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# WHAT SHOULD I BUILD?

## A FEASIBILITY METHODOLOGY FOR DEVELOPERS SEEKING PRODUCT GUIDANCE

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## A Feasibility Methodology for Developers Seeking Product Guidance

*HVS is regularly approached by developers who have control of a site and a sense that new hotel development is economically justified thereon, but who need guidance as to what product type will generate the strongest return. This article details a simple and logical methodology that can be used to determine which among a variety of brand/product scenarios are feasible, if any, and to gauge which among the feasible uses will generate the strongest return.*

### Step 1: Which Products Should Be Tested?

To begin, we determine which products should be tested. In most cases, some product categories can be dismissed as candidates without further analysis. Luxury and full-service hotel locations are far less common than locations suitable for limited-service hotels; thus, for example, an outlying highway interchange location will almost always be ill-suited to a costly high-end project. In addition, a lack of brand availability can be a factor. If the developer has restricted the analysis to Marriott and Hilton brands and the market contains existing Courtyard and Hilton Garden Inn affiliates, then the select-service category should be eliminated. In this example, we'll assume that the following products are viable candidates: 1) limited-service, 2) extended-stay, 3) select-service, and 4) full-service.

### Step 2: Estimate the Threshold NOI

In the next step, we develop a forecast of the stabilized net income level necessary for each candidate product type to be economically feasible. Two variables are at play in this calculation: construction cost and market-level capitalization rate.

Referencing actual data in our database, and adjusting for land value and the local construction cost environment, a development cost estimate can be formed for each product. The land value can be approximated based on typical industry standards for each product type, or stipulated by the project developer, based on either the acquisition cost or the desired return factor.

The capitalization rate is derived from a review of recent sales data in our database, and consideration of recent investor surveys. The product of these two variables is the net income level that represents the feasibility threshold. This step also requires assumptions as to room count.

In Figure 1, the threshold net income levels are calculated.

FIGURE 1 CONSTRUCTION COSTS, CAP RATES, AND NOI THRESHOLDS

| Product Type | No. of Rooms | Est. Construction Cost Per Room | Est. Construction Cost Total | Selected Capitalization Rate | Threshold NOI |
|---|---|---|---|---|---|
| Limited-Service | 120 | $125,000 | $15,000,000 | 9.5 % | $1,425,000 |
| Select-Service | 120 | 145,000 | 17,400,000 | 8.5 | 1,479,000 |
| Extended-Stay | 120 | 150,000 | 18,000,000 | 8.5 | 1,530,000 |
| Full-Service | 250 | 250,000 | 62,500,000 | 8.0 | 5,000,000 |

## Step 3: Establish the Income & Expense Structure

In the third step, we establish an income and expense structure for each product type based on actual historical operating data. HVS has the advantage of an unparalleled database, which makes us uniquely qualified to employ this methodology.

Based on aggregate comparable data selected based on similarities in location, product scope, brand affiliation, and market orientation, we form an income and expense model for each product type. Figure 2 represents a sample composite, for the extended-stay scenario.

