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Methodological Limitations and Proposal to Improve Lodging Feasibility Studies

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1. Introduction and Context

Real estate as an economic good in the marketplace is quite varied and differs from other economic goods exchanged in the market place. There are four concepts that make real estate unique as an economic entity, 1) fixed location, 2) a very long life, 3) large economic units and 4) decisions relating to real estate are long term decisions. (Shafer, 1975)

The lodging product is very complex as it is not purely a real estate venture and not a pure business. According to management consultant Morris Lasky, “A hotel is not real estate. A hotel is a business located in real estate.” (Lasky, 1990) This highlights two important points about hotel investments, the first is that hotel investments have all the attributes of real estate investment such as being site specific, large initial investment and long economic life, and the second is that it has a business element which requires professional management to generate an ongoing revenue stream and manage the fixed and variable costs associated with this asset. In economic terms, once the resources have been allocated to the project, it is very important for it to achieve and maintain certain levels of utilization in order to be successful.

Based on the HVS Hotel Development Cost Survey a hotel investment can cost anywhere from $70,000 per room to over $700,000 per room in today's environment (HVS, 2008). Lenders and investors, when making this level of capital commitment, require an analysis of the proposed hotel's market area. An independent consultant usually performs this study. The final report ranges from a review of the proposed market to attest its overall strength and associated market opportunity to a full feasibility study with an associated return on investment analysis.

The hotel industry has been through several periods of overbuilding, practically one in each decade since the 1970s. Various reasons for this situation include some periods of overbuilding as the result of favorable tax laws, availability of excess capital as a result of deregulation, or creation of financially engineered debt and equity investment products.

The process of hotel development involves several stakeholders, each with a specific interest in the development. These include, developers/investors, lenders, management companies, franchisors, local governments, taxing districts, prominent citizens of a community, existing hotels, local businesses, consultants who prepare feasibility studies, and appraisers who prepare valuation reports.

A confluence of their interests during several economic cycles has consistently created the “perfect storm” and resulted in excessive hotel building.

2. Purpose of Research and Methodology

The purpose of the research was to identify methodological limitations and present a proposal to improve lodging feasibility studies based on summary results of previously conducted surveys of lenders and hotel consultants that identified a gap between sections of the study that are important and weakness of these sections (Schmidgall, Singh, and Damitio, 2010). The proposed improvements to the studies are based on an extensive synthesis of the industry literature combined with telephone interviews with leading hotel consultants. These are discussed in the context of an evolving business environment from the mid 1970s to the current period and consequently changed the lodging product, which makes it necessary to examine the methodology of the existing studies.

Industry Dynamics of the Lodging Industry from the 1950s to the Current Period

Since the beginning of the 20th century, various external factors have affected the supply and demand of hotels. Supply of hotels (available rooms) is usually affected by the availability of capital, government policies and programs, such as favorable tax laws and the highway act of 1956 (Rushmore, 1992).Demand (occupancy of rooms available) for accommodations usually resulted from common factors such as the state and general health of the economy, technological changes (automobile and jet plane) and increased disposable income due to broadening of the middle class. During each period there were fluctuations in demand due to unexpected events such as a depression, political conflict and impact on fuel prices due to supply-demand imbalances related to crude oil prices.

Three factors differentiated the dynamics of the hotel industry of the period before the 1960s from the post 1960s era.

FIRST: Hotels ceased being homogeneous products. This started with the introduction of motels in the era after World War II, which differentiated motels from hotels. Next, the concept of "market segmentation" was introduced during this period and a second generation of hotels such as Marriott, Hyatt, Radisson and Ramada was introduced. They attempted to penetrate markets using a segmentation strategy. The segmentation process reached its pinnacle in the 1980s.

The late 1980s also saw the growth of "product segmentation." This was the result of the market segmentation concept of the 1960s. Chains saw that the only way to grow was by creating new products and promoting brand loyalty. According to industry experts the industry overdid the "market segmentation thing." According to one management consultant, "the proliferation of new products has been overdone by lodging companies, which dreamed up more concepts than there are real and discernable market segments" (Trice, 1992). In the past thirty years, with the exception of the All Suite concept and Boutique hotels, all the other brands have not been truly new products but merely a micro-segmentation of the same market. The result of this fragmentation of the market was an excessively competitive marketplace.

