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Considerations For a Hotel Investment

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by

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Table of Contents

ABSTRACT

This writing will provide novice hotel investors, new owners, and hotel associates new insight on hotel investments. This writing discusses industry topics such as: the definition of a hotel asset, an overview of occupancy and transaction levels, different kinds of risk related to hotel investments, location, franchising, the hotel investment cycle, incremental and base impact, and hotel construction related issues. At the conclusion, the reader will be familiar with a few uncommon concepts that affect a hotel investment.

PART ONE

Introduction

Does the idea of owning a hotel excite you? Do you have enough information to make the investment profitable? The hotel business frequently attracts first-time owners and investors (Isenberg, 2014). Successfully investing in a hotel asset is both an art and a science. It takes immense knowledge of the market(s), hotel operations, and in-depth financial concepts to make great returns. Stephen Rushmore of Hotel Valuation Services stated "Investing in hotels and motels is considered by many to be a high-risk use of time and capital (HVS, 2002, p. IV). Vesta Hospitality reported that in 2010 there were 2,500 distressed hotels in the United States which accounted for a nearly $40 billion loss (VH, 2011, p.1). Not everyone does it right. For example, Eli Segall of the Las Vegas Review Journal reported that a 8.6 acre site for a hotel was purchased in 2004 for $50 million and was sold in 2016 for $13.6 million (2016, p.B005). Today there are few relevant academic writings to inform parties interested in learning about what is important in a hotel investment. Bernie Dowell (1997) wrote, "most of the existing body of literature on hotel valuation has been offered by Stephen Rushmore of Hospitality Valuation Services" (p.1). Wisdom about what to avoid is even harder to find. The local library is sure to have books on this subject that were published 20 years ago and will be of little use. The hotel investment cycle and hotel operating practices often change so quickly that printed material is often outdated by the time the book hits the shelf.

Purpose

This writing will introduce novice hotel investors, potential owners, and curious hotel operators to hotel investment concepts and new trends industry. The topics include: a definition of a hotel investment, a brief summary of recent hotel transactions and occupancy trends, the hotel investment cycle, base and incremental impact, and current construction trends. At the conclusion of this writing, the reader should have a broader view of the concepts to be considered for a hotel investment.

Justification

Buying a hotel or being a private equity partner in a hotel investment is a huge commitment. There may be cases when potential investors do no know where to start when trying to make a hotel investment. Unfortunately, the same aspects that lure investors and owners are the aspects they fail to grasp (Isenberg, 2014). Maureen Farrell of Forbes describes hospitality investments, " while some two-thirds of small firms make it past the two-year mark, just 44% can hack it for four years, according to the latest data from the Bureau of Labor Statistics" (2007, p.1) . As such, it is critical that investors understand a few basic and not-so-basic concepts on how hotels are organized and the responsibilities of being an owner. Failing to research and understand hotel investment structures and concepts and have negative repercussions.

Constraints

There are a few limitations to this writing. First, this writing will focus on the science of hotel investing, and not the art. Second, this article is meant for novice hotel investors who have not worked or have little experience in the hotel industry. Professionals working for a Real Estate Investment Trust or the like may find some of this information to be basic or common sense. Furthermore, there will be information presented that will not be applicable to every hotel in every market. This paper is aimed to serve investors of the United States. The information offered in this writing may not be generalized to all international markets. Hotels with condominiums or residences attached are outside the scope of this paper because only part of the business is not hotel related. Likewise, mega resorts and casinos are not considered in this writing because of their heavy emphasis on gaming and retail. Sometimes hotel casinos have a different strategy and do not prioritize hotel room sales. Additionally, this writing will contain information about construction and renovations which may not be relevant to all owners because they do not plan to hold the property long enough to necessitate capitol expenditures. Finally, the nature of the paper does not lend an in-depth explanation of all topics presented; rather a basic foundation will be presented.

Part Two

Literature Review

Throughout the investment process, investors face many decisions. Choices pertaining to the investment must be carefully analyzed. The focus of this literature review is to provide basic knowledge of hotel specific investment concepts and practices. This literature review introduces factors that potentially impact the profitability of the asset. The articles referenced convey the importance for market research as investment dynamics change over time. The synthesized articles all discuss relevant information and pertinent study results for hotel investing and decision making.

First, this literature review will define a hotel asset and present facts on transaction and occupancy levels in the US hotel industry as of late 2016. The following topics include information on different types of risk, location, scale, and franchising. Additionally, information is included on who is required to launch a hotel, namely an owner, a lender, and an operator will follow. There will also be a summary of the most valued factors investors have historically sought. An interpretation of the real estate market life cycle and the impact the timing of the acquisition of a hotel will have will be analyzed. A definition of base and incremental impact and how the profound affect it can have on the investment will be presented. Lastly, modern day issues of hotel construction will be put into focus.

Definition of a Hotel Asset

To begin, it will benefit novice investors to know what kind of an investment a hotel is. There are a number of different sectors of commercial real estate investments which include commercial, residential, industrial, and specialized real estate (Frehse, 2007, p.8). Hotels are considered specialized real estate investments (Frehse, 2007, p.8). In *Hotel Investment Analysis: In Search of Business Value,* Bernie Dowell (1997), reveals the difference between real assets and financial assets. "Real assets are income-generating assets, whereas financial assets define the allocation of income or wealth among investors. Financial assets permit separation of ownership and management of the firm and facilitate the transfer of funds to enterprises with attractive investment opportunities, writes Dowell (p.1). Hotels have characteristics of both because the operation requires multiple parties to function, like an owner and an operator, and the investment is in tangible assets that generate revenue (Dowell, 1997, p.1). It is important to understand the nature of the asset so the investment can be best cared for and identified. A hotels is not a passive investment like a strip mall (Jones, 2013). Hotels fit in the real estate category but they are also specialized businesses that sell more than a product. Today, the hotel business is rapidly changing and individuals trying to break into the hotel business should be cognizant of the current state of the industry.

Transactions & Capitalization Rates

If the business of hotels is a new topic for an individual and/or the individual plans to make a capital commitment to an investment or acquisition, that individual should be aware of some of the current macro-economic hotel trends. The following will include a summary of recent hotel transactions and increases in capitalization rates nation wide.

First, transaction volume is another word for hotel acquisitions or hotel sales/purchases. It's no secret transaction levels in this industry have increased in recent years. According to Julie S. Higginbottham (2014), Senior Editor of Building, Design & Construction:

> Transaction volume in the sector is predicted to reach nearly $50 billion this year—about 10% higher than last year, which was more than 30% higher than the year before. Travel research consulting firm STR says nearly 3,000 construction projects were active at the beginning of 2014 in the U.S. alone, up 16% compared with 2013. The previous year saw a 48% increase (BDCnetwork.com).

From 2014 to 2015, hotel transaction boomed, bringing increases of almost 30% for the year. (Mellen, 2016). Although 2016 has not shown the same success, some of the largest hotel transactions occurred in 2016 due to big acquisitions and mergers like the purchase of Starwood by Marriott, Strategic Capital by Blackstone, and the Kimpton Brand by IHG (Mellen, 2016). Actually, transaction volume is projected to slow compared to previous years (Mellen, 2016). The last five years have brought increased numbers for asset evaluations due to heightened numbers for net operating income (Mellen, 2016). This has recently led to an industry wide rise of hotel capitalization rates (Mellen, 2016). Capitalization rates are an important number to understand because it is a metric used to evaluate hotels.

