarily on the Morgantown, West Virginia market.

Historical Overview of Morgantown Market

Major investments in the Morgantown area, specifically in the medical, educational and natural resources sector have contributed to a revitalization and diversification of the local economy. West Virginia University (WVU) Hospitals is a not-for-profit corporation operating teaching hospitals of West Virginia University. WVU Hospitals is currently planning a \$248 million expansion on the Morgantown campus, which would add 139 beds by 2016; once completed, the facility will have a total capacity of 670 beds. This expansion is expected to create roughly 750 jobs across WVU Healthcare. West Virginia University is an important stabilizing factor for the local economy; the university consistently ranks among the nation's top public universities and full-time undergraduate enrollment has grown approximately 49% since 1995. WVU College of Law is planning a \$24 million project that will include construction of a 20,000 square foot addition to the College of Law, along with renovations to its existing building. In addition, West Virginia University just recently announced that the 2012-13 athletic season will begin their first season in the Big 12 Conference; prior to joining the Big 12 Conference, WVU was a member of the Big East Conference. Local hoteliers believe that this conference change will have a positive impact on hotel demand due to fans travelling nationally into Morgantown, requiring longer overnight stays during the football season.

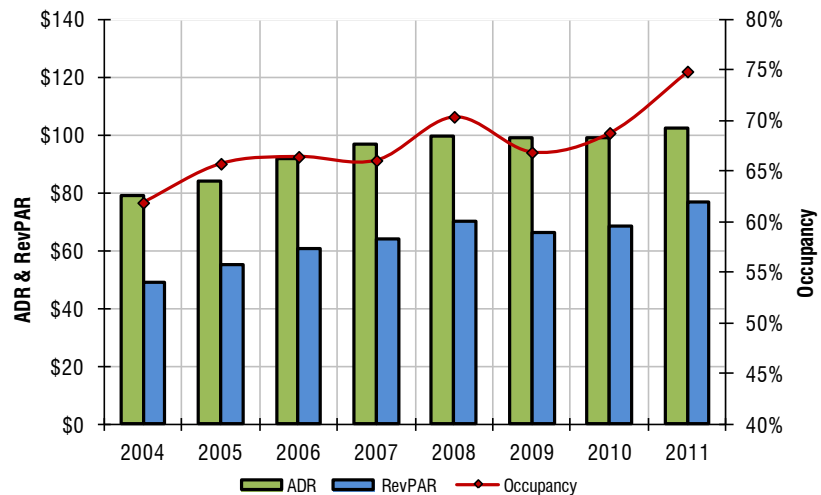
The U.S. Department of Energy has an Energy Technology Center that is located in Morgantown; in late 2010, the U.S. Department of Energy announced that it is building a new \$14 million facility in Morgantown to test energy-efficient appliances. This 30,000 square foot facility which will house nine labs, a warehouse, and office space, is expected to be completed in July of 2012. Moreover, the U.S. Treasury Department has recently approved West Virginia's application for a State Small Business Credit Initiative funding program; this approval will give the state of West Virginia access to \$13.1 million in federal dollars to fund new small business lending programs through the West Virginia Capital Access Program. The U.S. federal government currently employs approximately 1,300 workers in the Morgantown area and this number is expected to increase when the new energy testing facility opens in 2016.

Drilling and exploration for natural gas in the state of West Virginia has expanded rapidly since 2002 when technological advances in horizontal drilling and hydraulic fracturing allowed this type of natural gas extraction to be economically feasible. In addition to the rising natural gas prices, this industry has rapidly expanded throughout Marcellus Shale region, where Morgantown is located. Monongalia County

did some some early hydraulic fracturing work on a vertical research well in the 1980s, while the latest round of natural gas development, using horizontal wells and hydraulic fracture stimulations, has occurred in the past four years. The market has experienced a substantial influx of companies, contractors, and consultants involved in exploration and extraction of natural gas from this rock. There are currently over 1,400 Marcellus Shale wells that have been fractured in the state of West Virginia, and over 500 new drilling permits were issued during 2011. There are approximately 15 Marcellus Shale wells in Monongalia County. An economic impact study conducted by West Virginia University indicates that the oil and natural gas industry employed nearly 10,000 individuals and paid more than \$550 million in wages throughout the state of West Virginia, while generating a business volume impact of more than \$12 billion to the state's economy in 2009.

These and other investments and activities during the past decade have led to significant growth in lodging supply and demand locally. The following table shows long-term upward trends in occupancy, average daily rate (ADR), and revenue per available room (RevPAR).

