

Hotel Market & Feasibility Studies: Connecting Vision with Viability in Untapped Markets

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Since the COVID-19 pandemic, macroeconomic trends have helped breathe new life into secondary and tertiary hotel markets. The shift to hybrid and remote work, an increase in highway tourism, and a strengthening of the logistics and manufacturing sectors have supported a resurgence of leisure and commercial hotel demand in many small and medium-sized communities. These factors, among others, have generated interest in new hotel development in these areas, often by local municipalities and/or economic development

organizations.

However, these smaller markets often fly under the radar of well-established hotel development groups, many of which are facing significant headwinds from rising construction and capital costs in today's market. A hotel market or feasibility study can be a key tool in bridging the gap between these communities and developers, but the usefulness of such a study is highly dependent on the consultant's ability to understand the perspectives and motivations of both public and private interests.

Balancing Local Lodging Needs with Hotel Development ROI

In my numerous conversations with municipal stakeholders, I've found they often speak of a "need" for hotel rooms, asking me to evaluate and quantify that need. This perception of "need" is typically based on anecdotal observations of a lack of quality hotel rooms during periods of peak demand, such as special events or summer weekends. However, community residents and stakeholders do not often consider lodging demand during off-peak travel periods, such as a Tuesday night in January. On the other hand, one of the fundamental concerns of a private developer is the depth and diversity of hotel demand in a given market and its potential to support a profitable operation throughout the year. As a result, the concept of "need" can be somewhat of a distraction, as it does not necessarily correlate to the viability of hotel development. Orienting the discussion and evaluation of a potential hotel development around its possible benefits, both to the local community and a potential developer, is the first step in bridging the gap between public and private stakeholders.

The potential benefit to a private developer is the expected return on investment (ROI), a relatively straightforward metric to evaluate. As profit-oriented private business enterprises, hotel development firms actively seek out projects that will produce an adequate return for the work and risk required to undertake the development. In other words, a developer needs to know if the expected profitability of the hotel operation will justify the cost of construction, including the cost of debt and equity capital. From a municipal perspective, the benefits of a hotel may be less direct and tangible. Hotels generate a variety of direct taxes for a community, including property, sales, and occupancy taxes. They also accommodate visitors to the area who spend money at other local businesses. Additionally, hotels can serve as an amenity to residents and area businesses, allowing them to conveniently host visitors near their homes or offices.

The Role of Incentives

Numerous hotel development groups throughout the country are actively searching for their next projects. There is a high likelihood that these private developers are already involved in most communities with strong enough lodging demand to produce adequate returns on new hotel development. There are also many other

Summary

Post-COVID macroeconomic shifts have revived hotel demand in smaller cities, but these markets can be overlooked by hotel developers, especially amid rising costs. Market and feasibility studies are essential tools for aligning local development goals with investor interests.

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communities that could support profitable hotel operations but not a strong enough ROI level to entice private development. In these locations, many municipalities attract hotel development by offering development incentives to offset project costs and/or improve operational profitability. The same factors come into play in markets where private development is targeting a different hotel class or product type than what would most benefit the community. These incentives frequently include the following:

Profit Enhancement	Cost Reduction
Property Tax Abatement	Construction Sales Tax Exemption
Sales Tax Rebate	Reduced Site Cost
Occupancy Tax Rebate	

The potential impact of incentives can be evaluated by comparing the stabilized profitability and cost of a proposed project under both a private development scenario and an incentivized scenario. This is illustrated in the following table, which shows two proformas for a hypothetical select-service hotel development under these different scenarios.

Hypothetical Select-Service Hotel Proformas Show Positive Effects of Development Incentives

	Private			Incentivized		
		%	Per Room		%	Per Room
Number of Rooms	125			125		
Occupancy	73%			73%		
Average Rate	\$150			\$150		
RevPAR	\$110			\$110		
		%	Per Room		%	Per Room
Rooms Revenue	\$4,995,938	91%	\$39,968	\$4,995,938	91%	\$39,968
Non-Rooms Revenue	499,594	9%	3,997	499,594	9%	3,997
Total Revenue	\$5,495,531	100%	\$43,964	\$5,495,531	100%	\$43,964
Gross Operating Profit	2,582,900	47%	20,663	2,582,900	47%	20,663
Management Fee	\$164,866	3%	\$1,319	\$164,866	3%	\$1,319
Property Taxes	274,777	5%	2,198	5,496	0%	44
Insurance	82,433	2%	659	\$82,433	2%	659
Sales/Occ. Tax Rebate	0	0%	0	(219,821)	-4%	(1,759)
Replacement Reserve	219,821	4%	1,759	\$219,821	4%	1,759
EBITDA	\$1,841,003	24%	14,728	\$2,330,105	34%	18,641
Development Cost	\$28,125,000		\$225,000	\$28,125,000		\$225,000
Resulting Cap Rate on Cost	6.5%			8.3%		

Source: HVS

Without incentives, the project would produce a capitalization rate below 7.0%, which would not meet investor return expectations in most markets. However, an abatement of property taxes on the improvements and a partial rebate of sales and/or transient occupancy taxes would increase the cap rate above 8.0%, resulting in an attractive investment.

Let Market Intelligence Guide Your Community's Next Hotel Project

From a municipal standpoint, adding new hotel rooms to an area may attract and accommodate additional visitors during peak periods, but they may also cannibalize demand from other hotels in the same market during off-peak periods, negatively impacting tax revenue from those properties. In order to accurately assess potential benefits of a hotel development for a community, it is important to focus on net new demand to the market as the driver for tax growth, not just the anticipated performance of the newly constructed property. Additionally, the quality and scope of hotel facilities should be evaluated in relation to the needs and desires of community stakeholders to ensure the incentivized project is truly providing community benefits.

In order to properly examine these potential benefits to a community, as well as the return on investment for a private developer, a hotel market and feasibility study should thoroughly evaluate the nature of hotel supply and demand in the local market, in addition to the performance, profitability, and return on investment for an individual proposed hotel project. When the perspectives and motivations of both public entities and private developers are addressed, such a study can serve as a key tool in bridging the gap between private and public stakeholders to support mutually beneficial hotel developments.

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About **Daniel P. McCoy, MAI**



As the HVS Practice Leader for the Midwest, Dan McCoy, MAI, oversees the firm's seven offices in this region. A Senior Managing Director at HVS, Dan is a recognized thought-leader, collaborative advisor, and invaluable resource for the Midwest's lodging industry. He combines a deep understanding of regional hotel markets with strong analytical thinking to provide a wide variety of clients with up-to-date hospitality intelligence and tailor-made solutions. Dan is a Designated Member of the Appraisal Institute (MAI) and a certified general appraiser. Contact Dan at +1 (970) 215-0620 or [\[email protected\]](#).