How To Improve Feasibility Studies
by Stanley Turkel, MHS, ISHC

Marcus & Millichap, the nation's largest real estate brokerage firm, recently released its National Hospitality Research Report for Spring 2004, which indicates the hospitality industry is on the cusp of the next wave of expansion. Robert B. Hicks, national director of Marcus & Millichap's National Hospitality Group said, "Lenders have opened their coffers to hotels, giving hospitality investors the opportunity to benefit from historically low interest rates. This will aid in the hospitality market's recovery as fundamentals are expected to make substantial gains in the next 24 months."

As the national economy improves, new hotels are being planned to meet the increased demand. These hotel projects will require feasibility studies to measure market demand and to prove that they are economically viable. In order to avoid the problems of overbuilding, these new studies should focus on the major question: is there a market for this hotel at this location? and several related questions: where is that market, how large is it, what are its needs, how is it currently being served and what share can be captured? Will the new hotel meet the market's needs better than the existing properties?

To make these studies more realistic, I recommend we take a fresh look at their methodology, including the following important issues:

- Occupancy and average daily rate projections should reflect the real volatility in the marketplace. There should be an genuine analysis of the tradeoffs inherent in the yield management decisions and internet competition as they pertain to both market penetration and revenue maximization.

- There should be a serious analysis of the relative profitability of the food and beverage outlets beyond the misleading departmental profit margins provided by the Uniform System of Accounts. The feasibility study analysis should enable owners to decide whether to manage, lease, franchise or shut down the food outlets.

- Marketing expenses are usually projected as four to six percent of gross revenues. In a new hotel, this is about half of what is needed in the first few years of operation.

- In it's excellent report Cap Ex 2000, the International Society of Hospitality Consultants stated that "three percent of gross revenue isn't even close to being enough in terms of the true amount of capital spending which will be needed in the future to keep a hotel competitive." New feasibility studies should review this report and take special note of the recommendation that estimated future capital expenditures range from 7.5 to 8.8 percent of gross revenues for the three most common types of hotels.

- The feasibility study needs to analyze the cost/ benefit value of the productivity of the franchise system. A good feasibility study should also discuss the dangers of encroachment by additional franchises in the marketing area and if objective impact studies can preserve the hotel's RevPAR performance.

- There should be constructive criticism of the management contract regarding basic and incentive fees. In the current economic environment, a good study will discuss the benefits of performance standards as a basic for incentive fees and termination clauses. The study should also investigate the purchasing policies of the management company.

- One of the most critical subjects in determining the success of the new project is the level of debt and interest rates. The feasibility study should report on the relationship between projected bottom-line results and the level of debt service for the subject hotel and its competitive set.

- Finally, sensitivity analyses should be undertaken to enable owners to understand the range of alternatives under various assumptions of reasonableness and uncertainty.

As stated in “Marketing Leadership in Hospitality”, (Robert C. Lewis, Ph. D., Richard E. Chambers, MBA, Harsha E. Chacko, Ph. D., Van Nostrand Reinhold, New York (1995) p. 169). “A market feasibility study should have only one purpose: to show the opportunity to attract that many customers, to pay that price, to come to that property, over a period of time. That’s the hard part. Once done, the easier part is to estimate revenue, subtract cost, predict net and cash flow, and determine whether the project is “feasible” – that is, a financial opportunity…. In marketing, opportunities depend on creating paying customers – and nothing else.”

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