WHY RETURN ON HOTEL INVESTMENT CAN SIGNIFICANTLY UNDER PERFORM

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1. Introduction

1.1. Hotel valuations achieved some of their highest levels in 2015, fuelled by good hotel performances, and the availability of low cost capital. Capitalization rates remained stable as demand for quality hotel assets remained strong.

1.2. The boom in new properties is evident in the balance sheet of hotel companies. In the ten years to 2015, the cumulative investment in properties of the top seven listed companies has been growing at a compounded annual rate of 14.1%.

1.3. The inventory of rooms during the same period grew even faster as many hotel chains, especially brands such as Marriott and Starwood, most prevalent took the management-contract route to growth where high-net worth individuals', Real-Estate Investment Trusts (REIT) and equity firms invest in properties.

1.4. However, many hotel investors are courting financial trouble by over-investing in properties. There is a certain aspiration and glamour around hotels and many developers get in the race to build a grand property rather than one that will give them the best financial return.

1.5. This White Paper discusses the forces that can lead to under-performance and presents 4 key success criteria for a sustainable hotel project.

2. Failure versus Success

2.1. The long term fate of a new hotel tends to be determined by the quality and expertise of agents and developers at the construction and pre-opening stage.

2.2. Many hotel developers have a real estate background, where projects are pretty straight forward and have a quick turn-around.

2.3. The objective is to move from a draft financial plan to construction and opening, as soon as possible to secure a percentage fee and move on to the next project.

2.4. The number one threat to hotel performance is a lack of understanding the complexities of hotel development and the expertise needed to build a sustainable hotel business model. This leads at best to a permanently underperforming asset and at worst to failure.

2.5. Often, a dollar saved on the front end will cost two dollars in the long run, and in general the more corners are cut during the development stage, the lower the return on equity.

2.6. The 'Hotel death toll' has been harshest since the recession in 2008, but whilst many hotels faltered during this period, others managed to maintain and even increase their values. These hotels, that were built on solid foundations, did not refer to the credit crunch, the banks or on any other external scapegoat. They had the internal knowledge, resource and expertise to withstand a serious downturn and were able to protect their investment and build their empires during this tough period!

2.7. So, as an investor in a new hotel, what should you be looking out for in order to achieve a good equity return?

3. Six Warning signs

What follows next are 6 development warning signs and further down are 4 key critical success criteria to hotel development. Any one of them can erode operating profit and valuation. Two or three of them in tandem will have your developer practicing his "The Economy Did It" speech to you. Hopefully, by then you will not be too entangled in the business and be forced to pour in more money in the hope that one day it will make you money!

3.1. Greed and percentage takers

3.1.1. Vast sums of money are frequently paid to what I classify as 'Hangers-on' - i.e. agents that introduce or 'manage' certain parts of the development process, but who do not specifically contribute or add value to the development or management process.

3.1.2. Vast hotel development budgets can attract characters who see you, the investor, as their 'retirement meal ticket'.

3.1.3. Any contract fees should be fixed and must demonstrate a <u>significant</u> ROI. By all means agree a bonus payment upon successful completion of a contract in order to maximise commitment, but NEVER agree to percentage down payments to unknown 'contributors'.

3.2. A quick return plan never delivers long term success

3.2.1. In general, per m2 a hotel costs 4 times as much as an office block and takes 3 times as long to build.

3.2.2. Any developer who suggests that he has re-invented the wheel and can develop much quicker, would need to demonstrate a constructive argument and explain how this will be achieved. Failure to do so should act as a real warning sign. Cutting corners and skipping critical steps will have an ultimate negative impact on the bottom line and asset value.

3.3. Over or underspending in the wrong areas

3.3.1. The following categories reflect approximate costs in hotel development budgets:

- ❖ Land 12%
- ❖ Construction 65%
- ❖ Soft Costs 10%
- ❖ FF&E 10%
- ❖ Pre-opening and working capital 3%

3.3.2. Although these percentages are not meant to be all encompassing, the feasibility and impact on the business model of any over or underspending in these categories must be fully understood.

