



SMITH TRAVEL RESEARCH

How Land Cost Impacts Value

Reprint April 2005 Article By Steve Rushmore, MAI, CHA, CRE, HVS - New York

The first steps in a hotel's development are finding the site and acquiring the land. While factors such as location, access, visibility, size, shape, frontage and zoning are important, it is the purchase price of the land that has the greatest impact on the character of the hotel and ultimate success of the project.

The land cost usually determines the type, quality and size of hotel. In addition, its cost might sometimes prove that a hotel is not the best use for the site. This month, I will show how to value a hotel's land component and determine the best use of the property.

A hotel's development consists of three components: the land; the building; and furniture, fixtures and equipment. For a hotel project to have economic viability, the cost of each component must be in balance with each other. You should not develop a 1-star hotel on a site suitable for a 5-star. Essentially, as the cost of the land increases, so must the quality of the hotel. Ideally, the land component should represent approximately 10% to 15% of the total project cost. Once this land component percentage exceeds 20%, it is difficult to find the hotel economically feasible.

The purchase price of a hotel site can be determined using either a comparable sales or income approach. The income approach is best when evaluating feasibility (see table).

Let's say you want to develop a 200-room, mid-rate hotel. Based on a market study, you think the hotel should achieve 70% occupancy with a US\$125 room rate. The land value income approach starts by determining the estimated annual rooms revenue, which is US\$6,387,500. A typical ground rental percentage is 4% of rooms revenue, which calculates a ground rent of US\$255,500. The land value is then calculated by dividing the ground rent by a land capitalization rate, which in this example is estimated to be 8%. This results in a land value of US\$3,193,750. If the land component typically represents 12.5% of the total project cost, then the value of the entire hotel (land, building and furniture, fixtures and equipment) should be US\$25,550,000 (US\$3,193,750/12.5%). On a per room basis, the

Determining Hotel Purchasing Price	Per Room	Room Rate Thumb Rule
Rooms	200	
Occupancy	70%	
Average Room Rate	US\$125	
Rooms Revenue	US\$6,387,500	
Ground Rent Percentage	4%	
Ground Rent	US\$255,500	
Land Capitalization Rate	8%	
Land Value	US\$3,193,750	
Land Value as % of Total Value	12.5%	
Total Project Cost	US\$25,550,000	US\$127,750 US\$128
Land Cost	US\$5,000,000	
Land Value as % of Total Value	12.5%	
Total Project Cost	US\$40,000,000	US\$200,000 US\$200
Land Cost	US\$10,000,000	
Land Value as % of Total Value	20%	
Total Project Cost	US\$50,000,000	US\$250,000 US\$250

total value equates to US\$127,750 per room. Applying the room rate thumb rule that states that for every US\$1,000 per room cost, US\$1 in room rate should be created (US\$128), the project appears to be in balance with an average room rate of US\$125. In other words, this type and quality of hotel represents a good use of the site.

Now let's say you find another site in the heart of the upscale area of the city that costs US\$5 million and local zoning allows 200 rooms. Applying the same 12.5% land component percentage results in a total project cost of US\$40 million or US\$200,000 per room. To make this alternative economically viable, the hotel must be designed, built and furnished as a luxury rather than a mid-rate property to achieve a US\$200 room rate. If the site was twice as expensive, say US\$10 million, and you pushed the land component percentage up to 20%, the project cost could be US\$50 million or US\$250,000 per room, which requires a room rate of US\$250. In this instance, the luxury traveler might not be willing to pay this much, so the economics do not support this type of hotel development.