There are many ways to appraise a hotel property. When trying to uncover the fair market value of a hotel using a hotel income approach, the capitalization rate is used (Craig, 2003). A capitalization rate describes the value of the hotel and is calculated by dividing the net operating income (NOI) into the purchase price/current market value of the hotel (Craig, 2003). In other words it is a rate that compares a single year's operating income to the purchase price of the hotel (Appraisal Institute, 2001). The capitalization rate is used to indicate the present value of the asset (Appraisal Institute, 2001). In an example provided by HVS for a particular hotel, total revenue jumped 165% from 2010 to 2015 while expenses increased only 140%. The recent success had an extraordinary impact on NOI - a 432% increase (Mellen, 2016). Such an increase would make the capitalization rate drop. The example provided was for one hotel, but many have been experiencing similar success. These number translate well and add value at the time of evaluation. According to Mellen, in 2008 real estate investment trusts cap rates reached an average of 12%. In 2010, those same cap rates fell 5.1% and have steadily increased to 8.3% in 2015 (2016). Thus, hotel valuations have slightly declined over the past few years.

Risk

Most conspicuously, hotel assets are risky and, as such, decisions should not be made in a hasty fashion. At every stage throughout the life cycle of the hotel, owners will be faced with different levels of risk. Elie Younes and Russell Kett of HVS provide insight regarding three different kinds of risk hotel investors will face. These risks are development risk, operating risk, and exit risk.

Risk is the probability of unforeseen events taking place or setbacks occurring during a project. Development risk is present during the development stage which range from one to three years (Younes & Kett, 2006). Investors face development risk when constructing a new hotel or improving an existing structure (Younes & Kett, 2006). Development risk is a relevant threat to investors because the finished product sometimes differs from the first envisioned product. Other times, development risk occurs when the schedule is changed and the opening of the hotel may be delayed. Cost overruns can be another source of development risk (Younes & Kett, 2006). Perhaps the development of the asset is over budget. Most of these issues can be avoided with thorough communication and project management skills. Investors should take note of the development risk before investing because it can have a profound impact on the overall performance of the asset.

Similarly, operating risk is another form of risk investors may find. This risk refers to the hotel's capability of generating enough revenue to reach specified levels of profitability. This risk is evident from year four to twenty five of the asset life cycle (Younes & Kett, 2006). Risk is elevated in a hotel that has volatile levels of EBITDA, or earnings before interest, taxes, depreciation, and amortization (Younes & Kett, 2006). A hotel that operates and achieves consistent levels of EBITDA has less risk because it is likely the hotel can continue to consistently reach those same levels (Younes & Kett, 2006). It is both the operator and owner's job to seek positive financial performance. Unfortunately, hardships often present themselves in the form of an economic slow down or new hotels entering the market. Sometimes the operator may be unqualified and can not produce adequate levels of cash flow to cover debt service. These types of risk can cause hardship because insufficient levels of cash flow will weigh heavily against the owner in the valuation of the asset when it is time to sell the hotel. Additionally, the owners will have to find others ways to pay the debt service amounts to the lender.

The third type of risk owners and investors face is exit risk (Younes & Kett, 2006). Exit risk is present during the divestment stage of the hotel and may occur after twenty years of ownership (Younes & Kett, 2006). Selling a hotel can be risky because there are many dynamics that affect price. The internal risk refers to the physical condition of the hotel - maybe it needs a major renovation. Perhaps the hotel's condition is so severe it does not make sense to renovate it (Younes & Kett, 2006). External factors to selling the hotel include taking a loss due to the economic climate in the market. Other external factors that could lead to taking a loss on the sale are new legislation, social factors, and environmental changes (Younes & Kett, 2006). Many of these factors are out of the owners control. Before being an owner, one should recognize that limited service hotels are the most prone to this risk (Younes & Kett, 2006). Exit risk is critical to analyze because a large capital gain can be made upon the sale.

Location

Hotel location is a factor that will heavily impact the investment. Location can be a big demand generator that drives revenue and customer satisfaction. It can also add value to the property when it is time to sell the hotel. As a result, owners and investors highly value analysis that identifies the characteristics of a remarkable location (Yang, et al, 2014). The location will influence guest satisfaction, hotel revenue per available room, increased demand, and overall profitability (Yang, et al, 2014). In *Theoretical, Empirical, and Operational Models in Hotel Location Research*, the authors convey different theoretical models used to find suitable hotel locations. These models are important because hoteliers and commercial developers can potentially utilize them to make educated guesses for future hotel locations.

As part of the theoretical framework, the authors present Ashworth and Tunbridge's Tourist-historic city model, or THC model. The THC model is an analysis of hotel locations in European towns. This theory essentially explains that throughout a city there are many different types of locations, and in each type of location resides a specific type of hotel. The different types of locations, according to Ashworth and Tunbridge, are “traditional city gates, railway station/approach roads, main access roads, ‘nice’ locations, transition zones and urban periphery on motorway, and airport transport interchanges” (Yang, et al, 2014). Each location provides a different purpose. As such, different types of hotels can be found in each of these categories (Yang, et al 2014). For example, airport hotels are located near an airport and offer amenities that will benefit travelers like a free airport shuttle service. Over the past 25 years, many hospitality researchers have used this model to analyze the distribution of hotels in a city. The theory has proven successful across many international cities. According to authors, researchers have been able to analyze a city and identify many different types of zones and specific kinds of hotels located with in them (Yang, et al 2014). The THC model can individually identify sites for hotels with certain characteristics related to location (Yang, et al 2014). This is one method an investor could use to assist to determine an excellent location of the hotel.

Additionally, the authors introduce the mono-centric model. Simply, the mono-centric model analyzes the relationship between the cost of land to the proximity of the city center. According to the Yang, Luo and Law, “In the model, it is assumed that an urban area is mono-centric with a single central point for sprawl, and the bid-rent curve is introduced to depict how much land users are willing to pay for locations with different proximities to the center” (2014). In other words, it predicts that the closer the hotel is to the center of a large city, the more expensive the hotel will be. As a result, one can potentially infer the luxury hotels will be located in downtown environments while class A and economy brands will be located at distances further from the center of the city (Yang, et al 2014). First time owners can apply this model to their own potential business plan. Determining where the hotel will be located should be based on the budget for the cost of the land. The opposite can also be applied. Investors could select a scale or brand of a hotel to determine the location.

Thirdly, there is the agglomeration model. This model proposes that hotels benefit when they are clustered by similar and different characteristics (Yang, et al 2014). This model fails to predict precise hotels locations; however, it does advise locating next to other hotels (Yang, et al, 2014). Hotels in close proximity with similar services may benefit. A cluster of different hotels may have more services to offer and may meet the needs of other travelers. From a productive standpoint, hotels in a clustered location may have “exclusive access to goods and services, suppliers, and special services” (Yang, et al, 2014). From a demand point of view, the authors state that consumers will spend less time searching and their costs will diminish as the services they need are centrally located (Yang, et al, 2014). On the other hand, there are downsides to agglomeration. Business competition may be increased and the overall performance of the assets in the cluster depends on the strength of the assets (Yang, et al, 2014). These clusters of hotels are often located in metropolitan areas and this strategy may be a viable one if that is the intended market.

In contrast, Jones (2013), addresses first time investors to give them advice on how to select a location for their investment. Jones does not refer to any theoretical frameworks but provides a practical approach to searching for a great location. Jones directs investors to go to a hotel website and try to make a reservation in the town where the future hotel will be. In the early planning stages knowing the exact street corner is not relevant. Picking a town is the proper starting point. Establishing *where* the hotel will be will assist the investor in determining *what* the investment will be. Investors should start by looking at room rates in the intended market for brands like Hampton Inn, Courtyard by Marriott, and Holiday Inn Express. If those hotels are not offering rooms at $110/night or higher, an investor should consider looking elsewhere for an investment (Jones, 2013).

