

# Select-Service Hotels: A Guide to Understanding the Lodging Industry and One of Its Most Attractive Segments

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Master of Science in Real Estate Development

at the

Massachusetts Institute of Technology

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## **ABSTRACT**

This thesis serves as a pedagogical guide to the hospitality industry, and presents a broad overview of the unique issues that arise through the development, ownership and management of select-service franchised hotels. It attempts to answer the following four questions:

- How is the lodging industry organized?
- How has the industry changed over time, and where is the industry headed?
- What hotel product type is particularly attractive from a development, investment and operational standpoint?
- What are the issues to be aware of when developing this particular product?

To answer the first two questions, Section One of this paper offers a full discussion of the industry evolution and focuses on three major innovations that have been gaining momentum in the lodging industry. These innovations are the trends toward franchising, market segmentation, and the "life-style" brand. The study will describe how franchise and management relationships have gained strength in the lodging industry since their introduction in the mid-twentieth century. The study will then explore the intricacies of the on-going process of market segmentation. Through market segmentation, hotel firms have been able to create and introduce greater operationally efficient hotel typologies, one of which is the select-service hotel. Finally, this section of the thesis will explain how the third innovation--that of the "life-style" brand hotel--combined with the ideas of franchising and of operationally efficient product types, has borne into the hotel market a new and exciting product, the select-service franchised life-style hotel called Aloft.

Section Two of the study will address the third and fourth questions by presenting a broad overview of the development process for a hotel of this type, as well as highlight the most pertinent issues and requirements that are associated with such a development. Additionally, this section will explore the relationships associated with owning and operating a franchised hotel, and the advantages and pitfalls of owning and building an asset under such an arrangement.

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# TABLE OF CONTENTS

I. INTRODUCTION .....	7
SECTION 1 .....	9
II. THE HOSPITALITY AND LODGING INDUSTRY: The Industry Evolution .....	9
The Earliest Years.....	9
The Railroad and Depot Hotel.....	10
The First Hotel Boom and the Depression Years .....	10
Post World War II and the Prosperous 1950s .....	11
The Birth of the Motel.....	12
The First Hotel Franchise .....	13
Tax Code Changes Spur Growth.....	14
The Rise of Air Travel.....	14
The 1970s and the Energy Crisis.....	15
Industry Growth and Consolidation - The 80s & Beyond.....	15
III. FRANCHISING.....	19
A Brief History of Franchising .....	19
Hotel Franchising: A Closer Look .....	20
IV. HOSPITALITY SEGMENTS: A Brief Description.....	30
Classification According to Smith Travel Research.....	31
Smith Travel Research - Chain Scale Categories .....	31
The Consumer's Classification System.....	33
An Alternative Classification Methodology .....	35
New Product Types Arise from Segmentation.....	37
V. THE LIMITED-SERVICE HOTEL SEGEMENT .....	40
Growth of Limited-service.....	40
The Limited-service Advantage.....	41
Ease of Development.....	41
Ease of Operation.....	42
Comparative Risk Analysis .....	43
A More Profitable Product.....	45
The Segment is Further Refined.....	47
VI. ALOFT: The Next Generation of Select-Service .....	49
Aloft: The Prototype .....	50
Aloft Design Features: A "Lifestyle" Brand.....	51
Franchising with Starwood: A Case for Franchising .....	54
Development Advantages .....	56
Operating Advantages .....	59
SECTION 2.....	64
VII. THE PROCESS: A Franchised Hotel Development .....	66
VIII.DEAL PURSUIT AND SITE IDENTIFICATION.....	68
The Initial Market Study .....	68
The Formal Market Study.....	71

Evaluate Site & Locational Characteristics.....	73
Quantify Lodging Demand .....	74
Quantify Competitive Lodging Supply .....	75
Current Supply vs. Proposed Hotel Comparison .....	76
Forecast Revenue & Expenses.....	77
Estimate Construction Cost and Market Value: .....	79
IX. PRE-DEVELOPMENT.....	81
Franchise Agreement.....	81
Application Fee .....	84
Operational Fees.....	84
Licensor’s Responsibilities.....	86
Licensee’s Responsibilities.....	86
Territorial Restrictions.....	87
Management Contracts & Duties .....	88
Staffing a Select-Service Hotel.....	90
Management Rights and Duties of Manager .....	92
Management Compensation .....	96
Obligations of Owner .....	98
Financing.....	99
Hotel Investment Risks .....	99
Securing Debt Financing.....	103
A Few Words on Debt Financing .....	105
Selecting an Equity Partner .....	107
Expected Returns .....	109
X. HOTEL CONSTRUCTION.....	111
XI. PRE-OPENING AND OPERATIONS.....	114
Pre-Opening.....	114
Operations.....	117
XII. CONCLUSION.....	119
APPENDIX A – Major Hotel Companies and Affiliated Brands.....	120
APPENDIX B – STR Chain Scale Report .....	121
APPENDIX C – Aloft Facilities Program and Development Summary .....	122
APPENDIX D – Sample Aloft Profit and Loss Analysis & Valuation.....	123
APPENDIX E – FF&E Summary .....	124
APPENDIX F – OS&E Summary .....	125
GLOSSARY OF HOSPITALITY TERM DEFINITIONS.....	126
REFERENCES.....	128

