What Can Make New Hotel Construction Economically Feasible When New Hotel Construction Isn't Economically Feasible?

by Karen E. Rubin, CRE

We all know the conventional wisdom about the lodging industry's inherent cyclicity. As hotel room night demand grows in a market with a fixed number of rooms, hotel occupancies increase; at some point the market's hotels can start to move their rates upward. As occupancies and rates increase, profitability and net incomes at the market's individual hotels increase. And, all things being equal, as net incomes increase, values of the individual hotels generally increase. Eventually, values of individual hotels in the market rise to the point where they start to approach, equal, and exceed the cost of building new hotels. At this point, the cost of building a brand new hotel will be equal to or less than the cost of acquiring a pre-existing one. It is easy to see why new hotel construction can be economically justified at this point in the cycle: it is a better deal to build than to buy. This is the part of the cycle where new hotel development is economically feasible.

The rest of the cycle we also know: the new hotel rooms open, supply is diluted and demand is spread out among the increased number of rooms, occupancies decline, rates (sometimes) decline or may cease to grow, and profitability and net incomes decline at the individual hotels. All things being equal, these factors generally cause a decline in the value of the market's hotels. And when values decline to something less than the cost of building new rooms, it is cheaper to buy than to build and the cycle begins anew.

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So we all know the conventional wisdom. Now here's the question: how can new hotel construction be economically feasible when the values of the market's existing hotels have not risen to the point where they are at or above replacement cost new? Or, to phrase the question another way, what can make new hotel construction economically feasible when new hotel construction is not economically feasible?

The answer . . . government can.

GOVERNMENT IS INCENTIVIZING NEW HOTEL DEVELOPMENT

Based on the author's own and HVS International's recent and ongoing experience in lodging markets throughout the nation, it has become increasingly apparent that government is becoming involved in new hotel development to a heretofore unprecedented level of frequency and magnitude. It is obvious that cities, counties, and redevelopment agencies throughout the nation have, as a group, decided that new hotel development in their purviews is to be devoutly desired - desired enough, in fact, to do something about. In a substantial number of markets this desire is being translated into significant public subsidies for new hotel construction.

These subsidies are taking a number of forms. One of them is tax increment financing (TIF), which is itself being structured in a number of different ways. This type of development incentive permits a certain portion of what a new hotel property would accrue in real estate taxes to be diverted to pay debt service. We have found that the maximum amount of property taxes usually made available for debt service is the difference between the taxes that would have been paid had the property not been developed (*i.e.*, the taxes that would have been paid on the undeveloped site or on the un-redeveloped land and building), and the taxes payable on the developed (or re-developed) property. While a property owner must still pay property taxes in amounts commensurate with the redeveloped property's value, the amount of cash flow made available for debt service is effectively increased, permitting additional leverage on the deal. The ability to borrow more results in higher leverage, which is very attractive to real estate investors and developers, who like to capitalize projects with OPM ("other people's money"). And given that the cost of debt is generally lower than the cost of equity capital, higher leverage means a lower total weighted cost of capital, translating to better economic feasibility at lower occupancy, rate, and net income levels.

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Property tax abatements are also popular forms of government incentives. Abatements relieve property ownership from the burden of paying real estate taxes in full or in part, usually for a predetermined period of time. We find that the abatement period typically ranges from 10 to 20 years. Abatements can be total abatements, partial abatements, or a combination of the two. An abatement may start, for example, by requiring no real property tax payment at all; as the property matures in the marketplace, the expiration of the abatement may be phased. In one example, a property owner may pay no taxes for the first five years, then 20 percent of the full tax burden in year six, 40 percent in year seven, and so on, until full property taxes are paid in year 10. Property tax abatements, be they full or partial, can dramatically increase cash flow on the completed project, permitting more debt and higher leverage, increasing 'value,' and improving the economics of a project to the point where it is economically justified.