Consider the difference between the same hotel in two different cities in an example provided by Jones. One hotel is located in Marlborough, MA and the other in Branson, MI. The best available rate for the hotel in Marlborough is $144/night while the hotel in Branson receives $89/night (Jones, 2013). Because of the strict brand standards of Hampton Inn, Courtyard by Marriott, and Holiday Inn Express, it is a proper assumption that the products are similar. The building is the same, the furnishings, even the food in the free breakfast is the same (Jones, 2013). As a result, the hotel in Marlboro is more desirable for investors or owners. Because it has a $55 premium per night over the hotel in Branson, it will bring in $825,000/year more in revenue per year. By increasing the sales by $825,000/year, the value of the hotel increases by $2,475,000 (Jones, 2013). All of this comes as a result of the decision of one town or the other.

Property Characteristics

There are several reasons why an investor may find a hotel to be attractive. An individual's role in the investment will often dictate what is of most value. Some hoteliers decide a particular hotel is attractive because it is in an unbeatable location. Others might look at previous financial performance over the recent past and see opportunities for improvement. There are a plethora of characteristics that many may find value in. In *Factors Influencing Hotel Investment Decision Making* by Grame Newell and Ross Seabrook (2006), the authors discuss the value of property characteristics to different types of owners.

In 2004, Newell and Seabrook attempted to survey thirty of the largest hotel owners and investors in Australia. The investors were involved in public/private hotel company transactions. Of the members of the group, fifteen individuals had experience in ten of the major markets in Australia and collectively control 20,487 rooms or 36% of the market (Newell & Seabrook, 2006). The authors conclude that the participants are a representative sample of all major hotel investors in Australia.

The study required the participants to rate five major categories of factors in the hotel investment decision making process with a total of twenty five sub-factors. The major factors were based on location, economic, financial, diversification, and relationship. Under the five major factors were twenty five sub-factors like, volatility of demand, site attributes, and forecasted return on investment (five years) (Newell & Seabrook, 2006). The data was collected in a personal interview. The participants were responsible for deciding which of the factors and sub-factors were most important in the investment decision process. Using a seven point scale, the participants were asked to rate the attributes in pairs. A rating of one meant the attributes were equally important. A seven point rating gave the attribute absolute importance (Newell & Seabroo, 2006). This method allowed for sub factors to be matched against each other and evaluated.

While the survey results between hotel owners/operators and hotel investors were very similar, there were a few differences in how they rated the importance of the five major factors. The authors stated that hotel owner/operators recognized factors based on location to be the most important (Newell & Seabrook, 2006). For example, site attributes and current hotel supply were highly rated sub-factors. On the other hand, hotel investors valued financial factors more. Five year ROI, volatility of demand, and gross operating profit were rated in the top five sub-factors. This may not come as a big surprise as hotel owners and operators may have more expertise in knowing what drives business and gives value to a hotel. The hotel investors focus on the financial numbers associated with operations, like return on investment and gross operating profit.

In addition, Newell and Seabrook (2006) present a second table comparing the ratings for public and private investors. The public investors gave a higher score to location factors. Private investors prioritized financial factors. Overall, the study yielded results indicating that sub-factors relating to location were highly regarded and financial sub-factors were less influential (Newell & Seabrook, 2006). The authors believe this to be the case because “hotel investment issues appear to be micro or localized rather than being broader or macroeconomic influences” (Newell, Seabrook, 2006). The results from this study conclude that hoteliers value location because it cannot be manipulated, but financial results can change over time.

Scale

A hotel scale is another word for category or class. It refers to the actual product that the hotel is. Not all hotels are created equal. Scale communicates the quality of the hotel or what services are offered. Smith Travel and Research (STR) reported six different scales in 2015 (STR, 2015). The scales are: luxury, upper upscale, upscale, upper midscale, midscale, and economy (STR, 2015). There are several ratings agencies with different systems. Others refer to hotel quality by using classes after the alphabet - A,B,C, etc. Selecting the class of hotel to develop should be a conscious decision because each class will cost a different amount to build, each class will cost a different amount to manage, and each class will attract a different customer segment. The different scales of hotels are all different because they offer different services and provide different touches of luxury.

Moreover, Jones (2013) favors Class A hotels in the upscale to midscale tiers for firs-timers and warns of the complexity of investing in full service hotels including luxury brands. Compared to the other classes of hotels, full service and luxury are the most critical (Younes & Kett, 2006). Full service hotels are more complex because they include food and beverage operations and maybe even a full service spa (Jones, 2013). As such, first timers should avoid getting involved in these extra businesses. Instead of managing the financials for only a hotel, now the owner has worry about not loosing too much money in the restaurant(s), lounge, or spa (Jones, 2013). Do not forget, with so many specialized amenities there is a requirement to hire qualified managers to operate those areas. As a rookie investor, one should consider making things as simple as possible.

Because of their simplicity Class B hotels are also worthy of investing (Jones, 2013). Class B hotels include brands like Comfort Inn and Sleep Inn. These hotels are known as Class B because the quality of the each hotel is different and they run on lower rated business as a result (Jones, 2013). Individuals should consider investing in this class for a first time investment because the assets can be purchased at an affordable price and little resources are required renovate the hotels (Jones, 2013). Jones writes that a class B is especially appealing if the proposed market is small and Class A hotels are achieving $129 rates. Second, if other class B properties are in poor condition and receive $50/night (Jones, 2013). Third, there are no options for customers that fall in between the Class A hotel and the run down Class B hotel (Jones, 2013). Other than that, it may be smart to stay away from those type of assets.

Economy brands can be attractive to some investors. The mission is to not to be the cheapest hotel in the market. Rather, “the goal is to be the cheapest decent hotel in the market” (Jones, 2013, p.8). When investing in these types of assets they are to be purchased, not built (Jones, 2013). Because hotels are expensive to build, it can take a much longer period of time for an investment to pencil. If a pre-existing hotel is purchased, it can likely keep operating as soon as the owners receives the title. Another consideration is that owners should buy in a market that they envision will not disintegrate over the next few decades and expect to renovate that property extensively (Jones, 2013). With these kinds of hotels, Jones warns, owners need to be on top of the operation to make sure it is up to their standards. Doing so will protect the asset from undesirable guests and keep customers satisfied (Jones, 2013). Economy branded hotels are a good vehicle to invest in if the market calls for the product and this is the investors first asset.

Franchising

Hotel franchising has been a popular way to break into the lodging industry. The decision to franchise is one of the most important decisions an investor or owner will make (Isenberg, 2014). Franchises are a vehicle used to help companies grow and assist franchisees succeed in becoming profitable business owners. Onofre Cunill and Carles Forteza wrote “the franchise system has become the growth strategy most widely used by hotel chains and that the sharp rise in the use of this system has led to increasing market concentrations by hotel chains” (2010, p. 493). On the other hand, franchising can be a step when owners make many mistakes (Isenberg, 2014). Rookie investors should be cognizant of the many franchising opportunities there are and how to negotiate the franchise agreements. In fact, the brand name can add significant value to asset (Love, Walker, Sutton, 2012). Selecting the right brand name is a significant decision because, “a brand name is a complex and comprehensive, mass- marketed system of identification and operation” (Love, Walker, Sutton, 2012, p. 225). The tools provided for hotel operations and above property operations are invaluable for new owner operators - like sales, revenue management, and marketing. On the contrary, franchise companies charge fees for the services they offer, like franchising fees and other affiliation charges (Isenberg, 2014). A typical franchise fee after ramp up can be 5% of top line revenue (Isenberg, 2014). This is a fee paid for having the brand name on the building. Luckily, investors have many options to choose from. Today, almost every national hotel is selling franchise agreements.