SECOND: As a result of market segmentation, the concept of franchising became popular as a mechanism for growth of the industry. The process became a self perpetuating cycle. Market segmentation led to the growth of franchises, and the franchises, in order to maintain their growth levels, created more products. The maintenance of a certain critical mass was important to drive profitability and franchise brand awareness. The franchise component of the U.S. hotel industry is over 70 percent (Goldman Sachs, 2009), with over 300 brands.

THIRD: The third element that influenced industry dynamics starting in the 1970s was the introduction of the management contract. This was partially a result of the segmentation that was taking place in the industry, which further increased the complexity of hotel operations due to heightened competition. Therefore, hotel chains that had established themselves in the late 1950s started offering their services to the owners of hotels. This provided further impetus for growth, because these chains wanted to acquire a presence in a particular market for strategic presence. As a result of these previously noted changes in the post 1960s era, hotel development environment became more complex. In this type of development environment, economic and demographic trends that influenced supply and demand for hotel rooms were not the only influences on hotel development. Supplemental factors such as chain presence strategy, development of

critical mass by franchisors, and a continuous evaluation of consumer needs, by chains, in order to create new niches and penetrate an already over fragmented market, were important influences as well.

Implications for Market Analysis

The implication of the above changes for conducting hotel market analysis is not as much on the supply side, which is still influenced greatly by availability of financing, as it is on the demand side. With the creation of different products to meet the needs of consumers, demand is no longer merely a function of price and economic and demographic trends such as income and population. It is a continuously evolving product, created by chains, to expand by finding narrower market niches. Examples of this product driven growth strategy is the introduction of all suite concepts, no frills budget motels, and the recent introduction and steady proliferation of boutique or life style hotels. These were all the result of extensive consumer market research conducted by hotel brands.

This overall change in the dynamics of demand and the micro segmentation of the hotel product has not been reflected in the current methods of conducting market analysis.

In addition, the increase in consumer awareness and choice of substitutes, along with the sophistication of primary research methods, has made the need for these changes inevitable.

Current Definitions of Economic Studies

In order to understand aspects of the current analysis that need examination, we need to start with a definition of the studies as they are currently performed. What is commonly referred to as a "Feasibility Study" is part of a group of studies, collectively called Economic Studies. These studies can be broadly divided into the following four categories: (Beals and Troy, 1982).

1. MARKET STUDY
2. MARKETABILITY STUDY
3. FEASIBILITY STUDY
4. APPRAISAL

Market Study

The purpose of this study is to show the present and future demand of specific type of land use. Additionally it shows the present and future supply of competitive facilities in the market area (Beals and Troy, 1982). The focus of this study is to project those variables such as income, population, employment and retail sales which determine the demand for various forms of space or spatial activities (Messener, et al, 1977).

Marketability Study

The Marketability Study includes elements of the market study but adds three other elements. 1) How much space is likely to be sold or occupied over a specific time period, such as a year? 2) The estimated price it will command. 3) And the physical amenities or conditions of the property (Beals and Troy, 1982). For a hotel study, this converts into occupancy percentage, average daily rate and recommended facilities for the hotel.

Feasibility Study

The principle purpose of the Feasibility Study is to decide whether the subject property will provide adequate return on investment. In order to do this, the findings of the marketability study are converted into a revenue and expense stream, to derive cash-flow after debt service, reserve for replacement, and taxes. This cash-flow is then discounted to convert this future benefit stream into present value terms. This present value is then compared to the initial cost of the investment, to determine if the present value of future benefits exceeds the cost of initial investment.

In reality however, the term "Feasibility Study" is used synonymously with a Marketability Study with financial projections, and not a true feasibility study (Beals and Troy, 1982). The difference between the Feasibility Study and the Marketability Study with financial projections is that the financial projections in the latter study are only up to and including reserve for replacement. The reason for this abbreviated financial statement is that consultants for the project are not privy to capital costs and therefore do not include the debt service and income tax element. Further, long term lenders have been willing to provide funds for creditworthy projects based on the Marketability Study rather than a full blown Hotel Feasibility Study.

