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CHAPTER 8

Lodging Supply Analysis

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» 8.01 INTRODUCTION

The lodging supply in a given market area is composed of every facility within that market area that caters to transient overnight visitors, including conference centers, bed and breakfast inns, and health spas as well as hotels, motels, and microtels. All of the transient lodging facilities that operate within one market area are competitive with each other to some degree, but for the purposes of a market study and appraisal, only those that qualify as primary and secondary competitors are evaluated.

An analysis of lodging supply begins with the identification of the market area, generally considered the area within twenty travel minutes of the subject property (see Chapter 7). The market area in which the subject property is located in terms of supply is sometimes larger than the market area as determined by demand. This occurs when demand generators are located close to the outer boundary of the subject property's normal demand market area (usually no farther than five to ten travel minutes beyond its perimeter). These peripheral demand generators may neighbor other lodging facilities that though out of the market area may be to some degree competitive with the subject property. For that reason they are considered part of the supply in the subject property's area.

The analysis continues with the identification of the primary and secondary competitors of the subject property, the number of rooms currently available in the market area, and the number of rooms of proposed projects in the area. Finally, the appraiser must determine the current rate structure of area lodging facilities, their historic occupancy levels, their market orientations, and the amenities that they offer. This information is generally gathered through interviews with competing lodging facilities in the subject area.

» 8.02 EVALUATION OF COMPETITION

Primary competition includes any lodging facility that attempts to attract the same transient visitors as does the subject property. Secondary competition generally con-

sists of lodging facilities that attract the same transient visitors as the subject property, but under special circumstances.

The categorization of competitive facilities as primary or secondary depends, for the most part, on subjective judgments. The competitive environment of a market area can be evaluated either by investigating demand and determining the accommodations transient visitors actually select or by examining the local supply and determining the facilities that are similar in market orientation. Interviews with visitors can be helpful in analyzing the criteria that travelers use to select accommodations in the local marketplace, but an experienced appraiser can often evaluate similarities in the market orientation of competitive facilities simply by visiting each property and determining whether the criteria for competitiveness are met. To judge whether a lodging facility represents primary, secondary, or negligible competition for the subject property, the appraiser must answer the following questions:

- Does the facility in question offer a location similar to that of the subject property? Is it quickly and easily accessible for the market area's demand generators? Does it have a specialized location (e.g., airport, convention center, downtown, or resort)?
- Is the hotel similar to the subject property in terms of the facilities it offers? Types of hotels offering specialized facilities include convention, resort, suite, extended-stay, conference center, and casino.
- Does the hotel offer amenities similar to those of the subject property? Distinguishing amenities include restaurants, lounges, meeting rooms, swimming pools, exercise rooms, tennis courts, and golf courses.
- Is the hotel similar to the subject property in terms of quality and price? Classes of lodging facilities include luxury, first-class, standard/mid-rate, upper-economy, and economy/budget.
- Does the hotel in question have an image similar to that of the subject property? Image can be determined by the hotel's brand name, local reputation, management expertise, and any unique or distinctive characteristics (e.g., unusual lobby decor).

To best categorize competitive hotels as either direct (primary) or indirect (secondary) competitors, an examination of the targeted orientation of each hotel's current market capture is necessary. For a hotel to be considered a primary competitor, it must often compete for the same demand pool as the subject property. Two hotels that offer similar services and facilities are typically considered 100 percent— or directly—competitive. Such hotels do not have to be located in the same geographic area. Two five-star resorts located thousands of miles apart may be more competitive with each other than with the standard hotels located in their immediate area. More commonly, two extended-stay hotels located on the opposite ends of a metropolitan statistical are a (MSA) can be considered directly competitive with each other and indirectly competitive with the traditional transient hotels adjacent to them.

Primary competition occurs among lodging facilities that are similar to the subject property with respect to the following criteria: facilities offered, class, and image. Secondary competition occurs with lodging facilities that have similar locational characteristics but share few of the other major qualities of the subject property, particularly class and image.

Properties in the secondary category are considered competitive because they sometimes attract the same customers as the subject property and the subject property's primary competition. However, this tends to happen only as a result of special circumstances, such as when all of the primary competitors are at capacity, so that

travelers who would prefer that type of accommodation must settle for one of the secondary competitors. A lodging facility that is not of the same class or image as the subject property might also be a secondary competitor if it has a particularly good location—for example, one adjacent to a demand generator. Because travelers are inclined to stay at the first hotel they encounter, especially during inclement weather, *a*, secondary competitor with a convenient location will attract a certain percentage of the market for which the subject property competes.

In today's competitive hotel markets, franchise affiliation is a strong attraction for travelers, mainly because of frequent guest programs and national corporate room night contracts. Location is not always as important a factor as it has been in the past for guests seeking a place to stay. In many cases, guests will stay at a hotel outside of the immediate market area in order to stay at their preferred franchise. This is most common among the larger hotel chains with properties catering to the different market segments—for example Choice Hotels, Holiday Inn Worldwide, Hospitality Franchise Systems, Marriott, and Promus Hotels.

Hotel companies have realized the importance of national brand recognition. Rather than having new companies enter the market and develop a new national franchise, many of the larger hotel companies have developed new franchise divisions, For example, Marriott has its Marriott brand for its full-service hotels and resorts, Fairfield Inn for upper-economy limited-service properties, Courtyard for first-class commercial properties, and Residence Inn for extended-stay properties. Brand segmentation has been a strong tendency in the hotel industry over the past decade, and the process is continuing as other hotel companies continue to develop new brands to compete in today's complex marketplace.

Some hotels in the market area offer no competition to the subject property and would not be considered in the competitor analysis. Such properties are generally so dissimilar to the subject property that any crossover of demand would be highly unlikely. For example, a five-star hotel will rarely compete directly with an economy property,

» 8.03 FIELDWORK

Hotel appraisers must rely on fieldwork to produce information that is essential for a complete market study. For example, two key elements—the definition of the market area for lodging supply and the identification of competition—can be determined only by talking to a number of people in the local area.

Whenever a hotel appraiser goes into the field to gather information, he or she will find local parties interested in having a new hotel enter the market as well as other parties interested in keeping any new competition out. Each party usually wants to advocate its position; consequently the appraiser should anticipate an individual's viewpoint on the subject before undertaking any interviews. The local visitors' and convention bureaus and Chamber of Commerce usually welcome a new lodging facility, whereas the general managers of existing hotels and the local hotel association can generally be expected to oppose a new entry into the market. Local government (e.g., building and planning departments or assessors) typically take a neutral stance.

» 8.04 BENCHMARK INFORMATION

Before an appraiser conducts competitor interviews (see the following section) he should first collect some pertinent data that is verifiably accurate. The appraiser can

use this information as a benchmark to determine whether data that is gathered during the interviews, such as occupancy or room rates, is biased in any way. The most useful piece of information is an actual occupancy percentage for a competitive hotel in the market area under consideration. The following is a list of possible sources of actual occupancy information;

Hotel association. Local hotel associations often monitor occupancy levels of member hotels, either individually or on a composite basis.

Local assessor. Local assessing departments sometimes receive financial information pertaining to hotels in their jurisdictions. If a hotel appeals its assessment and a public hearing is held, the financial data generally enters the public record.

Rooms tax collector. Many jurisdictions collect a hotel rooms tax, which is usually based on a percentage of gross rooms revenue. The collector of this tax will sometimes make this information available to appraisers. However, the data may be available only on a composite basis, which is not very useful when the occupancy level of an individual property is required. Sometimes the collector provides this data on a property-by-property basis without identifying the properties by name. In such cases, if the market is small, the appraiser can often identify the property by the amount of tax paid.

In Texas, the hotel rooms tax by individual property is considered public record; in fact, appraisers can subscribe to a monthly publication from the Comptroller of Public Accounts, State of Texas, Austin, Texas 78774. This publication contains the names of all the hotels in the state and gives the amount of rooms tax paid by each facility in the past month.

If the rooms tax paid is a known quantity, total rooms revenue can be calculated by using the rooms tax rate. Then, if the average room rate can be determined, actual occupancy can be calculated by dividing total rooms revenue by the average room rate. Experience has shown that general managers of lodging facilities are less apt to inaccurately report average room rates than other information. Therefore, when rooms tax data for an individual property can be obtained along with an average room rate, the appraiser can usually produce a useful estimate of the occupancy rate for the property.

For example, if a 200-room hotel pays $10,416 in rooms tax for the month of January and the rooms tax is charged at a rate of 4 percent, the average room rate of the hotel can be fairly accurately estimated to be $60.00. The occupancy rate for the month can then be estimated as follows:

January rooms revenue = $10,416 - 0.04 = $260,400 Rooms revenue per day = $260,400 - 31 = $8,400 Rooms revenue per room per day = $8,400 - 200 = $42.00

Percentage of occupancy = $42.00/$60.00 = 70%

Lodging 400 survey. Every August, *Lodging Hospitality Magazine,* a leading trade journal, publishes the results of a survey of the operating results of the top 400 hotels in the United States. The magazine ranks each hotel by total revenue and occupancy, and lists the name and location of each facility, its room count, total sales, total sales per room available, total guestroom sales (rooms revenue), total food and beverage sales, total other revenue, and number of employees. It could be argued that information provided in the Lodging 400 survey contains exaggerated data because the reporting hotels are interested in achieving a ranking that is higher than it actually should be. History has shown, however, that the data reported is generally accurate. It must be remembered that the IRS has an interest in the data reported, as do franchisors who base their fees on a percentage of rooms revenue. Average room rate

can be calculated from this information by dividing total guestroom sales by the product of room count and occupancy rate and multiplied by 365.

For example, if a 300-room hotel is listed as having room sales of $5,435,000 and an occupancy rate of 73 percent, its average room rate is calculated as follows:

$5,435,000/300 X 0.73 X 365 = $68.00

Because most major hotel markets have at least one hotel that is listed in the Lodging 400, it is fairly easy to find the one piece of accurate occupancy data that is necessary to verify the answers given during competitor interviews.

Market research statistics. Numerous organizations, like Smith Travel Research (STR), the Rocky Mountain Lodging Report, and Source Strategies gather hotel market information from hotels and make it available for purchase. There are some limitations to such data, as some hotels are added to and removed from the sample, and not every property reports statistics in a consistent and timely manner. Nonetheless, STR provides the best indicators of aggregate growth in existing supply and demand in U.S. hotel markets. The statistics supplied by STR—which include occupancy and average rates—are useful in reviewing market trends and determining a hotel's position and level of penetration in the market, as illustrated in Exhibit 8-1.

Exhibit 8-1 Subject Property's Market Position

	1990	1991	1992	1993	1994	1995
Subject Property						
Occupancy	67.0%	68.0%	68.4%	69.3%	70.1%	72.1%
Percent Change	—	1.5	0.6	1.3	1.2	2.9
Occupancy Penetration	102.0%	102.4%	104.0%	103.9%	98.9%	94.4%
Average Rate	$54.67	$56.78	$57.50	$62.23	$63.46	$66.44
Percent Change	—	3.9	1.3	8.2	2.0	4.7
Average Rate Penetration	106.6%	104.2%	99.3%	98.8%	95.9%	94.8%
RevPAR	$36.53	$38.61	$39.33	$43.13	$44.49	$47.90
Percent Change	—	5.4	1.9	9.7	3.2	7.7
RevPAR Penetration	108.7%	106.7%	103.2%	102.6%	94.8%	89.5%
Areawide (STR)						
Occupancy	65.7%	66.4%	65.8%	66.7%	70.9%	76.4%
Percent Change	—	1,1	(0.9)	1.4	6.3	7.8
Room Rate	$51.29	$54.48	$57,92	$63.00	$66.16	$70.05
Percent Change	—	6.2	6.3	8.8	5.0	5.9
RevPAR	$33.70	$36.17	$38.11	$42.02	$46.91	$53.52
Percent Change	—	7.4	5.4	10.3	11.6	14.1

The exhibit shows that the subject property's market rate has been experiencing increases in both occupancy and average rate during the past few years. It also shows that the subject property, whose penetration was once greater than 100 percent in both occupancy and average rate, is now below that of the market, showing a decline in its market position.

Previous studies performed on existing hotels. Other hotel appraisers who have evaluated existing hotels in the area are often willing to share information.

» 8.05 COMPETITOR INTERVIEWS

Having defined the market area for lodging supply, identified the competition, and secured the benchmark piece of information, the appraiser can begin a series of interviews with selected staff members of the competitor hotels. The primary purpose of these interviews is to identify all of the competitor hotels in the market area and to determine as accurately as possible their occupancy percentages, average rates per occupied room, and market segmentations, The primary use of this information is in the performance of the competitive room-night analysis, (For a discussion of room-night analysis, see Chapter 10.)

Competitor interviews should also be. used to obtain the following additional information;

- Date of opening
- Physical condition
  - —Recent and planned renovations
- Access and visibility
- Identification of franchise and management company
  - —Past and present
- Room count
- Amenities
  - —Restaurants
  - — Lounges
  - — Meeting and banquet rooms
- Room rates
  - —Published
  - —Special
- Effectiveness of reservation system
  - —Number of fill nights
  - —Number of turnaways
- Seasonality, including monthly and weekly occupancy trends
- Average restaurant and banquet checks
- Local food and beverage market capture
- Union contracts
- Area generators of transient visitation
  - —Demand generators leaving or moving into area
- Area economic trends and market outlook
- Local hotels for sale
- Proposed hotels and hotels under construction
  - —Expected opening dates
  - —Current status of each project

The interviews generally involve the general manager or other high ranking personnel of the hotel (e.g., assistant manager, front office manager, or director of sales). The information gathered is, of course, confidential and somewhat sensitive, particularly when it may be used to justify constructing a new competitive property. As a result, the interviews are often difficult to conduct and the information elicited less than accurate (e.g., occupancy rates may be stated as lower than they actually are).

The interviewees at competitor lodging facilities generally tend to be fairly candid about their average room rates and market segmentation, although an appraiser should be aware of the hotel's published room rates before the interview so that the average rate that is quoted can be checked for accuracy. In addition, when asking for information about the market segmentation of a competitor hotel, the appraiser must be sure that each segment referred to is clearly defined and that the sum of all segments mentioned is 100 percent,

As discussed previously, in order to achieve the desired results from an interview and to be able to adjust the data for any bias on the part of the person interviewed, the appraiser must possess at least one reliable piece of information regarding one of the competitive properties, preferably an accurate occupancy rate. The procedure for detecting bias and adjusting data to reflect it is fairly simple. For example, if the appraiser knows that a particular property has an occupancy rate of 80 percent, and the general manager of the property claims during an interview that it is 75 percent, the appraiser can assume that the other data given by the interviewee is likely to be overstated.

When all the competitor interviews are complete, the data should be compiled on a spreadsheet that identifies the interviewees and their responses. From this information, the upward or downward bias for individual questions can be adjusted and final estimates determined.

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CHAPTER 9

Lodging Demand Analysis

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» 9.01 INTRODUCTION

Careful analysis of the demand for lodging in the subject market area is essential in determining the feasibility of a proposed facility or the value of an existing one. An appraiser should begin an analysis of lodging demand by identifying the demand generators in the area (the reasons why people who need overnight accommodation visit the subject market area). Exhibit 9-1 contains a list of typical demand generators. The unit of measurement used to quantify demand is the room-night, which represents one hotel or motel room occupied by one or more persons for one night. Exhibit 9-3, at the end of this chapter, provides an example of a lodging demand analysis.

Once the demand generators (also called generators of transient visitation) in the market area have been identified, the current amount of demand they create can be estimated. This estimate serves as a basis for projecting future demand, which is a basic component of an economic market study and appraisal. Two techniques—the demand generator build-up approach and the lodging activity build-up approach—are used to quantify current demand. The demand generator build-up approach is the more complicated and time-consuming of the two, but it is the preferred way to determine the level of demand in new market areas (i.e., those without competing facilities) for proposed facilities that would cater to untapped markets, or in markets with only one demand generator.

Exhibit 9-1 Lodging Demand Generators		
Airports	County seats and state capitals	National or state parks
Amusement parks	Court houses	Racetracks
Association headquarters	Festival sites	Regional shopping malls
Casinos	Historical attractions	Resort areas
Colleges and universities	Hospitals	Sports stadiums
Companies and businesses	Military installations	Theaters
Convenient highway stopping points	Museums	Tourist attractions
Convention Centers	Offices and industrial parks	World and state fairs

» 9.02 DEMAND GENERATOR BUILD-UP APPROACH

The demand generator build-up approach involves the use of interviews and statistical sampling techniques to estimate lodging demand by projecting the room-nights attributable to local demand generators. This method should be used when:

- The subject property will be situated in a new market area where there is no current competition by which to measure existing room-night demand, such as a new resort area.
- The subject property will cater to a particular market segment, such as upscale executive conferences, that does not exist in the current marketplace.
- The subject property will cater to a segment of the market that does not currently use standard hotels and motels, such as the extended-stay market.
- The market has only one demand generator (e.g., a large university situated in a small town, such as the University of North Carolina at Chapel Hill).

The demand generator build-up approach is not usually used to quantify room-night demand in established markets, because its sampling requirements are very time-consuming, it is an expensive process to carry out, and the final results are not always as accurate as those obtained from the lodging activity build-up approach. However, even when the primary method for gathering information is the lodging activity build-up approach, it is often beneficial to conduct the demand generator interviews in order to collect data on the needs, desires, and experience of actual participants in the marketplace. The resultant "feel" for the market can be very helpful during the evaluation of the competitive environment.

[1] Definition of Market Area

The appraiser's first step in using the demand generator build-up approach is to define the market area for the subject property. The boundaries of the market area for a lodging facility are generally considered to be the distance that can be covered in all directions from the subject property in 20 travel minutes. Normally, most of the demand generators relevant to the study are situated within this market area.

[2] Potential Demand Generators

The appraiser's next step is to identify potential demand generators within the market area. Common sources of information that may prove to be instrumental in the identification process include the following:

- Hotel managers
- Directories of local businesses (usually available from the Chamber of Commerce)
- Visitors' and Convention Bureaus
- Car rental agents, taxi drivers, gas station operators, restaurant managers, and real estate agents
- A drive-through inspection of the area (i.e., to determine the number of out-of-state cars)

[3] Demand Interviews and Surveys

Once all of the significant generators of overnight visitation in the market area have been identified, the appraiser conducts demand interviews. The key to obtaining useful information from demand interviews is to find and talk to the right person: an individual with firsthand knowledge about the room-night generating capability of the area demand generators. In most instances, this person is either a "seer" or a "booker."

A seer personally interacts with transient visitors to particular demand generators in the normal course of business. Purchasing agents, office managers, receptionists, security personnel, and admission ticket clerks are all seers. A seer typically can offer information that is general in nature, such as impressions of the volume and types of visitors to an individual facility.

A booker is responsible for actually booking transient visitors into local lodging facilities. In addition to travel agents and centralized reservation service agents, bookers include personnel managers, travel department personnel, office managers, training department personnel, and executive secretaries. A booker can usually provide more detailed data on lodging demand than a seer. In many instances, hookers are able to provide information concerning the preferences of travelers (e.g., the types of accommodations used and the frequency of travel).

After identifying appropriate seers and bookers, the appraiser can begin the demand interviews. Generally, the most effective interviews are those held in person or over the telephone. However, satisfactory information can occasionally be obtained from letter surveys. The following is a list of the most important questions that the appraiser should ask during demand generator interviews:

- How many visitors do you see or book during a typical week? (An important point to remember when asking questions such as this is to keep the timeframe as short as possible, because people generally have difficulty quantifying data over an extended period of time.)
- Are there any seasonal, monthly, or weekly patterns to the visitation?
- How long do the visitors stay in the area?
- Do the visitors go to other demand generators in the area?
- Where do visitors currently stay, and why?

- What would you estimate is the percentage split between single- and double-occupancy bookings?
- What facilities do visitors normally use in the hotel?
- What sort of price sensitivity do visitors generally have?
- How do visitors book their reservations?

Exhibit 9-2 is an example of the type of form that an appraiser uses to compile information elicited during a demand generator interview. The demand generator survey shown in Exhibit 9-3, at the end of this chapter, is an example of a written survey that can be used to quantify lodging demand and to learn about traveler preferences. When a written survey is used, it is essential that the most appropriate party receive the survey material. Sometimes a preliminary phone call is necessary to correctly identify the individual with the most knowledge of the material covered by the survey. The case study at the end of this chapter is based in part on the results of a battery of actual demand generator interviews.

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Exhibit 9-2 Demand Generator Interview Form

1. Company Name:

2. Phone Number:

3. Location (including subsidiary office in marketplace, if any):

4. Distance from site of proposed hotel:

5. Name of contact/position:

6. Present number of employees:

7. Projected growth in employees:

8. What hotels/motels does interviewee currently use?

9. Reason for lodging selection (location, rate, facilities):

10. Room-nights booked:

11. What rate would interviewee be willing to pay for a suite on a daily basis?

12. Describe the proposed hotel and ask whether interviewee would have use for this type of facility?

» 9.03 LODGING ACTIVITY BUILD-UP APPROACH

The lodging activity build-up approach is the most frequently used procedure for quantifying current hotel room-night demand, because it yields the actual number of occupied hotel rooms in the subject market area. In most parts of the country, the market area for a hotel can be readily defined and the competitive facilities within it easily identified, so that once these facilities' occupancy rates have been determined, current room-night demand in the market area can be calculated and future demand projected.

The steps involved in this approach are as follows;

1. Identify the primary and secondary competitive lodging facilities situated within the market area.
2. Estimate the occupancies of the competitive lodging facilities.
3. Determine the percentage of total occupancy represented by each market segment for each facility.
4. Quantify the current accommodated room-night demand in the area.
5. Estimate total latent demand (i.e., unaccommodated and induced demand) for the area and develop a forecast of latent demand.
6. Calculate accommodatable latent demand and total usable latent demand.
7. Forecast accommodated room-night demand over the projection period and combine it with total usable latent demand to yield total usable room-night demand.
8. Quantify the area's total guestroom supply and the total room-nights available.
9. Estimate overall area occupancy over the projection period.

The procedures that must be followed to accomplish the first three steps in the approach are described in Chapter 10. The balance of this chapter outlines the tasks that an appraiser must undertake to complete the process.

[1] Current Accommodated Room-Night Demand

The quantification of the current accommodated room-night demand is accomplished by totaling the number of occupied rooms by market segment for each of the competitive facilities in the subject market area. The formula for this calculation is as follows:

Room count X Occupancy percentage X Market segmentation X 365 = Total number of occupied rooms per year

[2] Current and Forecasted Total Latent Demand

Latent demand is defined as demand that potentially exists in a market but for any of a number of reasons, is not accommodated by the current lodging supply. Estimating the total latent demand in a market area is probably the most difficult part of the lodging activity build-up approach, because the two main components of latent demand— unaccommodated demand and induced demand—are not easily quantified.

[a] Unaccommodated Demand

Unaccommodated demand is difficult to measure because it is made up of transient travelers who seek accommodations within a market area but must either defer their stay or settle for less desirable accommodations because the facilities where they want to stay have no vacancies.

This form of excess demand is a result of the cyclical nature of the lodging industry. In commercial markets, for example, area occupancy levels from Monday through Thursday often approach 100 percent. When occupancy reaches this level, a certain number of visitors to the area will usually go unaccommodated. Similarly, when resort areas sell out during peak vacation periods, a percentage of total room-night demand goes unaccommodated. Unaccommodated transient visitation is, in fact, a normal occurrence in every type of lodging market, because total area room supply cannot freely expand in response to surges in lodging demand.

Unaccommodated demand is an important consideration in a market study and appraisal. If it is ignored or not properly quantified, the conclusions drawn by the appraiser regarding the effect of the entry of a new facility in the market will be inaccurate.

In order to properly judge the amount of unaccommodated demand in a market area, an appraiser must assess the following factors relevant to the market area in question.

Nature of demand. The appraiser must determine whether demand in the market is highly cyclical, with a tendency toward concentration at particular times (e.g., Monday through Thursday, vacation periods, or during special local events).

Area occupancy level. The appraiser must determine whether most of the local lodging facilities are operating at or near their stabilized levels of occupancy (considering, of course, the nature of transient demand in the area). As a rule of thumb, in a typical commercial market, where demand is high Monday through Thursday and drops considerably on weekends, a strong stabilized level of occupancy would be 70 percent. Under such circumstances, an areawide occupancy rate of 78 percent would probably produce a significant amount of unaccommodated demand. If, on the other hand, most of the lodging facilities in the area were operating with an occupancy level of around 60 percent, the unaccommodated demand would probably be negligible.

Number of fill nights. Some of the questions asked in competitor interviews (described in Chapter 8) should be directed toward estimating the number of nights on which area hotels actually fill to capacity. Once this number has been established, the number of potential customers who are turned away can be quantified. Some hotels with centralized reservation systems generate a monthly denial report, which shows the number of people who call to make a reservation at a specific hotel but are denied a reservation because the facility is fully booked. Occasionally, individual hotels also keep track of the number of walk-ins (people who arrive without a reservation) that occur on days when the hotel is fully booked. These alternative ways of measuring unaccommodated room-night demand are useful, but unfortunately are not often available to appraisers.

Alternative accommodations. If it is apparent that a sizable amount of unaccommodated demand exists in the subject area, the appraiser might want to interview personnel at some of the alternative choices of accommodations to determine where their demand originates and how many of these customers would use other facilities if they were available. (Alternative accommodations typically include lodging facilities outside the subject market area or hotels within the area that are considered less desirable by these travelers.)

Unaccommodated demand is generally estimated as a percentage of the accommodated demand for each market segment. Unaccommodated demand typically ranges from zero percent to 30 percent of the accommodated demand, with the upper

end of the range representing exceptionally strong markets. In good hotel markets, a reasonable level of unaccommodated demand is usually 5 percent to 10 percent. Un-accommodated demand is always difficult to quantify accurately, so a conservative estimate by the appraiser is usually warranted.

[b] Induced Demand

In addition to unaccommodated demand, there is a second form of latent demand called induced demand. Induced demand represents customers who are attracted to the market area for one or more specific reasons, such as:

- The opening of new lodging facilities that offer previously unsupplied amenities such as extensive meeting and convention space, a golf course, skiing, or a health spa.
- The aggressive marketing efforts of individual properties. Some of the major hotel chains bring new customers into the market through other properties they operate.
- Convention-oriented lodging chains, for example, are frequently able to book convention groups in a different hotel in their system each year, thus creating induced demand.
- The opening of a new major demand generator, such as a convention center, commercial enterprise, retail complex, or recreational attraction.

The procedure for totaling induced demand is similar to the demand generator build-up approach in that the appraiser evaluates each generator of induced demand to determine the number of room-nights that will be attracted to the market area. Induced demand can enter the market either all at once or gradually over one or more years.

[c] Final Determination of Latent Demand

The sum of unaccommodated and induced demand equals the latent demand in a market area. The method for forecasting unaccommodated latent demand over a projected period of time is based on the procedures described in Chapter 7 for evaluating economic and demographic trends in a market area and estimating future change in lodging demand. In most instances, accommodated room-night demand and unaccommodated demand change in the same direction and at the same rate over the projection period of time. Most types of induced demand, however, act independently. For example, the opening of a large convention hotel in an area that had little existing convention demand might cause a large increase in induced demand for convention room-nights. Depending on the size of the convention hotel, this additional demand usually increases rapidly over a period of time and then stabilizes as the hotel approaches its capacity. The growth in this induced demand is generally independent of the growth in the convention demand in the market area.

[3] Accommodatable Latent Demand

Accommodatable latent demand is the portion of latent demand that can be absorbed by a market area in the future; it is based on the number of additional new rooms that are expected to become part of the market supply. In order to calculate accommodat-

able latent demand, the appraiser must first determine the number of competitive rooms currently proposed and the number already under construction in the area. Locating the properties under construction is easily accomplished by interviewing personnel in the local building department, which monitors all area development activities. The building department is also a good source of information for identifying proposed lodging facilities. Most market areas have several hotel projects in various stages of planning but not presently under construction. The difficulty in making predictions based on proposed projects is that very few are actually built; in fact, probably only one in ten proposed hotel projects ever makes it out of the planning stages. The question the appraiser must answer is at what point should a proposed hotel be considered an addition to the competitive supply?

Appraisers use the following criteria to make their determination:

- Is the financing package in place? The total financing, including both debt and equity, must be fully committed and in place before a project can be considered definite.
- Does the developer have all zoning approvals, building permits, and licenses? Projects are required to obtain these approvals before construction can begin.
- Does the project have a franchise and/or management company under contract?
- Does the developer have a track record of successful hotel projects? This attribute is important, because the majority of first-time developers fail to complete their projects.
- What is the current condition of the hotel market? If the local lodging market has become overbuilt or occupancy levels are depressed, proposed hotel projects generally will be reconsidered and either postponed indefinitely or terminated.
- What is the current condition of the financing market? Very few hotel projects are developed without mortgage financing. In down markets, lenders tend to pass up hotel projects in favor of other investments that carry less risk.

Using these criteria, the appraiser evaluates each proposed hotel within the market area and determines whether the project should be considered a future addition to the lodging supply or whether it should be disregarded.

An alternative to working in absolute terms is to assign a probability factor to a proposed project on the basis of the likelihood of its being developed. This procedure allows a proposed project to be considered a future addition to the competitive supply, but with a weighted room count determined by the project's probability of completion. For example, suppose that a 300-room hotel is planned for a site within the subject market area. On the basis of discussions with the building department and the developer, the appraiser estimates that there is a 50 percent chance that this project will be built. When totaling the size of the competitive supply, the appraiser includes this project, but considers it to be a 150- rather than a 300-room hotel given the 50 percent probability factor. The appraiser should be liberal in including proposed hotel projects within the competitive supply in order to arrive at a reasonable estimate.

As stated previously, identifying proposed hotels is more difficult than locating projects under construction. However, there are a number of potential sources of information on proposed hotel developments, including:

- Local building department
- Assessor

- Chamber of commerce
- Development agencies
- Hotel managers
- Local hotel association
- Association development reports
- Local real estate brokers
- Local lenders
- Hotel appraisers and consultants

Once the currently proposed additions to the lodging supply have been identified, the appraiser calculates the number of room-nights of supply that will be available to absorb latent demand. The demand that can be met by this additional new supply is the accommodatable latent demand. As an illustration, assume that a 200-room hotel is expected to open in two years in the subject market area. This addition to supply would be able to absorb the following number of latent room-nights of demand (accommodatable latent demand):

200 rooms X 365 X 75% = 54,750 room-nights

The 75 percent is the estimated areawide occupancy as of the projected year. It is normally assumed that latent demand will not provide a property (or the market) any more occupancy than the average occupancy percentage for the area, although some forms of property-induced demand are exceptions to this assumption. For example, a new convention hotel that is part of a chain may receive business from its own internal resources.

[4] Accommodated Room-Night Demand

The appraiser's forecast of accommodated room-night demand over a projected period is based on the expected changes in lodging demand determined through careful analysis of the area's economic and demographic indicators, as discussed in Chapter 7.

The combination of the forecasted accommodated room-night demand and the total usable latent demand produces the total usable room-night demand, which serves as the basis for estimating areawide and individual property occupancy levels.

[5] Total Usable Latent Demand

Total usable latent demand represents the amount of latent demand in a market area that could be accommodated if the supply of rooms were adequate. It differs from accommodatable latent demand only in that it may be a smaller amount. In other words, although the market may have the capacity to accommodate a certain amount of latent demand, the actual "usable" latent demand may be smaller, so some capacity still remains that could absorb more latent demand if it existed.

[6] Total Available Room-Nights

The total number of room-nights available in the market area is calculated by multiplying the number of competitive rooms for each projected year by 365. If additional

rooms become operational during a projected year (either in the form of a new hotel or as an addition to an existing property), the total number of rooms must be adjusted to reflect the actual number of rooms available during the year.

[7] Overall Occupancy

The overall area occupancy for each year during the projected period is calculated by dividing the projected usable room-night demand (i.e., accommodated room-night demand) by the annual number of available rooms.

Overall area occupancy is an important statistic for providing a preliminary indication of project feasibility. A general rule of thumb applicable to new hotels is that the occupancy level of a hotel should be somewhat below the areawide occupancy during its first year of operation. In its second year, a hotel should operate at the same level as the overall area occupancy. A hotel should exceed the area occupancy by its third year of operation. If the overall area occupancy is expected to be below profitable levels when the new hotel is scheduled to open, the potential for financial difficulties could decrease the feasibility of the project. Extreme caution should be exercised when developing a hotel in a market that shows a potential overall area occupancy of less than 55 percent to 60 percent. If the overall area occupancy is projected to fall below 50 percent, a hotel project is rarely justified.

HVS

Exhibit 9-3 Sample Demand Generator Survey

Spring Valley Hotel Survey

A new hotel is planned for the Spring Valley area. It will be conveniently located for many area businesses at the northwestern corner of the intersection formed by Central Avenue (State Route 59) and Exit 14 of the New York State Thruway.

Your responses to the following questions will assist us in assessing what type of lodging facility will best serve the needs of your firm and other firms in the area. While we realize that you may not be able to precisely answer a number of the following questions, we would appreciate your best estimates. If you have any questions or comments, feel free to call John Smith at (212) 123-4567.

Your Name/Title _____

Company Name _____

Department _____

Street Address _____

City, State, Zip Code _____

Telephone Number _____

What is the current number of employees at this location? _____
Entire Firm _____ Your department _____

What are the primary business activities at this location? _____

In answering the following questions, please indicate whether your response is for your FIRM as a whole or for your DEPARTMENT individually by circling the proper word in the question.

1. Within the next year, is the number of employees in your FIRM/DEPARTMENT projected to (circle one) Increase? Decrease? By how much? _____
   Remain the same _____

2. During an average month, how many people visiting your FIRM/DEPARTMENT require overnight hotel accommodations? _____

3. What percentage of the people visiting your FIRM/DEPARTMENT who require overnight accommodations arrive during the following seasons?
   Winter ____ Spring ____ Summer ____ Fall ____ Total 100%

4. What percentage of the visitors described above currently:
   Book their own accommodations? _____
   Have their own accommodations booked by someone in your company? _____
   Please indicate the name, department, and telephone number of the person in your firm responsible for booking accommodations:

   Name: _____

   Department: _____

   Telephone Number: _____

5. Please complete the following chart.
   a. What percentage of the people visiting your FIRM/DEPARTMENT who require overnight accommodations do so for the reasons indicated? _____
   b. What is the average number of nights per visit? _____
   c. On average, how many people stay in one hotel room per visit?

HVS

Reason for overnight stay	(a) Percent of total visitors	(b) Average length of stay	(c) Number of people per room
Relocation			
Training			
Temporary Assignment			
Consulting			
Meeting/Conference			
Other (please specify) _____			

6. Which lodging facilities does your firm currently use (in order of preference)? (Please complete the following chart.)