Following his remarks about the location and scale of the hotel to built, Jones addressed the subject of franchising. There are many benefits to franchising the proposed hotel via a national chain. By selecting a large chain, the novice investor can obtain more favorable financing terms rather than starting an independent brand (Jones, 2013). Banks favor big brands because they have a proven track record and carry less risk than the independent owner does going it alone (Jones, 2013). Branded hotels have many attractive features; they can come equipped with a power house marketing system and a lucrative loyalty program (Love, Walker, Sutton, 2012). Not surprisingly, hotels under a flag of a major chain achieve higher RevPar Indexes (Love, et al 2012). Recommended brands include Best Western, Wyndham Hotel Group, LaQuinta Inns, Choice Hotels, Holiday Inn Express, Hampton Inn, Courtyard by Marriott, and Fairfield Inn by Marriott (Jones, 2013). If one of these brands is missing from the market, he would start by selecting that product (Jones, 2013). These are great brands to consider because their revenue performance is superior to independent brands (Love, et al 2012). Actually, independent hotels only produce 74% of the revenue branded hotels bring in (Love, et al 2012). Branded hotels exist and thrive in many markets across the world. The support they offer to a novice hotelier is sometimes invaluable, but keep in mind it is not cheap.

Owner, Operator, Lender

Have you considered what other parties are involved to operate and finance the hotel and how much they cost? In *Trends in Hotel Investment and Financial Management in Canada*, the authors detail the structure of hotel investments. Owning a hotel often requires three parties: an investor/owner, a lender, and an operator (Willie, et al. 2013). This is an important observation because it sets apart the role of owners from the role of managers.

The first party required in a hotel investment is an owner. There are many different types of ownership structures in the hotel industry. There are “Trophy Buyers” who are people with access to large lines of credit (Denton, 2009, p.23). This group makes large investments in hotels that are in competitive markets and the hotel assets are hard to duplicate (Denton, 2009, p.24). The “more common form of ownership now consists of corporations and multiple unit owners who are financial investors foremost and (occasionally) hotel operators as an afterthought” (Denton, 2009, p.15). In fact, many hotel investors have rarely spent time in a hotel as an employee. Instead, these owners are financial institutions or real estate companies who happen to have invested in hotels (Denton, 2009, p.15). Another class of investors exists, called individual owners or entrepreneurs (Denton, 2009, p.24). These individuals are typically energetic and willing to take on high risks to achieve the high returns that a hospitality investment can offer (Denton, 2009, p24). It is very likely that anyone reading this article could be classified as an individual owner/entrepreneur.

The second party is the operator. The biggest trend in hotel ownership has been the separation of duties from that of the owner to that of the operator (Denton, 2009, p.15). Surprisingly, Marriott International actually owns very few of the hotels it operates. Marriott International is a management company that works for the hotel owner. Marriott serves as an operator. If a hotel owner wishes to hire Marriott International or the like, it is the company's job to operate the hotel in such a fashion that meets the management agreement or contract. The selection of a qualified operator is imperative because, "the value of the property is very dependent on the skills of the hotel operator" (Frehse, 2007, p. 8). The management company is responsible for operating the business in a profitable fashion.

Furthermore, the authors illustrate how management companies, or operators, make money. There are hundreds of management companies out there to choose from but not all are created equal. It is likely that whoever the owner selects to manage the property will be paid a base management fee (BMF) and an incentive management fee (IMF) (Willie, Pirani, et al. 2013 p.192). Willie et al (2013 p.192) assert that an owner can expect to pay an operator a BMF of 5% of top line revenue and an IMF of 10% of the profit. A base management fee is the money the operator earns for managing the business. The incentive management fee can be interpreted a bonus for achieving a certain level of financial performance. A common level of financial performance is close to 8-10% return on investment (Rivera, 2011, p.2). Over the lifetime of the management contract this can be a lot of money, but there are certainly trade offs if one decides to run the operation on his/her own. The extra 26% of revenue Love, Walker, and Sutton refer to is why owners pay operators these fees.

The third important player is the lender. The lender can be a group of private investors, but more commonly it is an institutional bank. The bank offers the investor cash to secure the building with specified terms like interest rates and a payment schedule. If private investors are the source of funds then they are entitled to a portion of equity in the asset (Willie, Pirani, et al. 2013 p.192). Unfortunately, there have been situations where the lenders becomes the owner. Lenders may take over the keys to the hotel when the asset is in foreclosure and the hotel owners can no longer pay the debt service (Denton, 2009, p. 25). These situations were not uncommon in the 1990's and in 2008 when real estate markets tanked (Denton, 2009, p.25). It's unfortunate when this occurs, but lenders are the necessary evil. With out the lender, owners may not have the access to the cash needed to acquire the hotel.

The Hotel Investment Cycle

Some may have heard industry experts say "the hotel industry is cyclical", but may not know what it really means. The hotel industry, especially the investment portion, is very cyclical because demand ebbs and flows as it is closely tied to macroeconomic conditions. Vesta Hospitality (2011) gives a basic summary about the industry cycle:

> Development in the hotel industry seems to happen in waves. The waves start with improving market conditions that drive higher occupancy and revenue followed by loosening of capital markets causing new development to be feasible. Many developers jump in at the same time, causing a surge in new hotel inventory. Then when the economy starts to slow down, the wave crashes with hotel income declining due to demand and supply imbalance -- and values take a sharp downturn. The size of the wave

and the timing of and strength of future demand growth will determine how long it will take to recover from the impacts of the wave.

The hotel cycle referred to above closely mimics a prototypical business cycle; there are four stages. Economic expansion, maturity, recession, and recovery occur in a typical cycle and understanding each is essential (Denton, 2009, p.14). Each cycle is never the same as macroeconomic dynamics and public policy change over time. In the expansion stages, profit rapidly increases but starts to level off at the maturity stage which follows. During the maturity stage profitability levels slow and markets contract (Denton, 2009, p.15). When the cycle enters the recession portion of the cycle, profits reach negative levels but eventually bottom out. As profits start to rise again and meet an equilibrium, the cycle hits recovery (Denton, 2009, p.15). Investors will make the biggest impact on their investment by appropriately choosing when to enter the cycle.

A potential investor should be aware of the timing of his/her investment in the cycle, as summarized in *Timing the Market: You Don't Have to Be Perfect*. Timing is essential; it can have a profound impact on the appreciation value of the asset. The general rational is buy low sell high, but that takes a keen ability to time the market. From data for the last 50 years of hotel transactions, there is evidence that hotels transact in cycles. From 1969 to 1994, data shows two large supply booms with demand being closely tied to the state of the nation's economy (Rossoff & Wheaton, 1995). The supply and demand for a hotel, like many other products and services, fluctuates over time.

Anderson & Harris (2011) designed a simulation showing two models running on different frames. One simulation was based off of a macroeconomic cycle and the other was based off the real estate cycle. Anderson and Harris (2011) state the purpose of their study is two fold: 1) by comparing the results, potential investors can understand how real estate transactions are impacted during and after a recession and 2) the authors wish to convey the upside in attempting to time the market.