Appraisal Report

The Appraisal Report, which can only be prepared by a Member of the Appraisal Institute (MAI), uses all the information from a feasibility study, to provide an estimate of market value for the subject property. Banks require an appraisal before a loan is authorized, in order to ensure that the amount loaned is not more than the current value of the property. This may be done in conjunction with a feasibility study or at a later time.

The Feasibility Report (Marketability Study with Financial

This is the most frequently performed analysis by consultants as part of the loan package for developers and is the focus for the present research. As it is currently written, the feasibility report consists of eight distinct sections. Although every section has important information, the supply and demand analysis is the backbone of the report. The assumptions used in this section of the report affect all the subsequent parts of the report leading up to the projection of revenue and expenses.

- INTRODUCTION
- SUMMARY AND CONCLUSIONS
- GENERAL MARKET CHARACTERISTICS

- PROJECT DESCRIPTION AND SITE ANALYSIS
- RECOMMENDED FACILITIES
- ESTIMATE OCCUPANCY AND AVERAGE ROOM RATE
- PROSPECTIVE FINANCIAL ANALYSIS

Evolution of the Current Methods of Market Analysis

The current model of economic studies for the lodging industry was originally designed for the real estate industry. These methods were later adapted for hotel use in the 1970s and 1980s, as a response to developer attitudes (Beals, 1994). The original feasibility models were designed by public accounting firms such as Pannell Kerr Forster and Laventhol & Horwath. They designed the analysis using their experience in accounting and other commercial real estate such as office buildings and shopping centers. This model of market analysis, as described in the preceding section of the article, asks whether demand exists for additional rooms in the subject market area. The model then goes on to estimate the rate of absorption of the proposed hotel (occupancy) at a stated price (average room rate). Finally, it estimates the income stream from the project for five years in the future.

To answer these questions, these firms utilized current and historical secondary data with no emphasis on primary marketing research. As a result, this method of market analysis which is “inferring demand for the subject property by inventorying existing demands,” may be inadequate for the changing hotel development environment (Beals, 1994). As mentioned earlier, the current development environment is characterized by increasing market segmentation, competition, and the domination of chains introducing products in response to unfilled consumer needs. Due to these changes in the development environment, future projections of performance have become much more difficult to predict. Therefore, market analysis that relies on inferred demand from the existing market may not be sufficiently sophisticated.

Our disclosure of this change in the market dynamics is not a new revelation for those involved in hotel development. These changes are too apparent to go unnoticed. So why have methodologies gone unchanged, despite multiple periods of overbuilding in the past four decades? A good starting point for answering this question would be to ask large and small lenders about parts of the study they consider important and the extent to which they are satisfied with the preparation of these sections. The detailed results of this research are reported in a separate research article (Schmidgall, Singh, and Damitio, 2010). However, a synthesis of the results is consolidated in Table 1.

A brief review of this table identifies the importance of various sections of the study and the satisfaction with its preparation. In all categories of the feasibility study, satisfaction does not match the importance that lenders attribute to a particular section of the study. As an example, supply-demand analysis was consistently considered to be very important, however, satisfaction ranged from somewhat dissatisfied and closer to mostly dissatisfied.

“Insert Table I Here”

As a next step to researching this question we presented the summary results of the gap between importance and satisfaction to an expert panel of 18 consultants (Exhibit 1). Synthesizing the feedback from the consultants yielded the following insights into the reason for quality issues associated with feasibility studies. From their perspective, lenders are partly accountable for the deterioration in the state of these studies for several reasons, including unrealistic or unclear expectations, low fees, a lack of understanding of the hospitality business, and a lack of face to face interaction with consultants. One consultant indicated that the lender is primarily interested in reasonable estimates that will "hold up in front of a committee."

"Insert Exhibit I Here"

Therefore it would appear that feasibility studies in their current form are nothing more than a necessary evil designed to show adequate support for a project to move forward. As such, it is not surprising when the consultants indicated that a plethora of "consultants" have emerged over the years with no standardized training and who rely mainly on reports from secondary sources and with minimal field research. Furthermore, it is also no surprise that given the marginalization of the feasibility study in the development process, the methodological improvements for feasibility studies have remained stagnant as noted in the consultant feedback. Hence the reports in many cases have deteriorated into commodities versus a true feasibility of the project.