Name of Facility	Room Rate Charged
(1)	
(2)	
(3)	
(4)	
(5)	

7. What characteristics determine how a lodging facility is chosen?
   a. Please rank the following six factors in order of importance in choosing a lodging facility (1 = most important; 6 = least important).

Factor	Rating	Factor	Rating
Price	_____	Convenience of location	_____
Quality of amenities	_____	Chain affiliation	_____
Facilities offered	_____	Other (please specify)_____	_____

   b. Would the availability of a health club/fitness center be an important consideration in choosing a lodging facility? _____

8. Do you currently use meeting and/or banquet facilities in area hotels? (Please circle whichever applies) Meeting facilities Banquet facilities Neither

(If meeting and/or banquet facilities are used, please complete the following chart.)

	For meetings	For banquets
How frequently do you use these facilities?	_____	_____
What is the average size of your group?	_____	_____
What is the smallest size?	_____	_____
What is the largest size?	_____	_____
What percentage of attendees require overnight accommodation?	_____	_____
What percentage occurs on weekends?	_____	_____

HVS

9. a. Are you familiar with the location of the Spring Valley project? _____
   b. How would you rank the location of the Spring Valley project as compared with the locations of the hotels you currently use? (Please circle one)
   About the same Inferior Superior

10. Given a choice between a full-service hotel (e.g., Marriott, Hyatt, Westin, Hilton) and a limited-service hotel (e.g., Hampton Inn, Super 8, Red Roof Inn), which would you be more likely to choose when booking overnight accommodations for visitors?

    _____

    Why? _____

    _____

    _____

11. All-suite hotels (e.g., Residence Inn by Marriott, Embassy Suites) provide separate living and sleeping rooms within the same guest area. Typically, these accommodations are priced $10 to $15 more per room than comparable full-service hotels. Given the choice between a full-service hotel and an all-suite hotel, which would you be more likely to choose when booking overnight accommodations for visitors? _____

    Why? _____

    _____

    _____

12. Please rank the following hotel chains (eighteen are listed) in the order in which you would choose them when booking overnight hotel accommodations for visitors. Thank you for your cooperation.

Hotel Chain	*Rank*	*Hotel Chain*	*Rank*
Marriott	_____	Holiday Inn	_____
Sheraton	_____	Comfort Inn	_____
Westin	_____	Hampton Inn	_____
Hyatt	_____	La Quinta	_____
Hilton	_____	Days Inn	_____
Four Seasons	_____	Residence Inn	_____
Doubletree	_____	Hawthorn Suites	_____
Loews	_____	Embassy Suites	_____
Radisson	_____		

HVS

CHAPTER 10

Analysis of Market Share, Occupancy, and Average Room Rates

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» 10.01 INTRODUCTION

After the total current lodging demand in the subject market area is calculated and future projections for demand are made, the appraiser must identify the competitive positions of all of the area lodging facilities. This entails determining first the current market share, occupancy rates, and average room rates of the existing competitor facilities and then how these quantities would be affected by the addition of the proposed hotel. Once this information is generated, the appraiser can set about forecasting the average room rates for the market area facilities and for the subject property, so that a determination can be made about the economic feasibility of the proposed project.

Appraisers use one of two methods to analyze competitive positions: the market penetration method and the competitive index method. Both methods determine the market share captured by a lodging facility (market share is the percentage of the area's room-night demand actually supplied by the particular facility). By knowing the market share, a calculation can be made to determine the expected level of occupancy for the facility.

» 10.02 MARKET PENETRATION METHOD

The term penetration as it applies to the lodging industry refers to the percentage relationship between the actual market share and the fair market share of a lodging facility. The actual market share of a hotel is the number of rooms that are occupied per day in the hotel divided by the total number of occupied rooms in the market per day. The fair market share (also known as the average market share) of a hotel consists of its total number of rooms divided by the total of all the rooms in the market. The market penetration of a hotel is calculated by dividing its actual market share by its fair market share. It shows in percentages how well the hotel is attracting or capturing hotel room-night demand relative to a hypothetical "average" hotel in the market. Exhibits 10-1 and 10-2 illustrate the calculations that are used to determine the actual market share, the fair market share, and finally the market penetration of four hypothetical hotels.

The results of the penetration calculation show that Hotel A is achieving 12 percent more than its fair market share or 12 percent more than the average capture for the area; Hotel *B is* achieving 91 percent of its fair market share, so it is performing about 9 percent below the market; Hotel C is performing slightly above its fair market share; and Hotel *D* is achieving 2 percent less than its fair market share.

Exhibit 10-1 Determining the Actual Market Share

Hotel	Number of Rooms		Percentage of Occupancy		Number of Occupied Rooms Per Day	Actual Market Share
A	100	X	80%	=	80	13.2%
B	200	X	65	=	130,0	21.4
C	250	X	75	=	187.5	30.9
D	300	X	70	=	210.0	34.5
	850				607.5	100.0

Exhibit 10-2 Determining Fair Market Share and Penetration							
Hotel	Number of Rooms	Fair Market Share	Actual Market Share		Fair Market Share		Penetration
A	100	11.8%	13.2%	÷	11.8%	=	1.12
B	200	23.5	21.4	÷	23.5	=	0.91
C	250	29.4	30.9	÷	29.4	=	1.05
D	300	35.3	34.5	÷	35.3	=	0.98
	850	100.0%	100.0%		100.0%		

» 10.03 COMPETITIVE INDEX METHOD

The competitive index of a hotel simply reflects the number of days per year for which one room in a hotel is occupied. In contrast to the penetration method, only one calculation is necessary; the competitive index is calculated by multiplying the percentage of occupancy by 365 days, as Exhibit 10-3 shows.

Exhibit 10-3 Calculating Competitive Index					
Hotel	Percentage of Occupancy		Days per Year		Competitive Index
A	80%	x	365	=	292.0
B	65	x	365	=	237.0
C	75	x	365	=	273.0
D	70	x	365	=	255.0

The competitive index and market penetration show the relative competitiveness (i.e., the relative occupancy ranking) of each hotel. For example, Hotel A is 23 percent more competitive than Hotel *B*, as demonstrated by the calculations in Exhibit 10-4.

Exhibit 10-4 Calculating Relative Competitiveness					
	Hotel *A*		Hotel *B*		Relative Competitiveness
Competitive Index	292	÷	237	=	1,23
Penetration	1.12	÷	0.91	=	1.23

[1] Advantages of Competitive Index Method

One advantage of the competitive index method over the penetration method is that the one calculation it requires is based on a single room and thus is easy to carry out. The penetration method, on the other hand, makes use of the entire room count of a property in two of the three calculations that it requires, which becomes complicated

in dynamic market areas that have fluctuating room supplies. For example, assume an additional Hotel *E* were to enter our hypothetical market, and an appraiser wanted to determine the effect of the addition on the competitive relationship between Hotel A and Hotel *B*. Exhibit 10-5 shows the different calculations that would have to be done for each method.

As the exhibit shows, the competitive index method provides the same result as the penetration method, but requires less work.

Another advantage of the competitive index is that, as an analytical tool, it is generally easier for parties not familiar with hostelry terminology to grasp, particularly when market segmentation is being considered. For example, consider the competitive indexes for Hotels *A* and *B* for each individual market segment, as shown in Exhibit 10-6.

Exhibit 10-5 Two Methods Compared

Hotel	Number of Rooms		Percentage of Occupancy		Number of Occupied Rooms Per Day	Actual Market Share
A	100	X	80.0%	=	80.0	10.4%
B	200	X	65	=	130.0	16.9
C	250	*X*	75	=	187.5	24,4
D	300	*X*	70	=	210.0	27.3
E	225	X	72	=	162.0	21.1
	1,075				769.5	100.0%

PENETRATION

Hotel	Number of Rooms	Fair Market Share	Actual Market Share		Fair Market Share		Penetration
A	100	9.3%	10.4%	÷	9.3%	=	1.12
B	200	18.6	16.9	÷	18.6	=	0.91
C	250	23.3	24.4	÷	23,3	=	1.05
D	300	27.9	27.3	÷	27.9	=	0,98
E	225	20.9	21.0	÷	20.9	=	1.01
	1,075	100.0%	100.0%		100.0%		

COMPETITIVE INDEX METHODS

Hotel	Percentage of Occupancy		Days Per Year		Competitive Index
A	80%	×	365	=	292
B	65	×	365	=	237
C	75	×	365	=	273
D	70	×	365	=	255
E	72	×	365	=	263

COMPARISON OF METHODS

	Hotel *A*		Hotel *B*		Relative Competitiveness
Competitive Index	292	÷	237	=	1.23
Penetration	1.12	÷	0.91	=	1.23

Using competitive indexes, the appraiser can state in simple terms that in Hotel A, one hotel room is occupied 175 nights per year by a commercial traveler, 29 nights per year by a meeting traveler, and 88 nights per year by a leisure traveler. Compared with Hotel *B,* Hotel A is almost 50% more competitive in the commercial market and 83% more competitive in the leisure market. Hotel *B* is, however, almost 150 percent more competitive than Hotel A in the group and meeting market.

Exhibit 10-6 Market Segment Percentage and Market Segment Competitive Index

	Market Segment Percentage			Market Segment Competitive Index		
Hotel	Commercial	Group & Meeting	Leisure	Commerical	Group & Meeting	Leisure
A	60%	10%	30%	175	29	88
B	50	30	20	118	71	48

[2] Evaluation of Proposed Properties

The competitive index method is most often used to evaluate the relative competitiveness of proposed facilities and to forecast their stabilized occupancy.

This is accomplished by assigning competitive indexes to the subject's market segments based on how it is expected to compete with the other properties in the market. Once the relative competitiveness of each hotel is determined, an estimate of market share can be made. To accomplish this, the subject's projected market share is multiplied by the area's room-night demand, which yields an estimate of the room-nights captured; this figure is in turn converted into an occupancy percentage.

For example, assume that a market area comprises the five hotels (A, *B, C, D,* and *E)* discussed earlier. Another hotel, *F,* is a 150-room, commercially oriented facility that is planned for the area. It will have a minimal amount of meeting space and will be an average competitor in the leisure market. To estimate its stabilized occupancy, an appraiser would compile the data listed in Exhibit 10-7.

Exhibit 10-7 Estimating Stabilized Occupancy

		Estimated Market Segment			Market Segment Competitive Index		
Hotel	Occupancy	Commerical	Group & Meeting	Leisure	Commerical	Group & Meeting	Leisure
A	80%	60%	10%	30%	175	29	88
B	65	50	30	20	118	71	48
C	75	70	20	10	192	55	27
D	70	45	40	15	115	102	38
E	72	45	35	20	118	92	53

The proposed subject property might be expected to have the following competitive indexes;

	Market Segment Competitive Index		
	Commercial	**Group and Meeting**	**Leisure**
Hotel F	190	30	50

The rationale for assigning these competitive indexes is as follows: Hotel *F* is planned to be oriented towards the commercial segment, so it is similar to Hotel C, which has a commercial competitive index of 192. In terms of meeting space, the proposed hotel is similar to Hotel A, which has a group and meeting competitive index of 29. The average leisure competitive index for the five existing hotels is 50, so it can be assumed that the proposed hotel will be similar in that regard.

The competitive indexes serve as a basis for calculating market share and percentage of occupancy estimates for the proposed hotel. However, the appraiser must first use the lodging activity build-up approach to determine room-night demand, market share, and occupancy for each hotel that is currently operating in the market (see K 9.03 for a discussion of the lodging activity build-up approach).

[a] Current Room-Night Demand

Using the lodging activity build-up approach, the current room-night demand (including both accommodated and latent demand) is shown in Exhibit 10-8.

Exhibit 10-8 Estimating Stabilized Occupancy

Hotel	Commercial	Group and Meeting	Leisure
A	17,520	2,920	8,760
B	23,725	14,235	9,490
C	47,907	13,688	6,844
D	34,492	30,660	11,498
E	26,609	20,695	11,826
Total Accommodated	150,253	82,198	48,418
Latent Demand	7,513	2,466	484
Total Demand	157,766	84,664	48,902

[b] Projected Market Share

The projected market share for each property is determined by market segment by first multiplying the room count for each property by its appropriate competitive index, which results in a factor called the market share adjuster. The competitive index quantifies the competitiveness of only one room, so multiplying the competitive index by the property's room count adjusts the competitive index so that it reflects the entire property's competitiveness. The market share adjuster for one property is then divided by the total market share adjuster for all of the area's competitive hotels, which results in the market share for each property. Exhibit 10-9 shows the calculations for projected market share.

Exhibit 10-9 Calculations for Projected Market Share

COMMERCIAL SEGMENT

Hotel	Number of Rooms		Commercial Competitive Index		Market Share Adjuster	Market Share
A	100	×	175	=	17,500	9.8%
B	200	×	118	=	23,600	13.2
C	250	×	192	=	48,000	26.9
D	300	×	115	=	34,500	19.3
E	225	×	118	=	26,550	14.9
F	150	×	190	=	28,500	15.9
Total					178,650	100.0%

MEETING SEGMENT

Hotel	Number of Rooms		Meeting Competitive Index		Market Share Adjuster	Market Share
A	100	×	29	=	2,900	3.3%
B	200	×	71	=	14,200	16.4
C	250	×	55	=	13,750	15.9
D	300	×	102	=	30,600	35.3
E	225	×	92	=	20,700	23.9
F	150	×	30	=	4,500	5.2
Total					86,650	100.0%

LEISURE SEGMENT

Hotel	Number of Rooms		Leisure Competitive Index		Market Share Adjuster	Market Share
A	100	×	88	=	8,800	15.7%
B	200	×	48	=	9,600	17.2
C	250	×	27	=	6,750	12.1
D	300	×	38	=	11,400	20.3
E	225	×	53	=	11,925	21.3
F	150	×	50	=	7,500	13.4
Total					55,975	100.0%

The percentage of occupancy for each hotel is calculated by first multiplying the market share percentage by the total room-night demand for the corresponding segment to arrive at the room-nights captured for the corresponding segment. Then the subject property's combined total room-nights captured is divided by the number of available rooms per year at the subject property (i.e., the subject property's room count multiplied by 365).

[c] Projected Occupancy

Exhibit 10-9 shows the projected occupancy of Hotel *F*, as well as the effect it would have on the occupancies of the existing hotels in the market area. Note the difference in the number of room-nights captured as compared to the data for the market before the introduction of Hotel F (see H 10.03[2][a]).

Exhibit 10-10 Room-Nights Captured

Hotel	Commercial	Group & Meeting	Leisure	Total	Occupancy [1]
A	15,461	2,794	7,678	25,933	71%
B	20,825	13,885	8,411	43,121	59
C	42,439	13,462	5,917	61,818	68
D	30,449	29,886	9,927	70,262	64
E	23,507	20,235	10,416	54,158	66
F	25,084	4,403	6,553	36,040	66

[1] 0ccupancy = Total room-nights captured - (Room Count x 365)

In addition to the introduction of a new hotel, other factors that can change the competitive indexes of hotels include:

- A major renovation or an addition to an existing hotel.
- A change in management of a hotel franchise.
- A change in market orientation for a particular property.
- The physical or functional obsolescence of a facility.

Any of these factors can make the evaluation of the relative competitiveness of a new lodging facility more difficult. However, competitive indexes are useful tools in that they help to portray the competitive dynamics of a market area.

» 10.04 STABILIZED OCCUPANCY

Stabilized occupancy figures represent the anticipated levels of occupancy for lodging facilities over their economic life, including any stages of build-up, plateau, or decline in their life cycles. Stabilized occupancy calculations exclude any abnormal relations of supply and demand, as well as any transitory or nonrecurring conditions (favorable or unfavorable) that may result in unusually high or low levels of occupancy. While it is likely that a hotel will operate at occupancies above its stabilized level for a period of time, it is equally possible for new competition and temporary downturns in the economy to force the actual occupancy below this standard. Essentially, stabilized occupancy is the typical occupancy experienced by a hotel over its economic life.

For new hotels, an assumed two- to five-year build-up in occupancy is generally included in the projection; a stabilized occupancy level starting with the first year is not expected. The initial years often see operating losses, so the inclusion of the build-up period in the projection is necessary to properly account for the actual startup cash requirements.

Many factors influence the projection of a stabilized level of occupancy. The following are some of the key *market-specific* considerations:

- Historical occupancy cycles
- Composition of demand
- Supply and demand trends
- Trends in competitive properties
- Significant area development

These are some of the important *property-specific* considerations:

- Age
- Degree of obsolescence
- Location
- Market share
- Management and image

The nature of the local hotel demand is probably the best indicator for establishing a stabilized level of occupancy. Different types of travelers have different travel patterns (i.e., days of travel, length of stay and seasonality), and the particular mixture of these visitors within a given market will influence the area's overall level of occupancy.

For example, assume that the demand in a market has a very strong business base that generates a significant room-night demand Monday through Thursday nights. However, the local area has no leisure attractions, so very few people use the market area's lodging facilities on Friday and Saturday nights. There is, however, some commercial demand on Sunday nights from business travelers planning an early start on the work week. This occupancy pattern adds up to an average areawide level of occupancy of approximately 72 percent, assuming the daily occupancies listed in Exhibit 10-11.

Exhibit 10-11 Occupancy Statistics

Weekday	Percent of Occupancy
Monday	100%
Tuesday	100
Wednesday	100
Thursday	100
Friday	30
Saturday	35
Sunday	40
Weekly Average	72%

Under the market conditions given in the exhibit, and given the nature of the existing lodging demand, there would be little justification for using a stabilized occupancy factor of more than 72 percent for a proposed facility in this market unless the

property had significant competitive attributes that would enable it to capture a larger than average share of the limited weekend demand. Furthermore, because it is highly unusual for a hotel to consistently achieve 100 percent occupancy levels 52 weeks a year with the normal commercial drop off on three-day weekend holidays, Christmas week, and the summer months, it would be difficult to maintain a 72 percent level on a year-round basis in any event, so a good case can be made for establishing the stabilized level in this example at a more reasonable 68 percent level.

Historical occupancy cycles for a market area provide an indication of the level at which stabilized occupancy should be set. Exhibit 10-12 provides the twenty-year occupancy cycle, with related statistical data, for three different cities:

Exhibit 10-12 Twenty-Year Occupancy Cycle for Three Cities

Year	City A	City B	City C
1	71,0%	72.0%	57.0%
2	66.0	74.0	68.0
3	63.0	76.0	62.0
4	69.0	75.0	56.0
5	60.0	69.0	50.0
6	61.0	68.0	47.0
7	63.0	69.0	49.0
8	66.0	70.0	51.0
9	64.0	69.0	46.0
10	66,0	64.0	57.0
11	68.0	71.0	59.0
12	69,0	71,0	61.0
13	72,0 f	77.0	63.0
14	72.0	78.0	60.0
15	69.0	76.0	63.0
16	66.0	72.0	62.0
17	59.0	68.0	61.0
18	65.0	68.0	61.0
19	69.0	70.0	57.0
20	70.0	69.0	60.0
	City A	**City B**	**City C**
Average Occupancy	66.4%	71.3%	57.5%
Highest Occupancy	72	78	68
Lowest Occupancy	59	64	46
Difference			

The stabilized occupancy for each of these three cities should approximate their average occupancy, which is generally close to the midpoint between the highest and lowest recorded occupancy level during the twenty-year period.

» 10.05 AVERAGE RATE PER OCCUPIED ROOM

The average rate per occupied room is among the most important variables in a forecast of the income and expense of a hotel because it directly affects both financial feasibility and market value. Professionals who conduct market studies should understand how average rates are calculated and be familiar with the various factors that affect their future movement.

To be fully documented, an economic market study and appraisal for a lodging facility should include a detailed analysis that explains the derivation of its forecasted average rates as well as a comparison of the subject property's rates with those of competitive hotels. An estimate of average rate depends on the evaluation of many factors, including:

- Supply and demand conditions in the local hostelry market
- Management's marketing expertise and ability to create a positive price/value relationship in the eyes of the consumer
- Current room rates of competitive hotels
- The quality, class, and other attributes of the subject property
- The market orientation of the subject property, including the rate-sensitivity characteristics and double occupancy percentages of each individual market segment

A hotel's average rate per occupied room is calculated by dividing the net rooms revenue derived from guestrooms by the number of paid rooms occupied. The result is the weighted average of the various rate categories used by the hotel during the period.

The equation used to calculate the average rate per occupied room is as follows:

Overall Average Rate Per Occupied Room = Net Rooms Revenue/Number of Paid Rooms Occupied

The *Uniform System of Accounts for Hotels* (8th ed., Hotel Association of New York City, Inc., (1986)) defines the components of this formula as follows:

- *Net rooms revenue:* Total rooms revenue less allowances.
- *Allowances:* Rebates and overcharges or revenue not known at the time of sale but adjusted at a subsequent date. Allowances may also include revenue forgone as a result of hotel promotions or complimentary services.
- *Paid rooms occupied:* Rooms occupied by hotel guests on a paid basis. The overall average rate per occupied room does not include any occupancy derived from complimentary rooms.

» 10.06 FORECASTING AVERAGE RATE PER OCCUPIED ROOM

The procedure used to forecast average rates per occupied room for lodging facilities varies depending on whether the property is an existing or proposed hotel. An existing hotel's established room rate level and competitive position may change slightly, but they provide the appraiser with a benchmark from which to forecast future trends in average rates. Because proposed hotels have no operating history, an average rate must be derived from an analysis of the competitive rates of local lodging facilities, both current and forecasted, based on anticipated changes in supply, demand, and competitive factors.

[1] Procedure for Existing Hotels

The first step for the appraiser in this procedure is to compile the property's overall average rates by month for the previous three to five years. The appraiser must verify that the average rates do not contain complimentary rooms. The next step is an analysis of the historical trends in average room rates for the subject property—to determine what the compounded growth rate has been over the past several years. If the data is available, the average room rate should be examined by individual market segments. Lastly, average room rates should be examined to determine if there are any seasonal effects on demand. If so, the average rate by season and month should be elevated to determine the compounded growth trends by season.

After the data regarding historical average room rates has been compiled and analyzed, the historical relationships between occupancy and average rate fluctuations should be investigated. Average room rates are often affected by changes in occupancies. For example, average rates usually soften or even decline as occupancies trend downward, and the reverse takes place as occupancies increase. The reason for this relationship lies both in the local market and in the individual property. On a marketwide basis, hotel occupancies decrease when there is either an increase in the supply of hotel rooms or a decrease in the demand for transient accommodations. Both situations typically increase the competition among area hotels, which often leads to rate sensitivity. While not all hotels feeling the impact of greater competition will immediately institute a price-cutting program, they will be more conscious of the negative effect of raising room rates or of holding a hard rate policy when negotiating new business with groups and contracts. As area occupancies decrease, hotels feel pressured to cut rates in order to hold on to their market share. In a declining market, therefore, appraisers should look for the real possibility that average rates may remain flat or even decline.

Notwithstanding local market conditions, average room rates usually increase as a property's occupancy rises. This can be attributed to the fact that when a hotel approaches 100-percent occupancy, it is able to sell more of its high-priced rooms. In addition, management's bargaining position is enhanced, so it does not have to offer discounts or other inducements to attract patronage. For example, a customer making a reservation at a hotel with one room remaining will probably pay rack or full rate. By selling out the higher-priced rooms, a hotel's average room rate will generally increase faster than either inflation or local market conditions would dictate.

[a] Average Rates of Competitors

The next step for the appraiser is to compile a list of average room rates for the subject property's primary and secondary competitors. One year's worth of historical data is adequate, but a trend analysis can be made if data from additional years can be gathered. The appraiser must be certain that the information represents average room rates and not other types of hotel room rate statistics, of which there are many. The following is a list of some of the terms used in the industry to describe different types of hotel room rates:

- *Rack rate:* An undiscounted room rate. The term is taken from the front desk's room rack which contains information about each room's rate including the highest rate that can be charged for that accommodation. When a hotel is operating full or when someone comes in without a reservation, the rack rate is generally the only rate available. The average rate is always less than the rack rate.

- *Published rate:* The rate found in directories and other publications. This rate is usually quoted in ranges (i.e., single; $70-$100) and represents the range of rack rates for specific types of accommodations. Published room rates typically set the upper limits of average rates. Average room rates tend to be closer to the published rates for single rooms than for doubles.
- *Commercial rate:* A special discounted rate available to certain commercial accounts. Some hotels allow almost any commercial traveler to use a commercial rate, while others apply this rate only for specific accounts.
- *Contract rate:* A discounted rate available to specific users, such as an airline, convention group, or bus tour. Arrangements for this rate are negotiated individually by the user, and payment is often billed directly to the firm or organization using the room. Depending on the amount and timing of the usage, a contract rate can be heavily discounted and significantly lower than either the average rate or the commercial rate.

[b] Comparison of Subject Property With Competitive Properties

The next step for the appraiser is to compare the subject property's average rate with that of the competition to determine the reasons for any differences in average rates. Generally, rate variances can be attributed to several factors, including location, physical facilities, management, image, quality, and market segments served. In addition, if there have been any trends in average rate movement over time, these factors should be quantified and evaluated.

[c] Future Changes in Market Area Economy and Competitive Supply

Once the historical competitive data has been analyzed, the appraiser must forecast any changes in the local economy or competitive supply that may affect average rates in the future. The appraiser must also forecast a yearly percentage change in average room rates over a projection period. The key factors that influence future trends in room rates are:

- *Supply and demand relationship.* As discussed in Chapters 9 and 10, the balance between the market area's supply of transient lodging facilities and the local demand generally has a significant impact on future trends in average room rates, because hotel room rates tend to mirror changes in area occupancies.
- *Inflationary trends.* When an appraiser forecasts the income and expense of a hotel over a projection period, the occupancy usually levels off at a point in time known as the stabilized year. Until this hypothetical point of equilibrium, room rates are usually affected more by local conditions and the increased (or decreased) occupancy of the subject property than by inflationary pressures. After the level of occupancy has reached this stabilized point, and all external market conditions are assumed to be in equilibrium, the average room rate is typically projected to increase at the rate of inflation.
- *New construction.* Newly constructed lodging facilities must typically achieve room rates that are higher than the going market rate in order to cover development costs.

In addition to improving the neighborhood in which it is built, a new hotel often allows existing hotels to push average room rates up so that they are competi-

tively below the new property's rates but significantly above the current levels. However, this type of rate movement takes place only in markets that are not overbuilt. If too many new rooms open at once, the rates of every hotel in the market area will suffer.

[d] Average Rate Projection for Subject Property

Once all the previously described data has been accumulated and evaluated, the appraiser forecasts the subject's average rate over the projection period.

[2] Procedure for Proposed Hotels

The procedure for forecasting average rates for a proposed hotel is similar to that used for an existing facility except that the appraiser does not have the benefit of operating history to provide a starting point for the projection. The appraiser must therefore rely upon room-rate data for competitive properties, particularly average rates by market segment. The relative competitiveness of each property must also be carefully evaluated in order to determine the room-rate differentials necessary to maximize the subject's competitive position.

Appraisers use four basic methods to project average room rates for proposed hotels: competitive positioning, the bottom-up method, the rule of thumb approach, and the market segmentation approach. Each method has advantages and disadvantages that the appraiser must consider in light of the particular circumstances surrounding a proposed hotel. In some instances a combination of methods is used when the strengths of one can counterbalance the weaknesses of another. Each method is analyzed in the following sections.

[a] Competitive Positioning Method

The competitive positioning method forecasts the room rates of a proposed hotel by using the rates currently achieved by competitive lodging facilities. The range of average room rates established by competitive hotels is considered to set the general limits for the rates that can be achieved by the proposed hotel. The rate for the proposed hotel is then determined by the actual average room rate of the competitive property that it most closely resembles in quality, size, facilities, market orientation, and location.

Exhibit 10-13 provides the average room rates of the primary competition in a hypothetical market area,

An analysis of the attributes of these hotels reveals Hotel *F to* be the most similar of the group to the proposed property. On the basis of this conclusion, the appraiser should give the room rate achieved by Hotel *F* the most weight when setting the average rate for the proposed property. Further analysis reveals that Hotel *F's* rate of $88.00 should be scaled slightly upward for the following reasons;

- The subject property will be new when it opens. Hotel *F* will be six years old.
- Hotel *F* derives a larger percentage of its business from the meeting and convention market segment, which tends to receive greater discounts than the commercial segment.
- The subject property will have a more visible location with better access than Hotel *F*.

Exhibit 10-13 Hypothetical Market Area's Average Room Rates	
Property	**Estimated Average Room Rate**
A	$68.00
B	82.00
C	77.00
D	80.00
E	87.00
F	88.00
G	78.00
Average	$81.00

It appears that an average room rate of between $89.00 and $90.00 would be justified and reasonable for the subject property.

Advantages of the competitive positioning method are as follows:

- The dynamics of the surrounding market area are taken into account by the consideration of actual average room rates achieved by competitive properties.
- The price sensitivities of local demand are reflected in the data used in the process.
- The method is based on other local hotels, so it inherently considers area operating costs.

The disadvantages of the competitive positioning method are as follows:

- It depends on accurate average room rate information from competitive hotels, which is sometimes difficult to obtain.
- It relies on the assumption that a property, similar in almost all respects to the subject, exists in the marketplace. If such a property does not exist, subjective adjustments must be made to compensate for the differences in the subject property. The appropriateness of the ultimate result depends on the skill and experience of the appraiser. The competitive positioning method is a good way to verify that the average room rate achieved by an existing lodging facility actually reflects its competitive position in the local market.

[b] Bottom-Up Method

The bottom-up method (also known as the Hubbart Formula) assumes that a proposed hotel should charge room rates that will cover all the costs of its operation, including a predetermined net income level, debt service, and development costs. To use this method, an appraiser first determines the development and financing costs of the project. The process continues by working upward from the bottom of an income and expense statement which is tailored to the anticipated operating characteristics of the subject property, until the required room rate is derived. The required room rate, as determined by this method, directly reflects all of the predetermined development and operational considerations specific to the subject property.

Exhibit 10-14 is an abridged version of an income and expense statement for a hypothetical proposed property.

Exhibit 10-14 Abridged Income and Expense Statement	
Required Net Income*	2,883,000.00
Total Fixed Charges	878,000.00
Undistributed Operating Expenses	3,207,000.00
Required House Profit	6,968,000.00
Estimated Departmental Profits (non-rooms)	1,519,000.00
Required Rooms Profit	5,449,000.00
Estimated Rooms Expense (22.6%)	1,591,000.00
Required Rooms Revenue	7,040,000.00
Total Occupied Rooms (300 x 72% x 365)	78,840.00
Estimated Average Room Rate	$89.29

*Net income to cover debt service and rate of return on invested equity

Using the bottom-up method, it was determined, on the basis of the total project cost, the amount of the mortgage, and the resulting debt service and equity return requirements, that a net income before debt service of $2,883,000 would be required. Taking into consideration local market conditions and expense factors, estimates were made for expenses such as fixed charges, undistributed operating expenses, and rooms expense as well as several miscellaneous profits such as departmental profit. Assuming an occupancy of 72 percent, the resulting calculation indicates that an average rate of $89.29 would be necessary to generate the required net income.

While the bottom-up method can be used to estimate an average room rate, it does not take into account any local market conditions or competitive factors, which means that many marketplace factors are ignored. Thus, the bottom-up method is more appropriate for justifying project feasibility than for setting actual average room rates. For example, the foregoing computation might be better used to conclude that if the market cannot support an average room rate for the subject property of at least $89.29, then the net income before debt service of $2,883,000 would probably not be achieved, resulting in a lower than contemplated return to the invested capital components (debt and equity).

The bottom-up method of establishing an average room rate has the following advantages:

- Several property-specific factors are accounted for, including return requirements of invested capital, the property's fixed costs and operating expenses, and the contemplated level of occupancy,
- This method does not require information pertaining to the average room rates of competitive lodging facilities.

The bottom-up method has the following disadvantages:

- It does not use a market basis to evaluate the reasonableness of the average room rate estimate. This method may, therefore, result in an average room rate that is unobtainable in the local marketplace.
- This method is relatively complicated to use and is overly dependent on assumptions, such as cost and expense levels.
- It requires an estimate of occupancy for the subject property, which would probably necessitate some fieldwork to compile data on occupancy percentages of competitive lodging facilities.

[c] Rule of Thumb Method

The rule of thumb method relies on the time-honored theory that every dollar of average room rate should support approximately $1,000 of total hotel value (i.e., land, Improvements, and FF&E) on a per room basis. Exhibit 10-15 illustrates this theory.

Exhibit 10-15 Rule of Thumb Calculations	
Total Hotel Property Value	$26,780,000.00
Number of Available Rooms	- 300
Value Per Room	$89,267.00
Required Average Room Rate	$89.27
	or
Estimated Average Room Rate (market)	$89.27
Value Per Room	$89,267.00
Number of Available Rooms	X 300
Total Property Value	$26,780,000.00

These calculations show that the rule of thumb method can be used in two directions. The first calculation starts with the local property value and determines the average room rate necessary to justify this amount of investment. This procedure and its conclusion are similar to the bottom-up method in that the average room rate is not market-justified but rather illustrates economic feasibility. The second calculation starts with the average room rate, which is derived from the market, and calculates the maximum amount of total property value this room rate would be able to support.

The rule of thumb method relies on a number of assumptions, including the subject's occupancy, ratio of food and beverage revenue to rooms revenue, operating costs, fixed expenses, and capital costs. Properties that do not fit the national norms for these assumptions are apt to require more or less than $1.00 of average rate to justify $1,000 of per room value. For example, assume that this rule of thumb works for hotels with an assumed occupancy level of 72 percent. If the subject property was projected to achieve only a 68 percent stabilized occupancy then it would take more than $1.00 of average room rate to equate to $1,000 of per room value.

The advantages of the rule of thumb method are:

- It is simple to calculate and easy to use.
- It may be used to determine either an average rate based on total value, or the total value based on an achievable average rate.

The disadvantage of the rule of thumb method is that it relies upon a number of inherent assumptions that are not explicitly accounted for. For this reason, it should only be used to establish broad parameters for room rates and project value.

[d] Market Segmentation Method

The market segmentation method uses a forecasted market breakdown (i.e., commercial, meeting and group, or leisure) for the subject property as a basis for calculating

a weighted average room rate. This method involves multiplying the average room rate per market segment by the anticipated number of occupied room nights for each respective market segment that produces revenue for the hotel. The overall average room rate is then calculated by dividing the total rooms revenue by the total number of occupied rooms. The result is a weighted average room rate that reflects the price sensitivity of each segment of lodging demand. ,

Most hotel market studies and appraisals use the competitive positioning or market segmentation methods for estimating average room rates. Each method works well for all types of existing and proposed lodging facilities. However, neither of the methods are purely objective; they both rely heavily on the experience and judgment of the appraiser who conducts them.