Municipalities are also incentivizing lodging property development by assisting with the process and the cost of obtaining land. Sale-leasebacks of land are sometimes used to motivate new hotel development. In some instances, a developer will assemble a site per pre-agreement with the city; the developer will then sell the site to the city at his/her cost. The city will then lease the site back to the developer at a favorable or nominal rental under a long-term lease. Rental can be as low as $1 a year. Or, rent can

start low and be phased in over time to represent market rent.

We have also seen governmental or quasi-governmental agencies assemble a site, prepare it for development, and then make it available for sale to a developer at a favorable (*i.e.*, below-market) price. In one or two instances, we have even seen a city contribute a parcel's title outright to a hotel developer. By eliminating or reducing land cost, total project cost is lowered, and the economics of a project are improved.

Some governmental agencies have floated bonds to help incentivize development. In these cases, the developer's financing can be all or partially provided in the form of municipal bonds that may be guaranteed by the government and therefore bear favorable interest rates, lowering the cost of capital for the project and improving economic feasibility.

We have seen one recent case where a governmental entity essentially "donated" more than $20,000 a room – in the form of a one-time, up-front, cash contribution to the developer - to spur a lodging facility's development. We have even seen one case where a government agency agreed to rebate, for a specified number of years, its portion of the sales taxes generated by the project once it was up and running!

The federal government is also "in the act," albeit more peripherally. Federal tax credits can enhance a lodging property's economics if it located in a Federal Empowerment Zone, or if it is an adaptive re-use of a historical building. These types of federal incentives are influencing the economics of a number of hotel development projects of which we are aware; however, these efforts are not targeted specifically toward the lodging industry in the way that their local and regional counterparts are.

In short, the ways and means of public incentivization of hotel development vary, and appear to be getting more and more creative. But they all have one common message: governments and quasi-governmental agencies at virtually all levels throughout the U.S. are telling developers to build hotels!

HOTEL DEVELOPMENT IS PARTICULARLY DESIRABLE

Why are hotel projects, in particular, so favored? There are several reasons. As an industry, lodging is relatively clean. No nuclear reactors, no slag, no smokestacks belching black carbon products into the troposphere. And, lodging facilities create jobs, jobs that require both unskilled, hourly labor and middle and upper managers. Thus, they not only create jobs, they create a number of different kinds of jobs, providing opportunities throughout the labor market spectrum. In addition to creating jobs, hotels can also help to stabilize and define neighborhoods and cities. The right kind of hotel can even enhance a neighborhood's, or a city's, or a civic convention center's prestige.

But even more significantly, hotels by their very nature attract visitors. These visitors bring new dollars into an area and they spend them at local businesses; the business owners have more dollars to spend at other local businesses, and the multiplier effect assures that the increased spending is felt throughout the community. Government and quasi-governmental agencies – especially the more local ones – view hotels as a way to augment the public coffers without additional taxation of the local resident base. This is a good thing, government officials tend to reason, because the folks who comprise the local resident base have a nasty habit of voting government officials out of office for little things like raising taxes.

THE CONVENTION CENTER CONNECTION

Many of the recent hotel development incentives we have seen being offered are connected somehow with the market's civic convention centers. There are three typical scenarios. In one, a city or other governmental agency is trying to get a civic convention center built. Often a new hotel project is seen as instrumental in helping to ground this type of civic project.

In another scenario, a city may be trying to expand its existing convention center. No matter how low area-wide hotel occupancies may be, we find that the local convention and visitors' bureau often believes that its market does not have enough hotel rooms. Given that many hotel markets do have a difficult time housing large groups at peak periods, convention and visitor's bureau personnel may have a point.