Despite this apparent lack of motivation to examine the current methods of conducting the studies, this is a good time to discuss methodology for various reasons. There is a change in the anatomy of the hotel deal. While in the 1980s the motivation for the development of hotels was a combination of favorable tax laws, and increased availability of financing; in the 1990s, hotels returned to the "back to basics mentality" for a few years. However, excessive capital became available at favorable terms during the financial deregulated expansionary era from 2003 to 2007. This resulted in an increase in supply of hotel rooms, primarily fueled by excess capital on favorable terms. As a result of the collapse of the financial sector in 2007, and consequent recession, financiers are still in various stages of recovery with regard to their overleveraged real estate portfolios. Historically, recoveries have followed most real estate cyclical downturns, and this may be a good time to evaluate our current practice of market analysis and look for ways to improve the predictability of these feasibility studies.

While it is true that a market study or feasibility study will never be 100 percent accurate due to many unknown variables, consultants surveyed did feel that there are several additional levels of analysis which would take more time and money but could improve the quality of these reports. They indicated adding primary demand interviews, scenario planning, sensitivity analysis, and conducting full feasibility studies as some of the improvement measures.

The authors of this research built on this feedback to conduct further secondary research based on articles and reports published from 1970 to the present. Based on this research we categorized existing limitations in the current methodology of preparing these studies and have recommended changes to these methods.

Methodological Limitation # 1: Market Analysis

As discussed previously in this article, the purpose of a Market Study is to outline the determinants of demand, and based upon that, make an estimate of demand for a market area. Once the components of demand have been forecasted according to the analyst's needs, the next step is to compare these projections to the existing supply and proposed additions to the supply. "In effect, then market analysis is concerned with the existing economic health of a specific market area (city, region etc), its future, and the potential for new spatial units within that area". (Messener, et al, 1977).

If a market study was being conducted for a shopping center, the analyst would project demand by analyzing determinants of demand such as population, effective buying income, and retail activity in the city where the project was proposed. Hotel feasibility reports have borrowed this concept from general real estate studies and put in the section called General Market Characteristics. However, the usefulness of this section is limited, primarily because unlike the other commercial projects, the general economic demographic characteristics of the city are not determinants of demand, since the majority of the demand is generated from what are known as "feeder cities." The only demand that can be inferred from this section is for restaurant and banquet use. The current reports usually make a general statement at the end of this section on the general economic health of the area, based upon this information. As a result, this section of the report is generally known as a "filler" or "canned information." In 1985, the American Hotel & Motel Association did a survey of user attitudes toward Feasibility Studies, and all surveyed maintained that this section of the report was of limited use to directly or indirectly infer demand (AH&MA, 1989). In the survey of lenders conducted by Schmidgall, Singh and Damitio, the satisfaction level with this section leaned towards Dissatisfied (Table 1).

This is not to say that the economic and demographic information about the city where the hotel is planned is unimportant. However, the importance of this section of the report is not to establish determinants of demand, but to assess the general health, vitality and economic diversity of the community.

The five characteristics of the U.S. hotel market today are maturity, increased competition, reduced rate of market growth, aging plant, and sophisticated customer. Therefore, when the market size is more or less static, in order to succeed in this climate hotels entering a market need to take business away from someone else.

In an article published over twenty years ago (Zodrow,1989), stated that in the 1980s the service industry faced with increased competition outlined above, turned to consumer research which had proven successful in the packaging and consumer product industries. For the past two decades, growth of branded hotel products, such as boutique, extended stay, and various segments of luxury, upscale, mid price and budget hotels has been driven by extensive consumer market research. Based upon these structural changes in the lodging industry and inadequate information from the current market analysis, we propose that the General Market section be supplemented to evaluate the determinants of demand for the market area and collection of attitudinal and behavioral data from purchasing the lodging product in a specific market. Our recent survey of consultants also supported the importance of embellishing this section of the report (Schmidgall, Singh, and Damitio, 2010).