HVS

CHAPTER 11

Revenue Forecast

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» 11.01 INTRODUCTION

Forecasting the revenue of a lodging facility is best accomplished in a step-by-step fashion that follows the format set forth in the *Uniform System of Accounts for Hotels* (Hotel Association of New York City, Inc., 8th ed. HANYC Inc., 1986). In this system, sources of income are categorized and estimated separately before they are combined in one complete statement of both revenue and expense. Most hotels follow this uniform procedure; it has become the standard format for forecasting.

The major categories of revenue in this system are room, food service, beverage, and telephone. A miscellaneous category of other income—in which smaller amounts of revenue from sources such as rentals, forfeited advance deposits, and vending machines are combined—is also usually forecasted.

The build-up cover approach and the fixed and variable component approach are the two most commonly used methods for projecting food and beverage revenue. While the build-up cover approach is used only to forecast food and beverage revenue, the fixed and variable component approach is also used to estimate other types of revenue. Where possible, appraisers use both methods as a means of verifying the accuracy of a forecasted estimate.

The build-up approach forecasts food and beverage revenue by developing estimates of individual revenue components such as patronage, number of meals served,

and average price per meal. The fixed and variable component approach is based on the anticipated relationship of food revenue to rooms revenue and beverage revenue to food revenue. The build-up approach requires knowledge of local market conditions, and it takes into account the specific facilities offered by the subject property. The fixed and variable component approach depends on data from a directly comparable hotel, but can easily be adjusted to reflect differences in occupancy levels.

This chapter explains the theory behind the fixed and variable component approach and demonstrates its application in revenue forecasts. Chapter 12 shows how it is used to make expense projections. The procedure used in the fixed and variable component approach is identical for both revenues and expenses.

» 11.02 ROOMS REVENUE

The estimated total rooms revenue is the most important component of the overall revenue forecast because it is the major source of profit for any lodging facility. It is also important because it sets the benchmark from which other revenues are projected. The procedure for forecasting rooms revenue is relatively straightforward. The appraiser multiplies the projected occupancy rate for the subject property as determined by the room-night analysis conducted earlier in the market study (see Chapter 9) by the forecasted average room rate (see Chapter 10). The result is then multiplied by the room count of the property, which is in turn multiplied by 365 days. These computations yield the total rooms revenue.

» 11.03 FOOD AND BEVERAGE REVENUE

Most full-service lodging facilities provide both food and beverage outlets for the use of their guests as well as local residents. The primary outlets found within most lodging facilities are restaurants, lounges, bars, banquet rooms, and room service. These outlets generate two kinds of income: food revenue and beverage revenue.

Food revenue is defined as revenue derived from the sale of food, including coffee, milk, tea, and soft drinks. Food sales do not include employee meals charged on hotel employees' checks, which are usually an adjustment to food cost. Beverage revenue is defined in the *Uniform System of Accounts for Hotels* as revenue derived from the sale of alcoholic beverages. In addition to the revenue generated by the sale of food and beverages, hotels generally produce related income from meeting room rental, cover charges, service charges, and miscellaneous banquet revenue.

[1] Food Revenue

Exhibit 11-1 lists the various revenue categories included in the food department of a hotel. The table also shows whether the category is relatively fixed, occupancy sensitive, rate sensitive, or food sensitive. This information is useful when food revenue is projected through use of a fixed and variable component approach.

Food revenue varies greatly, depending on the number of outlets, the management expertise, and the market orientation of each outlet. External factors such as the competitive environment, proximity to demand generators, and the market segmentation of a hotel also influence the revenue-generating potential of a food outlet.

Exhibit 11-1 Food Revenue

Source: Uniform System of Accounts for Hotels

Category	Percent of Sales	Fixed Revenue	Variable Revenue: Occupancy-Sensitive	Variable Revenue: Rate-Sensitive	Variable Revenue: Food- and Beverage-Sensitive
Food	60–85	—	Moderately	—	Highly
Beverage	15–40	—	Moderately	—	Highly
Other income					
Public Room Rentals	0–2	—	Moderately	—	Slightly
Cover and Minimum Charges	0–2	—	Moderately	—	Highly
Sundry Banquet Income	0–2	—	Slightly	—	Highly

Food revenue is calculated by multiplying factors for demand and average check. The unit of demand used to quantify food volume is the cover, which represents one meal served to one person. This term originates from the cover plate in each place setting that is removed just prior to the appetizer course. The number of patrons served during each meal period is simply determined by counting the cover plates that were used. The average check is similar in concept to average room rate and is calculated by dividing the total food revenue for a period of time by the number of covers served. (Generally, the average check is calculated separately for food revenues and beverage revenues.)

[a] Build-Up Cover Approach

The build-up cover approach is a means of forecasting demand for food service by estimating the total number of covers a property is expected to sell. The forecast of food revenue is then determined by multiplying the total number of covers by the estimated average check. The appraiser can project demand (i.e., number of covers) by analyzing either restaurant activity or lodging activity.

The analysis of restaurant activity also involves multiplying turnover—the number of times a seat is occupied during a given meal period—by the number of seats available per meal period. By totaling the number of covers for each meal period for all of the food services of a property during the projection period, the appraiser can approximate total food demand.

Eating- and drinking-place sales statistics are used to formulate two restaurant market indexes for approximately 300 U.S. metropolitan areas. Since 1968, Market Statistics, a division of Bill Communications, Inc., has published restaurant data and statistics in *Restaurant Business* magazine. This information is summarized in two indexes.

1. Restaurant Activity Index (RAI)
2. Restaurant Growth Index (RGI)

The restaurant activity index (RAI) measures an area's eating-place sales activity relative to its food store sales and compares this ratio with the national average. More specifically, it is the ratio of an area's eating-place sales (expressed as a per-

centage of total U.S. eating-place sales) to the area's food store sales (expressed as a percentage of total U.S. food store sales). Eating-place sales include retail sales of restaurants and lunch rooms, cafeterias, fast-food sales, banquets, and sales of specialty foods such as those found in ice cream and frozen yogurt stands. Drinking-place sales are excluded.

The national average is the index base, expressed as 100, and a specific area is compared with the national average by the following formula.

RAI = Percentage of U.S. Eating-Place Sales Located in the Market/ Percent of U.S. Food Store Sales Located in the Market

If the resulting number is larger than 100, it indicates a greater than average propensity to eat away from home. Some of the reasons why a restaurant activity index may be greater than 100 include the fact that local citizens dine out more than the national average or that local restaurants receive non-local patronage from sources such as transient vehicular traffic, hotel guests, conventioneers, vacationers, or residents of nearby communities.

An index lower than 100 indicates that an area's percentage of dining out sales is lower than that of the nation as a whole. This may be attributed to an insufficient number of restaurants, which forces residents to dine out in neighboring metropolitan areas, and restaurants situated in neighboring metropolitan areas that draw patronage away from local outlets.

The purpose of the restaurant activity index is to indicate the current level of dining-out activity, and further analysis must be made to identify the reasons for this level.

The restaurant growth index (RGI) presents the relationship between restaurant supply and demand in the form of an index. When supply equals demand, the index is 100. The mathematical equation used to calculate RGI is as follows.

RGI = Demand/Market's Percentage of U.S. Total Eating Place Sales X 100

In the foregoing equation, demand is an average of the market's share of the following five variables: the number of working women (this figure is multiplied by two to give it extra weight), U.S. households with effective buying incomes of $25,000 or more, U.S. eating-place sales, U.S. hotel and motel receipts, and the U.S. population under the age of 14 and between the ages of 25 and 44. Multiplying by 100 ensures that the final figure will be in an index form.

The amount by which the RGI exceeds 100 indicates the growth potential that is present. For example, an RGI of 120 indicates that the current market area is underdeveloped and could support an approximate 20% increase in the number of food and beverage facilities. When the market is saturated, the index will drop below 100. The lower the number, the more saturated the market.

Both the RAI and RGI should be evaluated concurrently in order to make a proper determination of an area's future restaurant potential.

Turnover is generally estimated by determining the actual past turnover experienced by the subject property if it has an operating history; if not, by that of similar facilities in the market area.

If the appraiser has no operating history to refer to, data for similar outlets can be used. The necessary information can usually be obtained through discussions with the management of the hotels in which the outlets are operated or by actually surveying and counting the number of patrons served during specific meal periods in such outlets. Once the turnover has been estimated for each of the food outlets, it is multiplied by the number of seats, meal periods, and business days to arrive at a forecast of the total number of covers the property will sell.

There are, however, two drawbacks to the analysis of restaurant activity. The first is that it can be difficult to obtain accurate turnover ratios from competitive facilities. The second is that adjustments must be made to the data that are needed to reflect the attributes of the subject property. This procedure requires a number of subjective decisions on the part of the appraiser and can become quite complicated.

Projecting food demand by the analysis of lodging activity is justified by the fact that the number of covers sold by a hotel is directly related to guestroom usage (room-night demand) and market segmentation. Through statistical analysis and knowledge of the frequency with which each market segment makes use of a hotel's facilities, the total in-house demand can be estimated. The appraiser then combines the in-house forecast with a factor for demand created outside the hotel (i.e., meeting and banquet business) to forecast the total number of covers the property will sell.

The analysis of lodging activity takes into account the total house count (number of people occupying the guestrooms) and the patronage patterns of the different market segments into which the guests fall. Since in-house demand typically accounts for 60 percent to 80 percent of the food and beverage sales for a hotel (depending on hotel type, location, and proximity to alternative dining facilities), the analysis of lodging activity generally produces a more supportable estimate of food demand than does the analysis of restaurant activity.

To project future total food revenue using an analysis of lodging activity, the appraiser must take the following steps:

1. Calculate the total house count by market segment using the projected occupancy and double occupancy estimates derived during the room-night analysis and the average room rate analysis.
2. Apply the percentage of each market segment that patronizes each of the proposed subject's food outlets by meal period to the total house count to yield the approximate future in-house food service demand in each of the market segments.
3. Estimate the out-of-house demand generated from non-hotel guests using a hotel's restaurant facilities either on a per-cover basis or as a percentage of total demand to yield out-of-house restaurant demand.
4. Estimate total banquet covers served to non-hotel guests based on the product of the average number of banquets per week and the average number of covers per banquet or the average number of banquet covers per day.
5. Determine total food service demand by adding together in-house food service demand, out-of-house restaurant demand, and non-hotel guest banquet demand.
6. Estimate the average check for each meal period based on the operating history of either the subject property or similar competitive food facilities in the marketplace.
7. Multiply the average check for each meal period by the estimated total number of covers (per year) for that meal period to yield the total food revenue.

[i] **House count.** The term "house count" refers to the number of guests that stay at a hotel over a specific period of time (usually one year). This quantity is used to determine the rate of double occupancy, which is the average number of guests occupying one guestroom. The double occupancy rate is calculated by dividing the house count for the year by the number of occupied rooms for the same period of time, as in the following example:

House Count/Occupied Rooms = 85,252/64,659 = 1.32

Thus, every guestroom sold within this hotel had an average of 1.32 occupants. The commercial market segment is typically composed of individual business travelers; as a whole, therefore, it has a low rate of double occupancy (1 to 1.4). Meeting and convention demand generally has a higher rate. Commercial groups (i.e., business meeting attendees) typically have a lower double occupancy rate (1.35 to 1.50) than social groups, which are sometimes more price sensitive and thus produce a range of double occupancy of 1.5 to 2.0. Leisure travelers are typically families, for which the double occupancy rate is 1.7 to 2.5.

[ii] **In-house capture.** In-house capture is based on the propensity of each hotel guest to use the property's food outlets. Capture differs depending upon the market segment, meal period, and type of food facility available.

For example, commercial travelers exhibit a higher than average propensity to take breakfast at the property's facilities, especially from room service. The meeting and convention segment exhibits mixed propensities to dine at the subject's facilities, depending on whether the meeting or convention is held within the hotel, and whether a planned breakfast is provided to the group. Similarly, leisure travelers also show a mixed propensity to use in-house facilities. This segment tends to forgo breakfast on weekdays, but has a high tendency to order breakfast or brunch on the weekends.

In-house capture also varies by meal period. In most hotels there is a fairly strong breakfast demand from guests, especially on the weekends if the restaurant offers brunch. Typically, the lunch meal period captures little in-house traffic. Because few guests are in the hotel at midday, lunch demand is predominantly from local business people and shoppers, depending on the hotel's location and proximity to office buildings and retail outlets. The hotel's dinner demand usually depends on the dining alternatives in the local area. If suitable alternatives exist, commercial and leisure travelers do not usually dine at the hotel's food outlets. Meeting and convention guests often have planned functions at night and will therefore create little dinner demand.

[iii] **Out-of-house restaurant demand.** Food service patronage from local clientele (outside capture) includes demand generated by nearby residents, business people, and transients passing through the area. Out-of-house restaurant demand can be calculated as a percentage of total food service demand excluding banquet patronage. Typical ranges of out-of-house demand percentages are listed in Exhibit 11-2.

Exhibit 11-2 Out-of-House Demand Percentages

Meal Period	Percentage of total food demand excluding banquet patronage
Breakfast	5%–15%
Lunch	30%–70%
Dinner	20%–60%

Out-of-house restaurant demand is generally lowest during breakfast and highest at lunch. Dinner demand is variable, depending on the quality of the facilities of the subject property and the local dining alternatives.

Most new hotels typically experience a high out-of-house restaurant demand during the initial year or two as local residents and business people try out the new

food outlets. As the appeal of the hotel's novelty subsides, out-of-house usage generally declines. Overall, the percentage of total food demand (excluding banquet patronage) remains constant albeit minimal for breakfast, but generally declines for lunch and dinner.

[iv] **Banquet demand.** Banquet covers are estimated separately and are based on the product of the average number of banquets per week multiplied by the average number of covers per banquet. Banquet covers are assumed to be out-of-house patronage. Use of banquet facilities by in-house meeting and convention patronage is included in estimates of overall food service use.

[b] Fixed and Variable Component Approach

The second approach that may be used to forecast food revenue is the fixed and variable component approach. The forecasting procedures used in this approach represent one of the most accurate models of hotel financial performance. With proper input, it can produce reliable forecasts of every category of hotel revenue and expense. The fixed and variable component approach forms the basis for most computerized hotel forecasting models employed by hotel appraisal and consulting firms as well as by a number of hotel companies, investors, lenders, and developers.

This approach is based on the concept that most items of revenue and expense within a hotel have a fixed component, which does not vary with a hotel's occupancy or other volume measure, and a variable component, which changes in direct relationship with occupancy or another measure of volume (e.g., total revenue). By estimating the food revenue for a specific level of occupancy and knowing what portion of the revenue is fixed and what portion is variable, the appraiser can calculate the revenue for other different levels of occupancy.

For an existing hotel, the estimate of food revenue at the specific occupancy level is based on past operating history. For a proposed facility, the food revenue estimate is derived from either the actual sales volume of a similar facility or the percentage relationship of food revenue to rooms revenue and beverage revenue to food revenue of a similar facility.

This same procedure can be used to project all categories of revenues and expenses found in a hotel's operating statement. It should be noted, however, that not all categories vary directly with occupancy. For example, food departmental expense varies with food revenue, telephone expense varies with telephone revenue, administrative and general expense varies with total revenue, and energy cost varies with total revenue.

To use the fixed and variable component approach to make financial forecasts, the appraiser must complete the following steps:

1. Obtain actual income and expense data from the subject property for an existing hotel, or from similar properties for a proposed hotel.
2. Make any necessary adjustments to this data so it reflects as closely as possible the individual characteristics of the subject property. These adjustments may include changing the average room rate, modifying income and expense ratios, and altering fixed charges. The end result of these changes should be a one-year profit-and-loss statement that expresses the undiscounted first year average room rate for the subject in current dollars, and income and expense ratios at a level appropriate for the given occupancy percentage. This profit and loss statement is called the base and will serve as the basis for calculating the fixed and variable component relationships.

3. Inflate (or deflate) the revenue and expense numbers in the base to a level that reflects current dollars for the forecast year. The average room rate used in the base comes from the average rate projection. Any discounting of the average rate is disregarded in developing the base for each projected year.
4. Estimate the fixed and variable percentages for each revenue and expense category. Exhibit 11-3 lists typical ranges of fixed and variable percentages along with the index used to measure variable changes.

Exhibit 11-3 Fixed and Variable Percentages for Revenues and Expenses

Revenues and Expense Category	Percent Fixed	Percent Variable	Index of Variability
Revenues			
Food	25-50	50-75	Occupancy
Beverage	0-30	70-100	Food Revenue
Telephone	10-40	60-90	Occupancy
Other Income	30-60	40-70	Occupancy
Departmental Expenses			
Rooms	50-70	30-50	Occupancy
Food and Beverage	35-60	40-65	Food and Beverage Revenue
Telephone	55-75	25-45	Telephone Revenue
Other Income	40-60	40-60	Other Income
Undistributed Operating Expenses			
Administrative and General	65-85	15-35	Total Revenue
Management Fee	0	100	Total Revenue
Marketing	65-85	15-35	Total Revenue
Franchise Fees	0	100	Rooms Revenue
Repairs and Maintenance	55-75	25-45	Total Revenue
Energy	80-95	5-20	Total Revenue
Fixed Expenses			
Property Taxes	100	0	Total Revenue
Insurance	100	0	Total Revenue
Reserve for Replacement	0	100	Total Revenue

5. Calculate the fixed component by multiplying the appropriate base revenue or expense category for the projected year by the fixed percentage estimated in Step 4.
6. Calculate the variable percentage change. Variable revenues or expenses are assumed to vary directly with some index of variability. Exhibit 11-2 shows the appropriate index of variability for each revenue and expense category. The variable expense change is calculated by dividing the projected index of variability by the base index of variability for the projected year.

7. Calculate the unadjusted variable component by multiplying the appropriate base revenue or expense category for the projected year by the variable percentage estimated in Step 4.
8. Adjust the unadjusted variable component for variability by multiplying it by the variable percentage change calculated in Step 6. The resulting product is the adjusted variable component.
9. Total the forecasted revenue or expense for that specific category, in the projected year, by adding the fixed component calculated in Step 5 to the adjusted variable component calculated in Step 8.

[c] Test for Reasonableness

After making a financial projection, the appraiser should evaluate the result for reasonableness. The appraiser must determine whether the result is sensible (i.e., whether it is supported by the results achieved by similar hotels), whether it is likely that the subject property can actually achieve the projected figures, and finally, whether the individual projection is in line with all of the other projections.

To evaluate financial operating information, the appraiser generally uses various categories of data—for example, percentage of total revenue, percentage of rooms revenues, dollars per available room, and dollars per occupied room. These units of comparison put the financial data on a common base (e.g., amount per room) so that the operating results of many hotels can be compared and contrasted.

Each unit of comparison is better suited to certain revenue or expense categories than others. The applicability of certain units is due to specific relationships that cause various revenues and expenses to react differently to changes in occupancy, average room rate, and food and beverage volume. For example, if a revenue or expense category is primarily fixed, then greater emphasis should be placed on the dollars per available room as a unit of comparison, since it remains fixed even when revenues change. If the category varies in relation to changing occupancy levels or average room rates, the appropriate unit of comparison would be percentage of rooms or total revenue data, which will change in accordance with changes in revenues. Exhibit 11-4 shows the primary units of comparison used in the analysis of hotel financial data along with the factors that affect the sensitivity of these units. Listed next to each unit of comparison are the revenue and expense categories best suited for the particular form of comparison.

[2] Beverage Revenue

Beverage revenue is derived through the sale of beverages (generally alcoholic) from a hotel's restaurants, lounges, banquet rooms, and room service. In accordance with the *Uniform System of Accounts for Hotels*, beverage revenue should be given a category separate from food revenue (although it should share the same expense category).

Beverage revenue can be forecasted in a manner similar to food revenue by using either a build-up cover approach or a fixed and variable component approach. The main difficulty in preparing forecasts of beverage revenue is estimating the future success of an in-house bar or lounge. Because the bulk of beverage revenue generally comes from a lounge outlet, the appraiser should have a clear understanding of the various dynamics that create success or failure in this type of business. Lounge customers tend to be fickle, so one year's "in" spot may be unpopular the next. Much

of the success has to be attributed to the skills and expertise of management, which means there is a high degree of business risk (and opportunity) in operating a hotel lounge,

Exhibit 11-4 Primary Units of Comparison

Unit of Comparison	Sensitivity Factors	Revenue and Expense Categories Analyzed
Percentage of total revenue	Occupancy Average room rate Food and beverage revenue	Administrative and general Management Fee Marketing Property Operations and maintenance
Percentage of rooms revenue	Occupancy Average room rate	Food revenue Telephone revenue Other income Rooms expense
Percentage of food and beverage revenue	Food and beverage revenue	Food and beverage revenue
Per available room	Fixed categories	Administrative and general Marketing Property operations and maintenance Energy Insurance Property taxes
Per occupied room	Occupancy	Food revenue Beverage revenue Telephone revenue Other income Rooms expense Energy

[a] Build-Up Cover Approach

The build-up cover approach for forecasting beverage revenue is handled in a manner similar to that for projecting food revenue. The appraiser first looks at the percentage of the business that will be generated by in-house guests and the percentage that will originate outside the property. If the hotel lounge has any degree of success, a substantial portion of the beverage revenue will come from patrons who are not hotel guests. In addition to the demand generated from the beverage outlets, a certain amount of beverage revenue originates from liquor consumption by in-house restaurant-goers.

[b] Fixed and Variable Component Approach

As with food revenue, the fixed and variable component approach is generally the preferred procedure for forecasting this category of income. Exhibit 11-2 shows that beverage revenue is typically 70 percent to 100 percent variable and 0 percent to 30 percent fixed. Because of this high variability, which is attributable to the direct relationship between food and beverage revenues, an assumed 100 percent variable component is normally used.

» 11.04 TELEPHONE REVENUE

Telephone revenue is derived from fees paid by hotel guests for local and long distance calls and from out-of-house patrons' use of public telephones. As part of the deregulation of the telephone industry, hotels are now permitted to resell telephone services to their guests at a reasonable profit. Prior to deregulation, hotels could collect only a 15 percent commission on long distance telephone calls, which was usually inadequate compensation, and many hotels suffered losses as a result of providing telephone service. At present, hotels have highly sophisticated telephone systems that incorporate automatic billing and posting to guest accounts, least-cost routing, and use of various providers of long distance services (e.g., AT&T, MCI, and US SPRINT). Hotel telephone departments are now more likely to show some profit, although revenues depend largely on the usage characteristics of the guests.

In recent years, long distance telephone charges billed by hotels to individual guests have decreased significantly because many long distance carrier services can be accessed by either a toll-free local call or an 800 number. Callers are generally charged merely an access fee rather than the normal long distance tariff. As a result, profits from telephone service have not grown as rapidly as the hotel industry had expected with telephone deregulation.

As a rule, telephone revenue varies directly with changes in occupancy. A small portion is fixed, representing pay station revenue generated by out-of-house patronage of food and beverage outlets and meeting rooms. The appropriate units of comparison are a percentage of rooms revenue or an amount per occupied room. Exhibit 11-5 lists the various categories of telephone revenue and describes their individual characteristics.

Exhibit 11-5 Telephone Revenue

Source: Uniform System of Accounts for Hotels

			Variable Revenue		
Category	Percent of Sales	Fixed Revenue	Occupancy-Sensitive	Rate-Sensitive	Food- and Beverage-Sensitive
Local	25-60	—	Highly	—	—
Long distance	35-60	—	Highly	—	—
Service charge	0-20	—	Highly	—	—
Pay station	0-20	Somewhat	—	—	Somewhat

Telephone revenue is normally projected through the fixed and variable component approach, with 10 percent to 40 percent of the revenue being fixed and 60 percent to 90 percent occupancy-variable. The fixed component represents the out-of-house use of pay phones as well as telephone service for meetings and conferences.

» 11.05 OTHER INCOME

Other income is revenue derived from sources other than guestroom, food and beverage, or telephone sales. The following is a list of the most common categories of other income with examples of specific sources:

- Rentals: Stores, office space, concession space, showcases, clubs, and storage.
- Commission: Auto rental, photography, telegram, and vending services.

- Concessions: Gift shops, barber shops, and beauty salons.
- Cash discounts earned: Discounts from creditors' accounts for payment within the discount period (does not include trade discounts, which count as a deduction from cost of goods sold).
- Electronic games and pinball machines.
- Forfeited advance deposits and guaranteed no-shows.
- Service charges: Charges added to customer's account for service.
- Interest income: Interest from moneys invested.
- Salvage; Revenue from the sale of old and obsolete items.
- Vending machines.

Other income is highly occupancy sensitive and slightly food-and-beverage sensitive, which means that the appropriate units of comparison are a percentage of rooms revenue adjusted for any unusual food-and-beverage volume and other income per occupied room. Care must be taken when projecting other income to evaluate all the potential sources of revenue. Hotels with extensive retail space or recreational amenities should divide other income into several categories so as to recognize and properly account for significant revenue generators.

» 11.06 TOTAL REVENUE

Total revenue is the sum of the rooms revenue, food revenue, beverage revenue, telephone revenue, and other income for the subject property. Projected total revenue is an important data point because it will serve as a unit -of comparison and an index of variability for several expense categories.

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CHAPTER 12

Expense Forecast

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» 12.01 INTRODUCTION

After the forecasted revenue for a proposed property has been determined, the next task for the appraiser is to project the expenses that the property would be likely to incur. Expenses for lodging facilities should be categorized according to the standardized system outlined in *Uniform System of Accounts for Hotels* (Hotel Association of New York City, Inc., *Uniform System of Accounts for Hotels* (8th ed.), HANYC, Inc., 1986). The accounts in this system include rooms, food and beverage, telephone, other, administrative and general, management fees, marketing, property operations and maintenance, energy, property taxes, insurance, and reserve for replacement.

Each expense account should be analyzed separately and projected independently of any other, because each account has unique fixed and variable characteristics. As part of this process, the appraiser divides each major account into its component categories. Each category should then be evaluated on the basis of

whether it is fixed or varies with differing levels of occupancy, room rate, or food and beverage volume. The fixed and variable method of forecasting expenses, which can also be used to forecast revenues, is discussed in Chapter 11.

The fixed and variable approach to forecasting hotel revenues and expenses involves the following steps:

1. The financial statements of comparable hotels form the basis for forecasting revenue and expense items. If the subject property is an existing hotel, its historical operating performance is considered in formulating projections. For proposed hotels, the appraiser must rely on the operating results of comparable properties.
2. The comparable financial statements are adjusted to reflect the unique characteristics of the subject property, so as to create a one-year financial statement using the subject property's undiscounted first-year's average income and expense ratios representing the occupancy level actually experienced by either the subject or comparable hotels. This procedure yields a base-year profit-and-loss statement that can be used to determine the relationship between the fixed and variable components.
3. The base-year revenue and expense amounts are inflated or deflated to reflect current dollars for each projection year. The rate of inflation reflects the anticipated price change for the individual line item in the income and expense statement. This step is performed to adjust the comparable financial data that constitutes the base to the inflated dollars anticipated for that particular year.
4. The fixed and variable percentages of each income and expense item are estimated. Exhibit 12-1 illustrates typical fixed and variable percentages and the index used to measure change in the variable component.

The index of variability refers to a factor that controls the movement of the variable component. For example, the variable component of food revenue changes with occupancy; beverage revenue is tied directly to food revenue; and food and beverage expense is largely dependent on food and beverage revenue. The variable component of undistributed operating expenses and fixed expenses is correlated with revenue.

5. Each individual line item is projected separately. The fixed component is estimated by multiplying the appropriate fixed percentage by the inflated base-year revenue or expense for the corresponding projection year.
6. The variable components are assumed to be in accordance with the index of variability set forth in Step 4. The amount of change is quantified by dividing the appropriate projected index of variability by the index of variability for the base year.
7. The unadjusted variable component is calculated by multiplying the appropriate base revenue or expense category for the projection year by the variable percentage estimated in Step 4.
8. The unadjusted variable component is adjusted for variability by multiplying the results of Step 7 by the variable percentage change calculated in Step 6. The resulting product is known as the adjusted variable component.
9. The forecasted revenue or expense is the total of the fixed component calculated in Step 5 and the adjusted variable component calculated in Step 8.

The fixed and variable approach can be illustrated graphically. Exhibit 12-2 shows the subject's rooms department expense as of the stabilized year.

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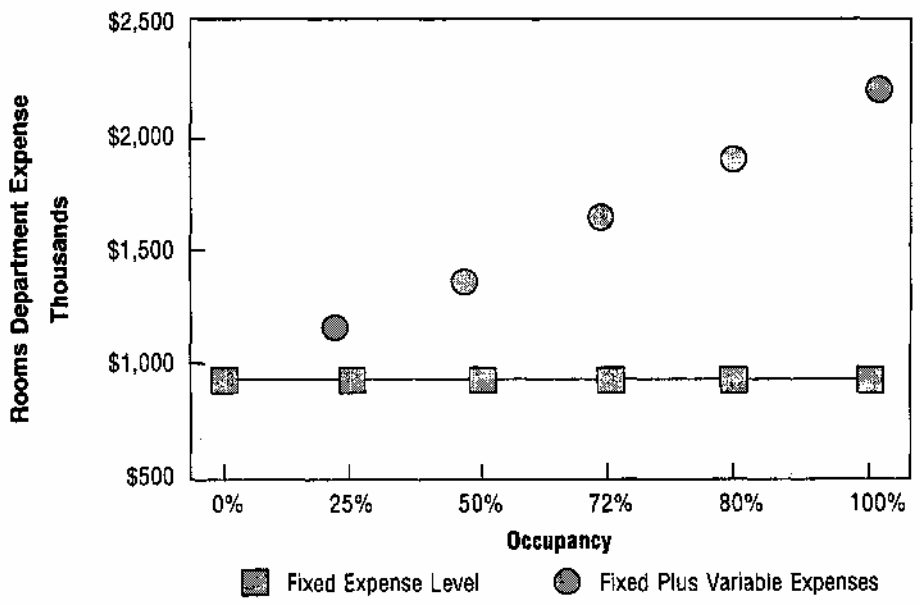
Exhibit 12-1 Range of Fixed and Variable Expenses

Revenue and Expense Category	Percent Fixed	Percent Variable	Index of Variability
Food	25-50	50-75	Occupancy
Beverage	0-30	70-100	Food Revenue
Telephone	10-40	60-90	Occupancy
Other Income	30-60	40-70	Occupancy
Departmental Expenses			
Rooms	50-70	30-50	Occupancy
Food and Beverage	35-0	40-65	Food and Beverage Revenue
Telephone	55-75	25-45	Telephone Revenue
Other Income	40-60	40-60	Other Income
Undistributed Operating Expenses			
Administrative and General	65-85	15-35	Total Revenue
Management Fee	0	100	Total Revenue
Marketing	65-85	15-35	Total Revenue
Franchise Fees	0	100	Rooms Revenue
Repairs and Maintenance	55-75	*25-45*	Total Revenue
Energy	80-95	5-20	Total Revenue
Fixed Expenses			
Property Taxes	100	0	Total Revenue
Insurance	100	0	Total Revenue
Reserve for Replacement	0	100	Total Revenue

Exhibit 12-2 Illustration of Fixed and Variable Relationship of Rooms Expense



» 12.02 ROOMS EXPENSE

Rooms expense consists of all the costs involved in the sale and upkeep of guestrooms and public space. The individual categories of rooms expense are moderately occupancy-sensitive and slightly rate-sensitive, which means that a portion of the overall expense is fixed and the remainder is occupancy-variable.

Salaries, wages, and employee benefits represent a substantial portion of rooms expense. Although part of the payroll cost is occupancy-variable, because management can schedule maids, bell personnel, and house cleaners to work on an as-needed basis when occupancy requires, much of the rooms payroll is actually fixed. Many positions, including front desk personnel, public area cleaners, and the housekeeper and other supervisory staff, must be maintained at all levels of occupancy. As a result, salaries, wages, and employee benefits are only moderately occupancy-sensitive.

Commissions represent remuneration to travel agents for booking rooms business. Because these charges are usually based on a percentage of rooms revenue, they are very sensitive to occupancy and average room rate. Reservations incur a similar expense that reflects the cost of a franchise reservation system, which is typically a certain percentage of rooms revenue. Other rooms expense categories such as laundry, linen, supplies, and uniforms are also somewhat affected by volume and are therefore slightly occupancy-sensitive.

Rooms expense is strongly influenced by changes in occupancy and average room rates, so the appropriate units of comparison that the appraiser should use to project rooms expense are a percentage of rooms revenue and an amount per occupied room. The projection derived from these quantities is then compared with a similar hotel's rooms expense.

The ratio of rooms expense to rooms revenue, the "rooms expense ratio," is an important statistic that often is a key indicator of the skill and effectiveness of management. Unless a hotel suffers from an extremely low level of occupancy or an unusually depressed average room rate, rooms expense should not exceed 25 percent of rooms revenue. If rooms expense is greater than this amount, problems may exist that warrant ownership investigation.

Rooms expense projections are usually made using the fixed and variable component approach, with 50 percent to 70 percent of the expense being fixed and 30 percent to 50 percent occupancy-variable. For example, it is estimated in Exhibit 12-3 that 60 percent of rooms expense is fixed and 40 percent varies with occupancy.

» 12.03 FOOD AND BEVERAGE EXPENSE

Food and beverage expense consists of the expenditures that must be made to operate the food, beverage, and banquet facilities of a hotel. Although food revenue and beverage revenue are normally projected individually and entered separately in an income and expense statement, the expenses for these two revenue sources are combined into a single entry.

The majority of food and beverage expense is made up of the cost of sales, salaries, and wages. These components are moderately to highly food-and-beverage-sensitive in that they vary directly with changes in food and beverage volume. The other associated costs (e.g., laundry and dry cleaning, operating supplies, and uniforms) tend to be either slightly food-and-beverage-sensitive or moderately fixed (i.e., they vary only slightly with changes in occupancy or room rates, or food and beverage volume). Given the nature of the components of food and beverage expense,

Exhibit 12-3 Forecast of Rooms Department Expense ($ thousands)				
	1996	**1997**	**1998**	**Stabilized**
Base Rooms Expense	$1,400	$1,456	$1,514	$1,575
Percent Fixed	60%	60%	60%	60%
Rooms Expense Fixed Component	$840	$873	$908	$945
Base Rooms Expense	$1,400	$1,456	$1,514	$1,575
Percent Variable	40%	40%	40%	40%
Unadjusted Variable Component	$560	$582	$606	$630
Unadjusted Variable Component	$560	$582	$606	$630
Variable Percentage Change	0.9854	1.0157	1.0612	1.0915
Adjusted Variable Component	$552	$591	$643	$687
Fixed Component	$840	$873	$908	$945
Adjusted Variable Component	$552	$591	$643	$687
Total Rooms Expense	$1,392	$1,465	$1,551	$1,632
Percent of Rooms Revenue	23.5%	23.1%	21.7%	20.5%
Amount Per Available Room	$5,352	$5,634	$5,966	$6,278
Amount Per Occupied Room	$22.57	$23.04	$23.35	$23.88

the appropriate unit of comparison is a percentage of food and beverage revenue. When this unit of comparison is used, the appraiser should select comparable hotels with similar ratios of beverage to food. The profit margin from the sale of beverages is considerably higher than that from the sale of food, so a hotel with a higher ratio of beverage to food should have a lower food and beverage expense ratio. The reverse is true as the ratio of beverage to food sales declines.