The data used was gathered from the National Council of Real Estate Investment Fiduciaries (NCREIF). The NPI, or NCREIF Price Index, measures the rate of return over a period of time of real estate investments only. The properties in the NPI consists of office, industrial, retail, hotel, and multi-family residential (Anderson & Harris, 2011). Anderson and Harris matched this NPI with the National Bureau of Economic Research (NBER). NBER is responsible for identifying the market highs and lows (Anderson & Harris, 2011). The authors introduce these sources because they can be vital tools for gathering market research.

In their study, the authors show that a simple buy and hold strategy can produce an annualized rate return of roughly 8% over a 30 year span from 1980-2009 (Anderson, Harris, 2011). They also convey that investing after a recession, or when the market is down with a predetermined divestment date can produce mixed results. These results are volatile because the disposition is based on an assumption that macroeconomic factors will be favorable at a predetermined time (Anderson, Harris, 2011). Sometimes the market may be up and other times it may be down. There is no way of knowing what the economical climate will be years later. With rich explanations and visual aids, Anderson and Harris conclude that making real estate transactions at the *exact* top or bottom of the market is improbable (2011). This is an extremely rare occurrence because absolute market highs and lows are not determined until some time after they have been realized (Anderson & Harris, 2011). Timing a market entry and exit is nearly impossible.

Not only is perfect timing unlikely, but the authors find that investing or selling a year late or early did not have a significantly negative impact on the return (Anderson & Harris, 2011). The takeaway however, is that attempting to time the market on both sides can have a significant positive impact on the investment. Fortunately, the timing does not have to be exact. For example, buying at the market low of 1991 and selling at the peak of 2001 provides a return of 10.53%. If an investor entered the market in the downturn of 1991 and divested in 2002, then the investor would receive a return of 9.1% - only 143 basis points less (Anderson & Harris, 2011). This example shows that exact timing may not make or break the return on investment; even entering and exiting the market within one year of the market highs and lows and still yield profitable returns.

Hotel Impact

Hotel impact is a topic that new hoteliers may be unfamiliar with, but owners need to be clued in on the different kinds of impact. Note that this term is potentially a negative one for owners because the development of competing hotels can rattle the financial performance for a pre-existing hotel.

One of the many frustrating situations that can occur as a hotel owner is seeing a new hotel come into the market that will directly compete with his/her hotel. This may easily ruin a hotelier’s day because the new hotel is likely to take a piece of the existing business. This is not an uncommon situation and is known in the hotel industry as impact. Base impact refers to new competition coming into the market via additional rooms (Roginsky, 1995). If a hotel changes flags or hires a new management company it is not considered base impact because the hotel rooms were already in the market. The base level of competition does not change. The addition of new hotel rooms is problematic to existing hotels because new strategies have to put into action for a hotel to keep the current customers and to prevent new customers from going to the new hotel. Today, base impact that occurs as a result from competitive climate is common place.

What is more troubling as an owner is incremental impact. Incremental impact is not so well accepted and will make an owner cringe (Roginsky, 1995). It is a step higher than base impact. Like base impact, new rooms are entering the market which a previously existing hotel has to compete against; however, now multiple hotels of the same brand are competing for the same rewards members and loyal customers (Roginsky, 1995). A conversion of an existing hotel to a brand that is already present is impactful to the pre-existing franchise. Incremental impact brings challenges in capturing customers who use the same reservation system. With multiple hotels under the same flag, there are many properties a customer can choose from. As an owner, operator, or investor this issue of incremental impact is a significant one because additional hotel options can make it harder for his/her hotel to keep its market share. For a hotel owner, it may force him/her to invest resources into an updated room design or improved event space. As an operator, one may feel the need to discount room rates in order to appear attractive. No matter what role one plays in the hotel, the presence of incremental impact is troublesome.

If an owner is concerned about potential impact from a new hotel in the market, he/she can hire a hospitality consulting firm to write an impact study. This study, simply, looks at variables like the competitive set in the market, market segmentation, current hotel occupancy and average daily rate and tries to determine if the new hotel will take marketshare from the existing hotel and how much. It is known that the these studies can be subjective, but there are important approaches to analyzing the impact: percentage take analysis, percentage contribution analysis, and segmentation analysis (Sangree, 2005). As an owner, one will not likely be doing the impact studies in full. It is important for owners to have their own forecasts for potential impact. Understanding the process is helpful because owners can potentially spend a lot of resources for a consulting firm, like PFK, or HVS to complete the impact analysis.

The first method is called percentage take. Percentage take analysis attempts to ball park the percentage of business the new hotel will take from the existing hotel (Sangree, 2005). For example, the new hotel might capture demand from the company reservation system (Sangree, 2005). Percentage contribution analyzes the number of room nights for the new hotel that is taken from the existing hotel (Sangree, 2005). This is a test of reasonableness. For example, "while it may be logical to consider an existing owner's belief that half of his 200-room property's reservation system demand may be lost to a new licensee, it is less logical to believe that 100% of a 100-room new property's contribution will come from the existing hotel's reservation system demand" (Sangree, 2005). Lastly, segmentation analysis compares the demand of the new hotel and existing hotel and seeks potential change in the market segmentation (Sangree, 2005). This method is especially useful in deterring impact on the existing hotel's average daily rate (ADR). For example, a new hotel could attract the existing hotel's highest rated guests thus negatively effecting ADR. On the other hand, the new hotel could be more attractive to guests paying the lower rates. This could result in an ADR increase (Sangree, 2005). When a new hotel, or new licensee enters the market it can change the business dynamics. The information on the methodologies can assist investors to form their own conclusions on new competition.

Impact studies cover a lot of information, but nearly all focus on key factors that diminish or enhance impact. These factors are: distance, positioning, size, number of existing franchises, travel patterns, geographic origins of business, affiliation contribution, daily occupancy, incremental contribution, and denials (Sangree, 2005). The distance between the new hotel and the existing hotel is a critical factor in measuring impact. The distance will never dictate impact but it assist in determining the severity (Sangree, 2005). Factors of hotel positioning such as price, amenities, segmentation, and meeting space capacity will also influence impact (Sangree, 2005). Size is considered when analyzing impact because the room capacity of the new hotel may be the same or vastly different from the existing hotel. A small hotel will have significant less impact on a large hotel (Sangree, 2005). The number of franchisees in a market is also examined. When a new franchise enters a market with many other similar franchises, the impact is decreased because it is shared between all the franchises. If the market has few franchises, then impact is more severe because the damage can not be spread around (Sangree, 2005). Travel patterns is considered because they can abate the impact from distance. An analysis of travel patterns will usually show how traffic will change with the new development (Sangree, 2005).

This topic blends well with the concept of the market cycle. Roginsky (1995) summarizes the the 1980's and 1990's as a time when development was sparse due to a recession and the Gulf War. As the cycle evolved to a maturation stage from a growth stage in the cycle, hotel chains could not grow by developing new hotels, rather they incorporated existing buildings and hotels into their own system (p.19). As a result, incremental impact occurred. Roginsky (1995) asserts that even though development may occur in the market, the cycle will mature and franchise systems will be forced to expand causing incremental impact.

Additionally, franchise companies do describe their policies regarding incremental impact in the agreements they sign with franchisees (Raginsky, 1995). Many companies describe the policy in detail while many others find solutions on a case by case basis. In contrast, many franchisors try to avoid the issue all together by including territorial-restriction clauses in the contracts (Roginsky, 1995). These pieces of the contracts will include language that describe a zone where additional hotels of the same brand cannot be built. Typical descriptions include a barrier like a 5 or 10 mile radius. Due to the negative repercussions, it is in the owner's best interest to know the policies of the franchiser before signing the contract.