Initially, this will have to be done in the form of primary research. Thompson stated that primary market research means that "existing and potential consumers of various market segments be directly asked about their attitudes, perceptions expectations...through focus groups, surveys, telephone interviews etc"(1989). This recommendation was originally proposed by Beals and Troy (1982), who suggested researching Marketing Channels that bring consumers and the city together, such as travel agents, corporate meeting planners, corporate travel offices, and wholesale operators. Most of this research will have to take place in the feeder cities. Another part of the primary research to determine demand would be the demand generators within the city itself. These could be area attractions, offices, convention centers and hotels themselves.

The primary market research would have a two- fold purpose. The first is to determine quantity of demand by identifying its determinants. Secondly, primary market research will assess the quality of the demand as well. As the current methodology does not tell us what the consumer wants in a given market, research to support the new studies will be about potential customer attitudes, perceptions and expectations. This is a radical departure from current practices, which are retroactive versus proactive. However, demand for lodging today is not only a reaction to the economic trends but also shaped by the product segmentation strategy adopted by chains, which in turn is based upon identifying consumer needs.

Methodological Limitation #2: Supply Analysis

The second problem related to current methodology concerns how analysts estimate the supply of hotel rooms in their market analysis model. The analyst starts with the current supply of competitive hotels and adds a certain number of rooms, based upon projects expected to enter the market area. However, what about the period after that? When estimating demand, the analyst applies growth factors to the entire period of the study, based upon historic trends and related assumptions. This increases the demand for the market, for the entire period of the study. However, in the case of supply, no such assumption is made. As a result, the study disproportionately increases demand, while increases supply only for a limited period. The result is a higher market area occupancy estimate (Mosser, 1982).

In our opinion, if a growth assumption can be made for demand, based upon past trends and some economic and demographic variables, then we should be able to make certain assumptions about the growth in supply as well, for the entire period of the study. These could be based on a review of business cycles for the region and historic construction pipeline reports for the region and city.

Methodological Limitation #3: The use of Market Analysis computer models and Market Segmentation

Market analysis programs have helped speed up the process of analyzing market data, but they also created a mentality of trying to make the analysis fit the model versus the model being used to analyze information. This is particularly true in the case of "fitting" the market segments to suit the model. For example, if the market has five distinct market segments, but the model had the capacity to recognize only three, the analyst may get

creative and make them "fit." Additionally, during this period of micro market segmentation, markets do not fit into neat generic categories such as Group, Leisure and Corporate. Each of these segments has a sub-segment based upon rate sensitivity, consumer preference, brand loyalty and many other factors.

Furthermore, since the present method estimates the market demand from existing hotels, certain methodological errors are possible. First, each hotel has a different definition for their market segments. If the consultant does not convert them accurately, the result would be an over or underestimation of certain market segments. As an example, some hotels may break down their segments as Corporate, Tourist and Group, while another may categorize them as Transient Tourist, Transient Business and Group, while another may have only two categories, Transient and Group. Sometimes, converting all these different categories so that they are "standardized" is subjective. Second, since the demand is estimated from existing market segments, the study may be missing an opportunity to identify unfulfilled consumer needs in the market place, which can only be obtained by primary market research.

These factors, along with limitations of the computer analytical models, make the results of this section of the study questionable. In order to arrive at the true market segmentation for the market area, primary market research as outlined earlier in the article is required. Additionally, we need to develop computer models which allow for flexibility in the various market demand variables for a particular study. This would require consultants to be trained in creating and adapting market analysis models to fit the needs of a specific project, which includes the analysis of qualitative factors such as consumer preferences as well.

Methodological Limitation #4: Growth Rates

As part of analyzing a market, consultants identify the historic performance of the various market segments by conducting interviews at competitive hotels and then estimating growth rates for the individual market segments. These take into account historical growth and assumptions based on economic, demographic activity. While this approach is logical, its application could lead to erroneous growth assumptions in the following ways. First, because the hotel industry is cyclical in nature, directly using historic growth rates to estimate the future demand in the market area challenges the nature of natural business cycles. For example, a study might be conducted when the market is at its peak and has been preceded by very high growth rates. If at this point the market is saturated and is about to enter into a contraction phase of the cycle, the study will not reflect that, as it will base the future growth upon past performance.