HVS - CANADIAN LODGING OUTLOOK

May 2007	Number of Rooms	Occupancy Rate (%)		Average Room Rates (in \$CAD)		RevPAR (in \$CAD)		Room Supply % chg	Room Demand % chg
		2007	2006	2007	2006	2007	2006		
Nova Scotia Area	1,083	59.5%	56.9%	\$93.40	\$90.50	\$55.57	\$51.49	0.0%	4.5%
Halifax, NS	3,161	75.1%	73.5%	\$130.64	\$126.23	\$98.11	\$92.78	-2.8%	-0.5%
Montreal Downtown	9,671	78.3%	81.5%	\$154.44	\$169.29	\$120.93	\$137.97	2.5%	-1.5%
Montreal Area	5,323	67.0%	71.7%	\$106.94	\$107.46	\$71.65	\$77.05	1.1%	-5.6%
Quebec City, QC	3,732	68.8%	73.4%	\$138.06	\$139.35	\$94.99	\$102.28	0.8%	-5.5%
Quebec Area	5,726	56.3%	54.8%	\$115.38	\$109.80	\$64.96	\$60.17	0.4%	3.1%
Toronto Downtown	13,733	75.8%	80.6%	\$187.26	\$194.70	\$141.94	\$156.93	1.5%	-4.6%
Toronto North/East	6,556	66.3%	72.1%	\$119.39	\$117.87	\$79.16	\$84.98	2.5%	-5.8%
Toronto Airport/West	7,741	73.0%	71.8%	\$116.12	\$116.17	\$84.77	\$83.41	-2.0%	-0.4%
Ottawa, ON	6,489	80.3%	81.9%	\$142.05	\$137.24	\$114.07	\$112.40	-0.3%	-2.2%
Ontario East	4,173	58.4%	60.1%	\$102.30	\$100.13	\$59.74	\$60.18	1.0%	-1.9%
Windsor/ Ontario SW	2,943	56.6%	54.4%	\$101.30	\$103.35	\$57.34	\$56.22	0.0%	4.0%
London/ Kitchener	6,411	60.7%	63.9%	\$102.05	\$99.80	\$61.94	\$63.77	2.3%	-2.9%
Ontario North/ Thunder Bay	1,837	74.8%	70.7%	\$87.73	\$83.31	\$65.62	\$58.90	0.0%	5.7%
Ontario NC/ Sudbury	4,123	59.1%	59.9%	\$96.21	\$93.31	\$56.86	\$55.89	1.0%	-0.4%
Niagara Falls, ON	8,329	58.1%	57.9%	\$125.91	\$130.54	\$73.15	\$75.58	-0.5%	-0.2%
Ontario Central	3,253	50.8%	52.9%	\$102.87	\$100.05	\$52.26	\$52.93	3.5%	-0.6%
Mississauga, ON	5,683	62.3%	61.8%	\$110.20	\$107.49	\$68.65	\$66.43	2.0%	2.8%
Winnipeg, MB	3,693	73.1%	70.1%	\$102.00	\$96.71	\$74.56	\$67.79	-0.2%	4.0%
Regina/Saskatoon, SK	4,423	80.8%	64.2%	\$103.77	\$95.89	\$83.85	\$61.56	0.0%	25.9%
Calgary, AB	8,519	76.4%	77.1%	\$142.61	\$126.18	\$108.95	\$97.28	3.3%	2.3%
Edmonton, AB	7,364	76.6%	75.7%	\$117.20	\$106.44	\$89.78	\$80.58	0.5%	1.7%
Alberta North Area	3,015	69.0%	70.9%	\$151.10	\$130.24	\$104.26	\$92.34	0.7%	-1.9%
Alberta South Area	7,891	66.9%	65.5%	\$132.06	\$123.54	\$88.35	\$80.92	0.4%	2.5%
Vancouver Downtown	7,569	84.1%	84.4%	\$178.25	\$174.72	\$149.91	\$147.46	-2.7%	-3.1%
Vancouver/ Burnaby Area	2,144	85.4%	78.3%	\$122.93	\$112.19	\$104.98	\$87.84	0.0%	9.1%
Richmond-Surrey/ East Area	5,903	75.6%	70.7%	\$112.76	\$104.00	\$85.25	\$73.53	1.0%	8.1%
British Columbia Area	5,726	51.0%	52.9%	\$110.87	\$110.82	\$56.54	\$58.62	0.5%	-3.2%
Kamloops/ Kelowna Area	4,375	62.1%	63.4%	\$99.65	\$96.42	\$61.88	\$61.13	2.4%	0.3%
Vancouver Island	3,888	75.5%	69.9%	\$134.67	\$127.14	\$101.68	\$88.87	0.4%	8.4%
Provinces									
Alberta	26,789	70.3%	70.2%	\$122.07	\$109.88	\$85.82	\$77.14	1.1%	1.2%
British Columbia	28,896	68.0%	65.5%	\$116.67	\$111.50	\$79.34	\$73.03	0.5%	4.3%
Manitoba	4,463	67.0%	64.5%	\$84.19	\$76.52	\$56.41	\$49.36	-0.1%	3.8%
New Brunswick	3,379	50.6%	50.4%	\$92.93	\$90.88	\$47.02	\$45.80	-0.4%	0.1%
Newfoundland	1,839	72.5%	57.8%	\$112.13	\$100.78	\$81.29	\$58.25	0.0%	25.5%
Nova Scotia	4,244	56.8%	57.4%	\$106.39	\$99.97	\$60.43	\$57.38	-1.1%	-2.2%
Northwest Territories	124	INS	INS	INS	INS	INS	INS	INS	INS
Ontario	71,271	63.4%	64.9%	\$119.03	\$118.45	\$75.47	\$76.87	0.9%	-1.5%
Prince Edward Island	951	41.6%	46.3%	\$87.32	\$91.47	\$36.33	\$42.35	0.0%	-10.1%
Quebec	24,452	61.7%	59.9%	\$112.95	\$119.80	\$69.69	\$71.76	0.9%	4.1%
Saskatchewan	5,965	65.4%	57.5%	\$88.29	\$80.10	\$57.74	\$46.06	0.3%	14.0%
Yukon Territory	585	53.2%	52.3%	\$97.23	\$78.93	\$51.73	\$41.28	0.0%	1.7%
Canada	172,958	63.0%	61.8%	\$112.53	\$109.87	\$70.89	\$67.90	0.7%	2.6%