New Trends in Construction

Owning a hotel may sound fun and exciting, but be aware, hotels are not a one time expense. For a hotel to win on a consistent basis it needs to offer a fresh, clean product. Unfortunately, hotels often require capital intensive upgrades and renovations to accomplish this. Owners may find this to be untimely, but the products offered in hotels are drastically changing. Hotel owners and designers face pressures from customers, especially millennials, on many fronts of hotel development. Millennials want a clean product that is up-to-date, stylish, provides the right atmosphere, and is environmentally friendly. It is well known that younger travelers multitask and mix work and pleasure creating a need for functional spaces in the lobby (Pomeran, 2015). Lobbies are being redesigned to accommodate more social experiences. There are spots designed for a small group of people to hold a brief meeting and enjoy an artisan cocktail or sharable appetizer made from locally sourced products (Trejos, 2015). Many new design features like interactive media screens showcasing information of the local area are available in the lobby, but the new inspirations in design are also featured in the room. One who is involved in acquiring a pre-existing hotel should not ignore age and current condition of the hotel because of the large costs it may take to properly position the hotel.

Even if the intended holding period is short, many owners may face capital expenditures of some sort. Fortunately, these room overhauls are coming at a time when owners have expendable resources to reinvest into guest rooms (Levere, 2015). Most recently, multiple national chain brand standards have not been overlooked or neglected in the process - old TV's are coming in, new smart high-definition TV's are going in (Lever, 2015). Likewise many changes are also occurring in the hotel bathroom including: tub to shower conversion, LED lightbulbs, and bathrooms with more space (Rosenbloom, 2013). Specifically, Marriott International is acting to improve the bathroom experience because customers are demanding it (Rosenbloom, 2013). As an owner, be aware of what changes the franchisee is asking you to execute. What are the estimated costs and what benefit do they provide? This requirement may have a positive or negative impact on the proposed investment.

Rising Project Costs

Despite the fact that many customers welcome the new designs and construction methods that are being introduced into hotels, the costs associated with the upgrades are rising. Several markets are experiencing a rise in cost as much a 5%-6% (Grant, 2015). Inside the 2010 Hotel Cost Estimating Guide published by HVS are industry statistics on the cost of building and renovations. According to HVS, in 2010 it costs anywhere from $14,389 to $23,363 to complete to renovate one midscale hotel guest room and bathroom (HVS, 2010). The 2015 Hotel Cost

Estimating Guide reports it costs $16,563 to $22,021 for the same type of renovation (HVS, 2015, p.12) . In 2012, the publication started reporting more details on specific costs. The 2012 Hotel Cost Estimating Guide reports a cost of $1500 for the tub to shower conversion (HVS, 2012, p.8). The 2015 Hotel Cost Estimating Guide reports the cost for the same conversion at $1,915 (HVS, 2015, p.12). The rising costs seen in hotel construction and renovation are not limited to guest sleeping areas and bathrooms. Public spaces and meeting rooms have seen some of the largest hikes in project costs. The 2010 Hotel Cost Estimating Guide reports a cost of $37/SF (HVS, 2010, p.36). This number makes the job sound affordable if one compares it to the cost in 2015. The 2015 Hotel Cost Estimating Guide records a cost of $77/SF to renovate meeting rooms and pre function area. Costs for up-to-date facilities are becoming increasingly expensive (HVS, 2015, p.55). There are two factors to think about when analyzing a project cost bid: materials and labor. Neither of the two are becoming any cheaper.

There are many costs to building a new hotel or making some simple guest room renovations. Labor is one of them. Architects and contractors do not work for free. Permits need to be acquired and materials need to be purchased. Unfortunately, many of these items are not getting any cheaper. One factor influencing higher costs of hotel constructions is the price of materials. In case you do not regularly shop for building supplies, wood, metal, and electrical fixtures are becoming more expensive. In fact, lumber costs are reportedly up 5.6% for the year, while steel increased 1.4% to 2.3% depending on the building products" (Mest, 2015). Also, lumber and gypsum prices skyrocket 15.6% and 14.5% respectively from 2012 to 2013 (Fabris, 2014). Additionally, lumber materials cost is up more than 20% in the last 4 years (Mest, 2015). Typically, prices rise two to three percent year over year but the influx of residential building projects has driven the demand for these materials since 2012 (Mest, 2015). There is no telling when prices will go down but hoteliers should be concerned of the recent trends. For an investor, these price increases will make the renovation process more expensive and will impact the return on the investment.

Overall, the literature gives specific advice for novice investors on topics such as: transactions levels and capitalization rates, risk, location, property characteristics, scale, franchising, the hotel investment cycle, hotel impact and rising construction costs. These concepts as they relate to hotel investing today are rarely described in printed materials and books. Thus, rookie investors often make uninformed decisions about their proposed investments in hotels.

Part Three

Introduction

The literature review conveys many strategies and concepts that are important for hotel owners and investors to implement and understand. The following section will provide interpretations and findings of the research provided in the literature review, recommendations for investors, and conclusions for the topics.

Transactions & Capitalization Rates

Interpretations & Findings

The information in the literature for this theme can be interpreted in a few ways. First, transaction volume is up over the past few years which is a positive indicator for success in the industry. Also, capitalization rates are climbing at a slow and steady pace which means hotel values are falling. The transaction levels convey positive dynamics for the lodging industry that investors will hope continues should one decide to invest or buy a hotel. However, the appraisals and valuations using the capitalization rate method show values slightly decreasing as net operating income is not as strong as previous years. This could potentially be a hint for investors to delay any large investment as the market is on the way down. Because hotel prices may be slightly decreasing, investors may find better opportunities if they wait until they level off completely or start to turn back positive.

Although many industry experts and market appraisers agree that capitalization rates are hovering, there is some variance about where the current rates are today. Jones, Long, and LaSalle (JLL), an industry trusted real estate appraiser, conclude that cap rates in 2015 were flat, but capitalization rates grew nearly 80 basis points to 7.8% in 2016 (JLL, 2016, p.5). The difference between the numbers reported by JLL and HVS is less than 1%. This should be considered by investors because 100 basis may be significant to some investors.

Recommendations

It is recommended the owners and investors stay up-to-date with these industry metrics. They act as a barometer for the hotel industry. By studying the transaction volume and cap rates early in the investment planning stages, owners and investors can make a more informed decision about when to enter the market. Investing with no knowledge or insight can have negative consequences that may result in low profitability. Transaction levels and cap rates will move over a period of time, thus doing market research in a text book will not be constructive. It is probable that the information one may find about transaction levels and cap rates in printed materials will be out-of-date and can not be applied to the market of interest.

Risk

Interpretations & Findings

In the literature review, readers are introduced to three types of risk. The information can be interpreted as a warning for investors as errors and setbacks can be met in each of the three stages.

It is unlikely that experienced hoteliers will disagree with information presented about development, operational, and divestment risk. As such, there is little evidence and support for the contrary. In fact, hotel revenue per available room (RevPar) in the US decreased 18% from 2007-2009 (Hudson, 2010). This is an example of operational risk. This fact supports the idea that hotel operating results can vary from year to year due to external factors. Likewise in 2010 and in years beyond, many hotel companies looked to expand on the strategy of becoming asset lite. By becoming asset lite, big hotel companies are decreasing their risk because they are not involved in all three stages of the investment process. Because hotels are risky and have high costs, hotel companies sold many of their hotels in 2010 and 2011 to decrease risk and potential debt (Hudson, 2010). Hotel companies sold their assets at a time when industry metrics like RevPar, average daily rate, and occupancy were rebounding (Hudson, 2010). By being asset lite, companies can focus on operational risk and place the development and divestment risk on owners. These statements support the facts in the literature review because the success of the divestment depends on many external factors like economic climate.