3.3.3. For example, land is often the most important component as this cost can make or break the profitability of a project.

3.3.4. However, investment in soft costs such as financing, and professional fees are often missing in budgets that I review. Developers in general do not appreciate what is involved to make the hotel operationally ready and will allow a small percentage of only, say, 2% for legal and accounting fees. It is hard to recover and catch up from a poor, ill thought out opening process and it is critical to acknowledge these costs as part of the long-term feasibility and productivity of a new hotel.

3.4. Inability to think beyond financial plan

3.4.1. Investors are frequently lulled into a false sense of opportunity by the sight of a 10-year cash flow plan that promises incredible Internal Rates on Return (IRR). Many are riddled with inconsistencies, unjustified assumptions and contradictions.

3.4.2. In basic terms investment in critical areas such as IT, distribution, team productivity, delivery, guest satisfaction etc. tends to be understated. In contradiction, above market operating margins, RevPAR's, ADRs and occupancy rates are assumed, and ill-thought out allowances are made for costs such as one-sided operating fees and marketing.

3.4.3. To put this in perspective, the following examples demonstrate what direct impact some assumptions can have on the Net Operating Income (NOI), hotel valuation and your Return on Investment (ROI):

3.4.3.1. In principal, for every point increase in on-line guest satisfaction ratings a hotel valuation can increase by 15%. Branded hotels with over 65% of 'Excellent' guest satisfaction scoring, tend to have above average operating profits. Thus, the valuation of hotels with an average score of 6 out of 10, can be 30% less than a hotel with ‘excellent’ scores – showing that a relatively minor investment in demand management and team delivery can have a significant impact on equity return.

3.4.3.2. Operator incentive fees should be linked to performance and cash flow or Return on Capital Employed (ROCE), in order to guarantee commitment to the investment objectives. They should not be paid out until equity and replacement reserves have been prioritized.

3.4.3.3. For example: A hotel investment objective is to achieve a NOI of $2.5m on sales of $10m, a ROCE of 10% on capital of $25m and its valuation objective at a cap rate of 7% is $35m. At the end of year 3 the Operator only achieves an actual NOI of $1.5m on sales of €8.5K and a Gross Operating Profit (GOP) of 65%.

3.4.3.4. Note the difference if incentive fee of, say, 8% is linked to ROCE or to GOP (poor negotiation, old style fee):

- ROCE Incentive: No incentive fee payment to operator as 15% equity and replacement priority leaves no further cash for operator. Property is valued at $21m.
- GOP Incentive: An incentive payment to operator of $440K, leaves a NOI of $1.0m and a valuation of €15m.
- So, in the case of a GOP Incentive, and careless negotiation, the hotel operator receives a bonus for poor performance, leaving equity returns trailing by -50%.

3.5. Poor market research and due diligence

3.5.1. In hotels, everything happens at the margin. If the hotel’s location, customer targets, new trends and behaviours cause it to achieve a lower occupancy, at rates similar to, better performing competitor hotels, its profit, value and viability will be significantly impacted.

3.5.2. Strong Revenues per Average Room (RevPar) and operating performance as well as outperforming competitors, results in significant NOI increases and in robust asset appreciation.

3.5.3. A lack of investment in order to achieve this tends to be due to short sightedness, a lack of expertise and poor advice during the development process.

3.6. Over-leveraging on expensive capital

3.6.1. Maintaining a healthy balance between cap rates and the cost of debt will enable the hotel to weather future downturns.

3.6.2. Beware, as the market cycle advances, to avoid the temptation to over-leverage. It requires a disciplined investment approach, which may lead to lower investment returns, but when times get rocky, will better position you to avoid a complete loss of capital.

4. Four Key Hotel Success Criteria

The objective of any new hotel development should be to generate a robust and long-term above market capital and income growth. Maximising NOI is achieved through optimising cash flows from operations, combined with smart investments and FF&E expenditure.

What follows are 4 key criteria to achieve these objectives.