FIGURE 2 COMPOSITE DATA – 35 EXTENDED-STAY HOTELS

| | | | | |
|---|---|---|---|---|
| **Number of Rooms:** | **4,563** | | | |
| **Avg. Number of Rooms:** | **130** | | | |
| **Occupied Rooms:** | **1,320,058** | | | |
| **Days Open:** | **365** | | | |
| **Occupancy:** | **79.3%** | | **Amount per** | **Amount per** |
| **Average Rate:** | **$129.50** | **Percentage** | **Available** | **Occupied** |
| **RevPAR:** | **$102.64** | **of Revenue** | **Room** | **Room** |
| **REVENUE** | | | | |
| Rooms | $170,952 | 97.5 % | $37,465 | $129.50 |
| Other Income | 4,396 | 2.5 | 963 | 3.33 |
| Total | 175,348 | 100.0 | 38,428 | 132.83 |
| **DEPARTMENTAL EXPENSES** | | | | |
| Rooms | 34,586 | 20.2 * | 7,580 | 26.20 |
| Other Expenses | 1,556 | 35.4 * | 341 | 1.18 |
| Total | 36,142 | 20.6 | 7,921 | 27.38 |
| **DEPARTMENTAL INCOME** | 139,206 | 79.4 | 30,508 | 105.45 |
| **OPERATING EXPENSES** | | | | |
| Administrative & General | 14,080 | 8.0 | 3,086 | 10.67 |
| Marketing | 8,777 | 5.0 | 1,924 | 6.65 |
| Franchise Fee | 13,676 | 7.8 | 2,997 | 10.36 |
| Property Operations & Maintenance | 7,524 | 4.3 | 1,649 | 5.70 |
| Utilities | 7,642 | 4.4 | 1,675 | 5.79 |
| Total | 51,699 | 29.5 | 11,330 | 39.16 |
| **HOUSE PROFIT** | 87,507 | 49.9 | 19,177 | 66.29 |
| Management Fee | 6,137 | 3.5 | 1,345 | 4.65 |
| **INCOME BEFORE FIXED CHARGES** | 81,370 | 46.4 | 17,832 | 61.64 |
| **FIXED EXPENSES** | | | | |
| Property Taxes | 10,023 | 5.7 | 2,197 | 7.59 |
| Insurance | 1,714 | 1.0 | 376 | 1.30 |
| Reserve for Replacement | 7,014 | 4.0 | 1,537 | 5.31 |
| Total | 18,751 | 10.7 | 4,109 | 14.20 |
| **NET INCOME** | $62,619 | 35.7 % | $13,723 | $47.44 |

*Expressed as a ratio to departmental revenue

## Step 4: Establish the Income & Expense Structure

In the fourth step, we impute the occupancy and average rate (and by extension, these variables' product: revenue per available room [RevPAR]) that generates the threshold net income, when entered into the income and expense structure. The following table represents a sample calculation, for the extended-stay scenario. The yellow-shaded cells represent the input variables.

FIGURE 3 STABILIZED FORECAST – EXTENDED-STAY HOTEL PRODUCT

| | | | | |
|---|---|---|---|---|
| **Number of Rooms:** | **120** | | | |
| **Occupied Rooms:** | **35,040** | | | |
| **Days Open:** | **365** | | | |
| **Occupancy:** | **80.0%** | | **Amount per** | **Amount per** |
| **Average Rate:** | **$125.00** | **Percentage** | **Available** | **Occupied** |
| **RevPAR:** | **$100.00** | **of Revenue** | **Room** | **Room** |
| **REVENUE** | | | | |
| Rooms | $4,380 | 97.3 % | $36,500 | $125.00 |
| Other Income | 123 | 2.7 | 1,022 | 3.50 |
| Total | 4,503 | 100.0 | 37,522 | 128.50 |
| **DEPARTMENTAL EXPENSES** | | | | |
| Rooms | 911 | 20.8 * | 7,592 | 26.00 |
| Other Expenses | 43 | 35.0 * | 358 | 1.23 |
| Total | 954 | 21.2 | 7,950 | 27.23 |
| **DEPARTMENTAL INCOME** | 3,549 | 78.8 | 29,572 | 101.28 |
| **OPERATING EXPENSES** | | | | |
| Administrative & General | 372 | 8.3 | 3,100 | 10.62 |
| Marketing | 228 | 5.1 | 1,900 | 6.51 |
| Franchise Fee** | 350 | 7.8 | 2,920 | 10.00 |
| Property Operations & Maintenance | 198 | 4.4 | 1,650 | 5.65 |
| Utilities | 201 | 4.5 | 1,675 | 5.74 |
| Total | 1,349 | 30.0 | 11,245 | 38.51 |
| **HOUSE PROFIT** | 2,199 | 48.8 | 18,327 | 62.76 |
| Management Fee | 158 | 3.5 | 1,313 | 4.50 |
| **INCOME BEFORE FIXED CHARGES** | 2,042 | 45.3 | 17,014 | 58.27 |
| **FIXED EXPENSES** | | | | |
| Property Taxes | 264 | 5.9 | 2,200 | 7.53 |
| Insurance | 48 | 1.1 | 400 | 1.37 |
| Reserve for Replacement | 180 | 4.0 | 1,501 | 5.14 |
| Total | 492 | 10.9 | 4,101 | 14.04 |
| **NET INCOME** | $1,550 | 34.4 % | $12,913 | $44.22 |