The message from the literature review is there are risks associated with developing, operating, and selling a hotel. Simply, hardships and setbacks may present themselves at any point of the investment process. These setbacks can cause operational and financial stress.

Recommendations

It will greatly benefit developers and individuals investing in a hotel to understand what risks are present at each stage in the investment. In all stages, owners should seek opportunities to prevent financial setbacks that could inflate the development or operational budget or cause delays to the hotel opening. It is recommended that new owners to thoroughly communicate with design and construction teams at every step in the building process. Being informed will reduce that chance of any surprises. To mitigate risk in the divestment stage, owners should avoid selling the assets at a predetermined time because the economical climate at the time of a future sale will be unknown.

It is recommended that industry leaders conduct research to discover the most common and most devastating financial setbacks. The research should also include steps to mitigate risk and how to avoid these setbacks.

Location

Interpretations & Findings

The literature review communicates that location will have the biggest impact on the profitability of the hotel. Investors can learn different methods to search for the right location in the literature review. Location will need to be determined early in the investment planning stages because many other decisions are contingent upon the location of the hotel.

Michael Forrest Jones and the authors of *Theoretical, Empirical, and Operational Models in Hotel Location Research* agree that location is the most important factor in the investment but disagreements exist about the best method to find the best location. Jones suggests looking for a location where franchised hotels have a strong demand and can command premium rates. Yang, Luo, and Law express theoretical methods to find the best location using three different models. Jones' advice is more practical while Yang, Luo, and Law's (2014) models are based on theory. No two hotel investments are alike so one way may not be better than the other in all cases.

Jones' approach to finding a a suitable location is based on practical business sense and economics. His approach adheres to laws of supply and demand. He asserts that bringing a new product to a market where there is demand should produce profitable results. Jones does not guarantee this approach will work; likewise, there are some gaps in his rational. Adding a new hotel brand to a market that does not offer it will not guarantee a successful investment. There are other dynamics besides supply and demand that may contribute to the profitability of a hotel.

Conversely, Yang et al present three methods to finding a location based on theoretical approaches that are not bulletproof either. Yang et al neglect to consider the laws of supply and demand in their analysis. For example, airport properties should be located close to airports; however, many airports already have an abundant of hotels near by. The theoretical models do not apply concepts of supply and demand very well. Perhaps the best way to determine a location is to apply the reasoning by Jones and Yang et al to find a suitable location. By using both methods, owners can assess if the location is right for the product and if the product is right for the market.

Recommendations

Developers, owners, and investors should be cognizant of how they approach the subject of hotel location. The literature review explains why location is important. As such, the hoteliers should consider the different methods. It is important to remember not all hotel investments are the same. Different approaches will work better than others, but the methods conveyed in the literature should provide rookie investors with enough information to make an educated decision. These methods will need to be considered early in the investment planning stages. The location in many cases will be the first point of decision in the investment. If a developer follows Jones' advice then that individual will focus on where the hotel will be. If a developer is going to adhere to the methods provided by Yang, Lou, and Law then the first decision may be what type of hotel will be built and the location choice will follow immediately after.

The information in the literature review is highly focused on productive methods and ideology to finding a hotel location. It provides more insight into selecting a location than the common rational of selecting a location that is "busy" or has "high demand". The findings will help guide first time owners to think rationally about what is an appropriate hotel location based on theoretical and practical approaches.

Property Characteristics

Interpretations & Findings

The literature review claims there are different kinds of investors and each investor values different investment attributes. Among hotel owners and operators, attributes of location and finance were interpreted as critical to the investment. The top three important sub factors include five year return on investment, site attributes, and volatility of demand. This data is important because it informs first time investors, that will play a role as an operator or owner, of highly valued factors in an investment. As such, new owners should seek hotels investments that offer a strong five year return on investment, great site attributes, and an acceptable level of volatility of demand. On the other hand, individuals who are investing in hotels and are not operating or owning the hotel first seek factors based on finance then location. The sub factors hotel investors analyze are five year return on investment, historical returns, and segmentation diversification. This is important to interpret because investors who contribute capital to the investment are less concerned about the physical attributes that attract business. Rather, hotel investors care about the previous and future financial performance of the investment. It is important to understand the rational of both kinds of investors.

Recommendations

Identifying the role a first time investor will play will assist individuals determine what attributes to seek and analyze in an investment. Understanding and interpreting location and financial factors will determine the quality of the investment to the individual. This thought process should take place before the a commitment is made to invest. Determining the investment position of owner or investor will come naturally but researching and collecting data about customer segmentation, historical financial performance of an existing hotel, demand analysis etc. will take some time and effort. Whether a new investor will have active or a passive role in the investment, one should understand the value behind all investment factors related to the proposed hotel.

Scale

Interpretations & Findings

Interpretations of the literature are many. According to Smith Travel & Research there are five tiers of hotel products. From the literature review, a first time investor can consider which tier is appropriate and then select a brand or product. This is a significant consideration as each hotel tier and each brand with in the tier offer different services with different levels of luxury. For first time developers and investors, hotels in the upscale and midscale tiers are going to be appropriate. As stated, the goal is to run a profitable hotel. Investing in luxurious brands that offer multiple restaurants and other amenities may seem enticing but can be an operational nightmare that can drain profits.

Recommendations

It is recommended that first time investors seek select service brands that fall with in the upscale-midscale tiers of the STR chain scales. To do so, individuals that are unfamiliar with the scales and products should conduct their own research to determine what product is best for their business model and market. Remember, not all of the hotel products are the same. Many of the brands are recognizable and are attractive to customers and travelers. The decision of the product to built or invested in should occur early in the planning stages. Typically, investors will choose a location first but depending on the situation, a product can be selected before the location. The choice of scale and selection of a franchise company may occur simultaneously.

For further research, investors and industry professionals should make information available on the profitability of each scale and brand of hotel. The findings can also communicate pros and cons of developing and investing in the different kinds of hotels.

Franchising

Interpretations & Findings

From the information in the literature review, first time investors learn of the benefits that come from franchising a hotel with a national chain. Owners and developers will have more top line revenue if they choose a name like Holiday Inn Express, Four Points by Sheraton, and the like versus an independent hotel name. This can be interpreted a huge benefit because it will impact the profitability of the hotel and the overall value of the hotel when it is time to sell the asset.

Recommendations

Based on the literature review it is recommended that hotel developers and first time owners seriously consider signing a franchise agreement with a highly regarded hotel company. The decision on whom to sign a franchise agreement with will likely be made after a location is selected and a the scale of the hotel is selected. Of course, it is possible that many first time investors will be heart set on franchising a certain brand before location and scale are determined. This method is acceptable but may not be the best route to take because better alternatives may be neglected. It is recommended that investors meet with the development representatives from various hotel companies. This will assure key details is considered in the process.

Franchising is also a concept that adapts and changes over time. There are currently many new brands being introduced to the market while other brands have stopped offering franchise agreements. This is especially relevant in 2016 with the recent mergers of many hotel companies like Marriott International and Starwood Hotels. There are published materials that will explain the benefits of franchising but none can specifically tell an individual what franchise agreement is best for his/her investment.

There is a lot of information on franchising that will help investors if made public. Information about failure rates and profitability will assist investors wisely choose a franchise company. To augment those findings, information on which franchise company will likely help investors to a second or third investment will be beneficial.