Furthermore, error in the growth analysis of the market results from the misapplication of concept known as "Latent Demand." In addition to the demand that is accommodated within a market, a percentage of demand is considered "latent." The latent component consists of demand that is "unaccommodated" or "induced" because of new demand drivers (Rushmore, 1992). This concept, which is used by consultants doing the study, assumes that demand will grow in the market area with the addition of hotels that have brands by virtue of expanded central reservation systems. However, the basis of this concept is erroneous because with the exception of destination resorts, hotels in themselves do not create demand. Demand grows as a result of a growth or an addition of a demand generator in an area. The addition of a hotel will not increase the size of the

market, except in markets with a very high turn away (unaccommodated demand) or with the introduction of a new brand concept in a market in response to a general consumer trend. An early example of this occurred in the early 1980s, when All Suite hotels were first introduced to the lodging industry. More recently, the trend of boutique or lifestyle hotels may also support the argument for latent demand. In most cases, however, the typical impact of a new property in a market is the demise of marginal properties with poor management to the benefit of new or better managed properties, or in the case of an oversupply, the area will see an all out room rate war and discounting spiral.

Finally, an error relates to the "creative" use of assumptions when assigning growth rates. The purpose of assigning growth rates to specific market segments (business, leisure, and group) is to show change in the size of the market. If past trends do not show sufficient growth, the consultant could "stretch" the use of assumptions to show higher growth rates than are feasible. As an example, the consultant may extrapolate national trends in the growth of commercial real estate space usage such as retail, office, or national trends in the growth of meetings and conventions as a justification for showing higher growth rates for the commercial segment in the subject market. While presumably there is an association with local commercial real estate absorption as a potential demand driver, extrapolating from national trends stretches this association.

We recommend further research to identify indicators of market growth and performance, which would lead to accepted and standardized measures of association between indicators of market demand and market performance. One such preliminary research project has been undertaken at Michigan State University by Singh and Schmidgall, in the form of the Lodging Market Potential Index (L-MPI), (2009). The next step in this research project could be to identify indicators of demand for individual market segments within the markets identified.

Methodological Limitation #5: Fair Share Analysis

The fair share analysis concept assumes that if a market has 1,000 rooms and the subject property has 200 rooms; your fair share is 20 percent. Based upon the subject property's strengths and weaknesses, relative to the competition, the market is penetrated to capture a percentage above or below the fair share. As noted earlier, the current studies lack primary market research, and thus the analysis is passive in nature because it is based upon existing demand. The missing element from this analysis is information from the consumer. The consumer information about each segment of the market, from either the end user or an intermediary, can identify the market potential for needs that are unfilled in the marketplace. Since the subject property has not been developed as yet, the three pieces of information which include a self-evaluation, an evaluation of the competition, and evaluation of the consumer would result in the subject property's niche (market positioning) in the marketplace (Rice, 1980). An estimate of occupancy that is derived as a result would be more active in nature. We have to be cautious in the use of this additional element in the analysis, because unethical or improper market research may result in identifying consumer needs that do not exist or are already satisfied by the existing market.

Methodological Limitation # 6: Occupancy Estimation

The current method of projecting demand for a particular hotel is based upon the performance of existing hotels in the defined market area. This method, which collects secondary information, is subject to bias for two reasons. Earlier in the article we indicated that a true Market Study must begin by identifying and measuring the determinants of demand. The current methodological practice in conducting market studies uses what is defined as the "build up approach based on analysis of lodging activity" (Rushmore, 1992). This benchmark practice, as universally practiced, is " to apply the build up approach based on an analysis of lodging activity, an area's transient room night demand is estimated by totaling the rooms actually occupied in local hotels and motels" (Rushmore, 1997). To implement this approach, the market analyst conducts interviews of existing hotel operators, owners, and others knowledgeable about individual hotels in the competitive set. In recent years, many consultants have substituted these interviews with proprietary and subscription based reports showing occupancy and average room rate trends in the competitive set of individual hotels.

This approach is inherently logical and practical, as the performance trends of existing hotels (occupancy and average daily rate) are indicators of the market's performance. However, the complete analysis should include supplementing information derived directly from hotels with trends in various demand generators that draw leisure, business, and group activity to a particular market. In many cases the market studies do not take the extra effort in time and expense to verify and support the initial analysis. Furthermore, individually collected data from existing hotels suffers from several biases as operators may not want to divulge accurate information for competitive reasons.