FIGURE 1: HISTORICAL HOTEL PERFORMANCE TRENDS



Source: Smith Travel Research

Demand in Morgantown experienced positive year-over-year growth, regardless of the recent national economic recession. In 2009, as the natural gas exploration was starting to begin, demand witnessed an increase; however, as a surge of new supply was added to the market, local occupancies dipped slightly due to the fact that supply grew at a faster rate than demand. This impact was exacerbated by the recent national economic recession and reduced consumer spending. As such, some volatility in occupancy occurred in recent years, as shown in the preceding chart. Nonetheless, this negative impact was not as severe as that experienced in many markets around the nation and occupancies have since rebounded to levels that are higher than they were prior to the onset of the most recent recession.

Recent trends in 2010 and 2011 indicate an improving lodging market in Morgantown. Demand growth in 2010 registered an all time high at a growth rate of 20.5% from the prior year, in part due to growth of the natural gas industry in the Marcellus Shale region. This recent trend of increasing demand indicates that Morgantown has recovered from the recent economic recession, as well as fully absorbed the new supply in the market. It also reflects the rapidly increasing impact of the energy services sector on the local lodging market. Based on our interviews with hospitality representatives in the area, we anticipate that some hotels will soon shift their strategy from that of increasing occupancy levels, to focus more on pushing up average daily rates (ADR) at local area hotels. Our interviews with local hotel representatives indicated a positive outlook for the near future.

Supply Changes

One of the biggest threats to existing hotels and their values is the potential development of new competitors. If supply grows faster than demand, then occupancies must decline, at least in aggregate. On a positive note, if new supply represents high-quality or high-rated hotels, this supply change can lead to increasing ADRs, assuming the supply is eventually absorbed and occupancies stabilize at a profitable level in the market area.

The Morgantown market has experienced rapid changes in supply over the past decade, corresponding with the city's revitalization, gas exploration and extraction, and major investments previously cited. The following hotels represent a sample of recent new supply additions and the year each property opened:

- Holiday Inn Express (2000): 68 rooms
- Waterfront Place Hotel (2003): 205 rooms
- SpringHill Suites (2004): 80 rooms
- Residence Inn (2006): 104 rooms
- Fairfield Inn & Suites (2009): 95 rooms
- Hilton Garden Inn (2009): 118 rooms

Together, these six properties represented a supply increase of 670 hotel rooms within a ten-year period, introducing nearly half of the new supply within a three-year period. Despite this rapid supply growth, the market appeared to absorb the added inventory relatively quickly, as occupancy levels are currently above historical levels.

The newly opened Hilton Garden Inn represents the only nationally-branded hotel within the upscale chain scale in Morgantown. It is currently the rate leader in this market. The introduction of the Hilton Garden Inn, along with the Fairfield Inn & Suites in 2009, is one potential explanation for why average rates remained flat into 2009 in the Morgantown market, while other markets throughout the country were witnessing large average daily rate decreases as the recent economic recession worsened.

Demand Generators

Lodging demand has increased significantly over the past decade in the Morgantown market. Leisure attractions, a thriving university, and business investments have augmented lodging demand growth. The following demand generators are key considerations for hotels in this market:

- West Virginia University
- West Virginia University Hospitals
- Mylan Pharmaceuticals
- MedExpress Urgent Care
- U.S. Department of Energy
- Various natural gas drilling companies

The continued success and popularity of West Virginia University athletics, along with the recent switch to the Big 12 Conference should attract an even larger fan base to the Morgantown area in near term. Local hoteliers expressed confidence that this change will benefit tourism in Morgantown due to the fact that fans of rival universities will have greater lengths to travel to come to West Virginia University, requiring longer overnight accommodations. West Virginia University's football and basketball teams receive national attention, making frequent appearances at NCAA tournaments and critically acclaimed bowl games. In addition, seasonal events such as parents' weekend and graduation weekend create a large base of leisure demand in the Morgantown market.

Morgantown is home to five hospitals that are part of the WVU Hospitals system. WVU Hospitals's planned \$248 million expansion is expected to increase lodging demand related to visiting teachers,

doctors, students, and patients, as well as friends and family members. Demand from suppliers and contractors may also increase during and after the expansion. The hospitals and university also make Morgantown an attractive location for private, for-profit companies operating in the broader healthcare industry. Mylan Pharmaceuticals has long been one of the largest employers in the area, while MedExpress Urgent Care is headquartered in Morgantown, and current operates 77 facilities across the nation.