4.1. Fully understanding and optimising all development Milestones:

4.1.1. Step 1: Development plan

- Investors brief - what is required, location, budget, etc.
- Initial research in area, population, connectivity, construction restrictions
- Feasibility study to include Market and Demand Analysis, Competitor and Supply Analysis, site and concept appraisal, Commercial Plan

4.1.2. Step 2: Acquisition and funding

4.1.3. Step 3: Management contracts, format and agreements: who is going to run hotel and carries responsibility for operations? Independent, franchise, management agreement, hybrid

4.1.4. Step 4: Construction and opening

4.1.5. Step 5: Performance and Property Management - driving bottom line, maintaining service levels and quality in the market

4.1.6. Step 6: Exit Strategy

4.2. Distribution, Revenue and Demand Management

4.2.1. The hotel sector has changed of late evolving from a situation where most hotels were independent and essentially competing in a highly specific local market, to one in which hotel chains increasingly dominate. All hotels are operating in a hyper competitive global market place.

4.2.2. Individual hotels work in a sector characterized by high operational and financial gearing, with the result that they need to pull out all the stops to maximise their revenue by selling every room every night at the optimum price.

4.2.3. Having effective and efficient distribution and revenue management is very important but is also challenging, given the fast paced change in the sector.

4.2.4. The distribution revolution, currently underway in the hotel sector, presents hotels with incredible opportunities, if only they have the knowledge and understanding of how to best exploit them.

4.2.5. This traditional landscape has changed with the emerging dominance and growth of Online Travel Agents (OTA's), who provide alternatives to owners, franchises and independent hotels

4.2.6. Not since the emergence of hotel chains in the late 1970's has the hotel business landscape changed as much as since the late 1990's, with arrival of Travelocity, Expedia and Priceline, followed by Airbnb in the 2000's.

4.2.7. With more and more channels managing distribution has become very complex and key to the future is effective distribution and revenue management.

4.2.8. New competencies are needed. The digital evolution makes entire eco system in which hotel rooms are searched, compared, evaluated, experienced and reviewed much more complex.

4.2.9. A whole new portfolio of distribution channels has developed to supplement – and in some cases even start to replace – traditional methods of driving demand. These forces are so powerful that, today, they are starting to provide independent hotels with a viable alternative to signing up with a hotel chain for a franchise or management agreement.

4.2.10. The situation will continue to evolve, making managing hotel electronic distribution a challenging prospect.

4.2.11. Understanding how to manage your hotel's positioning in this increasingly complex network of routes to market, as well as optimising your distribution strategy to maximise revenue and profitability, is key.

4.2.12. Hotel business is a fascinating and highly dynamic sector. One that is rapidly progressing as technology continues to evolve at an explosive pace. Being able to manage hotel electronic distribution is not the future, it is an essential skill for today.

4.2.13. Future success and competitiveness lie in the convergence of marketing and technology and a more integrated revenue strategy. For this to happen, there must be collaboration and a common goal throughout the organisation, starting at the top.

4.2.14. Savvy hotel developers realise this and ensure they invest, today, in the right systems and management process to be ready for tomorrow.

4.3. Very happy customers and employees

4.3.1. What truly matters in hotel performance is the ability to always exceed guest expectations and to have a happy, genuine and loyal team. This is not often discussed during the development process as it is not fashionable 'investment-speak', nor does it correlate obviously to financial performance.

4.3.2. Investors expect that this 'mere matter of detail' is dealt with by the operator, and the operator expects that the general manager follows brand guidelines and procedures on the matter.

4.3.3. And this is where we have reached the weakest link – it is very difficult to attract and retain a good hotel General Manager.

4.3.4. A good GM is critical to the performance of a hotel and creating happy teams and customers.

4.3.5. Good hotel managers are multi-skilled. They are commercially adept, they are strong leaders and they are passionate about the hotel.

4.3.6. Due to the multi-facetted nature of hotels, a good hotel manager is smart with his time and is able to stretch his abilities by doing fewer of the things that come naturally and by doing more of the things that he is less comfortable with.