As with rooms expense, the ratio of food and beverage expense to food and beverage revenue is a benchmark that can be used to evaluate the skill and effectiveness of a hotel's management. Many hotel operators run a highly efficient rooms department but lose thousands of dollars through poorly managed food and beverage service. Unless a hotel has an extremely low volume of food and beverage revenue or suffers from an unusually high cost of labor, food and beverage expense should not exceed 80 to 83 percent of food and beverage revenue. Food and beverage expense in excess of this amount may indicate poor management.

Food and beverage expense is normally projected through the fixed and variable component approach, with 35 percent to 55 percent of the expense being fixed and 45 percent to 65 percent variable. The appropriate index of variability for food and beverage expense is food and beverage revenue. This means that the variable portion of the food and beverage expense category will vary directly with changes in food and beverage revenue.

Exhibit 12-4 assumes that 55 percent of food and beverage revenue is fixed and that 45 percent varies with food and beverage revenue in its calculation of the subject property's food and beverage expense.

Exhibit 12-4 Forecast of Food and Beverage (F&B) Department Expense ($ thousands)				
	1994	**1995**	**1996**	**Stabilized**
Base F&B Expense	$1,221	$1,270	$1,321	$1,374
Percent Fixed	55%	55%	55%	55%
F&B Expense Fixed Component	$672	$699	$726	$756
Base F&B Expense	$1,221	$1,270	$1,321	$1,374
Percent Variable	45%	45%	45%	45%
Unadjusted Variable Component	$550	$572	$594	$618
Unadjusted Variable Component	$550	$572	$594	$618
Variable Percentage Change	0,9890	1.0116	1.0464	1.0690
Adjusted Variable Component	$543	$578	$622	$661
Fixed Component	$672	$699	$726	$756
Adjusted Variable Component	$543	$578	$622	$661
Total F&B Expense	$1,215	$1,277	$1,348	$1,416
Percent of Food and Beverage Revenue	93.3%	92.2%	90.5%	89.5%
Amount Per Available Room	$4,674	$4,910	$5,186	$5,447
Amount Per Occupied Room	$19.70	$20.08	$20,29	$20,72

» 12.04 TELEPHONE EXPENSE

Telephone expense consists of all of the costs associated with the operation of a hotel telephone department. For smaller hotels with automated phone systems, the telephone department may be as simple as an additional responsibility for the front desk personnel; in large properties, the telephone department usually has one or more full-time telephone operators to provide the necessary service to the guests.

The bulk of telephone expense is the cost of local and long distance calls that are billed by the telephone companies that service the hotel. Because most of these calls originate from in-house guests, these expenses are moderately occupancy sensitive. Unless a particular department has unusually heavy telephone usage, the normal use of telephone services by hotel employees is charged to the telephone expense account. The remaining costs, such as salaries and wages, miscellaneous expenses, and printing, are all moderately fixed. In light of a recent modification of accounting categories in the *Uniform System of Accounts for Hotels* that reallocates equipment rental expense from the telephone expense account to that of rent, taxes, and insurance, the appraiser should take careful note of the accounting for telephone equipment rental or lease expense.

Given the nature of the components of total telephone expense and in view of the fact that the cost of telephone service is largely driven by the in-house usage that generates telephone revenue, the appropriate unit of comparison is a percentage of telephone revenue.

Telephone expense is normally projected through the fixed and variable component approach, with the expense being 55 percent to 75 percent fixed and 25 percent to 45 percent directly variable with telephone revenue. The fixed component is the

operational usage of telephone services by hotel employees along with the normal fixed line charges from the telephone companies. The variable expense is the actual usage by hotel guests, which corresponds directly with telephone revenue.

In Exhibit 12-5, telephone expense is estimated to be approximately 60 percent fixed and 40 percent variable.

Exhibit 12-5 Forecast of Telephone Department Expense ($ thousands)

	1996	1997	1998	Stabilized
Base Telephone Expense	$149	$155	$162	$168
Percent Fixed	60%	60%	60%	60%
Telephone Expense Fixed Component	$90	$93	$97	$101
Base Telephone Expense	$149	$155	$162	$168
Percent Variable	40%	40%	40%	40%
Unadjusted Variable Component	$60	$62	$65	$67
Unadjusted Variable Component	$60	$62	$65	$67
Variable Percentage Change	0.9881	1.0124	1.0532	1.0818
Adjusted Variable Component	$59	$63	$68	$73
Fixed Component	$90	$93	$97	$101
Adjusted Variable Component	$59	$63	$68	$73
Total Telephone Expense	$149	$156	$165	$173
Percent of Telephone Revenue	64.9%	64.0%	62.5%	61.5%
Amount Per Available Room	$572	$600	$635	$667
Amount Per Occupied Room	$2.42	$2.45	$2.48	$2.53

» 12.05 OTHER INCOME EXPENSE

Other income expense includes all of the costs that are associated with the corresponding other income revenue, such as rentals, forfeited advance deposits, and vending machine revenues. The extent of these expenses depends on the nature of the revenue. For example, if a hotel leases a gift shop in its lobby, the cost to the hotel would be minimal, consisting of such items as rental fees and commissions. If, on the other hand, the hotel operated the gift shop, both the revenue and expenses would be higher; revenue would include the proceeds from products sold, and expenses would include the cost to purchase products to sell, payroll, and so forth.

On the basis of an analysis of the components that constitute other income expense, the appropriate unit of comparison is a percentage of other income revenue.

Other income expense is normally projected by the fixed and variable component approach, with 40 percent to 60 percent of the expense being fixed and 40 percent to 60 percent varying directly with other income revenue.

Exhibit 12-6 presents the calculation of the subject property's Other Income expense. Income expense is estimated to be 70 percent fixed, with 30 percent varying directly with other income.

Exhibit 12-6 Forecast of Other Income Expense ($ thousands)				
	1996	**1997**	**1998**	**Stabilized**
Base Other Income Expense	$81	$85	$88	$82
Percent Fixed	70%	70%	70%	70%
Other Income Expense Fixed Component	$57	$59	$62	$64
Base Other Income Expense	$81	$85	$88	$92
Percent Variable	30%	30%	30%	30%
Unadjusted Variable Component	$24	$25	$26	$27
Unadjusted Variable Component	$24	$25	$26	$27
Variable Percentage Change	0.9943	1.0066	1.0166	1,0295
Adjusted Variable Component	$24	$26	$27	$28
Fixed Component	$57	$59	$62	$64
Adjusted Variable Component	$24	$26	$27	$28
Total Other Income Expense	$81	$85	$88	$92
Percent of Other Income Revenue	47.8%	47.4%	47.0%	46.6%
Amount per Available Room	$312	$326	$340	$355
Amount per Occupied Room	$1.31	$1.34	$1.32	$1.35

» 12.06 ADMINISTRATIVE AND GENERAL EXPENSE

The administrative and general expense of a hotel is made up of all of the managerial and operational expenses that cannot be attributed to a particular department. For example, the general manager might work part of one day solving a problem in the rooms department and devote the remainder of the day to booking an important food and beverage function. It is too difficult to continually keep track of the manager's activities and allocate his or her salary to individual departments, so the category of administrative and general is used to account for it.

Most administrative and general expenses are relatively fixed. The exceptions are commissions on credit card charges, which are highly dependent on occupancy;

cash overages and shortages and provisions for doubtful accounts, all of which are affected moderately by the quantity of transactions or total revenue; and salaries and wages, benefits, and security, which are influenced slightly by volume.

In recent years, several new categories have been added to administrative and general expenses. One example is human resources, which includes the cost of recruiting, relocating, and training. Another example is security, which encompasses the cost of contract security for the property and other related expenses.

The category called "insurance/general" comprises the premiums for policies that cover liability, fidelity, life insurance, theft coverage, and business interruption insurance. Fire and extended coverage insurance on the building and its contents is a separate insurance expense category.

Liability coverage encompasses third-party actions involving bodily injury and personal property and is typically based on rooms receipts, meeting and banquet revenue, and food and beverage revenue. Some of the factors that affect liability insurance expense are the size of meeting, banquet, or restaurant facilities; the amount of

alcohol served as a percentage of total food and beverage sales; and the existence of a lounge dance floor. Factors that can increase liability insurance expense include building design (such as a high-rise structure), swimming pools, lack of life safety support systems (fire and smoke alarms), and any transportation services provided to guests.

Given the nature of the components of administrative and general expense, the appropriate unit of comparison to test for reasonableness is an amount per available room. The result of this test can be verified by using a percentage of total revenue.

Projections of administrative and general expense are normally made using the fixed and variable component approach, with 65 percent to 85 percent of the expense being fixed and 15 percent to 35 percent varying directly with total revenue.

In the example in Exhibit 12-7, it is assumed that approximately 70% of administrative and general expenses is fixed and 30 percent vary in relation to total revenue.

Exhibit 12-7 Forecast of Administrative and General Expense ($ thousands)

	1996	1997	1998	Stabilized
Base Administrative and General Expense	$675	$702	$730	$759
Percent Fixed	70%	70%	70%	70%
Administrative and General Expense Fixed Component	$472	$491	$511	$531
Base Administrative and General Expense	$675	$702	$730	$759
Percent Variable	30%	30%	30%	30%
Unadjusted Variable Component	$202	$210	$219	$228
Unadjusted Variable Component	$202	$210	$219	$228
Variable Percentage Change	0.9863	1.0147	1.0575	1.0863
Adjusted Variable Component	$200	$214	$231	$247
Fixed Component	$472	$491	$511	$531
Adjusted Variable Component	$200	$214	$231	$247
Total Administrative and General Expense	$672	$705	$742	$779
Percentage of Total Revenue	8.8%	8.6%	8.2%	7.8%
Amount per Available Room	$2,585	$2,712	$2,854	$2,996
Amount per Occupied Room	$10,89	$11.08	$11.17	$11.39

» 12.07 MANAGEMENT FEE EXPENSE

The management fee expense category accounts for the basic fee paid to the management company that will operate the subject property. Management fees differ depending on whether the management company is a first- or second-tier operator. The appraiser should use the actual fee structure negotiated for the management company, if it has been selected, or a fee based on market analysis in the event the operator is

not known. The estimate for the incentive portion of the management fee is generally found at the point in the income and expense statement that forms the basis for the incentive fee calculation. For example, if the incentive management fee is based on a percentage of income before fixed charges, then the incentive fee is located just after this point in the statement.

Basic hotel management fees are almost always based on a percentage of total revenue, which means that they are 100 percent variable. The proper unit of comparison is a percentage of total revenue.

In Exhibit 12-8, the management company is operating the subject property for a basic management fee of 3 percent, which is considered reasonable for this type of company.

Exhibit 12-8 Forecast of Management Fee ($ thousands)

	1996	1997	1998	Stabilized
Projected Total Revenue	$7,620	$8,153	$9,101	$10,016
Management Fee Percentage	3.0%	3.0%	3.0%	3.0%
Management Fee Expense	$229	$245	$273	$300

» 12.08 MARKETING EXPENSE

Marketing expense includes all of the expenses associated with advertising, sales, and promotion of a lodging facility. These marketing activities are designed to attract new customers and retain existing ones through efforts aimed at creating an image for the hotel, developing customer awareness, and stimulating patronage to the property and its various facilities. Unlike most expense categories, marketing is almost totally controlled by management. Hotel operators typically develop annual marketing plans that detail future expenditures. If such budgets are followed, total marketing expenses can be projected accurately.

The hotel operator must consider many factors when compiling a marketing budget. One of the most significant is that the results of marketing expenditures are not always immediately realized. Depending on the type of advertising and promotion, increased patronage may not be seen for months or even years. Over time, however, this lag period tends to be offset, because the benefits of a successful marketing campaign generally continue after the program has ended.

Hotels have unique operating characteristics that must be considered either when developing a marketing plan or when reviewing the effectiveness of an established marketing effort. For an appraiser to forecast hotel revenues, the marketing programs of the past several years (along with anticipated future plans) should be evaluated to determine their potential effect on the income and expenses of the hotel. Some of the unique characteristics that should be addressed are as follows:

- New hotels, especially those catering to the meeting and convention segment, should have a marketing plan that commences before the hotel opens. Organizers of business meetings and conferences typically plan their meeting accommodations three to six months in advance, while large national associations choose their convention sites as far as five years in advance. If a meeting-oriented hotel is not in the marketplace in time to obtain advance business, it will be passed over in favor of the established competition and suffer low occupancy levels during the initial years of its operation.

- Because the effect of marketing tends to be cumulative, the initial marketing efforts for a new hotel may require greater expenditures than those for an established facility in order to achieve the desired results.
- Marketing expenditures are similar to a hotel maintenance program. If an existing property has neglected its marketing efforts for several years, the appraiser may have to allow for a higher than normal marketing budget either to maintain or to increase current revenues. However, if an aggressive marketing program has been in effect, a reduction in marketing expenses may be justified, because revenues will not be adversely affected.
- The marketing budget should be designed for the specific property as well as for the nature of local lodging supply and demand. Characteristics such as location, visibility, chain affiliation, and class and types of market segments serviced can affect the type and amount of marketing expenditures required.

Marketing expense is divided into seven categories: salaries and wages, benefits, sales, advertising and merchandising, reservations, other marketing activities, and fees and commissions. Together they form the entire marketing effort of the property, incorporating both the internal staff and outside agencies. All categories are budgeted, fixed expenses, except for reservations and fees and commissions, which are occupancy and rate sensitive because they are generally based on a percentage of rooms revenue.

Costs related to the marketing of guestrooms, such as reservations and travel agency fees and commissions, have traditionally been charged to rooms expense. However, there is a growing recognition that these costs are elements of the overall marketing activity, and hotels that recognize these functions as marketing responsibilities should charge these expenses to marketing.

The appropriate unit of comparison for marketing expenses is an amount per available room. Sometimes it is helpful to remove the franchise fee cost and make a separate calculation for it because it is generally 100 percent variable, depending on the rooms revenue.

Marketing expense is normally projected through the fixed and variable component approach, with 65 percent to 85 percent of the expense being fixed and 15 percent to 35 percent varying directly with total revenue. The fixed and variable component approach must sometimes be adjusted to account for unique marketing considerations, such as the costs incurred by fees and commissions paid to travel agencies.

Exhibit 12-9 presents a marketing forecast based on a fixed and variable component model in which 70 percent of this expense is considered fixed and 30 percent varies with total revenue. This relationship takes into account the location of the subject property, the local market for transient accommodations, the competitive environment, and the hotel's anticipated market segmentation.

» 12.09 PROPERTY OPERATIONS AND MAINTENANCE EXPENSE

Property operations and maintenance (PO&M), which is also known as repair and maintenance, is another expense that is largely controlled by management (see Exhibit 12-10). Except for repairs necessary to keep the facility open and precautions against damage, most maintenance items can be deferred for various lengths of time. However, maintenance is an accumulating expense. If a needed repair is merely postponed, it is neither eliminated nor does it go away of its own accord. Rather it becomes what is known as deferred maintenance that must ultimately be attended to at some later date. When an appraiser projects income and expense for an existing lodg-

ing facility, the property operations and maintenance expenses over the past several years should be investigated to determine whether adequate expenditures were made to keep the facility in good condition. This should be done in conjunction with a physical inspection of the property to determine whether the funds that were expended were sufficient for the repairs required.

Exhibit 12-9 Forecast of Marketing Expense ($ thousands)

	1996	1997	1998	Stabilized
Base Marketing Expense	$540	$561	$584	$607
Percent Fixed	70%	70%	70%	70%
Marketing Expense Fixed Component	$378	$393	$409	$425
Base Marketing Expense	$540	$561	$584	$607
Percent Variable	30%	30%	30%	30%
Unadjusted Variable Component	$162	$168	$175	$182
Unadjusted Variable Component	$162	$168	$175	$182
Variable Percentage Change	0.9863	1.0147	1.0575	1.0863
Adjusted Variable Component	$160	$171	$185	$198
Fixed Component	$378	$393	$409	$425
Adjusted Variable Component	$160	$171	$185	$198
Total Marketing Expense	$538	$564	$594	$623
Percentage of Total Revenue	7.1%	6.9%	6.5%	6.2%
Amount per Available Room	$2,067	$2,168	$2,284	$2,396
Amount per Occupied Room	$8.71	$8.87	$8.94	$9,12

The following factors influence the required level of maintenance for lodging facilities:

- *Age of the hotel.* New hotels are typically protected for several years by new equipment and manufacturer's warranties, so PO&M costs during the initial years of operation are reduced. As hotels become older, maintenance costs tend to escalate rapidly.
- *Use of a preventive maintenance system.* Some hotel operators conduct preventive maintenance programs that consist of periodic checks and maintenance of all the important components of a lodging facility. The purpose of preventive maintenance is to anticipate possible maintenance problems early enough so that only minor repairs, rather than major overhauls, are necessary.
- *Quality of initial facilities.* The quality and type of the initial construction can have a direct effect on future maintenance requirements. The use of high-quality building materials and construction methods will generally reduce the need for maintenance expenditures over the long term. During the physical inspection, the appraiser should investigate the condition and quality of the original construction.

Property operations and maintenance is considered an operating expense and, as such, under IRS regulations, it can contain only items that can be expensed rather than capitalized. For example, if a table leg breaks, the repair of the leg would be considered an expense and chargeable to property operations and maintenance. If the table was instead replaced, it would become a capital expenditure that would not appear under the property operations and maintenance category. Appraisers account for capital replacements of items such as furniture, fixtures, and equipment reserve for replacement expense.

The items in property operations and maintenance are either fixed or very slightly influenced by changes in occupancy and food and beverage usage. The fact that PO&M is mostly fixed means that the appropriate unit of comparison for this expense category is an amount per available room that is verified by a percentage of total revenue.

Property operations and maintenance is normally projected by the fixed and variable component approach with 55 percent to 75 percent of the expense being fixed and 40 percent to 60 percent varying directly with total revenue. In Exhibit 12-10, it is assumed that 70 percent of the category is fixed to project operations and maintenance expense.

Exhibit 12-10 Forecast of Property Operations and Maintenance Expense ($ thousands)

	1996	1997	1998	Stabilized
Base Property Oper. & Maint. Expense	$338	$351	$365	$380
Percent Fixed	70%	70%	70%	70%
Property Oper. & Maint. Expense Fixed Component	$236	$246	$256	$266
Base Property Oper. & Maint. Expense	$338	$351	$365	$380
Percent Variable	30%	30%	30%	30%
Unadjusted Variable Component	$101	$105	$110	$114
Unadjusted Variable Component	$101	$105	$110	$114
Variable Percentage Change	0.9863	1.1047	1.0575	1.0863
Adjusted Variable Component	$100	$107	$116	$124
Fixed Component	$236	$246	$256	$266
Adjusted Variable Component	100	107	116	124
Total Property Oper. & Maint. Expense	$336	$353	$372	$390
Percentage of Total Revenue	4.4%	4.3%	4.1%	3.9%
Amount per Available Room	$1,294	$1,357	$1,430	$1,499
Amount per Occupied Room	$5.45	$5.55	$5.60	$5.71

» 12.10 ENERGY EXPENSE

Energy consumption within a lodging facility typically takes several forms: water and space heating, air conditioning, lighting, cooking fuel, and other miscellaneous power requirements. The most common sources of energy are electricity, natural gas, fuel

oil, and steam. In addition to these energy uses, energy expense also includes the cost of water service. The total cost of energy varies with the source and quantity of fuel used. Electricity tends to be the most expensive source, followed by oil and gas.

The cost of electrical energy is a function of the amount of energy consumed and the size of the peak demand. The unit of electrical consumption is the kilowatt-hour, which is measured by a watt-hour meter. To calculate the monthly electric bill, the utility company reads the electric meter and determines the number of kilowatt-hours of electricity consumed since the last reading. This amount is multiplied by the appropriate scheduled rate to determine the usage charge. The demand charge reflects the peak number of kilowatts required by the property during a specific, short-term time period. The demand is also read monthly from the utility meter, with the additional charge added to the electric bill on the basis of a demand rate schedule.

Utility charges for other sources of energy, such as gas and oil, are generally based entirely on usage, with no additional expense for demand. The unit of gas consumption is the therm, which is measured by a gas meter. Oil is delivered to the property and stored in tanks. Bills are rendered upon delivery and the unit charge is the gallon.

A large portion of energy consumption is relatively fixed and varies little with changes in occupancy. Restaurants, kitchens, public areas, and corridors must be continually lighted and heated or air conditioned, whether the hotel is full or nearly empty. The energy costs of an additional occupied room (i.e., a few hours of light, television, heat, or air conditioning) are minimal.

To forecast the energy cost for a hotel or motel, estimates must be made for total energy consumption, sources of energy, and utility rates.

The amount of energy consumed in the process of heating, air conditioning, and operating a lodging facility is measured in terms of British thermal units (BTUs). By estimating the number of BTUs a hotel or motel will use over a twelve-month period and multiplying this amount by a cost factor based on local utility charges, an energy cost forecast can be developed.

In order to estimate the amount of energy consumed by a facility, it is necessary to know the conversion factor that relates the unit of consumption (kilowatt-hours, therms, and gallons) to the specific number of BTUs produced. The following table shows the conversion factors for electricity, gas, and oil.

A portion of the energy consumed by hotels and motels is always in the form of electricity. This source is generally supplemented by either gas or oil when these alternatives are available and cost effective. Electrical energy accounts for approximately 40 percent to 60 percent of the total BTU energy consumption for a typical lodging facility, with the supplemental fuels representing the remainder.

Once the total units of consumption have been calculated, the appraiser contacts the local utility company and fuel oil dealer to determine rates and costs. In most instances, utility companies are extremely helpful in providing the necessary data, information, and costs to estimate the energy costs for a lodging facility.

Once the base year energy expense has been estimated, a projection is made using the fixed and variable component approach, with 80 percent to 95 percent of the expense being fixed and 5 percent to 20 percent varying directly with total revenue. In Exhibit 12-11, it is assumed that 90 percent of this category is fixed and 10 percent varies directly with total revenue.

» 12.11 PROPERTY TAX EXPENSE

Property tax expense includes the taxes paid to local municipalities for governmental services such as highways, schools, parks, sanitation, and other services and facilities. The purpose of property taxes is the allocation of the municipal tax burden on

the basis of value. The weight of the tax burden the owner will assume increases proportionally with the value of the property. The legal term for property tax is "ad valorem" tax, or tax "in proportion to value."

Depending on the policy of the municipality, property taxes can be based on the value of the real property alone (real estate tax) or the value of the personal property in its entirety (personal property tax).

Exhibit 12-11 Forecast of Energy Expense ($ thousands)

	1996	1997	1998	Stabilized
Base Energy Expense	$318	$331	$344	$358
Percent Fixed	90%	90%	90%	90%
Energy Expense Fixed Component	$286	$298	$310	$322
Base Energy Expense	$318	$331	$344	$358
Percent Variable	10%	10%	10%	10%
Unadjusted Variable Component	$32	$33	$34	$36
Unadjusted Variable Component	$32	$33	$34	$36
Variable Percentage Change	0.9862	1.0147	1.0575	1.0863
Adjusted Variable Component	$31	$34	$36	$39
Fixed Component	$286	$298	$310	$322
Adjusted Variable Component	$31	$34	$36	$39
Total Energy Expense	$318	$331	$346	$361
Percentage of Total Revenue	4,2%	4.1%	3.8%	3.6%
Amount per Available Room	$1,222	$1,275	$1,322	$1,389
Amount per Occupied Room	$5.15	$5.21	$5.21	$5.28

To establish the proper allocation of the tax burden, municipalities employ assessors to assess, or valuate, all the taxable real estate within their jurisdictions. Theoretically, the assessment bears a definite relationship to market value, so that properties of equal market values will have similar assessments, and properties of higher and lower values will have proportionately larger and smaller assessments.

Because the objective of assessed value is to maintain a specific value relationship among all properties in a taxing jurisdiction, comparable hotel assessments should be evaluated to determine whether the subject property's assessed value is equitable.

Some municipalities assess properties at 100 percent of market, while others use a certain percentage of market value. In any case, the allocation of the tax burden to each property will not change if the relationship between the assessed value and market value is altered. If additional properties are developed within a tax jurisdiction, the tax base increases while the tax rate decreases, assuming that the municipal budget remains constant. Although the assessed value of the properties does not change, the individual tax burden decreases because the additional properties generate tax revenue. If the municipal budget increases, however, the tax rate will increase proportionately.

Projecting property tax expense for an existing hotel is relatively simple. The as-

sessed value is normally on public record and can be found in the appropriate municipal office. Multiplying the assessed value by the anticipated rate yields the estimated property tax burden. The appraiser must determine, however, whether the assessed value might escalate at some future time, as the result either of improving trends in local real estate market values or of a new valuation of the subject property triggered by a recent sales transaction.

Projecting property tax expense for a proposed lodging facility is generally more difficult. Local assessors are often reluctant to provide initial estimates of assessed values until the hotel is complete and operational. They are apt to use a cost approach and say that the assessed value will be based on total project cost. Because the assessor has no incentive to provide an accurate projection of assessed value, there is always a tendency to overstate these initial estimates; consequently, when the final value is placed on the property, a reduced amount is looked upon favorably. The appraiser should, nonetheless, contact the assessor and attempt to obtain an indication of what the assessed value will be, although this estimate should be tempered by the results of research into comparable assessments.

The objective of assessed value is to maintain a specific value relationship among all of the properties in a tax jurisdiction, so that the best way to make an estimate of the assessed value of a proposed hotel is to base it on the actual values of similar hotels. The acumen of the appraiser comes into play in this process when the indicated assessed values must be adjusted to reflect any differences between them and the subject property.

[1] Real Property Assessment

Because tax jurisdictions provide separate assessed values for real property (i.e., land and improvements), it is advisable to compare the assessed values of only the improvements, not the combined land and improvement values. The combination of the two equals the total property value and forms the basis for calculating the real estate tax burden of an individual property. The assessed value of the land is developed from actual land sales within the jurisdiction. On the basis of these known land sales, the assessor can determine the relative desirability of the parcels; as value declines, so does desirability. Each parcel is assessed on the basis of its desirability relative to the surrounding parcels, which means that assessors are often reluctant to change one land assessment because doing so could alter the assessment grid for all the other parcels in the jurisdiction. As a result, when developing an assessed value estimate of a proposed hotel, the actual assessed value of the land should be considered unchangeable (because any locational advantages or disadvantages have theoretically been accounted for), and only the improvement value should be compared and adjusted. Improvement value does not include such factors as decor, management, franchise, or business value.

[2] Personal Property Assessment

If a tax jurisdiction imposes a personal property assessment, the appraiser must estimate the value of the furniture and equipment in addition to land and improvements. Because personal property assessment procedures differ widely, guidance from the local assessor is often helpful. In many instances, the assessed value of furniture and equipment is based on actual cost less a mandated depreciation schedule. The key factor for an appraiser working with this type of assessment is a clear definition of what is considered personal property and what is considered real property.

» 12.12 INSURANCE EXPENSE

Insurance expense consists of the cost of insuring the hotel and its contents against damage or destruction from fire, weather, sprinkler leakage, boiler explosion, and so forth. It does not include liability coverage, which is charged to administrative and general expense. Insurance expenses are generally 100 percent fixed and do not vary with a hotel's volume.

Insurance rates are based on many factors, including building design and construction, fire detection and extinguishing equipment, fire district, distance from fire-house, and the history of fires in the area. Sometimes it is possible to obtain an estimate of insurance cost from a local insurance agent who is familiar with the project and area insurance rates. If this is not possible, the appraiser should use the insurance costs incurred by similar lodging facilities expressed on a per available room basis.

» 12.13 RESERVE FOR REPLACEMENT EXPENSE

Furniture, fixtures, and equipment are essential to the operation of a lodging facility, and their quality often determines the overall quality of a facility, All non-real estate items that are normally capitalized rather than expensed are included in this category.

The furniture, fixtures, and equipment in a hotel are exposed to heavy use and must be replaced at regular intervals. The useful life of these items is determined by the quality and durability of their construction and the amount of guest traffic and use to which they are subjected.

Periodic replacement of furniture, fixtures, and equipment is essential to maintain the quality, image, and income of a lodging facility. Capitalized expenditures are not included in the operating statement but nevertheless affect an owner's cash flow;
consequently, an appraisal should reflect these expenses in the form of an appropriate reserve for replacement. As a general rule, a reserve of 3 percent to 5 percent of total revenue is usually sufficient to provide for timely replacement of furniture, fixtures, and equipment. The reserve for replacement is based on a percentage of total revenue, so it is 100 percent variable. The unit of comparison is a percentage of total revenue.

» 12.14 OVERALL STATEMENT OF INCOME AND EXPENSE

From the room-night analysis that produces an estimate of occupancy to the reserve for replacement calculation, the overall forecast must be combined into an overall statement of income and expense covering the appropriate forecasted years. This should be organized in accordance with the *Uniform System of Accounts for Hotels* and contain ratios of total and departmental revenues and amounts per available room.

The appraiser should examine the reasonableness of all the numbers and ratios in the overall statement. Among the numerical relationships that should be verified are the following:

- As occupancy increases, most operating ratios tend to decrease, with the exception of property operations and maintenance expense, which generally increases for a new property.
- As occupancy increases, the increase in the average rate per occupied room generally outpaces inflation.

Hotels with a high food and beverage volume (i.e., ratio of food and beverage revenue to rooms revenue) will tend to have lower profit ratios (i.e., net income to total revenue). However, if the food and beverage departments are operated at a profit, these properties will bring in more revenue. The optimum profit percentage for a lodging facility depends upon the food and beverage volume produced by the hotel (i.e., ratio of food and beverage to rooms). A well-run hotel will make a departmental profit of $.80 for each dollar of rooms revenue and only $.30 for each dollar of food and beverage revenue, so the volume of each department will dramatically impact the overall bottom line percentage. For example, a rooms-only lodging facility may have a net income ratio of 40 percent compared to a 20 percent bottom line for a property with a high food and beverage volume. However, the property with the high food and beverage volume will often generate a greater dollar profit on a per room basis.

HVS

CHAPTER 13

Property Valuation

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» 13.01 INTRODUCTION

Hotel owners, lenders, and operators frequently require appraisals to establish the value of properties in which they have an interest. In performing a market study and appraisal, a valuation is essential in order to determine whether the subject property is economically feasible. Simply put, a project is considered feasible when its economic value is greater than the cost that was incurred in its development; if the project's value upon completion is less than the cost of its development, then it is considered not feasible. Appraisals are also used to establish prices for sales and transfer, to determine the security for mortgage debt, and to verify assessed value for property taxes.

Professional appraisers use a combination of three approaches in appraising real estate for market value: (1) the cost approach, (2) the sales comparison approach, and (3) the income capitalization approach. Usually, all three are employed in an appraisal, and the appraiser takes into account the inherent strengths of each as well as the nature of the subject property when making the final estimate of market value.

The cost approach is based on a determination of the cost of replacing a property, with adjustments for various forms of depreciation and obsolescence. The sales comparison approach compares the known sales prices of hotels that are similar to the subject hotel. The income capitalization approach capitalizes the anticipated earnings of the property in order to estimate its total value.

In theory, all three approaches result in the same value estimate. In practice, however, the value indicated by the income capitalization approach most closely reflects the type of analysis generally performed by typical buyers and sellers. The results from the cost and sales comparison approaches are generally used to support and verify the results of the income approach.

» 13.02 COST APPROACH

The cost approach yields an estimate of market value by totaling the current cost of replacing a property. This is accomplished by determining the value of the land when vacant and available and combining it with the estimated cost to construct the improvements. For an existing hotel, depreciation, in the form of physical deterioration or functional or economic obsolescence, must be quantified and deducted from the replacement cost to estimate market value. For proposed hotels, the cost approach is compared with the market value conclusion by means of the income approach to determine project feasibility.

The cost approach may provide a reliable estimate of value for newly constructed properties not suffering from external obsolescence; as buildings and other forms of improvements age and depreciate, however, the resultant loss in value becomes increasingly difficult to quantify.

Knowledgeable buyers of lodging facilities generally base their purchase decisions on such economic factors as forecasted net income and return on investment. Since the cost approach does not reflect any of these income-related considerations but rather requires a number of subjective and unsubstantiated depreciation estimates, it is not commonly used as the primary process in a hotel valuation.

[1] Replacement Cost

Replacement cost is simply the cost of developing a property similar to the subject property. The replacement cost of several elements must be combined to determine the total replacement cost for the subject property. These elements are: land value;
building construction cost; furniture, fixtures, and equipment (FF&E) cost; soft costs;
opening costs; and developer's costs.

The replacement cost for property improvements, which includes buildings, parking facilities, landscaping, and signage can be estimated with information provided by one of several construction cost services, such as Marshall Stevens, Boecke, or Dow. Other sources of replacement data include local building contractors and developers, architects, engineers, and professional cost estimators. Cost may be estimated by an amount per square foot of improvements (calculator method), as an amount per room, or as an amount per each building component (segregated method).

A developer will typically provide the appraiser with the budgeted development cost of a proposed hotel. As of the writing of this book, the construction of new limited-service and extended-stay hotels has resumed. The development of full-service hotels is not yet feasible in most markets throughout the United States. The valuation of a proposed extended-stay hotel is used as a case study throughout this chapter.

The main element of the replacement cost for property improvements is physical replacement construction cost. Exhibit 13-1 sets forth the estimated construction cost of a proposed extended-stay product, as provided by the developer.