## TABLE OF EXHIBITS

Exhibit 1 : Chain Scale Room Revenue Share .....	32
Exhibit 2 : Hotel.com Star System.....	34
Exhibit 3 : Industry Segment Organization Chart (Alternative Methodology) .....	36
Exhibit 4 : Comparative P&L Reports .....	46
Exhibit 5 : Select-Service Hotel Development Task Timeline.....	65
Exhibit 6 : Lodging Demand Correlation with Real GDP Growth.....	72
Exhibit 7 : Operational Expense Breakdown .....	78
Exhibit 8 : Select-service Staffing Requirements.....	92
Exhibit 9 : Aloft Hard & Soft Construction Cost Summary .....	112

## I. INTRODUCTION

The lodging industry can present many attractive real estate investment, development, and ownership opportunities. However, for the uninformed investor or novice developer, understanding this industry may seem like a daunting task. This study has been designed as a pedagogical review of the hospitality industry as it is positioned in today's marketplace. It will start with a historical review of the development of the hospitality industry. Next, the focus of this study will shift to an in-depth exploration of an attractive segment within the lodging industry. A case study will be presented as a medium for discussion and exploration of the development and ownership nuances associated with select-service hotels.

In reviewing the historical evolution of the hospitality industry, three significant innovations will be identified as forces that have shaped and continue to shape the industry. Application of the franchise business model to the hotel industry is the first major innovation that is mentioned. The complex product and market differentiation process known as "segmentation" is the second important agent of change that has exerted its influence from the very inception of the industry. The paper will describe how continuous product refinement has led hotel firms to strive toward optimal operational efficiency in an effort to increase profits. The third and final innovation represents a generational "changing of the guard" within the hospitality industry. As the rising youth of the workforce and travel population gain market share, they bring unique lifestyle preferences. These preferences have shaped the supremely popular hotel environment dubbed the "life-style brand."

Once these three innovations have been identified and explored, the study discusses how they converge to form a specific hotel product. The study will break down the

development and operational advantages of such a product, particularly as it relates to the franchising of a national hotel brand. To highlight such advantageous characteristics, the latest select-service hotel product, the Aloft Hotel from Starwood, is used as a case study.

Section Two of this study shifts perspective to investigate a typical development of a select-service hotel product. This section serves as a pedagogical manual outlining how a hotel development of this type is executed from “cradle to grave.” Following a chronological task list which serves as an outline for the second section, the study examines the deal pursuit process, the pre-development phase, the typical financing strategies, and finally the pre-opening and operational stage of a select-service hotel development undertaking. This section also highlights the important and unique relationships and contracts that exist between the franchisor and franchisee, as well as the traditional management agreements between the hotel owner and operator.

Information has been gathered from numerous sources to devise this study. In addition to several industry specific texts, articles and trade journals; documentation provided by actual hotel owners and operators has been incorporated. Additionally, Starwood Hotels and Resorts Worldwide, Inc. provided access to confidential development information and resources in order to assist in the compilation of information for this study. To obtain the most current operational and development perspectives, interviews with industry leaders in development, ownership, and management was undertaken. The purpose of this study is to serve as a guide in understanding the evolution of the lodging industry, the intricacies of industry’s organizational system, the advantages of the select-service hotel product, and finally, several essential aspects associated with the process of developing and operating a select-service franchised hotel.



## SECTION 1

### II. THE HOSPITALITY AND LODGING INDUSTRY: The Industry Evolution

#### *The Earliest Years*

From its inception, the hospitality industry has grown and developed in response to the changing needs of those who travel for either business or pleasure. Therefore, as modes of transportation and commerce have evolved, the hospitality industry has been continuously reinvented to serve travelers.<sup>1</sup> Records dating back to 500 B.C. are the first documenting a commercial and leisure demand for lodging. In fact, many advanced societies including Babylonian, Greek, Egyptian, Roman and Asian had inns and taverns located near temples, in major centers of commerce or along well-established roadways. Throughout the Middle Ages, religious pilgrimages gave rise to lodging within monasteries, inns and hospices owned by the Church. It wasn't until the 13<sup>th</sup> century that a more formal organization of inns was formed in Florence, Italy to house the many visitors coming to view the city's impressive collection of Renaissance art and architecture.