4.3.7. He understands that business changes rapidly and changes trigger new challenges, requiring a new set of improvement goals.

4.3.8. A GM has 3 Key areas of focus – Guest, Staff, Finance and Operation and time spent on each should be on average 40%/30%/30% respectively; each having its own set of attainable goals and targets

4.3.9. In this new world of branded and stream-lined hotels, the actual focus of GM's is mostly on financial performance, instead of ensuring that the 'machine' is fully functioning, via well-trained operators, to ensure a consistent output (as would be the case in a factory!) – Typically hotel managers expect the machine to run by itself with poorly trained and unhappy operators. High staff turnover and poor guest satisfaction is than blamed on external factors (we can't get the staff)

4.3.10. As mentioned in point 3.4.3.1 above, low guest satisfaction ratings, that are below competitors' set ratings, significantly affect a hotel valuation. A relatively small Investment in a good General Manager and in a robust staff recruitment, training and development program will have a significant return on investment.

4.4. Maximising Operational Leverage

4.4.1. Mass hotel branding and operating since the 1980's has made hotel business models sterile. They lack creativity and a 'one-size-fits-all' structure has generated a one-dimensional operating methodology.

4.4.2. As a consequence, teams on the ground tend to lack commercial awareness, which can have a huge impact on the bottom line.

4.4.3. Owners and their asset managers communicate their financial objectives with the Operator and General Manager, but have little input in how their investment is actually managed, through the operational process.

4.4.4. Management contracts can be very one-sided and do not incentivise operators enough to go the extra mile to achieve NOI targets.

4.4.5. While the emphasis on maximising profit tends to be correct regarding effective revenue management, the abandonment of any further effort to optimize the operational process, routinely leaves a significant amount of easy profit on the table.

4.4.6. Why is this happening and what can you do, as investor, to remedy this situation in your hotel? In order to understand this, let me explain first why Revenue Management is the main, and often the only measure used, to optimize profits.

4.4.6.1. The first reason is that hotels are highly leveraged with fixed costs and a strong and effective revenue generating discipline is essential for debt service and long term survival.

4.4.6.2. Secondly, the objective of any asset manager is to maximise NOI in order to optimize the valuation of the property. An effective revenue management discipline will increase Price (or ADR) without reducing occupancy (or RevPar) – thus any such increase will more or less entirely go to the bottom line, as with exception of commissions, there are no variable operating costs involved in the extra revenue generated through Price. For example, increasing ADR's by 5% on a revenue of $10m, will generate a NOI increase of $500K. If the going cap rate is 10, this would increase the property valuation by $5m, not bad!

4.4.7. We have established therefore that Revenue Management is critical, but that should not be a reason why optimising the remainder of the operational process should be neglected!

4.4.8. There are three main areas where this neglect manifests itself:

4.4.8.1. The first is in **<u>Productivity:</u>** Unfortunately, we are all guilty of being creatures of habit and we tend to fall victim to settling into doing things one way only. A certain process may have been effective in the past, but new changes in the working environment may now deem it not to be efficient anymore. Routinely streamlining processes, and using IT to facilitate this will increase output & revenue and reduce costs. Independent hotels tend to score lower in productivity than branded hotels.

4.4.8.2. The second reason for focusing on maximising operational leverage is the opportunity of **Added Value Marketing (AVM**). The basic idea behind AVM is to introduce a 'wow-factor' throughout the entire customer experience – i.e. before arrival, during the stay and after departure. AVM is a key skill that has gradually been lost over time, as a result of brand streamlining. It used to be a key activity in hotels before hotel branding took over the independent hotel world in the 1980's, when the main focus of hotel general managers and their front of house staff was on PR and wowing their customers. This powerful and relatively cheap marketing tool is based on the Reciprocity Principle: i.e. exceed expectations, or give something at no costs and it sets up a psychological need to return the favour. If applied effectively, AVM does not only significantly increase revenue but it will also ensure a constant stream of repeat business and stronger customer loyalty and satisfaction – which, as we know, is vital in increasing a hotel's property valuation.