Exhibit 13-1 Estimated Construction Cost of Proposed Extended-Stay Product

Development Budget

Cost Category	**Amount**
Land	$1,235,000
Building	
Construction Contract	6,800,000
Architectural and Engineering	180,000
Real Estate Taxes	30,000
Insurance	38,000
Permits	620,000
Contingency	340,000
Furniture, Fixtures, and Equipment (FF&E)	1,755,000
Soft Costs	
Legal and Clearing Costs	110,000
Feasibility and Appraisal	40,000
Financing Fees	50,000
Construction Interest	352,000
Pre-opening and Startup Costs	225,000
Working Capital	100,000
Operating Reserve	325,000
Development Fees	600,000
	1,802,000
	$12,800,000

A cost analysis performed by the appraiser through the use of Marshall Stevens indicates a basic improvement cost of $68.20 per square feet for the 99,483 square feet of the proposed improvements, yielding an estimated basic structure cost of $6,784,740, supporting the basic building cost estimate provided by the developer.

The replacement cost of the FF&E can be estimated through the use of a cost service or design company or by surveying hotel companies for their typical FP&E expenditure. The Uniform Franchise Offering Circulars (UFOCs) of hotel franchise companies also provide a good source for a range of FF&E costs of different lodging products. For a proposed project the replacement cost for FF&E can be determined by multiplying the amount of money budgeted per room for the proposed project by the final number of rooms in the facility. The FF&E cost for this proposed extended-stay hotel is $12,500 per room or a total of $1,755,000 for the 130 units of the project.

Soft costs include legal and closing expenses, fees for financing and other professionals, as well as construction interest. Pre-opening costs consist of the funds necessary to hire and train personnel prior to the hotel's opening, pre-market the property, and equip the hotel with inventories. Estimates of working capital and funds

for an operating reserve to cover any operational or debt service shortfalls during the initial years of operation can be based on the profile and total cost of the development.

If the project is to be franchised, the initial franchise fee must be included in the cost estimates. In addition, the developer's cost—the fee that must be paid to a developer for providing project administration—must be considered.

A developer's profit of 10 percent to 20 percent of total project cost inclusive or exclusive of land value has historically been included in the cost approach estimate developed by appraisers. In practice, many developers made little or no profit during the last construction cycle. There are differing theories regarding developer's profit, but it is generally accepted that developers require profit in order to do their job. The reality is that development opportunities are often scarce, and a reasonable developer's fee is considered adequate to compensate a developer. Often the development arm of a hotel management or ownership company is motivated by the profits it will garner through its on-going involvement with the property. The earning of management fees or the upside of return on owner's equity can be considered a developer's profit for the entity undertaking the project.

[2] Land Value

The traditional method of estimating land value, through the review and analysis of comparable land sales, is generally the most accurate method of estimating land value for a particular site, but it is applicable only if enough relevant and recent data is available. Sales of land slated for hotel development are best analyzed in terms of price per room of the project proposed for the site. Comparably located and zoned sites can also be adjusted to the subject site to determine land value.

Because of the real estate depression of the early 1990s, few transactions of land purchased for hotel development occurred between 1990 through 1995. Land sales from the mid- to late-1980s are likely irrelevant in estimating land value today because of the dramatic change in market conditions since that time. The fact that land is worth something to someone only when it can be put to use explains why land values generally decline by a greater proportion than values of improved properties during a real estate downturn. Many markets in the United States are now experiencing the development of limited-service and extended-stay hotels, so land transactions for these projects are providing an indication of market value. However, because full-service hotel development is not yet feasible in many markets, land transactions are scarce for such projects. In the absence of land sales, two alternative approaches are useful in evaluating what a hotel site is worth.

[a] Ground Lease Approach

When the existing or proposed hotel improvements represent the highest and best use of the property, the ground lease approach is an accurate method for estimating land value because it is readily supported by numerous self-adjusting comparables (e.g., hotels that are constructed on expensive land tend to generate higher rooms revenue), as well as the overall economics of the individual project.

During the past twenty-five years, hotels have been routinely constructed on leased land. Lease terms differ somewhat from hotel to hotel, but the basis for the rental calculation is usually tied to a percentage of the revenue generated by the hotel. By using the forecasted stabilized revenues for the subject property and applying a typical hotel ground lease rental formula, the appraiser determines the hotel's economic rental, or what can be termed the income attributed to the land. The land value

is then estimated by dividing the economic rental by an appropriate capitalization rate.

One advantage of this method is that rental formulas are tied directly to a percentage of revenue that inherently reflects both the locational attributes of the site (occupancy and rate) and the allowable density of development, so the resulting economic ground rental justly represents the greatest net return to land over a given period of time. This self-adjusting aspect is one of the main reasons for the reliability of the ground lease approach.

Recalculating a data base of lease formulas as a percentage of only rooms revenue results in a range of 3 percent to 4 percent for areas in the United States outside of California and Hawaii, and 4 percent to 7 percent within desirable areas of these two states. Some local submarkets will fall outside of these norms because of specific market conditions. Applying the ground rental percentage to an estimate of rooms revenue results in the net income attributable to the land. Applying an overall capitalization rate of 7 percent to 11 percent, depending on the market and location, results in a land value estimate.

Assume, for example, that the proposed hotel, were it open and stabilized today, could be expected to achieve a $92 average rate. Exhibit 13-2 sets forth a land estimate using the ground lease approach, a 1996 average rate of $92, a 3.5 percent ground rental percentage and a 9 percent capitalization rate.

Exhibit 13-2 Ground Lease Approach

Stabilized Average Rate ($ '96)	$92
Days in the Year	365
Stabilized Occupancy	80%
Projected Rooms Revenue Per Room	$26,864
Ground Rent %	3.5%
Projected Income Attributable to Land	$940
Capitalization Rate	9%
Estimated Land Value Per Room	$10,447

[b] Land Residual Approach

An alternative method of estimating a hotel site's value is the land residual approach. This method, if used with accurate variables, is the most appropriate for determining what the developer can afford to pay for the land for a specific project. A market feasibility study is performed to estimate what the economic value of the hotel will be once it is open and operational. The development costs of the hotel, including all soft costs (e.g., interest and pre-opening expenses, as well as a developer's fee) are estimated. A developer's profit may or may not be generated, depending on the project's profile and market conditions.

The amount by which the economic value of the hotel, based on projected future cash flow, exceeds the hotel's estimated development cost is what determines the net residual value to the land. In our example, the developer's consultants have estimated that the hotel will be worth $105,000 per room once it is open and operational in 1998. The developer estimates that the total development cost of the hotel, exclusive of land costs and a developer's profit, will be $89,000 per room. The residual value of the land and developer's profit is equal to the value of the total project upon completion of $105,000 per room less the project's development cost of $89,000 per

room, or $16,000 per room. Assuming a developer's profit of 10 percent of the project cost exclusive of land value raises the total project cost to $98,000, leaving a residual to the land of $105,000 less $98,000 or $7,000 per room. Reducing the developer's profit to 5 percent raises the residual value of the land to $11,500.

Applying these two approaches to our example results in an estimate of land value ranging from $7,000 to $11,500, or 7.1 percent to 11.7 percent of total project cost. For this case study, we will conclude at the value derived by means of the ground lease approach, $10,500 per room or a total of $1,235,000. Once the hotel has been developed, the value of the land component may rise to represent a greater proportion of total value. However, the challenging economics of hotel development will likely reduce land values to below the traditional range of 10 percent to 20 percent of total project cost for the near term. While the choice of variables used in such an analysis is subjective, a careful consideration of the attributes of the market, the proposed project, and the site can lead to a prudent analysis and conclusion. Developers attempting to build new hotels should be careful not to pay too much for the land component in this current economic environment of low inflation and slim developer profits.

» 13.03 SALES COMPARISON APPROACH

The sales comparison approach is used to estimate the value of a property by comparing it with similar properties recently sold in the open market. To obtain an accurate estimate of value, the sales price of a similar property must be adjusted to reflect any differences between it and the subject property,

During the early 1990s, hotel sales transactions were scarce. The lack of data made this approach difficult to apply in the valuation process. In 1994 the market was revitalized, and sales activity picked up considerably. Today, hotel investors and developers keep current on hotel sales transactions, looking for the dollar amount per room for which a hotel has transacted and the capitalization rate at which the hotel has sold. Historical fiscal year, trailing twelve-month or first forecasted year net income before depreciation and income taxes but after deducting management fee and a reserve for replacement, is divided by the sales price to derive the capitalization rate. While these indicators are of interest to participants in the hotel industry, they do not serve as a basis for their own valuation conclusions regarding a specific project because of inherent limitations in the sales comparison approach.

The sales comparison approach can provide a usable value estimate for simple forms of real estate, such as vacant land and single-family homes, where the properties are homogeneous and adjustments are few in number and relatively simple to compute. However, for larger and more complex investments such as shopping centers, office buildings, and hotels, where the adjustments are numerous and difficult to quantify, the sales comparison approach becomes considerably less reliable,

As with the cost approach, hotel investors typically do not use the sales comparison approach to reach final purchase decisions. Various factors, such as the lack of timely hostelry data, the number of insupportable adjustments, and the difficulty involved in determining the true financial terms and human motivations of comparable transactions, usually render the results of the sales comparison approach somewhat questionable. The sales comparison is best used as a means of providing a range of values that bracket and support the income capitalization approach. Any reliance on its results, however, beyond the establishment of broad generalizations, is not normally justified by the quality of data.

The market-derived capitalization rates used by some appraisers (which rely on data derived from the sales comparison approach) are susceptible to the same shortcom-

ings inherent in the sales comparison approach itself. To substantially reduce the reliability of the income capitalization approach by employing capitalization rates obtained from unsupported market data not only weakens the final estimate of value but also ignores the normal investment analysis procedures employed by typical hotel purchasers.

» 13.04 INCOME CAPITALIZATION APPROACH

Appraisers and participants in the hotel industry use the income capitalization approach to value property by analyzing the local market for transient accommodations, examining existing and proposed competition and developing a forecast of income and expense that reflects current and future anticipated income trends and area cost components up through a stabilized year of operation or for a specific holding period.

The forecast of income and expense is expressed in current dollars as of the date of each forecasted year. The stabilized year reflects the anticipated operating results of the property over its remaining economic life, including the normal stages of buildup, plateau, and decline. A stabilized year level of occupancy and average rate should inherently take into consideration normal economic fluctuations that cause cyclical increases and decreases in the net income of a hotel investment. Any abnormal transitory or nonrecurring conditions that result in unusual revenue or expenses for the property are excluded from consideration in the selection of a stabilized year of operation.

The forecast of income and expense is then converted into a value through an income capitalization process that reflects the rate of return required by market participants. One of the considerable benefits of real estate ownership is that the investment may be leveraged (i.e., the buyer may finance a major portion of the purchase price and therefore significantly increase the yield on the equity invested in the project. One year of forecasted net income may be capitalized into an estimate of market value if the hotel's upside potential and downside risks can be adequately reflected through a single-year forecast. The overall capitalization rate applied to the net income may be derived from the market (i.e., calculated by dividing the historical or forecasted net income of a hotel that has recently been sold by the sales price). Since such a method is rarely reliable because of the numerous conditions affecting net income and transaction prices, an alternative method—the band of investment method—is often used. The band of investment is a calculation of the weighted cost of capital. The debt component, typically representing 50 percent to 75 percent of an investment, and the equity component, representing the remainder of the purchase price, are weighted at their respective rates of return. The resultant capitalization rate is divided into the forecasted net income to derive an estimate of market value.

Hotels, because of their large business and personal property components, are typically in some form of transition. Buyers generally look to enhance the value of the hotel they are acquiring by physically improving or changing the management of the property. Hotel markets are also often in flux because of additions to supply and changes in the make-up of existing supply. For these reasons, a multi-year forecast of income and expense is generally preferred to reflect future fluctuations in occupancy, average rate, and net income. Ten-year forecasts have become the norm for real estate valuations, because they represent typical holding periods and are used to analyze and value other real estate investments that require complete lease rollovers to accurately reflect market rents. A multi-year forecast of net income may be converted into an estimate of market value through a discounted cash flow analysis whereby the net income forecasted for the ten-year holding period plus the net sales proceeds at the end of the holding period are discounted back to the date of value by an appropriate discount rate. One overall discount rate that considers the varying costs of cap-

ital used in the market may be derived through surveys of market participants or through an analysis of actual sales. This simple discounted cash flow model may be further refined through the use of a mortgage-equity technique that considers the different cost of capital required by the debt and equity components.

Because of the compounding inherent in rates of return required over multi-year holding periods, the simple weighted cost of capital utilized in the band of investment is mathematically inaccurate for the development of an overall discount rate that accurately reflects the debt and equity components of an investment.

To estimate the value of the subject property, we have used a ten-year discounted cash flow analysis in which the cash flow to equity and the equity reversion are discounted to the present value at the equity yield rate, and the income to the mortgagee is discounted at a mortgage interest rate. The sum of the equity and mortgage values is the total property value. To convert the forecasted income stream into an estimate of value, the anticipated net income (before debt service and depreciation) is allocated to the mortgage and equity components on the basis of market rates of return and loan-to-value ratios. The sum of the mortgage component and the equity component equals the value of the property. The process of estimating the value of the mortgage and equity components is as follows.

1. The terms of typical hotel financing are set forth, including interest rate, amortization term, and loan-to-value ratio.
2. An equity yield rate of return is established. Numerous hotel buyers base their equity investments on a ten-year equity yield rate projection that takes into account ownership benefits such as periodic cash flow distributions, residual sale or refinancing distributions that return any property appreciation and mortgage amortization, income tax benefits, and various nonfinancial considerations (e.g., status and prestige). The equity yield rate is also known as the internal rate of return on equity.
3. The value of the equity component is calculated by first deducting the annual debt service from the forecasted net income before debt service, leaving the net income to equity for each projection year. The net income as of the eleventh year is capitalized into a reversionary value. After deducting the mortgage balance at the end of the tenth year and the typical brokerage and legal costs, the equity residual is discounted back to the date of value at the equity yield rate. The net income to equity for each of the ten projection years is also discounted to the present value. The sum of these discounted values is the value of the equity component. Adding the equity component to the initial mortgage balance yields the overall property value.

   Because the mortgage and the debt service amounts are unknown but the loan-to-value ratio was determined in step 1, the preceding calculation can be solved through an iterative process or by use of a linear algebraic equation that computes the total property value.
4. The value is proven by allocating the total property value between the mortgage and equity components and verifying that the rates of return set forth in steps 1 and 2 can be met from the forecasted net income.

[1] Mortgage Component

Data for the mortgage component is generally developed from statistics pertaining to actual hotel mortgages made by long-term permanent lenders. The American Council of Life Insurance, which represents twenty large life insurance companies, publishes

quarterly information pertaining to the hotel mortgages issued by its member companies. Exhibit 13-3 summarizes the average mortgage interest rate of the hotel loans made by these lenders. The AA utility bond yield as reported by Moody's Bond Record is shown for purpose of comparison.

Exhibit 13-3 Typical Hotel and Motel Mortgage Rates

Source: American Council of Life Insurance; Moody's Bond Record

Year	Average Interest Rate	Average AA Utility Bonds
1995	8.94	7.77
1994	9.50	8.22
1993	9.13	7.44
1992	9.73	8.55
1991	10.42	9.09
1990	10.53	9.65
1989	10.11	9.56
1988	10.27	10.31
1987	9.94	9.77
1986	9.83	9.30

(Data not shown for limited number of loans.)

The average interest rate of a hotel mortgage and the concurrent yield on an AA utility bond have a close mathematical relationship. Through regression analysis, this relationship is expressed as follows:

$$Y = 2.9040 + 0.77650X$$

where Y = Estimated hotel/motel mortgage interest rate
X = Current average AA utility bond yield (coefficient of correlation is 95.5%).

If, for example, the current yield on AA utility bonds, as reported by Moody's Bond Record, is 7.68 percent, the equation produces an estimated hotel/motel interest rate (Y) of 8.9 percent.

In addition to the mortgage interest rate estimate derived from this regression analysis, the terms of hotel mortgage loans made by institutional lending clients are constantly monitored. There has been a significant increase in the availability of debt financing since 1994, though one would not yet characterize capital as "free flowing" for hotel investments, particularly for new construction. Projects are able to secure mortgage financing at interest rates ranging from 8 percent to 11 percent, depending on the location, affiliation, and operator, and loan-to-value ratio. Underwriting is much stricter than it was during the 1980s, and lenders are looking for minimum debt coverage ratios of 1.4, and loan-to-value ratios rarely exceed 65 percent. Amortization schedules have also decreased from the thirty-year norm prevalent during the 1980s to anywhere from ten to twenty-five years, with twenty years being the most prevalent. Lenders are now more aware of the short life cycles and high risks associated with hotel investments and thus are requiring that debt be retired more rapidly than in the past.

For the proposed extended stay property, we have assumed that a 9.00 percent interest, twenty-year amortization mortgage with a 0.109769 constant, and a 65 percent loan-to-value ratio is appropriate,

[2] Equity Component

Additional capital required for a hotel investment is generally supplied by an equity investor. The rate of return that an equity investor expects over a ten-year holding period is known as equity yield. Unlike the equity dividend, which is a short-term rate of return, an equity yield specifically considers a long-term holding period (generally ten years), annual inflation-adjusted cash flows, property appreciation, mortgage amortization, and proceeds from a sale at the end of the holding period.

It is difficult to quantify the rate of return required by equity investors seeking to purchase hotel properties. To establish an appropriate equity yield rate, two important sources of data are past appraisals and investor interviews.

[a] Past Appraisals

Appraisers can derive equity yield rates from the market when they appraise hotels that sell on or about the time at which they are appraised. In the case of hotels that were actually sold after appraisal, it is possible to determine an appropriate equity yield rate by inserting the projection into a valuation model and adjusting the appraised value to reflect the actual sales price by modifying the return assumptions. Exhibit 13-4 shows a representative sample of hotels that were sold shortly after they were appraised, along with the imputed equity dividend and equity yield returns based on the valuation approach.

Exhibit 13-4 Summary of Derived Rates and Yields

Date of Hotel	City and State	Sale	Overall Rate (%)	Total Property Yield (%)	Equity Yield (%)
Warner Center Marriott	Woodland Hills, CA	12/95	9.1	11.7	14.8
Westin Bonaventure	Los Angeles, CA	12/95	1.9	17.8	24.2
Hilton at the Club	Pleasanton, CA	12/95	10.5	13.4	17.0
The Plaza	New York, NY	6/95	7.0	11.0	14.0
Residence Inn	Baton Rouge, LA	6/95	12.7	14.8	21,2
Residence Inn	Overland Park, KS	6/95	8.9	14.7	20.8
Residence Inn	Des Moines, IA	6/95	9.8	14.1	19.6
Residence Inn	Hunt Valley, MD	6/95	12.3	13.6	18.3
Residence Inn	Kansas City, MO	6/95	10.4	13.2	19.8
Residence Inn	Lincoln, NE	6/95	10.0	13.7	18.5
Fullerton Suites	Fullerton, CA	5/95	12.9	18.7	28.5
Savoy Hotel	San Francisco, CA	3/95	5.8	14.4	19.6
Marriott Fisherman's Wharf	San Francisco, CA	12/94	10.8	13.4	19.4
Sheraton Inn	Napa, CA	12/94	8.9	13.7	19.8

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Exhibit 13-4 Summary of Derived Rates and Yields *(cont.)*

Date of Hotel	City and State	Sale	Overall Rate (%)	Total Property Yield (%)	Equity Yield (%)
Marriott Hotel	Portland, OR	12/94	12.9	17.4	30.0
Radisson Inn	Springfield, MO	12/94	8.2	10.1	11.3
Williamsburg Hilton	Williamsburg, VA	12/94	15.4	19.0	32.0
Marriott Tech Center	Denver, CO	12/94	13.7	16.4	27.1
Holiday Inn Sunspree	Singer Island, FL	12/94	8.6	10.6	
Sheraton Hotel	Hasbrouck Heights, NJ	11/94	18.3	21.1	30.7
Marriott East Side	New York, NY	10/94	8.5	9.7	11.1
Marriott Resort	Vail, CO	10/94	14.2	18.9	30.5
Radisson Mark Resort	Vail, CO	9/94	8.9	15.8	24.1
Marriott SFO	Burlingame, CA	8/94	10.2	13.2	19.0
Best Western Otay Valley Inn	Chula Vista, CA	7/94	13.2	21.1	31.8
Sheraton Hotel	Cypress Creek, FL	7/94	9.0	13.3	19.4
Hampton Inn	Islandia, NY	7/94	12.6	16.6	28.2
Hampton Inn	Willow Grove, PA	7/94	11.0	14.3	23.0
Hampton Inn	West Palm Beach, FL	7/94	10.8	10.8	14.3
Hampton Inn	Naples, FL	7/94	11,4	11,5	24.9
Hampton Inn	Albany, NY	7/94	9.3	11.5	24.9
Westin Kauai	Lihue Kauai, HI	6/94	(1.9)	8.1	7,2
Residence Inn	Binghamton, NY	6/94	10.8	13.9	21.9
Hotel Millenium	New York, NY	6/94	9.5	14.1	23.0
Radisson Inn	Orlando, FL	5/94	12.9	18.0	28.2
Newark-Fremont Hilton	Newark, CA	5/94	8.8	14.9	20.7
Best Western Fireside Inn	Cambria, CA	4/94	11.7	15.8	24,3
Checkers Hotel Kempinski	Los Angeles, GA	4/94	3.0	18.3	27.0
Phoenician Resort	Phoenix, AZ	4/94	6.6	9.3	8.9.
Crescent Hotel	Phoenix, AZ	3/94	6.5	7.2	2.2
Holiday Inn	Edison, NJ	3/94	6.5	7.2	2.2
Ritz-Carlton	Phoenix, AZ	2/94	11.0	14,6	21.7
Sir Francis Drake	San Francisco, CA	12/93	7.7	16.9	25.6
Omni Chicago	Chicago, IL	9/93	8.5	14.3	20.4
Seven Peaks Excelsior Hotel	Provo, UT	8/93	8.7	15.3	20.7
Airport Marriott	Long Beach, GA	7/93	14.7	18.5	30.1
Doubletree Hotel	Salt Lake City, UT	7/93	10.4	16.5	26.5
Radisson Pan American	Miami, FL	5/93	8.3	12.0	17.1
Hyatt Hotel Airport	Atlanta, GA	4/93	8.0	10,7	11.7

[b] Investor Interviews

Institutional and individual hotel investors, as sources of equity funds, have definite return requirements that can be expressed as an equity yield rate based on a ten-year projection of net income before incentive management fees but after debt service. Based on surveys and investor interviews, Exhibit 13-5 is an illustration of the equity yield requirements of a cross-section of hotel investors.

Exhibit 13-5 Surveys and Investor Interviews

Source of Equity	Equity Yield Requirements
Private Placement	20%–24%
Institutional	18%–22%

Upward adjustments are indicated where expense and/or revenue projections substantially deviate from historical data, proposed properties, properties located in seasonal markets (which increase cash flow volatility), leasehold interests, properties located in very small markets, older hotels, properties that rely on only a few demand generators or cyclical demand generators, properties in areas that lack economic diversification, properties or markets that are particularly dependent on one demand segment, and properties located in areas characterized by a declining population and employment base. An upward adjustment is also indicated when a property has the potential to lose its franchise, when rooms revenue constitutes a small portion of total revenue, and when the penetration rate is high, to reflect its vulnerability.

Downward adjustment of the yield rate is indicated in primary market areas or hotels located in markets that have strong barriers to entry (making new supply unlikely beyond the stabilized year). Factors considered indicative of new competition include strong areawide occupancy and average rate levels and the availability of vacant land with favorable zoning and pricing.

Given an assumed 65 percent loan-to-value ratio, which is the risk inherent in achieving the projected income stream and anticipated market position of the subject property, it is likely that an equity investor would require an equity yield rate of 20 percent before payment of incentive management fees. This estimate is well supported by the equity yield requirements presented previously.

[3] Terminal Capitalization Rate

Inherent in the valuation process is the assumption of a sale at the end of the assumed ten-year holding period. The estimated reversionary sales price at that time is calculated by capitalizing the projected eleventh year's net income by an overall terminal capitalization rate. From this sales price, a percentage is deducted for the seller's brokerage and legal fees. The net proceeds to the equity interest (also known as the equity residual) are calculated by deducting the outstanding mortgage balance from the reversion.

In estimating the residual value of a property, the appraiser must select a terminal capitalization rate and an allocation for brokerage and legal fees. The terminal capitalization rate is an overall rate applied to one stabilized year; it thus incorporates the cost of debt and equity capital. The terminal capitalization rate can be derived through a mortgage equity band of investment technique, which calculates the weighted average cost of the capital used in a hotel investment. Exhibit 13-6 com-

bines the previously derived mortgage financing terms (a 65 percent loan-to-value ratio and a 0.109797 debt service constant) with a cash-on-cash equity dividend rate of 9 percent to calculate an overall capitalization rate.

Exhibit 13-6 Calculating an Overall Capitalization Rate

	Percent of Value		Rate of Return	Weighted Average
Mortgage	0.65	x	0.1070797	0.07018
Equity	0.35	x	0.09000	0.03150
Overall Capitalization Rate				0.10168

Because the overall rate will be used to capitalize net income ten years from the date of value, an upward adjustment is appropriate to reflect the uncertainty inherent in this extended time period. For the purpose of this valuation, an 11 percent terminal capitalization rate will be used.

As a point of reference, the terminal capitalization rate may be compared with the going-in rate implied by the value estimated for the subject property. The going-in rate reflects the capitalization rate that would be applicable if a hotel were operating at a stabilized level as of the date of value. This rate is calculated by dividing the stabilized net income, expressed in current dollars as of the date of value, by the value indicated by the income capitalization approach. Generally, the terminal capitalization rate is approximately 100 to 200 basis points above the going-in rate.

[4] Valuation of Mortgage and Equity Components

Up to this point in the analysis, a number of objective decisions and some subjective evaluations of market data have been made; the remainder of the valuation analysis is purely mathematical. An algebraic formula equation calculates the amount of debt and equity that the hotel will be able to support given the anticipated cash flow derived from the forecast of income and expense and the specific return requirements of the mortgage lender (interest) and the equity investor (equity yield). As an alternative to an algebraic formula, the value (based on the previously defined terms) may be calculated on an iterative basis, as described in the proof of value that follows.

The process of solving for the value of the mortgage and equity components begins by deducting the annual debt service from the projected income before debt service, leaving the net income to equity for each year. The net income as of the eleventh year is capitalized into a reversionary value using the terminal capitalization rate. The equity residual, which is the total reversionary value less the mortgage balance at that point in time and less any brokerage and legal costs associated with the sale, is discounted to the date of value at the equity yield rate. The net income to equity for each projection year is also discounted back to the date of value. The sum of these discounted values equals the value of the equity component.

The amount of the mortgage and the debt service are unknown; however, the terms and loan-to-value ratio of current financing applicable to the subject property have been derived. The annual debt service and resultant net income to equity cannot be calculated without knowing the property's total value, the very unknown that we are attempting to calculate. In essence, the property's value must be determined by forecasting the net income available for debt service, and by calculating, through an iterative or algebraic process, the mortgage amount that the net income is capable of

supporting at the assumed interest rate and a specified loan-to-value ratio. This process computes total property value on the basis of market-derived mortgage and equity return requirements.

A proof of value is established by allocating the total property value between the mortgage and equity components and verifying that the rates of return set forth can be met from the projected net income. Using a computerized mortgage/equity model to perform the necessary iterative calculations results in the following estimate of value.

The value is proven by calculating the yields to the mortgage and equity components during the projection period. If the mortgage achieves its 9 percent yield and the equity yield is 20 percent, then $13,695,000 is the correct value by the income capitalization approach. Using the assumed financial structure set forth in the previous calculations, market value can be allocated between the debt and equity as follows:

Mortgage Component (65%)	$8,902,000	+
Equity Component (35%)	$4,793,000	Total
$13,695,000		

The annual debt service is calculated by multiplying the mortgage component by the mortgage constant:

Mortgage Component ($8,902,000) X Mortgage Constant (0.107967) = $961,123

The cash flow to equity is calculated by deducting the debt service from the projected net income before debt service, as shown in Exhibit 13-7.

Exhibit 13-7 Cash Flow to Equity Calculation

Year	Net Income Available for Debt Service		Total Annual Debt Service		Net Income to Equity
1997	$1,124,000	–	$961,000	=	$163,000
1998	1,418,000	–	961,000	=	457,000
1999	1,663,000	–	961,000	=	692,000
2000	1,709,000	–	961,000	=	748,000
2001	1,769,000	–	961,000	=	808,000
2002	1,833,000	–	961,000	=	872,000
2003	1,898,000	–	961,000	=	937,000
2004	1,962,000	–	961,000	=	1,001,000
2005	2,032,000	–	961,000	=	1,071,000
2006	2,103,000	–	961,000	=	1,142,000

The equity residual at the end of the tenth year is calculated as follows:

Reversionary Value ($2,175,000/0.1100) = $19,773,000 - (Brokerage and Legal Fees (593,000) + Mortgage Balance (6,323,000)) = $12,857,000

Exhibits 13-8, 13-9, and 13-10 demonstrate that each of the components actually received their anticipated yields, providing that the $30,493,000 value is correct given the assumptions used in this approach.

Exhibit 13-8 Total Property Value

Year	Net Income before Debt Service		Present Worth of $1 Factor @ 14.1%		Discounted Cash Flow
1997	$1,124,000	x	0.876490	=	$985,000
1998	1,418,000	x	0.768234	=	1,089,000
1999	1,653,000	x	0.673349	=	1,113,000
2000	1,709,000	x	0.590184	=	1,009,000
2001	1,769,000	x	0.517290	=	915,000
2002	1,833,000	x	0.453399	=	831,000
2003	1,898,000	x	0.397400	=	754,000
2004	1,962,000	x	0.348317	=	683,000
2005	2,032,000	x	0.305296	=	620,000
2006	21,283,000*	x	0.267589	=	5,695,000
Total Property Value				=	$13,694,000

*10th year net income of $2,103,000 plus net sales proceeds of $19,180,000

Exhibit 13-9 Mortgage Component

Year	Total Annual Debt Service		Present Worth of $1 Factor @ 8.9%		Discounted Cash Flow
1997	$961,000	x	0.918465	=	$883,000
1998	961,000	x	0.843578	=	811,000
1999	961,000	x	0.774798	=	745,000
2000	961,000	x	0.711625	=	684,000
2001	961,000	x	0.653603	=	628,000
2002	961,000	x	0.600311	=	577,000
2003	961,000	x	0.551365	=	530,000
2004	961,000	x	0.506410	=	487,000
2005	961,000	x	0.465120	=	447,000
2006	7,284,000*	x	0.427196	=	3,112,000
Value of Mortgage Component					$8,904,000

*10th year debt service of $961,000 plus outstanding mortgage balance of $6,323,000

Exhibit 13-10 Equity Component

Year	Net Income to Equity		Present Worth of $1 Factor @ 20.0%		Discounted Cash Flow
1997	$163,000	x	0.833322	=	$136,000
1998	457,000	x	0.694426	=	317,000
1999	692,000	x	0.578681	=	400,000
2000	748,000	x	0.482227	=	361,000
2001	808,000	x	0.401851	=	325,000
2002	872,000	x	0.334871	=	292,000
2003	937,000	x	0.279056	=	261,000
2004	1,001,000	x	0.232543	=	233,000
2005	1,071,000	x	0.193784	=	208,000
2006	13,999,000*	x	0.161484	=	2,261,000
Value of Equity Component					$4,794,000

*10th year net income to equity of $1,142,000 plus sales proceeds of 12,857,000

» 13.05 BREAK-EVEN ANALYSIS

A break-even analysis identifies the point at which the level of sales for a lodging facility produces neither a profit nor a loss from operations. Basically, for hotels and motels the break-even point is the occupancy level at which all cash outlays necessary for the operation can be met. The break-even point can be established either before or after debt service, although most lenders require a calculation of the break-even point after debt service to determine the security of their loan.

The break-even occupancy level can be estimated by using a computerized analysis of the fixed and variable components of revenue and expense items. Programs have been written that are able to take an achievable occupancy percentage (and the corresponding operating ratios) established by an appraiser for a subject property and, through a series of steps, drop the occupancy level and automatically adjust the operating ratios to reflect the lower revenues that would be achieved. The calculations continue until the break-even point for occupancy, before and after debt service, is attained. The appraiser then compares the break-even figures with those for the projected stabilized year for the subject property in order to determine whether there is enough leeway to cover debt service during low points in the occupancy cycle.

» 13.06 FEASIBILITY

The key to determining the economic feasibility of a lodging facility is the value estimate derived from the income capitalization approach. A new hotel is feasible if the economic value of the hotel as determined by the income capitalization approach exceeds the total replacement cost for the facility by a wide enough margin so as to provide the developer and the investors in the project with a satisfactory profit.

The same type of feasibility analysis is carried out each time a hotel is bought or sold. Essentially, the buyer performs an analysis based on the income capitalization approach and establishes a maximum price that he or she is willing to pay. If the

selling price demanded by the seller is less than the value set by the buyer's analysis, the deal is made.

» 13.07 PROPERTY TAX ASSESSMENTS FOR HOTELS AND MOTELS

Among the significant expenses incurred by hotels are the property taxes paid to local municipalities. Because hotel owners may pay as much as 8 percent of their total revenue in real estate taxes, hotel owners and operators should constantly monitor their hotels' tax assessments to ensure that their property tax burden is kept to a minimum.

Property taxes are levied by municipalities to generate revenues to pay for essential government services. The purpose of real estate taxes is to allocate the municipal tax burden on the basis of real estate value. The higher the value of the real estate owned by a taxpayer, the larger the proportion of the tax burden the individual must assume. The concept underlying this tax is known as ad valorem, or in proportion to value. To establish the proper distribution of the tax burden, municipalities employ tax assessors to value all the taxable property within their jurisdiction. Theoretically, the assessed value of a property should bear a definite relationship to market value, so that properties of equal market value have similar assessments and properties of higher or lower value have proportionally larger or smaller assessments.

[1] Estimation of Market Value

The goal of the entire property tax assessment process is the accurate estimation of market value. This goal is fairly easy to achieve for real estate such as vacant land and single-family homes. However, the issues involved in developing a supportable estimate of value for more complex properties become highly complex. Leading the list of property types that are difficult to value for assessment purposes are hotels and motels. Assessors must understand that lodging facilities comprise more than the traditional property components of land, bricks, and mortar; they are retail-oriented, labor-intensive businesses necessitating a high level of managerial expertise. In addition, hotels require a significant investment in personal property (furniture, fixtures, and equipment) that has a relatively short useful life and is subject to rapid depreciation and obsolescence. Characteristics specific to lodging facilities must be taken into consideration during the hotel assessment process in order for an accurate value assessment to be determined.

[2] Improvement Value Evaluation

Hotel owners should monitor their property assessments on an ongoing basis to ensure that a favorable assessment relationship with other hotels in the taxing jurisdiction is maintained. This can be accomplished by evaluating the assessed values of all comparable hotels within the local market area. Assessors generally provide separate values for land and improvements. Since it is usually difficult to successfully appeal the land portion of the assessment, only the improvement value portion of the property assessment must be evaluated.