Our recommendation is for analysts to continue with the current process of the market based interviews of existing hotels in the competitive set but also supplement this with additional research either through direct surveys of demand generators, subscription based market reports, or primary research from source markets for the subject property. Without these built in checks and balances, the final analysis of the hotel market may be built on faulty assumptions, leading to an erroneous conclusion of the subject hotel performance.

Methodological Limitation # 7: Projecting Average Room Rate

The primary method of projecting average room rates in a market study for a proposed hotel is based on the current rate and growth rate at existing hotels in the competitive market set. This information could be derived from direct interviews or through subscribed market performance reports. While this is a good approach to establish the range of room rates in the market, it does not provide detailed information of rates for each market segment. While some market studies do supplement this by reviewing room rate trends by individual market segments, its application is limited due to the availability of information at this level of detail. Furthermore, a limitation of developing a projected room rate structure from existing hotels is the differences in the capital structure between hotels. Some hotels may have the flexibility to discount and reduce rates as a result of lower financial leverage.

Another problem with this method of estimating the average room rate is that the consultant has not measured the price elasticity of demand in the market area. For example, if the price elasticity of demand in the market area is inelastic, the consultant may miss some market opportunities by not setting higher prices, providing an improved product, and ultimately increasing revenue. On the other hand, if the demand in the market area is price elastic, a reduction, or going below the current market price may have a positive impact on revenues. The current studies do not conduct a formal or informal analysis to measure this demand relationship.

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Methodological Limitation #8: Recommended Facilities

The section on recommended facilities, as it is written currently, is in response to the fieldwork performed by the consultant. It mirrors the existing facilities in the market area. In order to be meaningful, this section of the report should reflect current consumer needs and unfilled demand in the market area. Most of this information can be gathered through primary market research. This shortcoming was first identified 30 years ago, when Beals and Troy pointed out the need for two essential ingredients in this section; “benefits sought by consumers and attributes required to differentiate the subject hotel from competitors”, (1982). With the inclusion of this information the facilities recommendation section can be upgraded to a market positioning statement.
An additional feature that will make this section of the report more relevant is to include sustainable building certifications such as the Leadership in Energy and Environmental Design (LEED). This information will form the basis of estimating building efficiency and related projection of energy and utility costs when preparing the pro forma income statement. Other relevant and recognizable quality benchmarks, such as AAA or Mobile ratings, will clearly communicate the amenities and features of the proposed hotel.

Methodological Limitation #9: Financial Analysis

The methodology of fair share analysis (#5), occupancy (#6), and average room rate projections (#7) have a direct impact on the resultant room revenue projects. Faulty assumptions and inadequate analysis will result in an inaccurate projection of room revenue. On the expense side of financial analysis, it is imperative for consultants to use accurate and standardized expense ratios. While this is usually not a problem at larger consulting firms, or for experienced consultants, it does pose a problem when studies are prepared by consultants who do not specialize in the hotel industry. The latter either lack good comparable data for expense ratios or blindly apply standard expense ratios without considering specific factors associated with an individual hotel.

First, based on our research, we propose two additional features that analysts should include in this section to improve its value. A projection of the hotel’s breakeven average daily rate and occupancy, would give the lender a down-side estimate of the projection. This will take a cost approach to the analysis which is an increasingly important part of the success of the hotel. It will also highlight and consider the capital structure for the hotel investment. Historically, most of the problems with hotel investments were related to high financial leverage leading to financial distress. Therefore, even hotels that

performed well could not sustain themselves, as they did not generate enough income to cover the debt service. Therefore, the analysis should include an analysis of earnings before interest and after taxes (EBIAT) as a percentage of debt service.

Second, an associated concept to the breakeven is a Sensitivity Analysis or Multiple Scenario Analysis, to assess the sensitivity of returns to changes in the operating performance of the hotel, such as occupancy, room rate and revenue per available room. This analysis will provide the user with optimistic, pessimistic and most likely case scenarios. Other related scenario analysis could consider changes in costs, prices, volume of business, on overall profits. For example if costs are higher than anticipated, and room rates are lower than projected, how many additional rooms would a hotel have to sell to make up the shortfall? If the occupancy is lower than expected, how much would the room rate have to be increased to maintain the same profit level?