4.4.8.3. The third and final force behind operational efficiency is a **lack of commercial awareness amongst the team on the ground**. Hotel operating budgets are usually based on prior year results, in which case the objective is to set expense targets that are the same or lower than the actual results in the year before. The obvious danger in approaching the budget in this way is that we are allowing poor cost control and wastage to repeat itself and this is a major issue that I have found in hotel operations, especially in F&B departments. The costs in F&B are highly variable and departmental margins are on average not more than between 10% to 15%. Hotel F&B areas are notorious loss makers, but this is both preventable and unnecessary. There are a number of causes, of which the main one can be attributed to bad design and planning before opening. However, a poor understanding of the business model results in the hotel routinely overspending on some costs, e.g. Cost of Sales (COS) and Cost of Labour (COL), and underspending in other areas such as Training and Development. COS and COL should not be more than circa 60% and a lack of control and effective pricing sees this percentage typically above 70%, thus more or less fully eroding the departmental profit margin.

4.4.9. So, if we go back to the question; "why are these inefficiencies not deemed to be important enough to be addressed?", I would say that the real downward impact on profit due to poor operational leverage is often misunderstood.

4.4.10. From an asset managers point of view, increasing revenue is seen as the big fish, as we have seen in example 4.4.6.2. above. An increase in revenue of 5% could result in a valuation increase of $5m. In contrast, in the eyes of a typical asset manager there are no further added value operational opportunities beyond 'cost savings'. The cost savings that an asset manager would refer to here are reductions in 'well-controlled cost budgets', which obviously would be counter-productive. A decrease in some departmental costs of, say, 5%, could have a net impact on NOI of 'just' $50K and valuation increase of 'only' $500K.

4.4.11. However, the **real** impact on profit by optimising Productivity, AVM and Commercial control can be the same as that of maximising RevPar. To emphasise this fact; in 2015 UK hotels reported large uplifts in room revenues but despite this, declines in TrevPAR (Total Revenue per Available Room) and GOPPAR (Gross Operating Profit per Available Room) cut back as much as 60% of the rooms' revenue growth, as declines were recorded on a per available room basis in Food & Beverage and Conference & Banqueting revenue, and increases in payroll costs.

5. Conclusion

5.1. You may be investing in a Hotel as a private individual or consortium at arms-length; as the owner, or as a lender. Whichever, you must have felt the buzz of excitement that comes with being associated to such a vibrant asset, with its transient population of customers, all looking for that special hospitality experience, whatever their reason for being there.

5.2. It takes a special team of people to deliver that customer experience, time after time, and nowadays, social media and specialist travel websites provide an easy way to for your Independent Hotel or your Chain, to have its failings broadcast and to have its satisfaction ratings fall.

5.3. This one simple performance statistic is proven to have a direct effect on Hotel valuations, and with a financial stake in the business, you are looking for strong, sustainable growth to deliver the expected ROI (or better!) not to be firefighting backsliding public opinion and a failing business model.

5.4. There is complexity to delivering a profitable Hotel, with the demands of optimising different profit and cost centres within the one unit whilst sustaining customer delight.

5.5. However, with the right business model, developed out of the four Key Hotel Success Criteria, and properly trained operators all bought in to the KPIs and the overall Hotel objectives and ethos, fabulous returns on investment can be delivered to you.

5.6. Those criteria?

- Understanding and optimising all the development milestones – even if the Hotel is already operating
- Revenue and Demand Management
- Very Happy Customers and Employees
- Maximising Operational Leverage

5.7 Everyone has excuses for the Hotel's poor financial performance. Management blame the economy; Management operators blame the owners; Staff blame the Management; Customers blame the Staff and so it goes on.

5.8 Our company, Hospitality Business Development, is a platform that provides the risk takers – owners, investors and developers, with the tools to build and run sustainable, successful Hotels and Restaurants directly, through your own management team, or through a Management Operator, if that is your chosen route.