The first step in the evaluation process is equalizing the improvement assessment by using a common unit of comparison, which for a hotel is the assessed value per available room (i.e., the improvement assessment divided by the room count). The assessed values (per room) of all the comparable hotels are then compared with the

owner's to determine whether the properties have been fairly assessed relative to each other. Adjustments related to differences such as quality of facilities, number and types of amenities, product class, and markets served should be considered. At this point in the analysis, owners should be looking for glaring discrepancies between the assessed value of their property and that of other hotels in the market area.

Comparing the assessed values of hotels within a taxing jurisdiction by means of this technique only pinpoints inequities between hotel assessments; it does not verify that the assessed value placed on a property is fair relative to its market value or the value of other types of real estate.

To evaluate the relationship between a property's market value and its assessed value, hotel owners should use the income capitalization approach, as previously set forth in this section, to aid in determining a fair assessment of the value of their lodging facility.

HVS

CHAPTER 14

Investment Strategies

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» 14.01 REASONS FOR INVESTING

The following is a list of reasons to invest in hotel real estate:

1. Hotel real estate is typically countercyclical to stocks and bonds and provides portfolio diversification.
2. Hotels are an inflation hedge because hotel rates can be adjusted daily, within the constraints of market conditions.
3. Hotel real estate provides a refinancing opportunity that can generate tax-free return of capital from appreciating assets. Mortgage amortization also creates equity.
4. Hotel investing can be tax efficient because of associated depreciation and amortization write-offs.

5. Hotel real estate provides a competitive total return, and includes a current income component.
6. Hotel real estate is less volatile than equities.
7. Real estate is the single largest asset class available for investment.
8. Travel and tourism is the world's largest employer and industry. According to the Wharton Economic Forecasting Associates Group (WEFA), travel and tourism accounts for 10.2 percent of global gross domestic product, or $2.6 trillion; 183 million employees or one in every ten workers; 11.2 percent of capital investment (US $613 billion) and 11.0 percent of consumer spending worldwide. Travel and tourism is expected to increase over the next ten years.

» 14.02 HISTORICAL PERSPECTIVE

Rarely can an investor or company succeed through imitation or cost cutting. Creativity is necessary. However, creativity usually does not mean a truly new or revolutionary idea. What is generally needed is a new combination of ideas, an extrapolation of what is already known. This chapter reviews the recent history of the hotel industry from the perspective of hotel investment, describes the investment objectives that hotel real estate is most suited to achieve, and, finally, develops a series of investment guidelines.

The various participants in a typical hotel investment do not usually have the same goals or interests. Most participants, with the exception of the owner, are geared toward up-front fees, short-term benefits, and maximizing annual fees based on total revenue rather than toward profitability of the asset. The following sections consider the goals of some of the participants in the traditional hotel investment.

[1] Hotel Chains and Management Companies

In the early 1960s, companies such as Hilton and Sheraton created management contracts as a means of expanding into overseas markets. Once the viability of management contracts as an expansion vehicle was demonstrated, most US hotel groups emulated this strategy during the 1970s and the 1980s to capitalize on the advantages of third-party ownership. These management contracts featured up-front pre-opening fees and annual base management fees, generally ranging from 3 percent to 4 percent of total revenue. While many of these contracts included provisions for an incentive management fee, some management companies had no expectations of ever realizing them. The 3 percent to 4 percent base management fee, in many cases, was sufficient to allow management companies to realize a 50 percent net operating income after all operating and fixed charges.

The revenue-based (as opposed to profit-based) fees led to a continual upgrading of a chain's amenities and services, which increased revenue (and the fees) but not necessarily profits for the owner. Most of these management contracts lasted for long periods of time (more than twenty years) and did not provide any performance clauses or mechanisms for replacing inappropriate or incompetent operators.

As the real estate industry expanded in the 1980s, both foreign and US hotel groups were pursued by investors and owners in what was generally regarded as a "sellers' market" for management companies. Today, however, there is much competition between and among hotel groups and other management companies, and the market has turned in favor of the buyer of management services.

[2] Developers, Syndicators, and Architects

The short-term goal of developers during the 1960s and 1970s was to earn an up-front development fee or profit. Limited partners, brought into a deal by a fee-taking syndicator, were motivated primarily by tax write-offs. Their short-term goal was to shelter personal income with accelerated depreciation write-offs. Architects, frequently unburdened by such tedious concerns as economic budgets, designed properties that satisfied the egos of developers and provided syndicators with a salable image. Property amenities, room sizes, and construction quality increased (only partly as a result of a more competitive environment), whereas consumers' willingness to pay for these improvements did not rise at the same rate.

[3] Lenders

The desire of savings and loans to compete with commercial banks, their new authority to lend money to nonresidential borrowers, and their desire to increase volume and achieve higher levels of fee income resulted in excessive financing during the 1980s. Many savings and loans made a profit with up-front points and fees, in addition to high interest rates on near 100 percent loan-to-value financing. Other underwriting deficiencies included the failure to obtain accurate independent and timely appraisals, and lenders operating with incomplete or nonexistent "in-substance" foreclosure rules. In-substance foreclosure occurs when the debtor has little or no equity remaining and loan repayment is doubtful but the mortgagee has not taken possession of the asset.

[4] Highs and Lows

During the past nineteen years, occupancies peaked in 1979 at 72 percent and declined to 61 percent in 1987 and 1991. The average occupancy for the nineteen-year period from 1976 to 1994 was 65.7 percent. The average occupancy in 1995 was 65.5 percent. With the exception of the five-year period from 1988 to 1992, room rate growth has exceeded inflation for the twenty-year period from 1976 to 1995, demonstrating that hotel investments, unlike stocks and bonds, are a good inflation hedge (countercyclical), and a good investment for inflationary economies. In 1970, only 35 percent of US hotels were chain affiliated. **By** 1995, roughly 75 percent of US hotels were chain affiliated.

Hotels are retail-oriented, labor- and capital-intensive businesses that depend on customer acceptance and require a high level of managerial expertise. The hotel industry is cyclical, event sensitive, and volatile. Hotels can be high-risk investments, especially if the management company, developer, syndicator, architect, and lender do not have congruent interests and goals. As a result of divergent interests among these participants, many hotels have been built in markets that did not need additional hotel capacity, and at escalated costs resulting from up-front fees, which meant that while many hotels were not profitable, many of the participants in hotel deals made money, at the expense of the hotel owner.

The US lodging industry during the 1980s was characterized by a massive building boom (product segmentation), favorable tax laws (syndication), strong economy, a rising stock market, extremely strong capital markets with declining interest rates, significant increase in hotel debt levels, and foreign participation (globalization), which drove up purchase prices. Net interest payments increased from less than 7 percent of total revenue during the late 1970s and early 1980s to more than 14 percent by 1991.

From mid-1990 to late-1993, the US lodging industry suffered through a worldwide recession and was further hurt by the junk-bond market collapse in late 1990, the Persian Gulf war in early 1991, illiquidity in the capital markets, and overbuilding. Overseas lenders and investors substantially reduced their activity in the US, and the Financial Institution, Recovery, Reform and Enforcement Act of 1989 (FIRREA) required more stringent capital standards for thrift institutions,

In addition to the changes in lending policies mandated by FIRREA, many newly conservative institutions reduced new real estate funding levels as a response to large increases in their nonperforming real estate loans. Because banks and savings and loan associations had historically been the source for roughly half the financing for commercial properties, a material reduction in loan activity significantly affected real estate markets. The shortage of debt financing occurred at a time when many 1980s bullet loans and mini-perms were approaching maturity. According to a national accounting firm, more than $2 billion in hotel loans was delinquent or in the process of foreclosure as of September 1990. More than 40 percent of the mini-perms and construction loans held by US banks were scheduled to mature by the end of 1992.

Hotel values eroded considerably during the recession, and capable buyers typically dictated price and terms of a hotel sale. Sales of foreclosed hotel assets by the Resolution Trust Corporation and the Federal Deposit Insurance Corporation during the early 1990s, regardless of the poor condition of the capital markets, resulted in liquidation pricing. In short, the market favored hotel buyers.

The industry returned to profitability in 1993 through a reduction in interest (lender write-offs), payroll (downsizing), property taxes (lower values), and food and beverage expenses and reductions in management fees. In 1993, for the first time in five years, average rate increased at a rate greater than inflation. By late 1993, a flurry of activity in the market began as investors slowly realized that hotel values had hit the bottom of the cycle. It appears that in 1996 the greatest inflow of capital into the hotel industry in more than a decade will have occurred. From 1994 to today, a rising US stock market, favorable interest rates, an expanding economy, and a lack of new hotel supply (particularly in the full-service segment) have helped the hotel industry.

[5] Current Environment

New full-service hotel construction in the US is currently inhibited because (1) development costs exceed value; (2) there is limited capital availability for new full-service construction, and (3) many projects require multi-year development lead times. Most industry sources do not expect significant new, full-service hotel construction in the US between now and 1999. Nationally, room starts have already increased 250 percent from 1993 (excluding Las Vegas casino starts—see Chapter 23) to 1995. Currently there is a shortage of decent hotels available for sale. At the same time, large pools of qualified potential buyers are seeking new acquisitions.

» 14.03 VALUE DRIVERS: INDUSTRY FUNDAMENTALS VS. CAPITAL MARKETS

Capital availability is a prime determinant of values in the hospitality industry. Liquidity facilitates transactions and provides for price discovery. Without liquidity, small capital flows can move pricing.

While occupancy figures receive a lot of publicity, other factors, such as changes

in average rate, investor psychology, financial liquidity, and profitability ratios are also very important. Capital availability and cost affect returns more than industry fundamentals such as occupancy and average rate. Capital availability drives capitalization rates and new construction feasibility and therefore new supply. Supply changes have a higher correlation with capital availability than with demand. Unfortunately, supply growth does not necessarily correlate with demand growth. In the early 1980s, room starts nearly doubled, while occupancy was steadily declining from its 1979 high. The early 1990s crash was a result of a capital crash more than it was a result of a demand crash or overbuilding.

Real estate assets typically exhibit lower volatility (and consequently lower returns) than stocks or bond investments; however, in the short-term, a hotel's performance may vary more than other types of real estate with long-term leases. This variability dictates either longer potential holding periods to smooth out industry cycles or a market cycle timing approach, with the end result of potentially greater equity returns for hotel investments as compared to other real estate.

Hotels, perhaps more than any other type of real estate, display cyclical occupancy trends over the long term. New hotels are built either because of an abundance of capital or because growth in demand causes an increase in area-wide occupancy levels and attracts the attention of developers, lenders, hotel chains, and management companies. When the rate of new property construction outpaces growth in demand, overall occupancy levels decline while demand "catches up" and/or the least competitive facilities drop out of the market.

» 14.04 INVESTMENT STRATEGIES

[1] Timing the Market

Unlike stock investing, the best strategy for investing in hotel real estate is market cycle timing, not dollar-cost-averaging or holding for long time periods. Hotel real estate market cycles take years to change, while equities can change in a day. The Tax Reform Act of 1986 removed many of the tax benefits associated with real estate ownership that had assumed greater importance than sound economic underwriting. That the industry remained relatively strong for three to four years after the Act was passed demonstrates how easy it is for an astute investor to time the hotel real estate market.

The hotel real estate cycle historically is eight to twelve years long. The building boom of the early 1920s came to an end with the depression of the early 1930s. The REIT-induced real estate slump of the early 1970s was forgotten by the time of the peak of 1979 and the early 1980s. That peak ended in the early 1990s. Many investors that purchased hotels at or near the bottom of the 1970s cycle and sold in the early and mid-1980s realized large returns. Those investors that purchased hotel property in the early 1990s will earn huge returns when as they sell in 1996 and beyond.

The most prudent time for hotel acquisition, as demonstrated by the 1970s and 1990s real estate cycle, is not when the market is achieving strong occupancies and many new properties are under development, but rather when new construction has peaked and occupancies and average rates are improving.

[2] Risk Avoidance

An approach that not only analyzes investment opportunities prospectively but also assesses potential risk complements this market cycle timing strategy. Controlling

downside risk maximizes portfolio yields, in the same way that the baseball batter that consistently hits doubles and triples will outperform the "home-run or strikeout" hitter. Risk is managed with adequate cash reserves, intelligent renovation plans, low property break-even levels, and an asset diversification strategy.

The selection of hotel properties may be the most important aspect of a combined market cycle timing/risk avoidance strategy. Recognizing current and future value, buying "right," enhancing value with effective asset management, negotiating well-structured property management and franchise agreements, and selling at or near the peak in the real estate cycle is a strategy that has proven successful.

[3] Appreciation Maximization

It is a good idea to focus on appreciation and seek to maximize total return and not just current yield, because yield can be more than offset by capital losses. Current income is not always a true indicator of underlying asset value. A high current dividend strategy favors premium-priced performing hotels in strong markets. These properties often have minimal upside, if they have any at all. Because at the time of acquisition these assets are maximally productive, they sometimes have only one direction in which they can move—downward—and are therefore higher-risk investments than they appear. The reliance of the pension fund community on this investment strategy is a significant reason for its poor performance in hotel investments. Strong hotels in strong markets sell at premium and may be at the peak of their life cycle. Appreciation maximization strategy seeks strong market positions with defensible niches. High penetration rates or profit margins are indicative of a dominant competitive position. However, when the market is very strong, it can attract competition.

Secondary markets are sometimes better markets in which to execute this strategy because they sometimes attract less notice, and therefore less new competition.

Performing hotels in recovering markets are hard to value, because market changes are beyond the hotel owner's control. The greater the percentage value attributable to future market behavior, the greater the likelihood that value will vary over time. However, market recovery bets can be very profitable—hotel investors that bought well-located, strong property in the oil-producing, depressed areas of Texas and parts of Colorado in the late 1980s have demonstrated this with huge earned appreciations since that time.

Some hotels are underperforming and are located in weak markets. Weak hotels in weak markets face two questions: will the asset improve and will the market improve? Such hotels are too risky.

[4] “Fixer Uppers”

The most consistent way to maximize returns and minimize risk is to find hotels that have a problem that can be fixed. The fixable requirement generally excludes locational problems. Buying underperforming hotels in sound markets is less risky because the investor is not dependent on factors out of his control. If the market is sound or even strong, he does not have to wait for the market to turn around—he needs only to turn the property around. Five basic strategies for purchasing hotels include:

1. Look for properties that are receiving their fair share of revenue but have high expenses that can be reduced with competent management. Increases in cash flow from expense reductions are generally less risky than forecasted

revenue increases. Historical statements should be recast to provide an example of potential cost savings and the effect on value. Roughly 40 percent of all the expenses at a hotel are labor. An expense reduction strategy should focus on the number of employees currently at the hotel, their wages and benefits, and labor productivity based on sales. Characteristics of under-performing properties may include rising expenses, expanded accounts payable, accelerated staff and management turnover, erosion of guest services, sales and marketing cutbacks, and deferred maintenance.

2. Properties that need capital expenditures are good acquisition candidates. One strategy is to buy well-located property in poor condition, and completely renovate and reposition. Pressure to sell is often strongest when the immediate need for property refurbishment clashes with owner illiquidity, loss of confidence, disinterest, and pressure from bankers.

A variation of this strategy is to purchase run-down, de-franchised hotels at the end of their economic life cycle for little more than land value, say $10,000 to $20,000 per room. In many cases these old properties have the best locations in a market, and after renovation the investor is left with a franchisable mid- or upper-level hotel in a strong location at one-half the cost basis of its competitors. One of the challenges with this variation is that many municipalities require that a property, upon a major renovation, be brought back into compliance with current codes. Compliance-type improvements rarely provide an adequate financial return.

3. Reposition properties at a lower level, if it will increase net operating income.
4. Buy hotels with excess development capacity or excess land in markets in which additional development is warranted. This provides immediate cash dividends from the existing asset and future development potential upside.
5. Buy hotels with clearly definable and divisible wings and replace with multiple brands at different price points.

[5] Buying Below Replacement Cost

The principle of substitution—essentially, that the buyer will evaluate available purchase options with equivalent utility and select the property with the lowest price—is the driving force behind hotel real estate values. In the income approach, it is embodied as the concept that a prudent purchaser would not accept a return on a property that would be below an alternative investment of similar risk. In the sales comparison approach, the principle of substitution means not paying more for a property than the cost of acquiring an equally desirable substitute. In the cost approach, the principle of substitution is expressed as not paying more for a property than the amount for which a site can be acquired and improvements that have equal desirability and utility constructed.

In most markets, supply and demand conditions eventually generate investment returns that justify new construction. When this occurs, existing buildings that are of comparable quality to new construction command similar rents (RevPAR), and thereby generate greater returns to the extent that the asset was originally purchased below replacement cost. The critical variables determining profitability include the duration of time for market supply and demand balances to change, capital adequacy, and the quality and life cycle position of the facilities.

A secondary advantage to buying below replacement cost is the fact that the feasibility of new construction is limited, which protects current yields.

Hotels are often mispriced because of limited data and inefficient capital markets. Often, too, value distortions are psychologically based. Common psychological distortions include overpaying for investments that appear secure (pension funds, for instance, are mistakenly drawn to assets with high dividend yields), overestimating risks, and overcompensating others for those risks.

A good way to separate value from emotion is to emphasize fundamental research, disciplined valuation techniques, and strict buy-and-sell rules when making a buying decision. While it is important to be able to identify unrecognized opportunity, one must avoid the tendency to overestimate the likelihood of a favorable but unlikely occurrence.

Financial projections should not automatically project that each year will be better than the preceding one. Recessions do occur. Real estate is a depreciating asset with a finite economic life that includes not only a growth phase, but also maturity and decline. Few operating histories trend steadily upward. Most properties move upward and downward.

Stabilization is an important concept in this regard. A stabilized occupancy and average rate is the average performance for the property *over its remaining economic life,* and not a point reflecting the hotel's current life cycle position. The danger occurs when a property is incorrectly stabilized at a peak level during the acquisition analysis, but the holding period is for a longer term. The buyer often ends up trying to exit the investment at a performance level below the level at acquisition, resulting in a loss. It is important to realize that most projection periods are longer than the ability to project new supply. Consequently, it is a good idea to have short holding periods, as well as an exit strategy developed prior to acquisition.

[6] Short-Term Holding Periods

Hotels have a definite functional life. Because exterior architectural styles change regularly, many lodging facility exteriors appear dated after seven to ten years. Major exterior renovations are usually required after twenty years.

Asset values decline exponentially after the mid-life point of a hotel. However, major renovation and repositioning can postpone a hotel's mid-life for many years, depending on the strength of its location and market.

The industry uses a standard 4 percent replacement reserve, which some claim is less than half what it should be. The naysayers, however, demonstrate an incomplete understanding of hotel valuation. First, the 4 percent replacement reserve is meant to cover only the costs of replacing the furniture and equipment. It specifically excludes so-called short-lived building components. Short-lived building components are building systems such as a roof, parking lot, or boiler that will need to be replaced before the end of the asset's useful life. Real estate theory holds that if short-lived building component replacements are not, by industry convention, deducted from cash flow, then those costs are considered by the market in its selection of an equity yield. In this respect, short-lived building components are not unlike the asset management function and incentive fees. All three of these items are costs implicitly considered in the selection of an equity yield rate. If short-lived building components are to be deducted from cash flow, then equity yield rates must be adjusted to reflect this new assumption.

Over the long term, all investment returns trend toward the mean. Short-term holding periods accomplish the following:

- Mitigate illiquidity because of increased stability in the forecast horizon. Short-term cash flows are more reliably projected, resulting in lower risk.

- Force a full evaluation of the exit strategy before committing to the investment.
- Reduce the potential for negative event volatility.
- Reduce the likelihood of short-lived building component (e.g., roof, boiler) replacements, which rarely result in increased profitability.

Beyond the stabilization period, value increases occur at a lower (inflationary) rate. The risks inherent in owning a hotel and associated required capital expenditures are generally not adequately compensated with a 3 percent to 4 percent annual inflation-driven increase in cash flow and value. The exception is a well-diversified portfolio that is investing in hotels purely as an inflation hedge.

[7] When to Sell

Signs that selling a hotel may be appropriate include:

- When a value estimated using the market data approach (comparable sales) exceeds that arrived at using the income approach or cost approach valuations.
- When national occupancy levels exceed 68 percent-70 percent;
- When gross domestic product (GDP) declines materially;
- When new construction occurs at a rate above demand growth;
- When comparable sales occur at or near historically high levels;
- When sales occur at capitalization rates that exceed the normal cap rates of the industry over a long-term period.

Exit strategies for investments in the fee, leasehold, or leased fee estates of real property can include, but are not limited to, the following:

- Sale of assets individually, as a group or a combination of group and individual sales;
- A public offering as a real estate investment trust (REIT) or other public offering;
- A securitization or other refinancing;
- Contributing the equity value in the assets to capitalize a new investment;
- A leveraged buyout;
- A syndication; and
- Conversion to time share, an alternative use, or term interval ownership (time share for a limited number of years which then reverts back to original estate interest).

Investments that have a high likelihood of being acquired by strategic buyers and/or are likely candidates for public offerings enhance the potential profitability of the exit or residual return.

[8] Public vs. Private Ownership

Does real estate belong in a public company? Should it be privately held, either wholly or with others? Consider the following when answering these questions:

- Depreciation depresses earnings and therefore stock prices.
- The public market historically has had difficulty measuring unrealized asset appreciation and value changes.
- Hotels have an earnings volatility that is greater than other forms of real estate because of high fixed costs, high leverage, and event sensitivity. An aberrational quarterly earnings report can dramatically change a company's stock price. This causes a drive to consistently improve each quarter's cash flow. The danger of this situation is that it may change management's focus from a value creation and appreciation maximization strategy to a high current cash-on-cash yield acquisition strategy. Current income is often not a true indicator of underlying asset value, and current yield can be more than offset by capital losses.
- Because of quarterly earnings pressure, public companies are more likely to hold a property for a period beyond a one-to-three-year turnaround-and-stabilize period. This is antithetical to short-term holding periods and locking in gains, and it may minimize the value of underlying assets.
- Public market pricing often results in a significant premium over market value of the assets. Public hotel companies are currently trading at multiples of 15 to 20 times earnings before interest, taxes, depreciation, and amortization (EBITDA). EBITDA is roughly the public market equivalent of the private market's net operating income or the REIT market's funds from operations (FFO). The reciprocal of an earnings multiple is a cap rate, and therefore the reciprocal of a 20 EBITDA multiple is a 5 percent capitalization rate (1/20 = .05). The assets held by the companies that are trading at 20 multiples would not be worth a 5 percent cap rate if sold in the private markets. For this reason going public can be an excellent portfolio exit strategy. The execution of this strategy however, will require a growth story.

The current difference between public and private market hotel valuation creates the question: Why are the public markets valuing these hotel companies so highly? The standard answer is that they will grow quickly and that today's 5 percent cap rate will grow into a 15 percent cap rate. The second question is What distinguishes a public company's growth prospects from a private company's growth prospects? The answer to this question is simply that public companies typically have greater access to capital. In essence, today's public companies are realizing a value arbitrage that doubles their value simply because they have ready access to capital.

In order to maintain this value arbitrage, public companies must meet the market's growth expectations. This can put pressure on the acquisition and development strategy at public companies. Valuations of public companies are often based on a single quarter's or a single year's performance. Therefore, fluctuation in revenues and cash flows leads to increased risk and volatility of share values. To attract investors, properties may be chosen on the basis of their *current* cash, which translates into the desired yield. As a result, sourcing product on the basis of high current yields may favor short-term, high-risk properties over high-quality, but developing, long-term prospects.

The public markets are fickle and do not completely understand real estate. Today's favorable valuation could easily be tomorrow's unfavorable valuation. The public markets are best used either as an exit vehicle or as a means to fund an aggressive growth plan and achieve critical mass.

Because of high fixed costs, marginal revenue creates disproportionate increases in net income. Publicly held companies, whose critical mass (growth) is supplemented by ready access to capital, should increase market share.

[9] Equity Leveraging

Equity leveraging, like debt leveraging, is designed to maximize the impact and return of equity capital. Equity leveraging generally consists of either (1) selling a partial interest in an asset, or (2) making acquisitions through a joint-venture arrangement. A joint-venture arrangement may consist of a new joint venture with, for example, one-third of the funding coming from an operator contributing the equity value of its owned real estate and a passive capital source contributing two-thirds in the form of cash. The advantage to the capital source in its investment is, for example, one-third specified, and is not completely blind. This arrangement provides an immediate cash-on-cash return. Presupposing that both joint venture partners receive the majority of their compensation on the same bottom line, this arrangement is very effective in aligning the interests of the operator and the passive capital source.

Selling a partial interest is a similar idea applied to a single asset. By selling a partial interest in an asset, generally 49 percent to 90 percent, the seller is able to free up equity for additional investment while still retaining a portion of a property's future appreciation. Equity leveraging is particularly useful when an investment strategy includes a market recovery bet. Equity leveraging a single asset occurs most often with larger more expensive hotels.

[10] Diversification Strategy

Because of event sensitivity, several smaller investments of any type are better than a single big bet. Because hotels are market- and management-sensitive, diversification is particularly beneficial. A strategy designed to accumulate a well-balanced portfolio that spreads market and product risk among different hotel types, affiliations, and sizes in a variety of locations reduces volatility. Diversification by strategic objective, quality of facilities, age, types of demand generators, financial structure, and seasonality as well as market segmentation increases stability and reduces risk.

[11] Miscellaneous Strategies

[a] Broker Relations

It is important to maintain regular and honest communication with the brokerage and investment banking community. A steady and consistent deal flow ensures that an investor is in tune with market conditions. Additionally, strong personal relationships with the agency community means that investors will be exposed to listings with short marketing periods.

Often the highest bidder is not the prevailing party. Issues such as speed and track record are important considerations. A personal relationship with your broker can help you in these "soft" considerations.

[b] Brand Creation and Critical Mass

Buy assets that can be leveraged into chains. Critical mass in the hotel industry is central to the success of most hotel companies and essentially separates the major chains from the minor ones. It may best be defined as the minimum number of hotels and hotel rooms that will economically support a full-service corporate structure. Typically, one hundred hotels in the US constitutes critical mass. Included in the full-service corporate structure are the advertising and consumer brand awareness of the

chain as a whole, a central marketing staff, and a central reservations system. Additional benefits that might be derived from critical mass include the availability of chain-wide purchasing contracts for both goods (furniture and equipment as well as consumables) and services (notably advertising and marketing services), and may also include such items as insurance.

When critical mass is achieved, having your own brand is cost-effective. Royalties paid to franchise companies are usually 3 percent of rooms revenue and generally represent the franchise's profit. Three percent of the rooms revenue for 100 hotels represents a substantial expense savings. The development of a brand also creates franchising as an option. Upon reaching critical mass, franchising can be very profitable. One of the criteria for a hotel to be a trophy hotel is whether its name is well-known enough to merit development as a brand name. If this criterion is met, part of the purchase price may be allocated to launching a brand as opposed to the acquisition of real estate,

Devotion to expanding a brand, however, might slow the pace of growth and cause an investor to miss good hotel real estate and business investment opportunities. The ideal situation, provided there is sufficient capital, is to have the ability to grow both a proprietary brand and other brands.

[c] Barriers to Entry

Because supply increases are driven by capital availability and not by industry fundamentals, it is a good idea to search for markets with high barriers to entry. The premium hotel in a premium market strategy should be combined with high market barriers to entry to justify the premium price paid. Barriers to entry include hotel mortgage financing and hotel equity availability, market values that are less than replacement cost, tax laws, interest rates, environmental issues, local protectionist sentiment, prevailing mechanisms for project approval, and local politics.

» 14.05 MANAGEMENT ISSUES

[1] Aligning With a Hotel Management Company

The investor should carefully choose and then limit the number of people he does business with. Funding long-term relationships and not deal-by-deal transactions and aligning with a value-adding management company willing to be compensated on the bottom line are ways to accomplish this. The profit on management fees enables management companies to pay more (10 percent-20 percent) than passive investors, to whom management/affiliation fees are simply an expense.

[a] Congruent Interests

Passive institutional investors, the public capital markets, and savvy but passive, high net-worth individuals are now focused on aligning their interests with management's interest. These entities generally recognize hotels as retail-oriented, labor- and capital-intensive businesses that depend on customer acceptance and require a high level of managerial expertise. They acknowledge that unlike hotel operators, they are not industry insiders and are not comfortable relying solely on the management contract to align their interests with management's. Therefore, many passive investors require, or are attracted to, the following:

1. Management that has enough confidence in itself to invest in the asset.
2. Management compensation that is based on net income rather than gross revenue.

One way to align the interests of operators and passive investors is for the passive capital source to purchase a majority interest in the real estate and a minority interest in the management company. This feature, ownership in both the operator and asset, is similar to the paired-share real-estate investment trust (REIT) now known as Starwood Lodging Trust. Starwood purchased its predecessor REIT, Hotel Investor Trust, not for its poor-quality assets, but because it is the only hotel REIT in the United States that pairs shares in the operator and asset with every share purchase. This structure provided investors with such confidence that they were able to raise almost one-half billion dollars. Several REIT initial public offerings, including Hospitality Investors Trust, were not successful because the market was concerned about the nonaligned interests of the passive investors (shareholders) and management.

Investment performance is maximized by aligning the goals of the owner and manager so that both entities benefit mainly from residual capital appreciation and equity cash flows rather than from front-end and ongoing fees that are unrelated to financial performance. Management contracts with competent operators should be structured at reduced base fees (2 percent or less), for much shorter lengths of time (one to five years is not uncommon now), with meaningful incentive payments (a percentage of improved cash flow after debt service and after a preferred equity return) and performance clauses and guarantees. Earnout provisions by which the management company forgoes some cash flow in exchange for a percentage of the residual and/or refinancing proceeds are also a good idea. The manager, for example, may be compensated with a percentage of the return earned by the investment, after a 9 per-cent-15 percent preferred return to the investors. There should be no charges for acquisition or asset management and no placement fees of any kind for property selection, underwriting, due diligence, or technical service fees for the management of property renovations.

To maximize capital return upon divestment, management contracts should be cancelable without penalty upon a sale. That way, property can be sold unencumbered by a management agreement. Meaningful performance clauses should be negotiated where possible so that non- or underperforming management companies can be terminated. Considering the recent consolidations of management companies, an investor should attempt to eliminate the right of any management company to sell, transfer, or assign its rights, except to a wholly owned subsidiary.

[b] Selecting a Management Company

Selecting a hotel management company with the specific capabilities necessary for running a particular property is a key step in a hotel investment. Knowledge of the financial and market capabilities of a variety of management companies is helpful in selecting appropriate management companies. One should match the various characteristics of the asset (e.g., size and type of hotel, class, geographic representation in local and feeder markets, critical mass, market segments served, and facilities offered) with the operator that has the best track record, operating performance, and experience in handling these characteristics profitably. Factors to consider when selecting a management company include the following:

- Geographically clustered hotel companies with strong centralization tend to outperform the median.

- Because of high fixed costs, incremental business is most profitable. Therefore, marketing skills add the most value.
- Technology (yield management) can improve marketing, income, and value.

The investor should also consider the management company's rate of growth, expertise and track record, depth of management, turnover of corporate staff and key personnel, years that management has been together as a team, present and future company profile and philosophy, reasons for any past contract terminations, operating policies and procedures, owner references after a competitive bidding process, and fee structure.

» 14.06 CONSOLIDATION

Mergers and strategic alliances can enhance returns through synergy, economies of scale, a harvest strategy (otherwise known as milking the cash cow), and risk-pooling. Principal reasons for mergers include access to capital for future growth, improved critical mass and economies of scale, and shareholder value enhancement. When two complementary companies are brought together with minimal initial cost, earnings may receive an immediate boost.

Mergers can be a quick way to grow, but they are not without risks. Mergers present the risk of an unsolicited, and possibly hostile, offer from a third company. Another problem with mergers is that the number of reasonably priced available suitor companies with real growth potential is often quite small. Early on, a decision should be made as to whether the goal is simply to acquire real estate assets at favorable pricing or whether the acquisition of an ongoing effective company is the goal. It is a good idea to seek valuable business assets locked inside weak capital structures. If there is a desire to keep the target company operating, then issues such as the following are important:

- Cultural fit, style, trust, similar philosophy;
- Product compatibility, with manageable hotel location overlap;
- Credibility and reputation;
- Financial strength, performance, and value of assets.

Tender offers for REITs and public hotel companies when their stock market capitalization is less than the value of the assets also constitutes an attractive consolidation strategy.

» 14.07 MEZZANINE FINANCING

Mezzanine financing is supplemental debt financing that is either (1) wrapped around an existing first mortgage, like a bridge loan or second mortgage; or (2) a single debt instrument tranched (split) into a first mortgage component and a mezzanine, earnout, subordinated, or "B-rated" component. Generally, mezzanine financing is flexible and customized and provides for a high loan-to-value ratio (ratios in excess of 90 percent are not uncommon) or a below-market interest rate. In return, the provider of mezzanine financing receives interest payments and a significant portion of a property's future appreciation. Additionally, the mezzanine financing provider may receive other "equity-like" rights, including management contracts and affiliation agreements. A

mezzanine financing arrangement, which generally includes a sharing of future appreciation, can be structured so that appreciation sharing is a percentage split, pre-determined fees paid upon maturity, or as a negative amortization loan. Mezzanine debt is usually short term (two to five years). Mezzanine financing can be used in the following ways and under the following circumstances:

- To bridge the gap between low loan-to-value public bonds and equity down-payments.
- When the buyer does not have sufficient cash, or chooses to deploy his cash resources elsewhere.
- For asset repositionings that involve a renovation.
- To achieve full or partial takeout of existing financing at a higher loan-to-value.

In many cases the operator/owner becomes the prevailing bidder when buying hotel assets because they receive the additional benefit of management and/or affiliation fees and are able to economically offer a higher price than the non-operator. This "operator arbitrage" could be applied to the debt markets.

Buying nonperforming debt, with a subsequent foreclosure planned, is another way to gain control of property. However, foreclosure laws vary by state and this strategy is more viable in certain states. Further, this strategy carries the additional risk that the foreclosure may not be successful and the debt buyer will remain a debt buyer. In a worst-case scenario, some or all of the debt buyer's expenditure could be dismissed by a bankruptcy court. This strategy works best when the principals have legal backgrounds.

» 14.08 DUE DILIGENCE

As discussed in detail in Chapters 6 through 10, the following market and site/ property items should be reviewed.