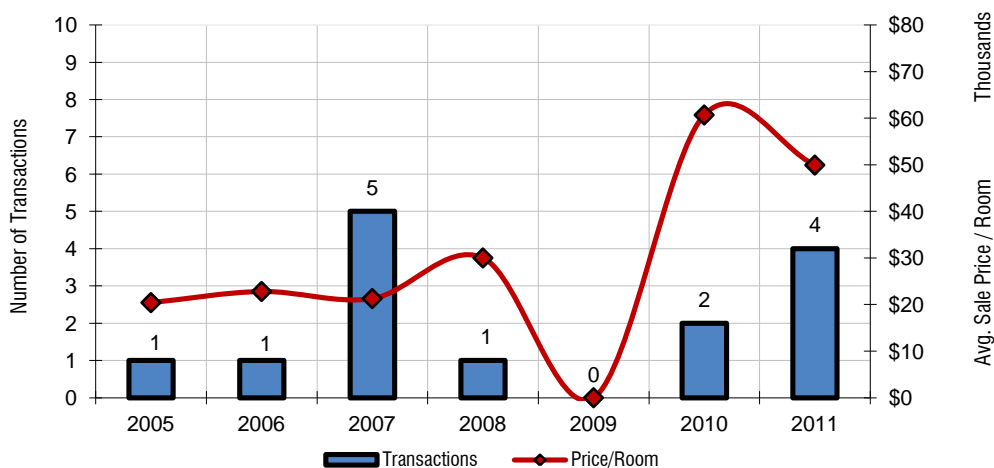
Local hoteliers noted that The Department of Energy is a major portion of their corporate business demand. Management at a variety of the local hotels noted that the Department of Energy is one of their top accounts. Hoteliers seem optimistic regarding long-term demand from the Department of Energy into the future due to the expansion that is currently under construction. Lastly, Morgantown calls home to a region abundant in Marcellus Shale, making natural gas drilling a growing industry in the region. Local hotels noted that the demand associated with the natural gas drilling is expected to continue to be strong well into the future.

These demand factors are generally increasing as new expansions have been planned and additional investments occur. The most notable increase in demand in the Morgantown market area is a result of natural gas exploration and drilling related to the Marcellus Shale natural gas development; according to an economic impact study conducted by West Virginia University, this industry has brought nearly \$12 billion of revenue to the state’s government in 2009. The expansion plans announced in the area are expected to lead to ongoing investment and job creation in the near term. As such, the outlook for lodging demand growth in the area is very positive.

Hotel Transaction Trends

The following table shows the number of hotel sales that occurred in each of the past five years in West Virginia as well as the average sale price per guestroom in each year. Please note that only one transaction has occurred in the first 2012.

FIGURE 2: HOTEL TRANSACTION TRENDS AND SALE PRICES PER ROOM



Source: HVS

The number of hotel transactions occurring in the West Virginia market has fluctuated significantly during the past five years, generally reflecting the economic cycle and the availability of financing. Transaction activity has increased in 2010 and 2011 compared to the prior years, which were marked by heightened uncertainty among hotel investors. In fact, 2011 registered the most amount of guestrooms sold in the seven year-trend that we analyzed.

The average value per guestroom during the past two years is substantially higher than prior years, likely reflecting some of the positive trends pertaining to natural gas exploration and drilling throughout the state. Average sale prices before 2009 were in the range of 12,900 to 30,000 per room. In contrast, average sale prices spiked in 2010 to just over \$60,000 per guestroom, marking a record high level compared to prior years.

These sale price trends reflect changes in the types of assets transacting and the conditions of individual hotels at the time of sale as well as overall trends in hotel values. Hotels in Morgantown appear to be transacting at higher sale prices per guestroom than in some other parts of the state, according to our research. For example, an economy-branded hotel in Morgantown recently sold for nearly \$70,000 per guestroom, which is higher than the statewide average sale price per guestroom for all hotels in the same year.

Development Cost Ranges

The replacement cost or development cost of hotels can be another factor that influences hotel values. Perhaps the most relevant unit of comparison for evaluating a hotel’s development cost is the cost per guestroom. We have evaluated developer budgets from several hotels in the region, including West Virginia and adjacent states. The following table summarizes development cost estimates from a sample of recently planned hotels, representing extended-stay, limited-service, and select-service hotels in the upper-midscale and upscale chains.

FIGURE 3: ESTIMATED DEVELOPMENT COSTS FOR RECENTLY PLANNED HOTELS

Development Cost	Extended-Stay Upper-Midscale		Limited- Service Upper- Midscale		Select-Service Upscale	
	\$	%	\$	%	\$	%
Building Construction	\$55,000	61%	\$70,000	66%	\$75,000	54%
Furniture, Fixtures & Equipment	16,000	18%	9,000	8%	21,000	15%
Other Costs	8,000	9%	14,000	13%	24,000	17%
Land	11,000	12%	13,000	12%	18,000	13%
Total Development Cost / Room	\$90,000	100%	\$106,000	100%	\$138,000	100%

These estimates indicate total development costs that range between \$90,000 per guestroom and \$138,000 per guestroom, including land. Building construction costs represent the largest component of a hotel’s cost, between about 54% and 66% of the total estimated development costs for these hotels. Land costs typically represent between about 12% and 13% of total development costs, depending on the location and design of each hotel.