About Hospitality Business Development

HBD is a platform that provides hotel owners, investors and developers with the tools to build and run successful and sustainable hotels and restaurants. A platform that stands for simplicity, flexibility, openness, intelligence and expertise. A platform that brings an end to the hidden long term percentage fees and the hassle of traditional consultancy approaches. No more frustration of paying for the top man, but getting the help of a university graduate. With HBD, clients always know they are making well informed decisions so that they minimize business risk and optimize potential. Transparency and trust are the core principles behind HBD.

We are on a mission to create significant value for you and to give you a substantial return on your investment in us, as well as your investment in your hotel or restaurant. We believe that hotel owners and investors have the right to remain in control of their capital. We create a simple and open way for clients to surround themselves with the best expertise required to develop great hotels and restaurants, by being clear on fees and removing any layers of unnecessary commission taking and by giving the middlemen the boot.

From speaking to Hotel Investors, Developers and Owners across Europe and their frustration at having little alternatives and poor advice. A new way of thinking for a new generation of hotel developers and investors.

Glossary of Terms Used

- **ACTUAL SHARE** - Measures a hotel's actual market share performance relative to the number of rooms actually sold in the competitive set, market or submarket. Formula = number of rooms sold in a hotel / total number of rooms sold in the competition set

- **ADR** - Average Daily Rate = Rooms revenue / Rooms sold

- **ARI** - Average Rate Index (how ADR compares to comp set) = hotel ADR / market ADR

- **CAPITALIZATION RATES** - often just called the cap rate, is the ratio of Net Operating Income (NOI) to property asset value. So, for example, if a property was listed for $1,000,000 and generated an NOI of $100,000, then the cap rate would be $100,000/$1,000,000, or 10%

- **FAIR SHARE** - Measures a hotel's performance relative to the rooms available in the competitive set, market or sub-market, i.e. your share if everyone performed to the same level. Formula = number of physical rooms in a hotel / total number of rooms in the competition set

- **FF&E** - Furniture, fittings & equipment

- **GOP** - Gross Operating Profit = gross operating revenue less gross operating expenses AM GOP % Operating Profit Margin = GOP/total revenue

- **GOPPAR** - Gross operating profit per avail. Room = gross operating profit / total rooms available

- **INCENTIVE FEE** - An incentive management fee is provided to the Operator for the incremental profitability of the hotel due to the Operator's operational expertise.

- **IRR** - Internal Rate of Return - The discount rate often used in capital budgeting that makes the net present value of all cash flows from a particular project equal to zero. Generally speaking, the higher a project's internal rate of return, the more desirable it is to undertake the project. As such, IRR can be used to rank several prospective projects a firm is considering. Assuming all other factors are equal among the various projects, the project with the highest IRR would probably be considered the best and undertaken first.

- **KPI** - Key Performance Indicators

- **MPI** - Market Penetration Index - Measures a hotel's 'Actual' share versus their 'Fair' share. Formula = actual market share / fair market share OR hotel Occupancy / market Occupancy Index = 100 = Fair Share achieved < 100 = Fair Share not achieved > 100 = Fair Share exceeded

- **NET RATE** - The Net Rate is the hotel rate provided to travel agents, wholesalers and tour companies, which can be marked up and sold at a higher rate to the end customer

- **NOI** - Net Operating Income

- **OPEX** - Operational Expenditure - A category of expenditure that a business incurs as a result of performing its normal business operations

- **RM** – Revenue Management

- **PROFPAR** Profit per available room = total profit / total rooms available

- **RACK RATE** - the price of the hotel room before any discounts or promotional rates are deducted

- **REVPAG** - Revenue per available guest = total revenue / total number of guests

- **REVPAR -** Revenue per available room

- **ROI** - Return on Investment

- **RPI** - Revenue Penetration Index (see also MPI) = RevPAR hotel / average RevPAR competitive set

- **TREVPAR -** Total revenue per available room= total revenue (incl. F&B, Vending machines, Ski lift tickets etc.) / total available rooms

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