In the 1700s the hospitality industry truly began to take a new form. The *posting inn*, created to provide lodging to mail-carrying coachmen, established the initial network of inns throughout England. Soon, the posting inn gave way to the traditional English inn and the Colonial inn, both of which preceded the hotel network which developed throughout Europe and the United States respectively. During this period, travel by

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<sup>1</sup> Ransley, J., & Ingram, H. (2004). *Developing Hospitality Properties & Facilities* (2nd ed.). Oxford: Elsevier Ltd. p.5

either ship or horse-drawn carriage created a need for these forms of hospitality to be located primarily in major towns or key ports.<sup>2</sup>

### ***The Railroad and Depot Hotel***

With the advent and rapid expansion of the railroad system in the mid-1800s, lodging facilities began to locate adjacent to railroad depots.<sup>3</sup> The local inn became a point of pride for many newly established American cities. As the railroad stretched west, every new outpost city established an inn or tavern to accommodate visitors. In the major cities of the east coast (Boston, New York & Philadelphia) hotel innovation was already in full swing. As these cities grew economically, geographically and in population at a rapid rate, new and elaborate hotels began to emerge which incorporated the technological advances of the time. Advances including running water, electricity, telephone and the elevator helped each generation of hotels push the previous generation into obsolescence.<sup>4</sup> Yet, the most interesting changes in the hotel industry were yet to come.

### ***The First Hotel Boom and the Depression Years***

Throughout the roaring 1920s, the hotel industry boomed and expanded – much like the American economy in general. This period in time marked the first major hotel development boom.<sup>5</sup> Unfortunately, also like the American economy, the hospitality

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<sup>2</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. pp.1-5

<sup>3</sup> Rutes, W. A., Penner, R. H., & Adams, L. (2001). *Hotel Design, Planning & Development*. New York: Architectural Press. p.10

<sup>4</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. pp.4-6

<sup>5</sup> Rutes, W. A., Penner, R. H., & Adams, L. (2001). *Hotel Design, Planning & Development*. New York: Architectural Press. p.5

industry suffered immensely with the stock market crash of 1929 and the onset of the Depression. Almost immediately, the hospitality industry stopped expanding and started to contract. With little to no commercial demand and even fewer leisure customers, many properties fell into foreclosure. Yet, for those individuals whose financial resources remained relatively liquid, the Depression years and the decade that followed offered vast opportunities. Conrad Hilton was one of these individuals. The boom of the 1920s and the subsequent precipitous drop in property values of the 1930s allowed Hilton to establish the first hotel chain as he purchased several landmark hotels in major cities for a fraction of their original cost. Earnest Henderson, founder of the Sheraton brand, was also able to capitalize on the economic doldrums of the 1930s.<sup>6</sup>

### ***Post World War II and the Prosperous 1950s***

As the general economy rebounded in the 1940s, so too did the hospitality industry. When automobiles displaced trains as the preferred means of travel, the rail-side hotels became increasingly less desirable and less relevant to the needs of the traveling population. Large-scale expansion in the hospitality industry was constrained due to the material and resource needs of the military during World War II. Therefore, it wasn't until the 1950s that there was another sustained period of growth and further transformation within the industry. The prosperity of the 1950s provided Americans with the financial means and physical infrastructure to stretch their legs, which contributed to the second major hotel boom.<sup>7</sup>

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<sup>6</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. pp.5-7

<sup>7</sup> Rutes, W. A., Penner, R. H., & Adams, L. (2001). *Hotel Design, Planning & Development*. New York: Architectural Press. p.10

## *The Birth of the Motel*

The Interstate Highway Act of 1956 as well as the continued popularization of the automobile all but eliminated the demand for hotels in near railways. This period of time was defined by unprecedented suburban sprawl. Proximity to urban areas carried a negative connotation for many homeowners as suburban neighborhoods and business parks came into vogue. With these changes, it made more sense for this new generation of hotel to be located along the interstate, near cities or major interchanges. This phenomenon led to the birth to the “motel”.<sup>8</sup> Originally referred to as “motor courts,” the early motels were often a cluster of cabins along the side of the interstate. In 1954 the Ramada was introduced in Flagstaff, Arizona. The first Ramada was called a “motor hotel” and literally translated from Spanish meant “a shaded resting place.”<sup>9</sup> As Route 66 grew in popularity as a means of cross-country travel, motor courts became more sophisticated “fully integrated buildings under a single roof [offering] rooms [that] were plain and functional, and facades that took advantage of regional styles.”<sup>10</sup>