[1] Market Analysis

The economic vitality of the area encompassing the subject property and its feeder markets is an important consideration in forecasting future demand and income potential. Trends that foreshadow probable future economic patterns of the market as well as the vulnerability of the lodging market to economic trends should be evaluated. The size of the market and the demand for transient accommodations should be investigated to identify the various generators of visitation operating within the local market. The current and anticipated potential of these demand generators should be evaluated. An investigation should be made of the respective strengths of the market in terms of seasonal volatility and other demand fluctuations, price sensitivity, required facilities and amenities, and changes in travel patterns and other related factors. The market's diversity, or reliance on a few demand generators, and the economic volatility, seasonality, and prospects of significant demand generators should also be analyzed.

Economic diversity within the local market has an important effect on the area's stability, growth, and risk. Economically diversified markets generally have reduced volatility. Seasonality creates volatility and risk. Large variations between months or daily occupancies and weekday versus weekend occupancies limit upside.

In analyzing demand, the overall transient lodging market should be subdivided into individual segments based on the type or nature of travel because individual classifications generally exhibit unique characteristics. Market segmentation helps to define major types of demand and to estimate future growth rates and customer characteristics. The market's and the subject property's reliance on or diversification by market segment, including contract business, should also be evaluated.

Competitive lodging facilities should be evaluated to determine their position, rank, and other pertinent operational characteristics with respect to the subject. An analysis of existing and proposed competition provides an indication of the current accommodated and latent demand, relative market shares and penetration, and price/value relationships for customers. Some of the competitive factors that should be specifically reviewed include:

- Number of rooms;
- Average rate;
- Occupancy;
- Market orientation and segmentation;
- Location;
- Chain affiliation;
- Age;
- Quality;
- Condition;
- Rate structure and pricing strategies;
- Class and type of facilities;
- Size of meeting facilities;
- Level of services and recreational amenities;
- Type of food and beverage outlets;
- Management difficulty and expertise;
- Frequent guest programs;
- Travel agent commission policy; and
- Market perceptions and the comments of property management.

The nature and status of projects under construction, proposed or merely rumored, that might be competitive with the subject property should be evaluated. Barriers to entry for new competition should be evaluated. The probability that existing, older, noncompetitive lodging facilities will receive substantial capital upgrades and thereby increase their level of competitiveness should also be considered.

[2] Site and Neighborhood Analysis

A thorough inspection should be made of the subject site that takes into account its physical and functional utility for hotel use, including its size, shape, topography, utilities, access, visibility, zoning, neighborhood, and other relevant location factors (e.g., proximity to both transportation systems and lodging demand generators). The supportive nature of surrounding land uses and patterns reflecting growth, stability, or decline should also be evaluated. The subject hotel's location, as compared with

competitor locations and vacant developable hotel sites and relative to current and future demand generators, is a prime location issue. Plot plans including frontages, total site dimensions, access points, orientation of the improvements, and survey and legal descriptions should be reviewed. In addition, soil tests and seismographic studies may be advisable.

[3] Subject Property Analysis

The physical improvements, facilities and amenities, should be inspected for their quality, style, design, layout efficiency, functionality, and effect on operating efficiencies and profitability. An evaluation considering size, condition, and suitability relative to the local market demand, segmentation, and competitive supply is necessary. As-built architectural/floor plans detailing the layout and relationship of spaces and areas within the property should be reviewed. This evaluation should include public areas, meeting facilities, restaurant and lounge facilities, back-of-the-house areas, mechanical equipment, and a sample of all guestrooms. Furniture and equipment are essential to the operation of a lodging facility, and their quality often influences class, image, and income. An assessment of the subject property's remaining useful life and the quality of its construction and materials used, including furniture and equipment, should also be required.

Historical refurbishment, FF&E and capital expenditures, maintenance records and programs, current budgets, engineering studies, ADA Compliance Reviews, and Phase I and II environmental studies should be reviewed. Deferred maintenance and other mechanical, building, or FF&E issues that require remedial attention must be identified. The sufficiency of proposed capital budgets, PF&E reserves, and insurance coverages should also be evaluated.

Franchise agreements; reservation reports; franchise inspection and deficiency reports; health, fire and building inspection reports and employee manuals should be reviewed as aids in evaluating the probability of losing or changing the current chain affiliation.

It is important to inspect the subject property's technology. This technology includes systems for yield management, accounting, property management, point of sale, building operations, sales and catering, life safety, security, and guestroom access. Yield management maximizes the ability to sell more higher-priced rooms during times of peak demand periods by specifying a varying number of rooms available at discounted rates during a given period, depending on overall demand. This technique reduces the likelihood of turning away guests who are willing to pay a higher rate because the units are occupied by patrons paying lower rates.

[4] Supply-and-Demand Analysis

A supply-and-demand analysis should be used to understand and quantify the subject property's competitive positioning with respect to other lodging facilities. This analysis integrates all information regarding the data and information gathered during the fieldwork inspection, such as the subject site and facility analysis, area hotel and economic trends, demand characteristics, and competitive analysis. The supply and demand analysis results in a quantification and documentation of probable future trends in the subject property's market share, occupancy, average rate, and overall rooms revenues. Markets in which competitors have a lower cost basis should be carefully evaluated, because the competitors can then profitably afford to undercut your rates.

[5] Financial Analysis

All practices and procedures involving financial management and results should be reviewed. In particular, the following items should be analyzed:

- Historic income and expense statements with full supporting schedules for the past three years (if available). Any audits or financial reviews should also be considered when available;
- Balance sheets (audited when possible);
- Operating budgets and projections;
- Annual reports (if a public company);
- Actual operating data from comparable lodging facilities;
- Marketing plans;
- Reservation system reports;
- Current definite and tentative pre-bookings and rate structures;
- Historic pre-booking conversion rates, booking pace, and rate structures;
- Occupancy and average rate summaries by month;
- Local expense factors relating to items such as labor, food and beverage costs, energy rates and bills, assessed values and taxes;
- Contractual obligations under frequent traveler programs;
- The relationship between rooms revenue and total revenue; and
- The level of fixed costs.

A projection of income and expenses representing future expectations of income potential, and corresponding to the level of activity and quality of operations indicated by the projected occupancy and average rate, should be developed. Various scenarios or "stress tests" (including best and worst case) should also be developed to test the sensitivity of various assumptions and projections. Actual inflation that varies significantly from projections can alter anticipated yields. The sensitivity of projected investment yields at different inflation rates should be tested. Because of the effects of compounding, a small deviation in assumptions can have a large impact on value.

[6] Other Analyses

Any property, equipment, ground or tenant leases or subleases, management contracts, union agreements, service contracts and key supplier relationships, or trademarks/trade names and any documentation pertaining to in-lieu of property taxes or other property tax concessions should be reviewed by a hotel real estate professional for business issues, as well as by an attorney for legal issues. Appraisals, market and feasibility studies, and impact studies should also be reviewed to discover any previously unknown facts, and to evaluate the reasonableness of the assumptions and conclusions. An accountant should be used for financial audits and reviews and to evaluate tax returns and other relevant tax and accounting considerations.

Payroll is generally a lodging property's greatest expense. The current staffing level, any wage and benefit surveys, qualifications, and compensation of on-site management should be reviewed and compared to industry norms, as should existing labor control systems.

A detailed ownership record and history of the subject property with names of legal owners is important. Legal due diligence should include all contracts and current letters of intent, including any existing mortgages to be assumed or wrapped, title reports and insurance, stock or partnership agreements, major group booking contracts, frequent traveler programs, and service and maintenance contracts. A zoning and life safety compliance analysis should also be undertaken and any Hart Scott Rodino and tax issues investigated. The existence of any violations and the transferability of all licenses, permits, franchises, and other documents also must be evaluated.

In the case of mortgage due diligence, the borrower's credit history and reports, track record, and references should be reviewed, along with the history of any existing indebtedness, both secured and unsecured. If due diligence is for a purchase, an inventory list of all furniture and equipment, supplies, and consumables will be necessary, as will a list of all employees and appropriate personnel information. Due diligence for acquisitions should also include a detailed list of advance room and catering reservations and bookings, including the name of the party, deposit received, rate guaranteed, dates, status, and other relevant information.

Understanding and staying current with the hotel industry is a full-time endeavor. Third-party due diligence is not a substitute for full investigation by principals to a transaction. Instead it is an extra set of trained eyes and independent confirmation that appropriate questions have been asked, answered, and understood. In addition, third-party due diligence may save time for principals by focusing their time and efforts on areas of greatest need. Due diligence is analogous to insurance in that it reduces, but does not necessarily eliminate, risk.

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CHAPTER 15

Ownership Considerations

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» 15.01 OVERVIEW OF OWNERSHIP ENTITIES

The form of hotel ownership is a very important decision that must be made in the early stages of the hotel development process. Usually the decision is 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 forms of 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. Trusts
8. Real Estate Investment Trust (REIT)

[1] Tax Considerations

Each form of business entity has its own tax consequences; therefore, it is important to study each entity's tax impact on the hotel venture before deciding on a particular business entity. A brief description of the tax treatment for each type of ownership follows:

- *Individual ownership* lumps income, gain, and loss from hotel properties together with the owner's other items of income, gain, and loss.
- *Concurrent ownership* taxes each owner as an individual owner to the extent of his percentage interest in the property.
- *Partnerships*, whether general or limited, are not taxable entities, but are merely tax conduits; taxable income, gain and loss is passed through directly to the individual partners, who then treat these items as though they were individual owners of the property.
- *Regular (C) corporations* are taxable entities separate from their shareholders; they report income, gain, and loss separately. Consequently, corporate income and gain is subject to a double tax, once on the corporate level and again on the shareholder level when the income or gain is distributed as dividends.
- *S corporations, LLCs, and REITs* are separate legal entities that distribute income and losses in a way similar to partnership forms. There are, however, very specific statute requirements in the Internal Revenue Code that must be met to qualify for these entities.
- *Trusts* are taxable entities separate from their beneficiaries and thus similar to regular (C) corporations.

[2] Business and Legal Considerations

It is important for the hotel owner to look at the various business situations that he is likely to encounter and to determine thereby what form fits best. The wrong choice could mean missing a business opportunity that could cost the hotel owner severely. Some of the more important nontax considerations to review when choosing an entity are as follows:

- Cost of formation
- Number of people and type of management needed to run the hotel
- Degree of flexibility required to conduct the activities
- Extent of and probability of exposure to liability
- Ease of transferability of interest in the entity

- Estate planning
- Ease of transferability of the hotel property
- Expected duration of the venture

» 15.02 INDIVIDUAL OWNERSHIP (SOLE PROPRIETORSHIP)

The simplest business form is individual ownership (sole proprietorship). A sole proprietorship is any business that is owned by one person as an individual. As such, there is no legal distinction between the owner and his business. The owner establishes the sole proprietorship simply by opening up his hotel for business.

Under sole proprietorship, the owner keeps track of his business income and expenses and reports the results on his schedule C federal tax form along with other income and deductions that he has on his individual tax form. A major tax disadvantage of sole proprietorship is that the owner is responsible for paying both the employer and employee portion of the social security tax on earnings from the hotel. However, the owner is allowed to deduct half the payments on his federal tax return.

Sole proprietorships are usually found in small family-run businesses where the hotel property is the major asset of the owner. Most potential liability claims can be handled by the purchase of insurance. Also, if the owner should need to borrow money to build the property, the lending institution would more than likely require the owner to personally guarantee the loan even if the entity were in a corporate form of business. Thus, there is little incentive for a small operator to incur the expenses of doing business as a corporation.

» 15.03 CONCURRENT OWNERSHIP

Hotels can be held in one of three forms of concurrent (i.e. multiple) ownership:

- Tenancy in common
- Joint tenancy
- Tenancy by the entirety

Because concurrent ownership requires a high degree of cooperation between co-owners, it is normally used only when property is acquired by members of a family or by a small group of investors who have had a long association. The ownership is reported on each individual's tax return in accordance with the ownership interest and thus is similar for tax purposes to a sole proprietorship.

[1] Tenancy in Common

A tenancy in common is created when hotel property is transferred to two or more persons without express language creating one of the other two types of concurrent ownership (i.e., joint tenancy or tenancy by the entirety). For example, a tenancy in common is created by either of the following two conveyances: (1) To A and *B* or (2) To A and *B* as tenants in common.

The term "tenant" is used in its original sense as a co-owner of property, not in the sense of one who possesses real estate pursuant to a lease.

When two or more persons hold as tenants in common, each has an "undivided

interest" in the entire property to the extent of his or her ownership share. For example, conveyance to three persons, without designation of any percentage to each, would give each tenant in common a one-third interest in the entire property. Alternatively, the conveyance may allocate different shares to each co-tenant: for example, one of three co-tenants may own a 40 percent undivided share, with each of the others owning a 30 percent share.

All decisions with respect to the co-owned property must be unanimous; the property may not be sold, mortgaged, or leased without the consent of all the co-tenants. For this reason, tenancy in common usually is considered a viable form of ownership only for a small hotel project with very few investors. Co-tenants can agree that one or only a few of them shall have the authority to make all decisions with respect to the property; however, this creates a risk that the relationship may be deemed an association taxable as a corporation.

Each tenant's right to possession of the property is subject to the rights of the co-tenants. Each has the right to an accounting of rents and profits, and in the event any tenant spends money for the payment of taxes, insurance premiums, or necessary maintenance and repair, he is entitled to reimbursement by the other tenants for their share of the expense. If the co-tenants are unable to agree as to the management or disposition of the property, any one of them is entitled to begin a legal proceeding known as an action for partition. If the hotel property cannot be equitably divided, the court can order that it be sold, with the proceeds to be divided among the co-tenants according to their interest.

Each co-tenant may sell, mortgage, or give away his interest during life or transfer it at death. When the interest of a co-tenant is transferred to another, the new owner becomes a tenant in common with the remaining owners.

For tax purposes, each tenant in common reports his share of income, gain, or loss. If a co-tenant makes a gift of his share, the usual rules of gift taxation apply. In addition, a gift is deemed to have been made if one tenant in common pays more than his share of costs and is not reimbursed by the others. The interest of a deceased tenant in common is taxed as part of his estate, according to its value on the date of death or on the optional valuation date. The heirs acquire the interest of the deceased tenant in common at a stepped-up basis equal to the value used for estate tax purposes.

[2] Joint Tenancy

A joint tenancy is similar to a tenancy in common, with one very significant difference—the right of survivorship. If any joint tenant dies, his interest automatically passes in equal shares to the remaining joint tenants. If three joint tenants had owned the property and one died, each of the two survivors would take one half of the deceased joint tenant's interest. At the same time, in a joint tenancy as in a tenancy in common, all tenants are deemed to have an equal undivided share of the property;

in other words, three joint tenants each own a one-third undivided interest.

A joint tenancy can be created only by express language in a conveyance, for example, "John Jones and Mary Jones as joint tenants with right of survivorship and not as tenants in common." A conveyance merely to "John Jones and Mary Jones" normally creates a tenancy in common, not a joint tenancy. Joint tenancies, because of their unusual survivorship feature, normally are used only among family members. One advantage is that this arrangement not only designates ownership of property, but also can serve as a substitute for a will. Thus, no public record will exist of the transfer of the property and no probate proceeding will be required; this is an attractive

feature to many wealthy people. In addition/except for unusual circumstances, creditors of the deceased joint tenant cannot reach property that has passed into the hands of the surviving joint tenant (or tenants).

However, a disadvantage of the joint tenancy in owning property is that it does not permit other types of disposition at death that may prove more beneficial to the overall estate.

Although a joint tenant cannot devise his interest by will, the interest can be sold or given away during his lifetime. If this is done, the new owner becomes a tenant in common, not a joint tenant, with the remaining owners. This reflects the conceptual basis of early English common law, which conceived of joint tenancy as a merger of four unities: interest, time, title, and possession. The time requirement means that all the joint tenancies must be established at the same moment. Consequently, if one joint tenant later transfers the interest to another, the unity .of time is broken and the new owner becomes a tenant in common. Similarly, any joint tenant (like a tenant in common) may start an action of partition; if the property cannot be equitably divided, the property will be sold and the proceeds will be distributed to the parties.

A joint tenant reports his share of income, gain, and loss from the property. However, unlike the case with tenants in common, if one joint tenant pays expenses in excess of his proportionate share, the full amount of such expenses is deductible.

[3] Tenancy by the Entirety

A tenancy by the entirety is a joint tenancy between husband and wife. The tenancy carries with it the same right of survivorship as a joint tenancy so that, upon death of either spouse, the survivor takes the entire estate. Unlike a joint tenancy, however, neither spouse can convey any part of the property during their joint lives unless the other spouse joins in the conveyance. Thus, tenancy by the entirety (like the ancient right of dower) acts to protect the rights of the surviving spouse in property owned during the marriage. In most states recognizing the tenancy by the entirety, any conveyance to a husband and wife is presumed to be to them as tenants by the entirety, unless the title is specifically indicated to be otherwise.

Property held under tenancy by the entirety is not subject to levy by creditors of only one of the owners. In the event that the owners are divorced, the tenancy is destroyed and the divorced spouses become tenants in common. Where the spouses choose to file separate instead of joint returns, each tenant by the entirety reports his own share of the income, gain, or loss from the property on his separate return.

The major disadvantage of the joint tenancy or the tenancy by the entirety is their inflexibility with regard to planning to minimize federal estate taxes. Since there is now an exemption of $600,000 for a decedent, a co-owner whose estate is not likely to reach this figure (even after inclusion of the full value of the jointly owned property) need not be concerned. However, in many cases, the estate may exceed $600,000; consequently, a federal estate tax (which begins at 37 percent) may be payable. In discussing this problem, a distinction must be made between jointly-owned property between a married couple and between unmarried persons.

If a husband and wife are joint tenants of property or tenants by the entirety, one half of the property value is included in the estate of the first spouse to die, regardless of the amount each contributed to the purchase. The half so included will receive a "step up" in basis to current market value (thus eliminating any future tax on the appreciated value of that half prior to the date of death). At the same time, the transfer of the decedent's interest to the spouse is tax-free because of the unlimited marital deduction.

Example: H and *W* are joint tenants of property worth $1 million that cost $500,000. The property is their sole asset. On *H's* death $500,000 (one-half the value) is included in his taxable estate. No federal estate tax is payable because of the $600,000 exemption (and also because of the unlimited marital deduction). *W* then becomes sole owner of the property. Her tax basis is $750,000, consisting of her one-half share of the original cost, or $250,000, plus *H's* stepped-up basis of $500,000. If she sells the property for $1 million, she will pay tax on only $250,000 of gain,

The situation so far is favorable. However, *W* now is the sole owner of an asset with a value of $1 million. Upon her death, the general $600,000 exemption will be available, but the remaining $400,000 would be subject to federal estate tax. The tax on this amount is approximately $153,000 (assuming no taxable gifts during *W's* life).

The federal estate tax would be eliminated completely in the foregoing example if the property were held by *H* and *W* as tenants in common. Upon *H's* death, his $500,000 share would be exempt from tax, because it is less than the $600,000 exemption. If *H's* share were left to his children (or in trust with income to *W* for her life), the property would not be included in *W's* estate. Thus, on her death, her estate would amount to only $500,000, which would be fully exempt from tax, on the basis of the exemption. In both cases, the value of the real estate would be stepped up to the value at date of death.

If the joint tenants are not married to each other, one important distinction must be made from the previous situation. If one co-tenant dies, only the value of the property representing his contributed share of the original cost is included in his estate. So if a parent and child create a joint tenancy, with the parent contributing 100 percent of the cost, the entire value of the property will be included in the parent's estate. If the child is the first to die, no portion of the property will be included in the child's estate.

» 15.04 PARTNERSHIPS: IN GENERAL

Partnerships are one of the most common entities used to own hotels. Partnerships are popular for three reasons:

- *Tax factor*. A partnership is not a taxable entity, so no double tax is imposed at the partnership and the partner level; alternatively, tax losses can be passed through directly to the partners in many instances.
- *Legal factor*. The partnership agreement can be amended at any time and thus provides a great deal of flexibility with respect to allocation of profits and losses, division of management responsibility, and the settlement of disputes.
- *Business factor*. A partnership often involves lower organizational costs, state fees and taxes, and administrative costs than a corporation.

A partnership has some disadvantages, notably the absence of limited liability for general partners and the lack of free transferability of ownership interests, both of which are provided in a corporation. In recent years, the limited liability company (LLC) has been chosen by many hotel investors as a preferred alternative to both the partnership and the corporation.

A partnership is a form of business organization in which two or more persons are associated as co-owners in a continuing relationship for the purpose of carrying on a common enterprise or business for profit. A written agreement of partnership

(also called articles of partnership) defines the rights and obligations of each partner and sets forth how profits and losses are to be shared. The two types of partnerships are general partnerships and limited partnerships.

The term "partnership" is sometimes used interchangeably with the terms "joint venture" and "syndicate." Although a joint venture or syndicate may take the form of a partnership (either general or limited), the terms are not synonymous, because a joint venture or syndicate may also use some of the other legal forms of ownership, such a regular (C) corporation, S corporation, tenancy in common, or business trust.

[1] Legal Characteristics of a Partnership

The legal characteristics of a partnership (both general and limited, except as otherwise indicated) are as follows:

Separate legal entity. For most purposes, a partnership is recognized as a legal entity separate from its individual partners. As such, the partnership may sue and be sued, and may hold and convey real property in the partnership name. In actions brought in federal courts, partnerships are recognized as separate legal entities, but diversity of citizenship (often a condition for bringing a federal lawsuit) is determined by looking at the individual partners.

Agency relationship between partners. Each individual partner in a general partnership (and each general partner in a limited partnership) has unlimited liability for any and all obligations of the partnership. This follows from the legal principle that every partner is the agent and principal of every other partner. Consequently, any debt incurred by any partner with apparent authority to do so in carrying on the business of the partnership is a debt of every other partner. A partner may have the right, under the partnership agreement, to have other partners contribute a portion of the liability or indemnify the partner held liable. A third party dealing with the partnership without actual notice of a lack of authority is not required to look into a partner's individual authority and thus may look to any of them to satisfy an obligation regardless of the terms of the partnership agreement.

Management of partnership. Unless they agree otherwise, all members of a general partnership (or all general partners in a limited partnership) have equal rights in the management of the partnership business.

Dissolution of partnership. The agency relations among the general partners is a personal relationship that cannot be changed without the consent of all the partners. Consequently, the partnership is automatically dissolved by the death or withdrawal of any general partner, notwithstanding any other provision in the partnership agreement. In effect, this means that any partner may dissolve the partnership at any time. No partner has the power to substitute another person as partner without the consent of the remaining partners. On the other hand, a partner who dissolves the partnership in violation of the agreement, or who refuses to consent to a substituted partner when such substitution is permitted by the partnership agreement, may be liable for breach of contract to the other partners. Nevertheless, the partnership is dissolved. In the situation in which all partners consent to the addition of a new partner, the partnership is not dissolved under the terms of most partnership laws.

Nature of interest. A general or limited partner's interest in the partnership is inheritable personal property consisting of the partner's pro rata rights in the specific partnership property, rights to a share of profits, and the right to participate in management (in the case of a general partner) and inspect the partnership books. The right to profits is expressly made assignable to third parties by UFA, regardless of any partnership agreement to the contrary. The result is that an assignee of profits has a legal right to claim the profits as against the partnership, although the partnership itself may have causes of ac-

tion against the assignor for a breach of contract. The assignee, however, does not become a partner unless the other partners agree. An assignee who is not admitted as a partner lacks the right to participate in management, inspect the books, dissolve the partnership by death of withdrawal, or demand an accounting prior to dissolution of the partnership. It is not clear whether an assignee not admitted as a partner is liable for losses (although it would seem that either the assignor or the assignee must be liable).

[2] Checklist for a Partnership Agreement

The following checklist includes factors that should be considered in drafting a partnership agreement;

- *Name of the Partnership.* While a partnership can choose any name under which to conduct its operations, its name should not be too similar to that of another business organization. How the participants' individual names are used as the partnership name—whether or not the partnership name will continue to be used after the death or retirement of a partner and whether or not it is permissible to do so under local law—must be considered.
- *Registration of name.* In some states, a partnership name must be registered with a public agency or officer—for example, a county clerk or secretary of state.
- *Nature of business.* The nature of the partnership business must be clearly spelled out.
- *Permits and licenses.* The partnership agreement should provide that it is not to become effective unless and until required licenses or permits are procured.
- *Partners' contributions.* These may be in the form of property, cash, or services, or any combination thereof. In addition to making a capital contribution to the partnership, a partner may make a loan or sell property to the partnership either for cash or on an installment basis. In each instance, the legal, tax, and accounting consequences to the partner and the partnership must be examined and dealt with.

  Where property is contributed, the partners' right to reconcile the tax bases and accounting values of the contributed property in order to prevent distortions should be taken into account.
- *Duration of partnership.* The parties may agree to a definite term, or the partnership may continue at will. As mentioned previously, a partner may terminate his relations with the partnership even if doing so breaches the partnership agreement.

  If the partnership agreement specifies a fixed term, the parties may continue the business beyond that term as a partnership at will, extend the term, or enter into a new partnership agreement.
- *Partnership profits and losses.* In cases in which the partners share both profits and losses, they are usually shared in the same proportion. However, the partners may agree that different kinds of partnership income shall be distributed among the partners in different proportions. Whatever the arrangement may be, it should be carefully set out in the partnership agreement.

  A partnership is not an entity separate from its members for income tax purposes. Each partner is taxed on his share of the partnership income and profits and is entitled to deduct his share of the partnership losses. The part-

nership files only an information return, not the income tax return that an individual or corporation would file.

- *Compensation of partner for services to partnership.* In the absence of an express provision in the partnership agreement to the contrary, a partner is usually not entitled to compensation for his services to the partnership. If a partner is entitled to and does receive compensation for his services from the partnership, this is a deductible business expenditure of the partnership.
- *Withdrawal of capital.* When it is anticipated that the partnership will accumulate a substantial amount of money, the partners should be permitted to withdraw a sufficient sum to meet their income tax obligations. The partnership agreement should clearly spell out the parties' understanding with respect to the partners' rights in this regard.
- *Management of partnership affairs.* All partners have an equal voice with respect to the management and conduct of the business affairs of a general partnership, unless they agree otherwise. The partnership agreement should clearly state each partner's rights and duties as well as the extent to which the partners are authorized to bind the partnership by their contracts.
- *Accounting.* The partnership agreement should require all partners to account to the partnership with respect to all matters affecting the partnership.
- *Partnership property.* Property acquired with partnership funds is partnership property, unless an intention to the contrary is clearly established.
- *Partners' death or withdrawal.* The partnership agreement may provide for the continuation of the business after the death or withdrawal of a general partner. Partners should be careful when Grafting the partnership agreement to provide for the valuation of any partners' partnership interest following death or to withdrawal.
- *Indemnification of partner.* The partnership may be required to indemnify each partner for payments made and personal liabilities reasonably incurred in the ordinary and necessary course of the partnership business.

[3] General Partnership

The simplest ownership form to use for two people who operate a business is the general partnership. This form of business can be as informal or formal as the partners wish it to be. General partnerships that have been formed with a simple handshake have lasted for many years. Although the requirements for forming the general partnership today have been made more formal by states adopting the Uniform Partnership Act (UPA) and the Revised Uniform Partnership Act (RUPA), hotel developers should be careful when choosing partners. In fact, partnerships among individuals have led to many court battles over such issues as control, valuation, and succession. Therefore, it is extremely important to state as clearly as possible in the partnership agreement all the relevant duties and obligations of the individual partners and the means of dissolving the partnership upon dissolution.

The UPA and RUPA both require that a general partnership file and record in a public office a certificate identifying the names and addresses of each partner. The certificate must be amended in the event of a change in the partners.

However, it is possible for a partnership to exist without the knowledge or the intent of the partners; on the other hand, investors may believe they are in partnership when in fact they are not. Under UPA, the following three rules aid in determining whether a partnership exists:

1. Persons who are not partners with respect to each other are not partners as to third persons except where, by their conduct, they have led others to believe that they are partners and to rely on that belief to their disadvantage so as to create a partnership by estoppel.
2. The mere existence of joint or part ownership of property does not establish that a partnership exists, regardless of whether or not the co-owners share the profits made by the use of the property.
3. The sharing of gross returns from property does not, in and of itself, establish the existence of a partnership, regardless of whether or not the persons sharing the returns have a joint or common right or interest in the property from which the returns are derived.

Proof that an individual shares in the profits of a business is prima facie evidence that he is a partner in the business, unless he receives the profits as payment of a debt (installment or otherwise), wages, rent, an annuity paid on behalf of a deceased partner, interest on a loan (even though the amount of the payment varies with the profits of the business), or consideration for the sale of the good will of a business or other property by installments or otherwise. There are four basic disadvantages in choosing the general partnership form of ownership:

- *Personal liability for partnership debts.* Each partner is personally liable for the partnership debts—that is, all of the partner's assets may be reached by a creditor of the partnership in the event that the partnership assets are not sufficient. For this reason, the general partnership is normally used only by a small group of investors who know each other.
- *Authority of individual partners to bind the partnership.* Those who deal with a general partnership have the right to assume that each partner has broad authority to bind the partnership, provided the transaction fits within the scope of the partnership's business and apparently relates to that business. Because each partner is jointly and severally liable for the partnership's obligations, a partner may find himself in the unenviable position of having to dig into his own pocket to pay an obligation that was incurred by another partner apparently on behalf of the partnership.
- *Limited transferability.* UFA permits a partner to assign his share of the profits from a partnership, but the assignee does not have the right to participate in the management or administration of the partnership business.
- *Less privacy and anonymity.* Generally, a partnership offers less privacy, anonymity, and confidentiality than does a trust or corporation. The requirement of filing a certificate (and sometime publishing it) forces the disclosure of the identity of the owners. In a partnership, any partner may inspect the books; in a corporation, however, the identities of the stockholders are confidential and the contents of the business records rarely have to be disclosed, even to stockholders.

[4] Limited Partnerships

One of the most popular business forms used for owning and operating hotel properties is the limited partnership. A limited partnership makes it possible for the hotel developer to combine his own skills with the financial resources of passive investors in an organization that allows flexibility of operation, limited liability for his in-

vestors, and the tax benefits of the pass-through of taxable income, gains, and, in certain circumstances, losses to investors.

A limited partnership is one formed by two or more persons, having as members one or more general partners and one or more limited partners. The general partner or partners manage the affairs of the partnership and are personally liable for the debts and obligations of the partnership. The limited partners, who are the passive investors, are not bound by the partnership debts and obligations, except to the extent of their equity investment.

A limited partnership is a hybrid of a corporation and a general partnership. A limited partner's exposure, like that of a corporate shareholder, is limited to his equity investment, and his status as a limited partner does not give him the right to control or actively participate in the affairs of the partnership. A general partner's role and is analogous to that of the director or officer of a corporation.

In other respects, a limited partnership resembles a general partnership. For the most part, the rights and liabilities of the general partners in a limited partnership are similar to those of a partner in a general partnership. Additionally, a limited partnership has the same problems of continuity of existence and transferability of interest as a general partnership.

While it is possible for one person to be, at the same time, both a general and a limited partner in the same partnership, such a person will be in the same position as to the general partners except that, in respect to contributions, this partner will be treated the same as the other limited partners.

States have adopted either the original Uniform Limited Partnership Act (ULPA) or the later Revised Uniform Limited Partnership Act (RULPA). Any hotel developer should check his or her state statute to determine which act controls in the state the partnership will be created. The discussion that follows is based on both the original statute and revision.

[a] Creating a Limited Partnership

There are four factors to note when creating a limited partnership:

1. *Public filing of certificate.* The ULPA requires that a new partnership make a public filing of a certificate of limited partnership that sets forth its name, capital contributions, and profit shares of the partners.
2. *Use of partners' names prohibited.* Limited partnerships are prohibited from using the name of any of the limited partners' names as part of the partnership name. Also, no name that is deceptively similar to that of any other corporation or limited partnership may be used in the name of the partnership. Both the ULPA and RULPA require that the partnership name include the words "limited partnership" in full. In addition there is a convenient procedure to reserve names for future limited partnerships.
3. *Maintaining office and records.* The ULPA requires that the partnership maintain continuously within the state an office at which basic organizational and financial records are kept. This requirement assures certain minimal contacts between the partnership and its state of organization and assures that the limited partners have access to vital partnership information.
4. *Avoiding liability in case of a defect in forming partnership.* Under ULPA, a person who has contributed to a business (an "equity participant") erroneously believing that he has become a limited partner in a limited partnership, is not liable as a general partner, provided that when he realizes his mistake, he promptly renounces his interest in the profits of the business. Un-

der RULPA, if the equity participant wishes to avoid liability as a general partner, he must withdraw from the business and renounce future profits or file an amendment curing the defect. Nevertheless, this equity participant is liable to any third party who has transacted business with the enterprise before the withdrawal or amendment and in good faith, believes that the equity participant was a general partner at the time of the transaction.

[b] Status of Limited Partners and Extent of Limitation of Liability

The most appealing feature of a limited partnership is the limited personal liability it offers. However, this protection is subject to three conditions:

1. There must be substantial good-faith compliance with the requirement that a certificate of limited partnership be filed.
2. The surname of a limited partner may not appear in the partnership name.
3. The limited partner may not take part in control of the business.

As long as the limited partners abide by these conditions, their liability for any and all obligations of the partnership is limited to their capital contribution.

A general or managing partner of a limited partnership occupies a fiduciary position with respect to his limited partners. The fiduciary duty imposed upon the general partner protects limited partners who are, as a general rule, at the mercy of the general partners' managerial power.

All the limited partners stand on equal footing vis-a-vis each other as to the return of their contributions, their right to income, and any other partnership matter, unless there is an agreement providing for priority as to such items. Such priority provisions must be stated in the partnership certificate.

Generally, a limited partner cannot bind the partnership by his acts, nor is he liable to partnership creditors; however, this does not mean that he is completely free from obligations arising out of the partnership. For example, he is liable to the partnership for the contributions he has agreed to make to the partnership and for any breach of the partnership agreement by him. Also, he may be held liable to the partnership for a sum equal to the amount he has received, plus interest as a return of his capital contributions where necessary to discharge the partner's liabilities to creditors who extended credit to it, or whose claims arose before his contribution was returned to him.

An important question for a limited partner is at what point would he be considered a general partner and thus lose his limited partner status. RULPA imposes general partner's liability only on a limited partner who takes part in control. If the control exercised by a limited partner is substantially the same as the power of a general partner, then he assumes the liability of a general partner to all third parties who conduct business with the partnership. However, if the limited partner's participation in control of the business is not substantially the same as the exercise of the general partners, his liability extends only to those persons who transact business with the limited partnership with actual knowledge of his participation in control. This approach recognizes the difficulty of determining when the control line has been overstepped and reflects the fact that the purpose of imposing general partner's liability is for the protection of creditor's expectations.

