Benchmarking Hotel Sale Prices to Replacement Costs:

Another reason why hotel acquisitions (and selective development opportunities) continue to be so attractive.

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We are in an investment market driven by large amounts of capital looking for yield. While hotels have traditionally been considered among the riskiest real estate investments, their potential for higher yield (particularly during this business cycle) has attracted both seasoned and new investors. Sellers are particularly excited about the robust hotel investment environment. Many willing sellers who held their assets through the tough times of the past few years are now realizing strong gains. Buyers are also enthusiastic about acquiring many types of hotel products. Investment plays include riding the upside in many recovering hotel markets, renovating and repositioning assets for greater revenue potential, and acquiring real estate in areas where the barriers to entry continue to increase, particularly due to the high costs of developing new hotels.

In the past few years, we have also seen development costs for hotel construction surge. It is unlikely that hotel development costs will decrease—the above-inflationary cost increases from 2001 to 2004 are expected to continue into the foreseeable future. The rebuilding of the Gulf Coast region and continued international competition for building materials and labor have put increased pressure on construction costs and materials.

The new hotel supply pipeline is substantially lower than in prior cycles, leaving many investors in pursuit of existing assets rather than development deals. And for most hotel product types, the relationship of development cost to purchase price supports this investment strategy. In order to measure the relationship between development cost and purchase price, data from HVS International's "Hotel Development Cost Survey" were compared to the data from national hotel sales. The following table illustrates the findings:

Period	Average Hotel Per-Room Sales Price	Average Hotel Per-Room Development Costs	Ratio of Sales Price to Replacement Cost
Midscale Hotels w/o F&B			
2001	$70,210	$87,100	(24.1) %
2002 to 2003	93,166	87,825	5.7
2004 to 2005	93,166	93,511	(0.4)
Extended-Stay Hotels			
2001	$124,013	$105,700	14.8 %
2002 to 2003	111,735	113,700	(1.8)
2004 to 2005	106,311	120,163	(13.0)
Midscale Hotels w/ F&B			
2001	$119,225	$116,400	2.4 %
2002 to 2003	131,499	115,550	12.1
2004 to 2005	140,965	109,120	22.6
Full-Service Hotels			
2001	$131,526	$172,000	(30.8) %
2002 to 2003	111,735	183,800	(64.5)
2004 to 2005	136,737	188,389	(37.8)
Luxury Hotels and Resorts			
2001	$310,917	$375,500	(20.8) %
2002 to 2003	384,571	467,725	(21.6)
2004 to 2005	607,208	578,105	4.8

Source: HVS International

Data analyzed in this table include the average sales price per-room for hotel assets sold between 2001 and 2005 and the average development costs per-room for comparable proposed properties, classified according to their product type. The average sales price was then compared to the average development cost as a measure of asset pricing to replacement cost, a benchmark used by investors in evaluating potential transactions. The percentage shown in the last column shows the relationship of the average price per room to the average cost per room. A positive percentage indicates the average sales price exceeds the average development cost, while a negative percentage indicates the inverse. When sales prices exceed development costs, hotel investors become interested in developing new hotels; with the inverse, buying existing assets is favored over developing.

As the table shows, development costs of midscale hotels with or without food and beverage often support new hotel construction. For the past five years, the average per-room sales prices of midscale hotels with food and beverage have exceeded the average per-room development cost. The newer hotels—which offer attractive guestrooms, accessible locations, limited food and beverage facilities, and efficient service—provide many developers with strong returns. This is evidenced by prolific new construction of brands such as Courtyard by Marriott and Hilton Garden Inn.

For the most part, full-service hotels remain a better value to buy than to build as the gap between average sales price per room and development cost per room remains high. The average per-room development cost of full-service hotels has exceeded the average per-room acquisition cost by the greatest margin of all of the hotel product types in the table. Full-service hotels are very expensive to build—from the cost of land to the pre-opening staffing, development budgets for new full-service hotels often exceed the initial market value of the asset. Creative and complex deal structures can enhance the success rate of new full-service hotel development. Projects such as mixed-use development, public/private deals, historical rehabs, and hotel development with complementary residential components are designed to spread the cost and risk of the investment.

The per-room price of luxury hotels and resorts has only recently surpassed the per-room development cost in the current investment cycle. This phenomenon is due to higher per-room sales prices of luxury assets in high-barriers-to-entry markets and the development of these hotel products as components in larger mixed use-developments. Mixed-use developments, particularly with residential components, generally support more-financially viable luxury lodging construction than single-purpose luxury lodging projects. The development costs are spread among the components in a mixed-use project with a for-sale component. The current trends include a substantial residential element such as residential condominiums, hotel condominiums, timeshares, or fractionals. By allocating only a portion of the overall mixed-use development costs to the lodging piece, the basis of the hotel investment is lower than for the construction of a stand-alone asset, positioning the property for a greater chance of financial success. While the trends indicate that within the mixed-use concept luxury hotel and resort development can also be successfully undertaken, development of these assets is not for the weak of heart, as the amount of investment can be staggering.

The relationship of acquisition pricing to construction cost is only one measure of the investment decision. The preceding table shows general data, which should not be interpolated to specific investments. Whether to build or buy a hotel remains a product-by-product, market-by-market decision.

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