Originally, the motel was a meant to provide business and leisure travelers with a lodging option that was more economical than the full-service hotels generally located in the city. As such, the motel was effectively the original “limited-service” hospitality product generally offering a room and scant amenities. Additionally, motels were typically smaller, located in secondary locations and built and managed to a lower standard than full-service hotels. Yet, because of the relative ease of building motels, the competition increased and existing owners looked for a way to differentiate their motel from others. This was accomplished through adding amenities and services, increasing the number of rooms and improving the construction quality. By the late

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<sup>8</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. pp.7-8

<sup>9</sup> *American Hotel & Lodging Association: The History of Lodging*. Retrieved from [http://www.ahla.com/products\\_lodging\\_history.asp](http://www.ahla.com/products_lodging_history.asp)

<sup>10</sup> *Motel Americana: The History of the Motel*. Retrieved from <http://www.sjsu.edu/faculty/wooda/motel/history/index.html>

1960s, the characteristics that defined a motel had blended with those of that defined the hotel and the two were becoming somewhat indistinguishable hotel product types. Over time, the term motel became synonymous with low-end spartan lodging which spurred a movement within the lodging industry to eliminate the use of the term all together. In the present day, there are few facilities that carry the motel moniker.

### *The First Hotel Franchise*

One of the most powerful methods of differentiating these properties was introduced to the hospitality industry by an entrepreneur from Memphis named Kemmons Wilson. Kemmons Wilson, developer of the Holiday Inn hotel chain, focused on providing the traveling individual with an experience he could rely on. Wilson expanded the Holiday Inn chain rapidly by developing the first hospitality franchise system.<sup>11</sup> Through Wilson's franchise system, he sold a license to use the Holiday Inn brand, operational plan and eventually the reservation system to other property owners. In return, these hotel owners paid Wilson fees based on the revenues generated by their property. Wilson and others immediately recognized the benefit of this system as it allowed the Holiday Inn brand to expand from one location to over 100 Holiday Inns over the course of 7 years.<sup>12</sup> This franchise system evolved over time, but was vital in laying the groundwork for a business strategy that revolutionized the hospitality industry.

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<sup>11</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. p.8

<sup>12</sup> Brewster, M (2004) Business Week: Kemmons Wilson: America's Innkeeper.  
[http://www.businessweek.com/bwdaily/dnflash/oct2004/nf2004111\\_3044\\_db078.htm](http://www.businessweek.com/bwdaily/dnflash/oct2004/nf2004111_3044_db078.htm)

## *Tax Code Changes Spur Growth*

There was another change in the 1950s that helped catalyze the expansion of the hospitality from 600,000 rooms nationwide to 1.5M rooms. The 1954 Amendment to the Federal Tax Code changed the Section 112(b)(1) number to Section 1031 permitting accelerating depreciation of real property and outlined the terms for like-kind exchanges.<sup>13</sup> This change made all forms of real estate ownership and development a more attractive investment vehicle to businesses since under the new law income taxes could theoretically be deferred indefinitely. The favorable tax change contributed significantly to the establishment of many now-familiar hospitality companies, including Marriott, Howard Johnson, Intercontinental, Radisson and Hyatt. Many of these companies grew out of other organizations that had made their initial fortune in a business that was completely unrelated to real estate or the lodging industry. Under the revised code, the more these firms invested in real estate, the more they could utilize the depreciation associated with the real estate to shield the income produced by their other lines of business. In the 1980s the tax laws changed again, eliminating many of the income tax benefits that had drawn these firms into the hotel industry in the first place. Yet, having established profitable businesses in the lodging sector, many of these firms continued to expand through the employment of the franchise system.<sup>14</sup>

## *The Rise of Air Travel*

Throughout the 1960s, air travel became an increasingly popular method of transportation. As air travel gained popularity, the hospitality industry again evolved to satisfy the “jet setters”. Airport hotel locations became a highly attractive asset.