In the last typical scenario, the new or expanded convention center is not performing as well as was projected. An oft-cited reason for underperforming civic conference and convention centers is a dearth of hotel rooms, a dearth of quality hotel rooms, and, most particularly, a dearth of

quality hotel rooms proximate to the civic facility. Philadelphia in the mid-1990s provided a very good example of this scenario. A beautiful new convention center had opened between July of 1993 and April of 1994, but no new hotel rooms opened in the market at that time. The convention center's performance was not spectacular - until the brand-new, upscale, ±1,200-room Marriott opened adjacent to it in February of 1995. From that time forward, hotel room night demand in the market exploded. In this instance, new hotel rooms really were needed to permit the convention center to reach its potential.

A counter-example is Baltimore. Baltimore expanded its civic convention center in April of 1997 from ±145,000 to about ±400,000 square feet. Hotel room night demand in the center city's core convention hotels actually fell slightly that year, and while rate growth in the market has been strong, room night demand has grown more slowly than it did in the early 1990s. With no concomitant new hotel construction, the new convention center doesn't appear to have had the momentum to induce into the market the new kinds of meetings and conventions (and their related hotel room nights) that had been envisioned. Now that one or two new major hotels are expected to open in the next two to three years, we will see what happens.

Hotel development in or near public convention facilities has always been a little problematic, in fact, from the hotel component's side. The challenge has always been that if a hotel relies solely on rooms business generated in tandem with the convention center, it is difficult to achieve occupancy of much more than 55 percent to 57 percent on an annual basis (and these levels are *at best*). This is because major meetings and conventions require time to set up and time to tear down. A three-day trade show may require two or three "dark" days at the convention center before and after the show days. A hotel whose only locational advantage is its proximity to the convention center has a tough time during these "dark" days. So the economic viability of convention center hotel development has, before the current era, typically been seen as something less than assured based on typical locational factors alone. But recent success stories involving convention-oriented hotels in Philadelphia, San Diego, and other major and non-major markets throughout the U.S. have permitted hotel developers to come around to the point where they may permit themselves to be coaxed into such projects – with the right incentives.

While not all current public incentivization of new hotel development displays this "convention center connection," much of it does. And. One of the *quid pro quos* that developers are being asked to give in return for the money can be, in these cases, blocks of rooms. The city may want you to build a new convention headquarters hotel enough to give you money to do it, but they may also want to know at the end of the day, that you are going to cough up the rooms when the city has a chance to book a big group.

EVERYBODY'S DOING IT

The list of governments and quasi-governmental agencies that are providing development incentives for new hotels reads like a "Who's Who" of American cities. Here are just a few of the recent and current efforts:

Atlantic City: The City Redevelopment Agency has provided low-cost financing to assist a number of the market's casino hotels to expand.

Austin: The city offered a fixed payment in lieu of property taxes (also called a PILOT), one-half of the payment to increase with inflation and the other half to remain flat for 10 years.

Baltimore: Property tax abatements and property tax abatements again. Both the new Marriott and the new downtown convention hotel are getting 10 years' worth.

Cambridge, MD: A ±350-room Hyatt Resort is apparently being funded with bonds issued by the Maryland Economic Development Department. Property tax and some sales tax abatements are also being provided.

Charlotte: Some development cash and a guaranteed lease by the city for a portion of the connected parking garage are planned to improve the economics of the ±700-room Westin planned for downtown, across the street from the convention center.

Chicago: The 800-room Hyatt McCormick Place was partially financed with bonds floated by the Metropolitan Pier and Exposition Authority. The property was constructed adjacent to McCormick Center, one of the nation's largest center-city convention centers, which was expanded in 1997.

Houston: The story of Houston's public involvement in hotel development is a saga worthy of its

own article. Most recently, however, the City Council has approved a plan to go forward with a new convention center hotel that is owned entirely by the public and financed with revenue bonds. The city would also contribute public land valued at $14 as equity for the project.

Indianapolis: The developer of the Marriott Convention Center here gets to lease the land for $1/year.