Working Towards a Long Term Solution

Over the years, several reports, studies, articles, and discussions have focused on blaming either the consultants for giving their stamp of approval on hotel projects or lenders for releasing funds for projects that ultimately failed. Those who have been active in hotel real estate development recognize that development is a multifaceted enterprise, with many parties involved which include lenders, consultants, developers, and management and franchise companies. In addition, the role of the government in terms of fiscal policies, and regulations are critical aspects to be considered as well. Furthermore, even after receiving approval, the future performance of a hotel will depend on several macro economic factors and quality of management. Therefore it is virtually impossible for a feasibility study or market study to make a perfect prediction on hotel performance. However, the aim and hope of the authors of this research study is to open a door for a dialogue on ways to establish minimum standards for the feasibility report and set up a system to ensure that the preparers of the study follow the minimum guidelines for its preparation.

Based on our analysis of the research results, we have three recommendations given our understanding of the current state of the practice in the preparation of these studies.

1. As the preparation of an Appraisal report and audit of a firm requires a professional with a specific designation such as MAI or CPA, Feasibility Studies should also require a certifying body and earned designation to establish minimum standards for the performance of these studies.

2. Professionals certified in the preparation of these studies should undergo a systematic and standardized training program, to establish appropriate competencies in the preparation of these studies. They should also establish a periodic recertification process to maintain and update knowledge and skills.

3. A joint task force should be created, with a credible professional consulting association such as ISHC, and associations representing financial institutions such as the Risk Management Association (RMA) or American Bankers Association (ABA), and bank and thrift regulatory agencies to establish definitions, descriptions, minimum standards and fair compensation guidelines for feasibility studies.

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Table 1
Comparison of Average Scores of Importance and Satisfaction

Large Lenders				
Sections	Factors	Importance	Satisfaction	Difference*
Supply-demand analysis	9	1.68	3.36	1.68
Occupancy and room rate analysis	8	1.78	3.54	1.76
Project & site analysis	6	1.84	2.90	1.06
Financial projections	11	2.04	3.52	1.48
Neighborhood analysis	7	2.19	3.21	1.02
General market characteristics	14	2.28	3.06	.78
Recommended facilities	5	2.73	3.22	.49

Small Lenders				
Sections	Factors	Importance	Satisfaction	Difference*
Occupancy and room rate analysis	8	1.61	2.93	1.32
Financial projections	11	1.79	2.75	.96
Supply-demand analysis	9	1.83	2.53	.70
Project & site analysis	6	2.02	2.98	.96
Recommended facilities	5	2.18	3.05	.87
General market characteristics	14	2.37	2.80	.43
Neighborhood analysis	7	2.59	3.00	.41

Importance Scale:
1 = crucial
2 = very important
3 = important
4 = somewhat important
5 = unimportant

Satisfaction Scale:
1 = completely satisfied
2 = mostly satisfied
3 = somewhat dissatisfied
4 = mostly dissatisfied
5 = completely dissatisfied

Exhibit 1
Panel of Feasibility Study Experts

Consultant Name	Affiliation
Scott Brush	Brush & Company (ISHC)
Drew Diamond	Dimond Hotel Consulting Group (ISHC)
Bruce Goodwin	Goodwin & Associates Hospitality Consultants, Inc. (ISHC)
Ted Mandigo	TR Mandigo & Co. (ISHC)
Rachel Roginsky	Pinnacle Advisory Group (ISHC)
David Sangre	Hotel & Leisure Advisors (ISHC)
Henry Staley, Jr.	Atlantic Hospitality Advisors (ISHC)
Rick Swig	RSBA & Associates (ISHC)
Stanley Turkel	Hotel Consultant (ISHC)
Ronald Watanabe	Ron Watanabe & Associates (ISHC)
Richard Conti	Plasencia Group Inc.
Jack Corgel	Cornell University
Joel W. Hiser	Horwath HTL, USA
David Johnstone	Miller Global Properties, LLC

Note: 4 consultants on the panel preferred to remain anonymous.