In addition, the RULPA enumerates certain activities that a limited partner may carry on without being deemed to have taken part in control of the business:

- Serving as contractor for an agent or employee of the limited partnership or of a general partner.

- Consulting with and advising a general partner with respect to the business of the limited partnership.
- Acting as surety for the limited partnership.
- Approving or disapproving an amendment to the partnership agreement.
- Voting on one or more of the following matters:
  - —The dissolution and winding up of the partnership.
  - —The sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership other than in the ordinary course of its business.
  - —A change in the nature of the business.
  - —The removal of a general partner.

The death or incompetence of a limited partner does not result in the dissolution of the partnership. The personal representative of a deceased limited partner has all his rights for the purpose of settling his estate, including the right to constitute an assignee of the limited partnership interest as a substituted limited partner. The estate also remains liable for the decedent's liabilities as a limited partner.

[5] Qualifying as a Partnership for Tax Purposes

An entity formed as a general or limited partnership by following appropriate legal procedures does not automatically qualify as a partnership under the Code. Rather, the classification of the entity as a partnership depends on meeting certain regulatory tests that distinguish a partnership from an "association taxable as a corporation." The determination is based on six criteria. Two of them—whether the entity includes "associates" and whether the entity has an objective to carry on a business for profit—are clearly common to both partnerships and associations (i.e., corporations). Thus the essential distinction rests on the remaining four criteria discussed in the following paragraphs.

The tax rules state that to qualify as a conduit for the pass-through of taxable gains and losses to its investors, a limited partnership must not show more than two of the following four corporate characteristics:

1. *Continuity of life.* Because a limited partnership can provide that death, insanity, or retirement of a general partner terminates the partnership, this characteristic is not usually present. The IRS has taken the position that a partnership subject to UPA or similar statute does not possess continuity of life.
2. *Centralized management.* A fundamental characteristic of a limited partnership is that the general partner (or partners) manages the partnership while the majority ownership usually lies in the passive investors who are the limited partners. Thus management is centralized. Consequently, this corporate characteristic is present in a limited partnership.
3. *Limited liability.* For income tax purposes, limited liability is not present and partnership treatment is indicated if the general partner is personally liable for the partnership's non-mortgage debts and also has substantial assets. Thus, neither a dummy corporation nor an individual who is judgment proof can be made a general partner so as to give the appearance, without the reality, of unlimited liability. Since most real estate partnerships are set up with

a general partner having substantial assets, partnership treatment should be indicated.

When a corporation, rather than an individual, is the general partner in a limited partnership, specific requirements have been set forth by the IRS in connection with the limited liability test. The limited partnership will not pass muster unless the following requirements are met:

—*Net worth requirement.* If the total contributions to the partnership are less than $2.5 million, then at all times during the life of the partnership the corporate general partner must have net assets equal to 15 percent of the total contributions or $250,000, whichever is less. If the total contributions are $2.5 million or more, the corporate general partner must have net assets equal to 10 percent of total contributions.

—*Ownership requirements.* The limited partners cannot own, directly or indirectly, more than 20 percent of the stock of the sole corporate general partner. If there are several corporate general partners, the assets of the corporate general partners can be combined for purposes of the net worth requirement. However, the ownership requirement is applied individually to each corporation; the limited partners cannot own more than 20 percent of the stock of any one corporate general partner.

4. *Free transferability of interest.* There is no free transferability of partnership interest, and partnership treatment is indicated if a limited partner needs the general partner's consent to transfer his partnership interest to a substitute limited partner. A provision requiring the general partner's consent is common in real estate limited partnership agreements. Likewise, there is no free transferability of partnership interests if a partner's right to assign his interest is limited to assigning his share in the profits of the enterprise. Free transferability of partnership interests is also lacking where the transfer of a partner's interest results in the dissolution of the partnership and the formation of a new partnership under state law.

There can be a modified form of transferability of interest under which each partner can transfer his interest in the partnership to an outsider only after offering it to the other partners at fair market value. This modified form of transferability is less likely to be viewed as a corporate characteristic than full transferability.

Because most hotel-formed limited partnerships do not show continuity of life, limited liability, and free transferability of partnership interest, partnership treatment—that is, the pass-through directly to the partners of taxable partnership income, gains, and losses—can reasonably be assured.

[6] Taxation of Partner's Share of Income, Gain, or Loss

The rules for the taxation of partnerships and partners (constituting Subchapter K of the Code) are among the most complex provisions in the entire tax law, and the advice of professional counsel is always beneficial in connection with partnership tax planning or tax reporting.

Each partner must report his distributive share (whether or not actually distributed) of partnership income, gain, or loss on his income tax return. The distributive shares of partnership items are shown on Schedule K and Schedule K-l of IRS Form 1065.

A partner may deduct his share of partnership losses only to the extent of the

adjusted basis of the partnership interest in the partnership. A partner's tax basis generally includes the amount of money the partner contributes to the partnership, the adjusted basis of any property contributed by the partner, and the partner's share of partnership liabilities that is allocated or assumed by the partner.

A partner's ability to deduct a share of partnership losses is further limited to the amount for which the partner is "at risk," A partner is considered at risk with respect to the sum of money and the adjusted basis of property he contributes to the partnership, including amounts contributed from funds borrowed by the partner or the partnership from third parties, but only to the extent to which the partner is personally liable to repay such amounts. In addition, nonrecourse financing (i.e., under which the partner is not personally liable) will be included as an amount at risk in either of the following two cases:

1. When the loan is from a qualified lender (i.e., one engaged in the business of making loans) or any federal, state, or local government or instrumentality, provided that the lender is not the promoter or seller of the property or a party related to either.
2. When a loan is from a qualified lender that has an equity interest in the venture as long as the terms of the financing are commercially reasonable and on substantially the same terms as loans by lenders that do not have an equity interest in the venture. The terms of nonrecourse financing are commercially reasonably if the following apply:

   —The borrower executes a written unconditional promise to pay on demand or on a specified date.

   —The amount to be paid is a fixed sum of money.

   —The interest rate is a reasonable market rate of interest, taking into account the maturity of the debt.

Another significant limitation on the ability of partners to deduct losses are the passive activity loss rules. When the amount at risk is reduced below zero at the end of a taxable year, the partner must recognize income to the extent that his or her at-risk basis is reduced below zero.

[7] Organization and Syndication Fees

A partnership often incurs significant expenses in connection with its organization or the sale of a partnership interest. Such costs may not be deducted in the year incurred. However, the partnership can elect to amortize certain of these costs over a period of not less than sixty months, beginning with the month the partnership begins business. If the partnership is liquidated before the end of the sixty-month period, any remaining balance can be deducted as a loss. The costs that may be amortized are organization fees but not syndication expenses.

Organization fees are expenses related to the creation of the partnership and that are chargeable to capital accounts. They include legal and accounting fees related to the organization of a partnership, and filing fees. They do not include expenses of acquiring assets for the partnership, or those connected with the admission or removal of partners other than at the time the partnership is first organized, or those connected with any contract relating to the partnership trade or business. Syndication expenses are specifically nondeductible expenses. These are expenses connected with the issuing and marketing of partnership interests, and include the following:

- Brokerage fees
- Registration fees
- Legal fees of the underwriter or placement agent and the issuer
- Accounting fees in connection with the offering material
- Printing costs of the offering material
- Other expenses relating to selling and promotional material

[8] Disposition of Partnership Interests

The disposition of a partnership interest generally results in capital gain or loss to the partner. The amount of gain or loss generally is the difference between the amount realized by the partner and the adjusted basis of the partner's interest in the partnership. If the partner is relieved of any liabilities of the partnership, the amount of such liabilities is included in determining the amount realized by the partner.

» 15.05 REGULAR CORPORATIONS

A corporation is a separate legal entity—an artificial person—created in accordance with the laws of a particular state; the federal government does not have the power to create business corporations. A corporation's charter may provide that it will have a perpetual life, and it establishes its operation through a board of directors elected by the shareholders. However, for business and tax purposes, the corporation is an entity entirely distinct from its stockholders. Thus, the major advantage of, and original purpose for, the corporate form was to limit each shareholder's liability to the amount of his capital investment; a secondary purpose was to make shareholder interest freely transferable by means of assignable corporate shares.

The basic legal and economic incidents and consequences of operating under the corporate form of ownership can be summed up as follows:

- A *corporation:*
  - —Can hold and, deal in property in its own name.
  - —Can sue and be sued in its own name.
  - —Has only those powers and can engage in only those activities that are within the scope of the powers expressly or impliedly granted to it under its state charter or certificate of incorporation.
  - —Continues to exist until it is dissolved by law, unless a statute limits its duration.
  - —Can raise capital by the sale of new shares, bonds, debentures, or other securities.
  - —Can, apart from its shareholders, seek out sources of credit and borrow funds. Also, in a closely held corporation, the corporate shares can be used as collateral for a corporate loan.
- *Corporate shareholders:*
  - —Are not, merely by reason of being shareholders, personally liable for corporate debts and liabilities; each shareholder has at stake only the amount of his capital contribution.

— Can freely sell or otherwise transfer their shares, in the absence of a provision to the contrary.

—Are not responsible for the management of the corporation or for any venture conducted by the corporation.

• *Corporate Directors:*

—Are the repository of the central authority of the corporation. The board of directors manages the affairs of the corporation and acts according to the vote of a majority of its members.

—Must account to and are responsible to their stockholders for their acts, or for conduct that is outside the scope of their charter powers, or that is otherwise improper or unlawful.

• *Corporate officers:*

—Can exercise only such authority as is delegated to them under the corporate charter or certificate of incorporation.

—Can bind the corporation by their acts or conduct that is within the scope of their actual or apparent authority.

—Are answerable to the board of directors and must account to the board for their activities.

[1] C Corporations

The major disadvantage in using a C corporation to own a hotel development is that the corporation is recognized as an independent entity for tax purposes. Thus, tax losses from corporate-owned real estate cannot be passed through to the individual shareholders, but can be used only by the corporation itself; because it may not have any other income against which the losses may be offset, the losses may be of no use.

On the other hand, if the corporate property produces net income, a problem of double taxation must be faced. The corporation first must pay a corporate income tax on its net income; then, to the extent the income is distributed in the form of dividends, the shareholders must pay a personal income tax on such income. In the case of a closely held corporation (known as a close corporation), the problem of double taxation can often be avoided by distributing corporate income to the shareholders in the form of salaries or other compensation. In this situation, the corporation may deduct the cost of such salaries and thus reduce its own income, although the shareholder-employees will be taxed on the income they receive.

In addition, a corporation can accumulate income (up to a point) that can ultimately be passed through to shareholders as capital gain when the shareholders sell their shares at prices that reflect the earnings that have been accumulated. Important tax factors to consider in choosing the C corporate form of ownership include:

- Principals, as officer-stockholders or as employee-stockholders, can have a tax-favored retirement or pension plan set up for them.
- Principals can be paid a salary that the corporation can deduct as an ordinary business expense.
- The compensation paid to a principal as a corporate officer or employee is subject to withholding and social security taxes.
- While a shareholder can assign his shares as he sees fit in the absence of restrictions imposed by agreement, corporate charter, or otherwise, he cannot assign earnings separate from the shares.

- Corporate income is taxable to the corporation and not to the shareholders until it is distributed to them in the form of dividends.
- A corporation is subject to various sate and local taxes, which are deductible on its federal income tax return.
- Death benefits of up to $5,000 can be received tax-free by a stockholder-employee's beneficiaries.
- Income accumulated in the corporation is not taxable to the shareholders, but there is a penalty tax if the purpose of the accumulation is to avoid the corporate surtax and the accumulation is greater than is permissible.
- A corporation may be able to use a loss generated by a hotel investment to offset income from its other properties, or it can carry over the loss to offset future income.
- Low-bracket taxpayers can manage the hotel and be paid salaries by the corporation for their services. The salaries can account for a substantial portion of the corporate income and thus reduce the corporate tax burden. The salaries would be taxed at ordinary income rates, but only at the taxpayers' low tax brackets. The corporation would be entitled to deduct the amounts it paid as salaries from its gross income, provided the salaries are reasonable and are paid for actual services rendered to the corporation.

[2] S Corporations

The corporate form of ownership has many limitations as far as its use in hotel development. Since hotels are capital-intensive projects that generate substantially early deductions for depreciation and debt service, the hotels usually show losses for many years. Corporate ownership of real estate prevents those losses from being passed through to the individual shareholders. In addition, if the corporation begins to generate income sufficient for distribution, then the hotel earnings are taxed twice, once at the corporate level and again when distributed as a dividend.

However, for many closely held corporations, the Internal Revenue Code provides for loss and income passthrough similar to a partnership, if the owners have elected the S corporation. As will be demonstrated subsequently, the S corporation is ideal for the hotel development when either the investors contribute proportionally, or are family members using the S corporation as a means of splitting income among family members.

S corporations are organized for the purpose of insulating their shareholders from personal liability for corporate obligations, and for making the transfer of ownership of stock certificates a simple matter. At the same time, they are not independent tax entities and, just as a partnership, are able to pass through to shareholders the profits and losses from operations.

[a] Eligibility Requirements

The following are five requirements for S corporation status:

1. *Domestic corporation.* This category includes any incorporated organization taxed as a corporation.
2. *Number of shareholders.* The maximum number of shareholders is thirty-five, but spouses holding shares are treated as one shareholder. Shareholders must be individuals, estates, or grantor trusts; they cannot be nonresident

aliens or foreign trust. Shares cannot be held in a custodial account for a minor.

3. *Shares.* An S corporation must have only one class of outstanding stock, and all outstanding shares must carry identical rights to share in corporate profits and assets. Differences in voting rights in common stock, however, are permissible. In addition, a debt instrument may not be reclassified by the IRS as stock, so as to constitute a disqualifying second class of stock, if it complies with the safe-harbor rules for debt instruments provided by the Sub-chapter S Revision Act of 1982.
4. *Affiliation.* A member of an affiliated group of corporations cannot be an S Corporation.
5. *Companies eligible for special tax treatment.* Banks, financial institutions, and insurance companies cannot elect S corporations status even if they can meet the eligibility requirements of the act.

[b] Election and Termination of Status

An S Corporation election made on or before the fifteenth day of the third month of a corporation's taxable year is effective beginning with the year made if all eligibility requirements are met during the preelection period, and all persons who held stock during that period consent to the election. The reason for requiring such unanimous consent is to prevent the allocation of income or loss to preelection stockholders who are either ineligible or do not consent to such allocation. If the eligibility requirements were not met during the preelection period or if the election is made late, it does not become effective until the following taxable year.

The following events will cause the S corporation status to be terminated effective on the date on which the event occurred:

- Exceeding the maximum number of shareholders
- Transfer of stock to an ineligible shareholder
- Creation of a second class of stock
- Acquisition of a subsidiary

In addition, an S corporation can be voluntarily revoked by its shareholders. If holders of more than 50 percent of the voting stock agree, the corporation may voluntarily revoke the S corporation status of the corporation. A revocation, filed up to and including the fifteenth day of the third month of a taxable year is effective for the entire taxable year unless a prospective date is specified. A new shareholder cannot terminate an election by refusing to consent to the election, unless he owns more than 50 percent of the voting stock.

[c] Comparison With Limited Partnerships

Many people assume that the limited partnership and S corporation are the same, but there are some major differences that usually make the limited partnership the preferred form of hotel ownership. Some of the more important differences are listed as follows:

- *Allocation of income and losses.* Both the S corporation and the limited partnership are conduits for tax purposes. However, the limited partnership has a greater flexibility in allocating income and losses to its partners than S cor-

porations. A limited partnership can allocate income and losses to the partners providing economic substance to the transaction. For example, a partner contributing property to the partnership may receive the depreciation expense, whereas the S corporation must allocate income and losses to each shareholder in direct proportion to their percentage of stock ownership.

Unlimited members. A limited partnership has no specified limit on the number of partners, while the S corporation is limited by law to thirty-five shareholders.

Tax basis. A major distinction between an S corporation and a partnership involves the tax basis for the investment. In a partnership, each partner receives a tax basis in his partnership interest equal to his capital contribution plus his share of partnership debt. Even limited partners share in partnership nonrecourse debt (but they may share in recourse debt only to the extent of any unpaid capital contributions). By comparison, S corporation shareholders receive only basis for their capital contributions plus their loans to the corporation.

Basis is important because losses may be taken by the individual investors only to the extent of their basis (assuming other hurdles, such as allocations, at-risk, and passive loss limitations, are overcome). In addition, excess financing and refinancing proceeds can be distributed tax free only to the extent of basis.

Tax status. The Subchapter S Revision Act of 1982 simplified the rules affecting S corporations, making it far less likely that an S corporation's status as such will be challenged by the IRS. Partnerships are subject to a somewhat greater risk of challenge. In either case, a successful challenge by the IRS would bar the pass-through of taxable losses to investors, because the corporation or partnership would be considered a C corporation and taxable as such.

» 15.06 LIMITED LIABILITY COMPANIES

The Limited Liability Company (LLC) is a fairly recent entity development that has been adopted in many states. The LLC can limit liability more effectively than a limited partnership and is less restrictive than an S corporation; for certain hotel developments, it may become the preferred form of ownership.

An LLC is an entity formed under state law to conduct a business or investment activity. It is created by filing articles of organization with the appropriate state agency in a manner similar to that required for corporations. Its bylaws are called regulations and its participants are called members. The three major advantages of an LLC are as follows:

1. *No double taxation.* When properly structured, an LLC is treated for federal income tax purposes as a partnership; therefore, no tax is payable at the partnership level but only by the individual partners.
2. *Flexible ownership.* Like a partnership, the LLC permits its members significant freedom in making disproportionate allocations of income, gain, loss, and cash flow. A major advantage of the LLC over an S corporation is that no limitations are imposed on the types and numbers of owners. For example, corporations and partnerships may be members of an LLC, but are ineligible to the shareholders of an S corporation. More than thirty-five individuals and/or entities may be members of an LLC, whereas S corporation shareholders are limited to that number. (However, an LLC must have more than one member as compared with an S corporation, which can have a single shareholder).

3. *Limited liability.* As its name indicates, an LLC puts only the assets of the company at risk. In comparison with a partnership, in which the general partner or partners must accept personal liability, all members of an LLC are protected against personal liability. Furthermore, any member of an LLC can be active in the management of the business while still retaining limited liability; in a limited partnership, the limited partners must be careful not to step over the line between passive investment and active management.

The four significant disadvantages of an LLC are as follows:

1. *State taxation.* Although an LLC is generally exempt from federal income tax, state tax rules may differ. For example, in Florida (which does not have an individual income tax), LLCs are treated as corporations subject to the Florida corporate income tax rate. At the same time, partnerships and S corporations are exempt from Florida income taxation. In addition, a state may seek to apply its franchise tax, which does not normally apply to a partnership, to an LLC.
2. *No perpetual life.* As in the case of a partnership, the LLC cannot have a perpetual life. For example, in several states, an LLC dissolves upon the earlier of the following:

   —Expiration of its state term

   —Agreement of all members to terminate

   —Death, retirement, insanity, bankruptcy, or expulsion of a member (unless all remaining members consent to continue the business pursuant to rights stated in the organizing articles).
3. *Limits on transfer ability.* The LLC (like a partnership) lacks the easy transferability of corporate share. Recipients of membership interests in an LLC often do not have full rights of ownership or management participation unless consent to the transfer is received from all members, thus restricting free transferability.
4. *Lack of legal precedent.* Finally, the short existence of the LLC as an entity means very few court decisions have been rendered. Thus, a good deal of uncertainty exists as to the legal status of the LLC and its members. Furthermore, it is not all clear as to the status of LLC members in states not having LLC statutes. For example, would a member of an Florida LLC be protected from personal liability for LLC obligations incurred while the LLC was operating in a state without an LLC statute? Additionally, the application of the partnership's tax concepts to an LLC may become complex. For example, allocating liabilities to determine tax basis and amounts at risk may produce unexpected results.

Trusts are the least frequently used form of ownership entity for hotels. A trust is a legal relationship in which a trustee holds legal title to property (the hotel property or otherwise) with the responsibility of administering it and distributing the income for a beneficiary who is deemed to be the holder of the equitable title.

Three kinds of trusts can be distinguished. The first is a real estate investment trust (REIT), which is a creation of the federal tax laws. This form of business entity will be discussed in more detail in the following section.

» 15.07 TRUSTS

Personal trusts are those set up for the benefit of members of a family, particularly the spouse or children of the grantor of the trust. They can be an effective means of shifting the tax burdens of property to persons in lower tax brackets, while at the same time reserving essential control of the property to the grantor or his associates. However, the Tax Reform Act of 1986 (TRA) limits the tax benefits formerly available from trust. Because the subject of trust and estate taxation is highly specialized, and because such taxation is applicable to all forms of property, not merely hotel development, a discussion of trust and estate taxation is not included here.

The third type of trust, the business trust (also known as the Illinois Land Trust, because it originated there), has a long history as a real estate-owning entity. However, its use today is limited to five states besides Illinois: Florida, Virginia, North Dakota, Hawaii, and Indiana. The land trust is a device by which a hotel or other real estate is conveyed to a trustee under an arrangement reserving to the beneficiaries of the trust the full management and control of the property. The trustee executes deeds and mortgages or otherwise deals with the property at the written direction of the beneficiaries, who exercise all rights of ownership, other than holding or dealing with the legal title.

The benefits of a land trust include the following five points;

1. *Secret ownership.* In states that recognize the use of a land trust, the identity of the beneficiaries is not contained in any public record. Only the name of the trustee, the date of the trust agreement, and the number of the trust is disclosed in the deed in trust. By comparison, all other states require that the name of an owner of real property, be it an individual, corporation, or other legal entity, be shown on the deed and be available for public inspection in the appropriate records office.
2. *Transfer tax avoidance.* In those states that recognize the land trust, the use of the entity may permit the avoidance of payment of a real estate transfer tax, since the real estate in the trust is not transferred as such; instead, the beneficial interest in the trust is assigned or sold, and these are designated as personal property.
3. *Insulation from judgment liens.* In Illinois, and possibly in other states that recognize the land trust, a judgment against a beneficiary does not create a lien against the title of the real estate held in the trust. The trust property, in effect, is insulated from the legal process (although the judgment creditor may be able to claim against the beneficial interest).
4. *Ease of transfer.* Because the beneficial interest in the land trust is treated as personal property, it may be transferred from one party to another by means of an assignment rather than by the more cumbersome process involved in transferring real estate, which involves examination of title, agreement as to covenants and warranties by the seller, and so forth.
5. *Not subject to partition.* Unlike other forms of concurrent ownership (i.e., tenancy in common and joint tenancy), land held in trust is not subject to the remedy known as partition, by which one co-owner may seek to have the property sold and receive his share of the proceeds. Usually, the withdrawal of a beneficiary from a land trust is a matter of voluntary agreement among all the beneficiaries.

» 15.08 REAL ESTATE INVESTMENT TRUST

Real Estate Investment Trusts (REITs) have been around since 1960, when they were made part of the Internal Revenue Code. A REIT is strictly a creation of the federal

tax laws. It must have at least 100 shareholders to qualify for special tax treatment, and more commonly is in the form of a corporation, rather than a trust. A qualified REIT is entitled to conduit tax treatment (i.e., it may distribute income to its shareholders without the imposition of a corporate tax, thus avoiding the "double tax" burden on regular business corporations). The congressional purpose for creation of REITs was to make real estate investments more accessible to the general investing public; at the same time, REITs enabled real estate developers and owners of large real estate portfolios to tap the general capital markets for financing.

As Exhibit 15-1 indicates, REITs have shown a high rate of return in recent years. It will be interesting to see if they are able to maintain that high level of return.

Exhibit 15-1 Total REIT Returns (1990–1997)

Source: NAREIT. (NAREIT reported a total return of 30.09% for lodging REITs in 1997.

Year	All	Equity
1990	(17.35)%	(15.35)%
1991	35.68	35.70
1992	12.18	14.59
1993	18.55	19.65
1994	0.81	3.17
1995	18.31	15.27
1996	35.75	35.27
1997	18.86	20.26

[1] Organizational Requirements

A REIT must be a corporation, trust, or association managed by one or more trustees or directors. Many REITs have chosen the corporate form over the business trust form, because it is simpler in terms of state law considerations.

The REIT must have beneficial interest represented by transferable shares or certificates of beneficial interest. There may be two classes of stock or shares (e.g., a second class with a preference as to dividends and liquidation). A REIT must be beneficially owned by at least 100 persons for at least 335 days of a tax year of 12 months, or a proportionate part of a short year. The attribution rules under the Code are not applied in making the determination; consequently, the number of shareholders, not the relationship among them, is the only determinant of whether the test is made.

The tax year must be the same as the calendar year.

At no time during the last half of the REIT's tax year can more than 50 percent of the value of a REIT's outstanding stock be owned by five or fewer individuals. Certain attribution rules are applied in this determination.

A REIT can be self-managed or can operate through an external adviser. A self-managed REIT operates in much the same manner as a corporation, with a board of directors (or trustees), officers, and employees. A REIT may also contract for an external entity to manage its operations and investments. Both types of management forms are widely used—the objective of the REIT determines which form is more desirable. A self-managed REIT is more logical for an active organization needing full-time operators, while an externally advised REIT is probably more useful in instances in which the REIT is one element of a larger organization.

[2] Income Requirements

REITs are required to receive 95 percent of their gross income from the following sources: dividends; interest; rents from real property; gains from the sale or disposition of stock, securities, and real estate; abatement and refunds of real property taxes;
income from foreclosure property; commitment fees; and gains from the sale of real estate assets that are not prohibited transactions (i.e., assets that were held primarily for sale, with the exception of foreclosure property).

Of the foregoing, 75 percent of the gross income of the REIT must be derived from the following income sources; rents from real property; abatements and refunds of real property taxes; foreclosure sales; commitment fees; gains from the sales of real estate assets; interest on obligations secured by mortgages on real property or interests in real property; gains from the sale of real property not held primarily for sale to customers; dividends or other distributions and gain from the sale of shares in other REITs.

Income derived from rents contain a number of restrictions, the most important of which is that any amount received with respect to property is not rent if the REIT furnishes services to the tenant or manages or operates the property without an independent contractor. The independent contractor may be affiliated with the adviser to the REIT; however, the independent contractor cannot hold more than 35 percent of the shares or beneficial interest in the REIT. In addition, the REIT is not to receive any income from the independent contractor.

Less than 30 percent of the REIT's gross income can be derived from the sale or other distribution of the following: stock or securities held for less than six months;
sales or dealer property; and real property (including interests in real property and interests in mortgages on real property) held less than four years, other than foreclosure property or involuntarily converted property.

[3] Asset Requirements

At least 75 percent of the value of the REIT's total assets must consist of real estate assets, including land, interests in real property mortgages, shares in other REITs, and partnership interests to the extent of the interest's proportionate share of partnership real estate assets; cash; cash items (including receivables); and government securities. Mortgage-backed securities qualify as real estate investments.

No more than 25 percent of the value of the REIT's total assets can be securities (other than those included in the 75 percent asset test above). The securities of any one issuer cannot be more than 5 percent of the REIT's total assets, and the REIT's interest in an issuer's stock cannot be more than 10 percent of the outstanding voting securities of the issuer.

[4] Dividend Distributions and Taxation

To avoid paying taxes at the corporate level, the REIT must distribute to the shareholders dividends in the amount of 95 percent of its taxable income, less net long-term capital gains, any net income from foreclosures, and certain other items. If the REIT does not distribute at least 95 percent of its taxable income during each taxable year, it is subject to a 3% excise tax on the amount of the underdistribution.

There is generally no tax liability for a REIT, because its income is taxed only at the shareholder level. The REIT is not a true pass-through entity like a partnership, but it is still effectively not subject to taxation because it is eligible for a deduction

for dividends distributed and must distribute nearly all of its taxable income as dividends, As a result, the typical REIT has an insignificant amount of taxable income, taxed at the corporate level.

Dividends received by the shareholders are ordinary income to the extent of the REIT's earnings and profits. The earnings and profits of a REIT are computed using a forty-year straight-line depreciation. Distribution of greater than 100 percent of earnings and profits, however, are treated by the shareholder as return of capital.

The sale of a shareholder's interest in a REIT is taxed in the same manner as the disposition of stock. The return of capital, as opposed to payment of dividends, reduces the shareholder's basis.

[5] Types of REITs by Asset Holdings

In terms of the type of assets held, REITs are of three types: equity REITs, mortgage REITs, and hybrid REITs.

[a] Equity REITs

An equity REIT is one that owns real estate directly. The purpose of an equity REIT is primarily to generate rental income that will be passed through to shareholders. The vast majority of REITs are considered equity REITs.

Some equity REITs invest in a diversified portfolio of income-producing real estate, while others specialize in a single category of property (e.g., hotels). Similarly, some REITs concentrate their investments in one geographic area of the country while others buy properties in various locations.

[b] Mortgage REITs

Mortgage REITs are lenders involved in financing real estate rather than owning it. Only a small percentage of REITs engage in this form of lending activity. However, because traditional lenders to the hotel industry have reduced their lending activities, mortgage REITs could play an important role in the future.

Mortgage REITs have one major advantage over traditional lenders in that REITs are subject to virtually no regulation as to the type of mortgages that they can make. Thus, a mortgage REIT can make loans in the form of participating mortgages that not only provide the REIT with a fixed return on invested capital, but also offer the prospect of a share in future growth or a share in the proceeds from any subsequent sale or refinancing of the property. REITs also are in a position to make the various forms of subordinate loans, including second mortgages, wraparound loans, and various forms of refinancing. They can also be a source for gap or bridge loans and other forms of interim financing for borrowers unable to find other lenders, particularly when interest rates are high.

Some mortgage REITs have engaged in land purchase—leaseback arrangements, whereby the REIT purchases the land on which income-producing property has been constructed. The REIT then leases the land for a long term (up to ninety-nine years). With various equity features built into the purchase-leaseback, the REIT can return in the form of ground rent. Finally, REITs still are involved to some degree in short-term construction and development lending.

[c] Hybrid REITs

As its name implies, a hybrid REIT combines the features of both an equity and a mortgage REIT. The hybrid attempts to structure a mixed portfolio that includes ownership interest in income-producing property, financing of property through mortgage loans, and holdings of short-term government securities and mortgage pass-through securities. The object is to create a balanced portfolio that provides a fixed income return to investors as well as the prospect of future growth in income.

[6] Structuring a Hotel REIT

A number of hotel chains are currently weighing the advantages of going public, possibly as REITs. The major benefit would be the ability to raise large amounts of equity capital to finance ongoing renovations and new development while avoiding the burden of high debt-service costs. The incentive for public investors would be the opportunity to participate in the enormous growth in travel that is anticipated by the end of the century.

It is true that hotel chains in the past often did not meet standard investment criteria for publicly traded companies. The returns from hotels, as already noted, often come as much from appreciation in value and tax benefits as from operating earnings. Ratios used to measure performance of public companies, however, focus almost exclusively on earnings (in the form of such ratios as price/earnings, return on equity, and return on assets). These and similar factors ignore the appreciation element and the prospects of tax-free distributions resulting from debt refinancing. Finally, earnings of many hotel chains often are extremely volatile because of their highly leveraged position and high level of fixed costs.

If hotel chains can raise equity capital via REITs or other public structures, earnings volatility would be substantially lessened. At the same time, hotel earnings could stabilize at relatively high levels if the trend to increasing travel materializes. The result could well be transformation of a hotel investment from one fraught with risk for the investor to one that compares favorably with other forms of real estate investment.

Hotel REITs are unique because hotel profits are considered "unqualified" income, i.e., not the type of passive income that a REIT is permitted to earn. Thus, instead of a REIT operating its hotels, that REIT must enter into participating leases with an outside entity. To comply with REIT tax rules, the participating lease payments made by the lessee to the REIT must be based on gross revenues (rather than net cash flow).

The debate concerning this structure is whether the lessee should be an independent third party having no interest in the REIT or an entity affiliated with the REIT sponsor. Each structure has its advantages and disadvantages.

The primary appeal of an independent lessee is that the lease terms are negotiated at arm's length and thus gives greater assurance that the lessee's profits are not excessive. The practical problem with this approach is that few, if any, creditworthy lesses are available. Furthermore, even an independent lessee would want a substantial share of the operating profits in light of the risks involved; this would require the REIT to give up a substantial portion of the upside potential. The net result is that the REIT would, in effect, hold a net lease with limited upside potential.

Historically, hotel management companies receive a fee (e.g., 3 to 4 percent) of gross revenues rather than of net cash flow. One cause of the hotel problems of the late 1980s was that third-party lessees were motivated to increase gross revenues without regard to bottom-line performance. The result was that their fees increased while the owners' return declined. For this reason, many investors now favor a lessee affiliated with the owner.

Leasing to an affiliated party has a reverse set of advantages and disadvantages. If the REIT sponsor is also the lessee, questions of fairness can arise from negotiations not made at arm's length. On the other hand, an affiliated lessee offers two advantages to the REIT. First, if the lessee has a substantial investment in the REIT itself (which usually should be the case), it not only has a fiduciary duty to the REIT but also is likely to earn more through REIT dividends than through a management fee. Second, an affiliated lessee is much more likely to accept a rent structure that mirrors the operating performance of the underlying hotel properties, passing as much upside (or downside) as possible to the REIT.

Possibly the best approach is to combine an affiliated lessee with various credit-enhancing structures that reduce the risks of conflicts of interest. For example, the lessee may be required to maintain a substantial reserve to guaranty lease payments before any profits can be retained by the lessee.

[7] The REIT Modernization Act

One of the most important changes to REIT structures will occur on January 1, 2001 when the REIT Modernization Act of 1999 (RMA) takes effect. This wide sweeping law will affect the lodging industry in a number of ways. The most important change is that it will permit lodging REIT's to own up to 100% of the stock of an independent entity or taxable REIT subsidiary (TRS) that engages in non-REIT activities. The practical application of the TRS provision to the lodging industry is that lodging REITs will now be able to lease their assets to a TRS, rather than some third-party or captive lessee. TRS that are of a lodging REIT will not be permitted to manage any property. As such, the hotels would still need to be managed by either third party management company. Additionally, no gambling can occur at the leased hotels. Many hotel companies have already stated that they will be setting up TRS structures and recapture their leases.

RMA allows changes to the payout requirement of REITs from the current 95% of income to 90% of income, beginning in the year 2001. This will allow hotel REITs to be able to retain more income for capital improvements. Also, the lower payout requirement will give hotel REITs more flexibility.

Finally, RMA designation will allow hotels to pursue different types of business that they were permitted under the old law. However, under the RMA, REITs will be prohibited from having more than 20% of gross assets (combined equity and debt) as investment in their TRS.