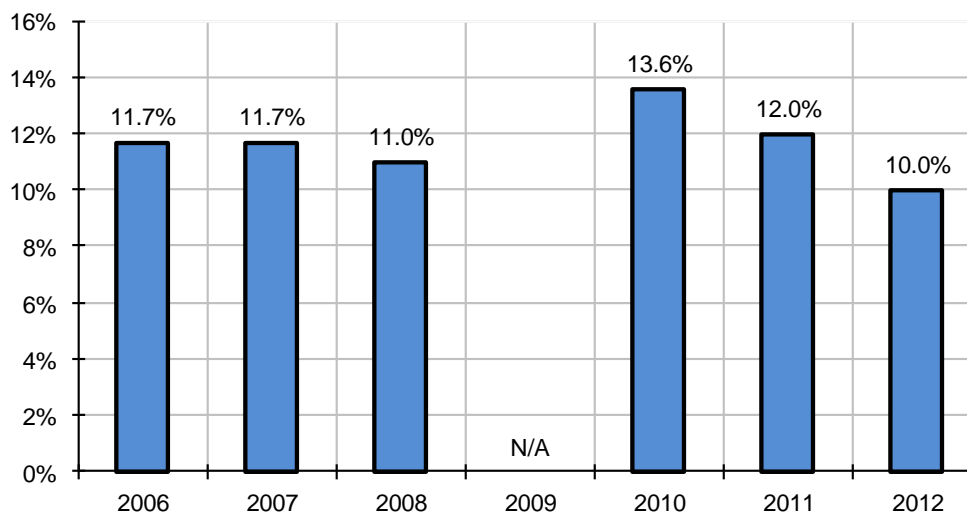
As is typical, average development costs for new hotels appear to exceed the average sale prices of older properties recently sold in this regional market area. When development costs exceed values, this can be an indication that new construction is not feasible in the near-term. However, the sale price of an older hotel is not necessarily a good indication of the market value of a new hotel. The unadjusted sale prices from recent transactions may not be sufficient to derive conclusions about whether a project is feasible because adjustments may need to be considered in order to derive an opinion of market value from hotel transaction data. An experienced appraiser can help determine whether such adjustments are necessary. Moreover, the income capitalization approach is often considered a more appropriate method for deriving value opinions pertaining to commercial properties, such as hotels.

Income Capitalization

The income capitalization approach is often considered the most relevant approach to valuing complex income-producing properties, such as hotels. There are numerous techniques that can be used in the income capitalization approach. One of the simplest techniques is known as Direct Capitalization. In this method, a value conclusion is developed by dividing a hotel's net operating income, from a single year, by an appropriate capitalization rate or cap rate. These cap rates can be derived from actual transactions if the sale prices and annual income figures are available for recent transactions.

Drawing on the extensive HVS database of hotel transactions and income statements, we developed the following table, illustrating the trend in direct cap rates for hotels in West Virginia for the past several years. As noted previously, we did not identify any hotel sales in West Virginia in 2009.

FIGURE 4: HOTEL CAP RATE TRENDS IN WEST VIRGINIA



Capitalization rates have fluctuated between about 10.0% and 13.6% during the past several years, based on our evaluation of transaction data and financial statements of hotels in West Virginia. Capitalization rates peaked in 2010, in part because of the strengthening economy in the Morgantown market. Based on a small sample of transactions that have occurred in the first quarter of 2012, capitalization rates appear to be declining further in 2012.

Why have cap rates fluctuated? A cap rate incorporates both a risk component as well as an assumed growth component for income over the holding period. One possible interpretation of this trend in the data is that hotel investors perceived hotel acquisitions to be relatively risky in 2010, but that those perceptions began to reverse in 2011 as the national economy strengthened, leading to increased competition among buyers seeking to acquire hotels.

A second possible interpretation of the data suggests that hotel investors have become increasingly optimistic, in 2011 and 2012, about the potential for hotels to experience significant income growth. This sentiment has been bolstered in recent quarters, especially as strong income growth has been realized at many hotels during 2011 and the first few months of 2012. Perhaps a combination of both factors – perceived reductions in risk and increased optimism about income growth potential – best explain the data.

Although cap rates can be useful to illustrate trends and can be an important value factor to consider, the Direct Capitalization technique is not always the most appropriate technique for valuing hotels. A

discounted cash flow analysis can allow for a more thorough analysis of a multi-year income projection. An even more thorough analysis could include a mortgage-equity technique, which allows one to value a property based on a typical financing that would generally include a loan component and an equity component. For more information about hotel valuation, please visit our library on the HVS website at www.hvs.com.



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