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<sup>13</sup> Exeter Co. 1031 Exchange Services. Retrieved from [http://www.exeterco.com/History\\_Section\\_1031.aspx](http://www.exeterco.com/History_Section_1031.aspx)

<sup>14</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. p.9

Beginning in the 1960s and extending into the 1970s, many of the larger hotel chains were actually affiliated or owned by the major airlines.<sup>15</sup> The synergy between the hotel industry and the air travel industry was ultimately overestimated and virtually all of these relationships have since dissolved. Nevertheless, the airport hotel continues to be a very valuable asset and new airport hotel developments are still highly sought after.

### ***The 1970s and the Energy Crisis***

The 1970s brought another building boom, which was quickly followed by a subsequent bust as the energy crisis effectively put a halt to most leisure travel and significantly reduced business travel. As a result, the hospitality industry refined its management practices to optimize their operational efficiency. In many cases it was determined that the ancillary functions of hotels (function rooms, restaurants and other amenities) simply did not make economic sense. Additionally, due to the “amenity creep” that had occurred within the motel sub-segment, the no-frills economical hotel had essentially disappeared. In response to this gap in the market, the budget hotel was re-born, thus marking the conventionally recognized commencement of segmentation within the hotel industry had begun.<sup>16</sup>

### ***Industry Growth and Consolidation – The 80s & Beyond***

The 1980s ushered in a period of massive expansion, primarily marked by market segmentation and widespread application of the maturing franchise business model.

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<sup>15</sup> Rutes, W. A., Penner, R. H., & Adams, L. (2001). *Hotel Design, Planning & Development*. New York: Architectural Press. p.11

<sup>16</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. p.12

This period in time represents the third major hotel boom.<sup>17</sup> Prior to the age of market segmentation, many of the major hotel chains had difficulty expanding their brand and growing profits without re-entering markets in which they already had an established presence. Yet, by the 1980s, identifying new market sub-segments had become a science that many of the large hospitality organizations spent millions of dollars researching. Recognizing an under-serviced segment or sub-segment of the population and creating a product that catered to that population's specific needs and desires allowed newly affiliated hotel brands to proliferate while providing the parent company with sustained growth for its shareholders.

Reinventing the hotel industry by creating tiers of hotel products to satisfy the needs of the different guest typologies proved to be a highly effective growth strategy. For example, this market segmentation allowed Holiday Inn to provide mid-range rooms and services to its mid-range customers and up-scale services and accommodations to its up-scale clientele through its new brand, the Crowne Plaza. Additionally, these two hotels could be located in the same market without competing for the same customers. Collaborating with franchisors allowed the brand to expand rapidly and without major capital investment by the parent company. Many of the major hospitality companies caught on to the concept and created new service tiers of their flagship brand and worked through real estate developers and owners to roll out their new products. New hotel types are being created constantly to serve the specialized needs of particular types of travelers or newly identified markets.

The hospitality industry has also gone through a major consolidation in recent years. Globalization has impacted the competitiveness of the smaller firms in basically all industries, with the hospitality industry being no exception. Most major hospitality firms are publicly traded, and as such, management is charged with the task of

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<sup>17</sup> Rutes, W. A., Penner, R. H., & Adams, L. (2001). *Hotel Design, Planning & Development*. New York: Architectural Press. pp.11-12



constantly growing earnings. As Rushmore puts it, “market segmentation continued to represent a viable approach to achieve earnings growth, [but] a far more efficient means to the end was commonly-practiced in the mid- to late 1990’s in the form of strategic acquisitions and mergers.”<sup>18</sup>

In recent years, the popularity that has been generated by what are termed “boutique” hotels has encouraged the hospitality industry to look at market segmentation through a slightly different lens. The popularity of the boutique hotel came largely as a result of the public’s attraction to differentiation and distinctive style. Hotel firms learned that modern guests gravitate toward an environment that is less sterile, more unique and more in line with how individuals view their lives. This gave rise to the latest incarnation of market segmentation – the creation of an environment typology coined the “lifestyle” brand. Eager to capitalize on the new trend that boutique hotels seemed to have stumbled upon, the hospitality industry studied the ingredients necessary to engender customer excitement and brand loyalty within the various segments of the market. By identifying the proper formula necessary for each segment, hotel firms could then build or reshape a hotel brand around that concept. The Ernst & Young’s 2006 Lodging Report explains that hospitality firms are, “focusing not only on guests’ basic product needs and preferences, but also on creating a unique lodging experience that ties into guests’ way of life, self-image, and interests, and delivers self-expressive benefits.” The product of this round of evolution within the industry is the lifestyle brand hotels, the cutting edge of the industry.<sup>19</sup> The W hotel by Starwood was the first major hotel brand to incorporate this type of environment on a large-scale basis.