Owner, Operator, Lender

Interpretations & Findings

The literature review distinguishes three key players in a hotel investment and describes the role and importance of each. The literature review describes the different styles of owners and ownership groups whether they are entrepreneurs, real estate companies, or banks.

Recommendations

Hoteliers, especially first time investors, need to understand the role of all the parties involved in the deal. The selection of the right operator is especially important because the right operator will add value to the hotel by managing a profitable business. Investors looking to hire an operating company to manage the business of the hotel should take interest in learning about base management fees (BMF) and incentive management fees (IMF) because they are a cost to the owner. Owners should respond to this information by researching many operating companies and review the costs and success of each company. There are many operating companies available that specialize in managing different types of hotels in many markets.

There are many books that provide information on how to own and operate a hotel, but not all discuss in detail why owners, operators, and lenders are necessary and how they make money. This information is important to consider before an investment is made. The role of the operator has the biggest impact when the hotel is open, so am operating contract should be signed in advance of the proposed opening date.

Hotel Investment Cycle

Interpretations & Findings

The information provided in the literature review explains the hotel investment cycle and how timing the investment can impact the profitability of the investment. Multiple sources were used to convey the dynamics of the cycle. There are many key takeaways. First, there are four stages of the lifecycle and each will effect the investment differently. The timing of the investment is critical to the success of the investment. Second, hotels starting construction at the top of the market may not be finished until after demand has fallen. On the other hand, hotels being built at the bottom of the market may open in time to capture increases in demand. Thirdly, it is impossible to locate the exact top and bottom of the market. Being aware of the market conditions and investing at an appropriate time will help the investment thrive. Finally, owners who hold onto the asset for multiple market cycles may mitigate development and operating risk.

Recommendations

This information should be considered in the planning stages. This will likely take place before and after a location is picked; however, research should be conducted on a macro level before a location is picked. It will also be useful to apply the analysis to the proposed market once a location is selected. Assessing the economical climate and market cycle will influence investment policy and decisions. Investors should collect information on the number of new hotel rooms entering the market and asses how the market will be effected. It is recommended that owners and investors take action to develop a hotel and open it in the during a time revenue per available room metrics are rising. Owners and investors opening a hotel in the contraction and maturity stages will be meet many financial hardships and may run risk of foreclosure.

The hotel industry is one that changes quickly. Investors and owners need to adapt and stay up-to-date on the current market cycle stages. The concepts behind the market cycle will not change; however, the cycle will always be moving. Printed material and books will prove to be useful in learning about the stages of the market cycle but will not be useful in determining the current stage at the time of investing. It is recommended the investors look industry reports published electronically by reputable hotel consulting companies.

Hotel Impact

Interpretations & Findings

The literature review communicates how competition can be increased in a market over time with the addition of new hotel rooms and the negative consequences it can have on investment returns and hotel profitability. This issue of base impact is serious one for owners because it can possibly decrease a pre-existing hotel's current market share. Situations that hinder profitability are also presented by the addition of a second or third franchise in a market.

Incremental impact, often cannibalizes hotels of the same brand when they all compete for the same guest.

There are many hotel consulting firms that investigate hotel impact on a daily basis via impact studies. Pinnacle Advisory (PA) recognizes that the 4,000 hotel projects and 500,000 rooms under construction poses a big threat to current hotel owners in America (Pinnacle Advisory, 2016). As hotel supply addition increase there is more growing concern for impact by current hotel owners (PA, 2016). Pinnacle Advisory findings and opinions coincide with the literature review. Impact is a relevant threat to owners of pre-existing hotels and it will likely continue to be given the new development in the US.

Recommendations

To apply the findings of the literature review, investors and developers should take cautionary steps. First, individuals should be able to determine if barriers to entry exist in the proposed market. Second. There are questions that will necessitate research which will assist in owners determine future impact issues: Who else can build a hotel here? What brands are absent from the market? Which franchisor already has products in the market? Do they plan on expanding? Does the franchise contract protect the land within a certain distance of the proposed hotel from future hotel development? The analysis will help owners determine if there are foreseeable impact issues. This process should take place before a franchise contract is signed. This will occur once a market is determined. This information will be helpful to investors especially if it conducted before an exact location is determined as data could influence the exact location choice. The research should also take place for all of the brands that are being considered for investment.

Hotel Construction Trends

Interpretations & Findings

The information in the literature states that building and renovating hotels is required and it is costly. There are a lot of new hotel designs that attract many different guests and they are not getting cheaper. These renovations are present in the lobby, public spaces, and guest rooms. If an owner wants to keep its position in the market, he/she will need to keep the hotel in an appropriate condition.

Building energy efficient hotels has been a trend for the last decade. Many favor building green hotels because it is a responsible act and travelers are demanding it. Other say it is cost effective. In *The Compelling "Hard Case" for "Green Hotel Development"* Butler (2007) argues that building energy efficient hotels is affordable and worthy of investing in. Butler's claim differs only slightly from those in the literature review. The literature review conveys that hotels are becoming more expensive to build and does not give any information on building energy efficient facilities. Butler claims that building energy efficient buildings used to raise the cost 10%-15% (Butler, 2008). As of 2008, the cost is only 1%-2% because of the energy costs savings (Butler, 2008). Butler explains the benefits to the efficiencies can cut energy costs up to 50% (Butler, 2008). As a result, Butler argues that more hoteliers should be building more in efficient hotel operations.

Butler does make a case that building green hotels from the ground up is more cost effective than retro fitting (Butler, 2008). However, his reasoning for the building green movement does not apply to all owners and investors. Hotels come in many shapes and sizes. Although a 1%-2% appears to be nominal, it could represent a different amounts. For example, 2% of a $10 million select service hotel equates to $200,000. On the other hand, 2% of a $100 million full service hotel equates to $2 million. Both dollar amounts represent a lot of capital to each kind of investor.

It is unlikely that the 1%-2% cost increase applies to all hotels in the US. Investors should conduct their own research about building energy efficient buildings. Over the lifespan of the hotel it will make sense for some owners. Also the hotel may be located in a market where society demands energy saving initiatives. Developers will have to gauge this for themselves and make a decision if the extra cost is appropriate.

Recommendations

As hotel construction and development costs increase, hoteliers should consider what items can be built to be efficient and the costs associated with them. These items should be considered by investors as it will guide their decision for building a new building or retro fitting a pre-existing hotel. Of course, hoteliers may decide not invest in efficient operations either. Perhaps it is best to research what makes the biggest impact on cost savings and which items have the least expensive construction costs - for example lighting versus water consumption. The items will need to be considered early in the early investment planning stages and soon after the location is determined. Contractors and architects will likely need to be included in these conversations as well.

Construction trends and cost issues is a broad topic, but hotel construction methods and design trends very specific. Along with the other themes, details and information on the specifics of this topic change quickly. Design trends and constructions costs at the time of this writing may different in the near future. As such, printed material, like books, will not be a suitable place to find current information on the issues.

Conclusions

Ultimately, the topics of: transactions and capitalization rates, risk, location, property characteristics, scale, franchising, owner, operator lender, the hotel investment cycle, hotel impact, and construction trends are critical to analyze when making a hotel investment. The decisions in the various stages of the investment will have a profound impact on the overall profitability of the investment. Many of the concepts presented, like the hotel industry in general, change over time. As a result, it is important to consider current and relevant advice from industry professionals and researchers and not published materials that may be out-of-date. If first time owners do their due diligence, they will reap the rewards of a profitable and stable investment.

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