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In appraisal jargon, we describe these phenomena as a "highest and best use" issue. Typically, when hotel room rates are too low to justify the cost of the land, there is probably another use that is willing to pay more for that particular site. For example, in the top areas of New York City residential condominium developers will outbid hotel developers almost every time for prime sites. At one time land in Hong Kong was so valuable that a developer actually tore down a perfectly good Hilton hotel and replaced it with an office building.

So what can hotel developers do when faced with high land costs in areas such as New Delhi, Paris, London and Beverly Hills? The first option, which can work for 1- to 3-star hotels, is to find good, secondary locations where land prices are generally lower than the prime sites. For 4- to 5-star hotels you might attempt to get approval for a more intense use of the site (more rooms) so the

land cost is averaged over a greater number of rooms. Recently, developers are solving this problem by incorporating a residential condominium component within the hotel complex, which effectively subsidizes the hotel's land acquisition price. The synergistic effect of combining hotel and residential uses enables the overall project to justify a higher land cost.

The hotel developer's Holy Grail is to find a way to economically justify building mid-rate hotels on prime, luxury priced hotel sites. While we are not quite there, the combination of factors that seems to work the best is a highly intense use (many rooms) of a relatively small site improved with a limited-service (no food and beverage), branded mid-rate hotel concept constructed with good quality materials and finishes. ♦

DEFINITIONS

Occupancy:	Rooms sold divided by rooms available.
Room Revenue:	Total room revenue generated from the sale or rental of rooms.
Average Daily Rate (ADR):	Room revenue divided by rooms sold.
Room Revenue Per Available Room (RevPAR):	Room revenue divided by rooms available (occupancy times average room rate will closely approximate RevPAR).

*If you have any questions regarding this publication please send a message to bmacdonald@hvs.com
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