In the sections that follow, the study will look more closely at two of the most recent and significant innovations that have occurred in the lodging industry. The existence and proliferation of the franchise model throughout the hospitality industry will be

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<sup>18</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. pp. 11-22

<sup>19</sup> *The 2006 U.S. Lodging Report* (Rep.). (2007). Ernst & Young. p.7

discussed first. Market segmentation will then be explored in relative depth. Through the discussion of market segmentation and franchising, the study will then look at how these two fundamental constructs in the hospitality industry have been combined with a third innovation, the lifestyle brand, to create a new and exciting hotel product.

### III. FRANCHISING

#### *A Brief History of Franchising*

From fast food to gas stations to professional athletic teams, the existence and proliferation of the franchise system through many business genres has shown what a powerful and viable business strategy it can be. Although some accounts of archaic franchise systems can be traced back as far as the time of the Roman Empire, most experts agree that the first appearance of franchising on a large scale came in the Middle Ages in Europe. The word “franchise” is derived from Old French meaning “freedom” or “privilege” and originally referred to the rights that were granted to people of a specific region to undertake a commercial venture on the land owned by the residing noble. These rights in essence allowed that particular family or organization to have exclusive rights to run that commercial activity in that particular region. Franchising evolved as societies and economies evolved. The Singer Sewing Machine Company is widely recognized for having developed the direct predecessor of the modern franchise agreement while creating a distribution network for their sewing machines.<sup>20</sup>

The model introduced by Singer expanded rapidly in the 1950s. This era ushered in a baby-boom, a time when the population of the United States grew at an unprecedented rate. Adding to the mobility of the growing American population, the Interstate Highway Act, which commissioned hundreds of thousands of miles of new interstate highway systems to be built, helped spur the growth of the automobile industry. The American public was increasing in size and traveling further from home, but still sought out familiar names, brands and services. In response to the societal sprawl and need to reach its ever-growing client base, the automobile industry employed Singer’s franchise model for car dealerships. This environment was fertile soil for franchising in

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<sup>20</sup>*The History of Franchising*. Retrieved from <http://www.franinfo.com/history.html>

many industries. Over the course of the next 30 years, franchising grew exponentially, reaching its height in the 1980s. Today in the United States, over \$1 trillion in goods and services are sold every year through franchises, there are over 650,000 individual franchise outlets and over 300 different industries are involved in franchising.<sup>21</sup>

### *Hotel Franchising: A Closer Look*

Recognizing the massive impact that the franchising system has made on the business world in general and the lodging industry in particular, this section will explore in greater detail the general mechanisms of that system with respect to the lodging industry. It has truly been a force of change within the industry since its introduction in the early 1950s and continues to gain momentum for reasons that will be explained below.

In the late 1980s and early 1990s, hospitality firms along with most entities that held real estate assets realized the negative effects of holding an abundance of highly leveraged properties on their books. As the recession of the 1990s hit, a rash of foreclosures ensued, ultimately leading to the famed Savings & Loan crisis. Reeling from this extreme downturn in the market, the hospitality industry underwent a transformation. Hospitality firms became very cautious and selective about the properties in which they would invest significant equity. Barring a few exceptions, these firms exited the real estate ownership business and looked to other applications to grow their brand. These firms found success in effectively licensing their brands through franchising or management agreements.

Before continuing to further explore the preponderance of brand affiliation within the industry, it is important to understand the relatively subtle distinction between a

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<sup>21</sup> McGraw Consulting. Retrieved from <http://www.mcgrow.com/history.htm>

management contract arrangement with a particular hospitality firm and a franchise relationship. Through a management agreement, a developer or owner of a hotel would contract with a firm like Marriott to have them manage the hotel for a period of time (typically 20 years). As part of the management agreement, the hotel company would brand that particular hotel with the most logical and appropriate brand within their family and run the property according to the standards that are established for that brand. Therefore, under a direct management contract arrangement, the hotel firm is not only provides the brand, but also provides the management services. This form of management is common among larger upper-scale projects where the hospitality company can capitalize on the economies of scale while also retaining more brand control on the higher-profile larger hotels. Although many of the upper tier hotels are affiliated through management contracts with a major flag, franchising is virtually ubiquitous.

The franchise arrangement differs in that a hotel company simply licenses the owner or developer the brand name and operating system for a period (also generally 20 years) but is not contracted to management the property. Typically a third party hotel manager is contracted to operate the hotel. Since this type of arrangement is common among smaller hotels that provide fewer services, it is not worth it to the hotel firm to management the property. Under both arrangements, the hotel firm assesses fees for the services it provides. Due to the widespread use of hotel management contracts and franchises, few hotels operating as part of a national chain are actually owned by that chain. Chain affiliation has increased from 35% in 1970 to approximately 80% in 2000.<sup>22</sup> Appendix A lists the current major hotel firms and their affiliated brands. In this study, we will focus primarily on the franchise arrangement.