* Expressed as a ratio to departmental revenue

** As a percentage of rooms revenue: 8.0%

Using the occupancy and average rate figures shown above, the net income approximately equates to the threshold net income level calculated in Figure 1, for the extended-stay product type.

## Step 5: Final Analysis

In the final step, the RevPAR levels required for each product type to realize the target net income are compared to current RevPAR levels realized by the existing hotels in the competitive set. In this case study, the RevPAR level necessary to cost-justify a full-service hotel on the subject site exceeds the most recent

RevPAR levels realized by the market's few full-service hotels by a wide margin, thus that product type is considered to be infeasible. In the limited-service and select-service segments, the necessary RevPAR levels could reasonably be considered achievable, but all of the most coveted limited-service and select-service brands are already taken in the market area. In the extended-stay category, however, an esteemed extended-stay brand is available, and the market's only existing extended-stay hotel realized a RevPAR of well over the estimated threshold in the most recent calendar year. Based on these considerations, our feasibility summary is outlined in Figure 4.

FIGURE 4 FEASIBILITY SUMMARY

| Product Type | Necessary RevPAR | HVS Feasibility Opinion |
|---|---|---|
| Limited-Service | $83 | Marginal |
| Select-Service | 94 | Marginal |
| Extended-Stay | 100 | Positive |
| Full-Service | 145 | Infeasible |

## Some What-Ifs

The preceding scenario was relatively simple. What if there *were* top-level limited- and select-service brands available in this case study? Which product would bring the highest return to the land? Which product would be the most feasible?

In such a scenario, we would use the income and expense structures previously developed and calculate the net income levels for each of the three viable product/brands, based on our estimate of attainable occupancy and average rate levels. The calculated net income levels would then be divided by the respective total development cost estimates in order to calculate each project's yield (or capitalization rate). That product/brand with the highest yield represents the highest and best development alternative.

## Conclusion

This methodology, presented in an abbreviated format for purposes of this article, is simple and logical, but data-intensive. It requires industry experience and acumen, and also the extensive database of actual construction costs, comparable sales with derived capitalization rates, and historical operating statements that HVS controls. It is our goal to provide our clients with the highest level of analytical performance available. This methodology will help assure that a newly conceived hotel product is based in economic realities, and that the selected product type is the one that is most likely to meet or exceed the various threshold return levels (i.e., RevPAR, net income, and yield).

## About HVS

**HVS** is the world's leading consulting and services organization focused on the hotel, restaurant, shared ownership, gaming, and leisure industries. Established in 1980, the company performs more than 2,000 assignments per year for virtually every major industry participant. HVS principals are regarded as the leading professionals in their respective regions of the globe. Through a worldwide network of 30 offices staffed by 400 seasoned industry professionals, HVS provides an unparalleled range of complementary services for the hospitality industry. For further information regarding our expertise and specifics about our services, please visit **www.hvs.com**.

## About the Author

**Erich Baum** is a Senior Vice President with HVS. Erich has been with HVS since graduating from Cornell's hotel school in 1989, working in the San Francisco office until 1996 and based in New England thereafter. Erich co-authored the 2001 edition of the Appraisal Institute's standard hotel valuation text ("Hotels & Motels: Valuations and Market Studies") with Steve Rushmore. Erich is a certified appraiser in the states of Massachusetts, New Hampshire, and Maine, has provided expert testimony in numerous courts of law. He also has a masters of arts degree from the University of San Francisco.