Miami Beach: Government incentivization assisted in the on-going renaissance of the art-deco Miami Beach market. The newly-constructed 800-room Loew's received a reported $60 million in incentives. The adjacent Crowne Plaza (new construction) also received public funding.

Philadelphia: The ±1200-room Marriott Convention Center started the trend in this city, helped along with both city-sponsored financing and a property tax abatement. Today, hotel projects being offered tax incentives by the city here are more common than those that are not. One recent example includes the new Courtyard by Marriott's tax increment financing.

Pittsburgh: The local transportation authority reportedly floated bonds to pave the way for the new ±300-Room Hyatt Conference Center on the airport terminal grounds.

Sacramento: A new 500-room Sheraton is under construction, and under subsidy, in the downtown area, next to the convention center. A parking garage, $8 million in cash, and a public bond offering have helped to bring this project to fruition.

San Diego: It looks like San Diego is going to get a new 1,200 to 1,500 room convention hotel. It is rumored (not yet confirmed) that the Port Authority is going to relieve the developer of the financial burden of building the necessary parking and of performing certain site improvements, which may include some substantial amounts for environmental clean-up.

Scranton: Scranton is negotiating. Reportedly, public offers to hotel developers considering building a conference center hotel in downtown have included a $10 million development grant (a federal subsidy), free land, a commitment from the city to provide parking, and a 10-year freeze on the property's tax assessment at the current level.

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Tucson: The county is offering a 75 percent rebate for the first 10 years of the lodging tax (two percent) that the new Marriott Resort will generate.

Tulsa: Tax increment financing aided and abetted the development of the Hotel Ambassador, which opened in early 1999.

And there's more, much, much more. Fort Lauderdale; New York City; Denver; Iron River, Michigan; Cambridge, Maryland; Washington County, Pennsylvania, the list goes on. Big and small, urban and suburban, communities throughout the U.S. are putting their money where their mouths are.

THE BOTTOM LINE

What can only be described as massive public incentivizing of lodging development is certain to effect the hotel development cycles in the markets where it is taking place. In some cases, the news will be good. In some markets, new hotel rooms are really needed to enable the market as a whole to grow. The Philadelphia story, referred to above, is a good example. When the 1,200-room Marriott opened in 1995, the new rooms represented a substantial addition to supply: about 16 percent to the total Philadelphia market's supply and as much as 33 percent to the core CBD's supply. The potential for significant supply-side dilution was certainly there, but dilution is not what happened. Growth in demand for hotel rooms commensurate with the growth in supply is what happened. In the same year demand in the greater Philadelphia market grew by 17 percent, and by as much as 35 percent

within the core CBD. Demand growth of 11 percent (both market-wide and in the core CBD) followed the year after. Thus, market-wide occupancies remained flat at first, and then grew. Market-wide room rates then grew. And, ultimately everybody won. In this case, the new hotel rooms were needed to enable the then-new convention center to work. In Philadelphia, the new hotel rooms were to the market and the convention center what gasoline is to an engine: you need it to make it go. In the positive economic conditions of the middle and late 1990s, Philadelphia-like stories are occurring more and more. In these markets, the new, government-approved and -encouraged hotel development may be helping along the values of pre-existing hotels by increasing everyone's occupancies, average rates, net incomes, and (all things being equal) values. In these markets, government incentives are helping the natural hotel market cycle along.

But in other markets, the story is not going to be as sanguine. Go back to the conventional wisdom: when hotel markets receive material amounts of new supply and cannot grow demand commensurately, occupancy declines. And so go, usually, average rates, revenues, net incomes, and (all things being equal), values. In these markets, government's economic intervention to spur new hotel room development before economic nature has taken its economic course may delay or prevent these markets from ascending the up-curve of the typical hotel cycle for a long time to come – at least this time around. In these markets, existing hotel owners may see their values decline as the new, government-subsidized rooms open and reach maturity within the marketplace. I would expect the future to bring us some unhappy hotel owners in these markets. REI

NOTES

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