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<sup>22</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. p.168

The traditional franchise arrangement established by Kemmons in the 1950s transformed into what was effectively a license or management agreement. This allowed property developers or owners to be associated with a particular flag for a period of time under very specific conditions. Revenue comes from the fees franchisors charge the franchisee. The fees are generated by room revenue, franchise applications and mark-up on proprietary supplies. A summary of the benefits of franchising to the franchisor is described below:<sup>23</sup>

- *Rapid, Inexpensive and Relatively Risk-free Proliferation of the Brand:* Employing the franchising system allowed hospitality firms to grow their market share in the relatively risk-less position of the franchisor. Having little to no real estate debt on their books meant that as franchisors, firms like Marriott, Hilton and Hyatt could explore less established market segments. Hotel firms were able to expand their reach without necessarily making significant capital outlays by employing the franchise arrangement. The more the brand branches out, the more recognition the brand receives and, theoretically, the higher the occupancy levels will be. Therefore, expansion of the brand brings more revenue through more hotels but also through higher fees.
- *Allied Expansion:* Many firms have established affiliated companies that are the sole-source or preferred provider of a specific necessary element of the franchise operation. For instance, a hospitality firm may establish a furniture company that is the only company a franchisee can purchase the furniture required under the FF&E specification of the franchise agreement. Most recently, it is common to find that the parent company of a particular online travel agency is also the parent company of a hotel firm. The parent company will allow discounted room rates for the hotel to be booked exclusively through its online travel

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<sup>23</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. p.180

agency, thereby receiving the credit from the franchisee for that particular booking and collecting the associated reservation fee.

The franchise model is not without its costs to the franchisor. As the market becomes more competitive, hospitality firms continue to work to improve the services they provide to entice developers and owners to franchise or contract with them. Below is an explanation of the disadvantages to the franchisor:

- *Dilution of the Brand:* As a hotel chain expands not only across the country but also across the world, control of the experience and policing practices become increasingly difficult but important. If not sufficiently monitored, brand dilution can significantly undermine any value that may have been generated by that brand. Consistency is the hallmark of the franchise and without consistency, the brand begins to disintegrate. Therefore, immense effort and time must be put into inspecting, supervising and enforcing the policies laid out in the franchise agreement.<sup>24</sup>
- *Franchise Services:* The franchisor must provide a specific suite of services to the franchisee as stipulated in the franchise agreement. These services may include development consulting, market and advertising, training and possibly even lines of credit. This costs the franchisor money and additional staff.<sup>25</sup>

The franchise model also provided hotel owners and potential developers (the franchisee) with value. Through this arrangement the franchisee could leverage the brand recognition, customer loyalty and marketing reach of the major hospitality firms

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<sup>24</sup> Langlois, T. (2003). Chain Hotels versus Independent Hotels: An Analysis of Branding, Room Revenue & Volatility (Master's thesis, Massachusetts Institute of Technology, 2003). *Master's Abstracts International*. p.9.

<sup>25</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. pp.180.

(franchisor) to improve their operations. The benefits to the owner or franchisee are enumerated below:<sup>26</sup>

- *Instant identity, recognition and image:* Unlike independent hotels, franchised chain hotels have a very uniform image and, if widely developed, are recognizable to a wide swath of the traveling population. Additionally, because of the uniformity of the brand, guests know what to expect and generally tend to be more loyal consumers.
- *Reservation and referral system:* The centralized reservation system allows guests to make reservations at any hotel in the chain by calling a single number. Good central reservation services account for between 15% and 30% of a property's occupancy.
- *Chain advertising and sales:* The corporate marketing effort allows the brand to generate more recognition and reach more potential guests. This is especially effective with large corporate customers.
- *Procedures Manual:* The procedures manual standardizes the management procedures and responsibilities to help create a consistent feel within all properties in the chain. Because franchisors stringently enforce the procedures outlined in the manual, they may also provide staff training to meet these standards.
- *Management Assistance:* Franchisors may provide additional assistance relating to the development and management of the hotel. These may include advice on planning, operations, sources for additional marketing or replacement FF&E.
- *Group Purchasing:* Economies of scale are very important in the negotiations for purchasing various items and services in the hospitality industry. Sometimes referred to as the "Wal-mart Effect", the larger or better positioned an

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<sup>26</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. pp.170-171.



organization or chain is the more purchasing power it will have. Independent hotels have virtually no purchasing leverage.

There are, of course, disadvantages to the franchise relationship from the franchisee's point of view. A summary of these is listed below:

- *Fees:* There are a variety of fees charged including an initial application fee, a percent of revenue (or royalty fee), a marketing fee and a reservation fee. The consolidated total fee that is typically charged to an owner by a franchisor is between 8% and 10%.<sup>27</sup> The hotel firms often provide a lower fee arrangement for new hotel brands that they are trying to introduce to the market and higher fees for more mature hotel brands.
- *Liability:* The franchise agreement generally locks the owner into a contract with that particular chain often for a period of 20-years and stipulates that the specific fees must be paid regardless of the performance of the property. If the franchisee attempts to break the agreement or is not managing the property up to the standards outlined in the franchise agreement, the franchisor can terminate the agreement and then sue the franchisee for liquidated damages. This may equal as much as three years worth of all fees based on the performance of the hotel over the preceding 12 month period.<sup>28</sup>
- *Competitive Encroachment:* The franchisee has little control or recourse if either a competitive property from a different flag or from their own flag gets established in the same market. As is described in *Hotel & Motel Management Magazine*, "Franchisees try to negotiate the best-possible territory protections when they sign a license agreement, but franchisors argue that rapidly changing market

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<sup>27</sup> Walsh, J. P. (2003, May 19). Fee Structures Under a Microscope. *Hotel & Motel Management*, 218.

<sup>28</sup> Stribling, D. (2006, June 1). No Place for Amateurs. *National Real Estate Investor*. Retrieved from [http://nreionline.com/mag/real\\_estate\\_no\\_place\\_amateurs/](http://nreionline.com/mag/real_estate_no_place_amateurs/)

dynamics, including new supply and depreciating assets, often render territory protection moot in a relative short period of time.”<sup>29</sup>

- *No Control Over Brand*: Another major negative of the franchise relationship from the point of view of the franchisee is periodic re-branding and adjustment of chain-wide standards. As part of the network of a particular brand whose marketing effort is centralized, the individual franchisee has little control over when, how and to what extent the brand may be altered and significant and costly adjustments would need to be made to their property. Although there are franchisee associations that can fight extraordinary re-branding demands, this is rarely successful. The franchisee typically has to simply adhere to the requirements or risk being in breach of the agreement.<sup>30</sup>
- *Additional Paperwork*: Since the franchise agreement may be consummated between a franchisor and a developer for an as of yet incomplete development, the introduction of an additional party in the form of the franchisor may either complicate or simplify matters during the financing and development stage of the project.
- *Loss of Flexibility*: As a practical matter it is very difficult for chains to develop and implement national positioning, pricing and promotional strategies and programs that meet the specific needs of all properties within their systems. Being an independent hotel can afford an owner greater flexibility in positioning a specific hotel against its competition. As an independent hotel, a property has the opportunity to "customize" its marketing program and pricing level to promote its uniqueness, specific strengths and special points of differentiation

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<sup>29</sup> Frabotta, D. (2001, September 17). Top Hotel Companies. *Hotel & Motel Management*, 216, 47. Retrieved May 28, 2007, from <http://web.ebscohost.com.libproxy.mit.edu/ehost/delivery?vid=47&hid>

<sup>30</sup> Langlois, T. (2003). Chain Hotels versus Independent Hotels: An Analysis of Branding, Room Revenue & Volatility (Master's thesis, Massachusetts Institute of Technology, 2003). *Master's Abstracts International*. pp.12-13.

and to specifically target where and how marketing and promotional dollars are spent.<sup>31</sup>

Ultimately, the decision of whether or not to brand a hotel project comes down to the projected revenue assumptions. Almost across the board, franchised chain hotels have higher revenue and occupancy numbers than their independent competitors. As is reported by a successful franchisor, “A franchise from one of the major names fetches a higher RevPAR (revenue per available room). If there is a Holiday Inn and a similar-level independent hotel next to each other, the RevPAR of the Holiday Inn will be much higher than that of the independent hotel.”<sup>32</sup> The value premium that brand affiliation provides to hotels is well documented in a recent study published in trade journal *Cornell Hotel and Restaurant Administration Quarterly*. The study concludes the following:

“As expected, we found that brands collectively have a significant [positive] effect on hotel values. More specifically, we found that hotel brands affect market values of four hotel types, namely, mid-scale without F&B, mid-scale with F&B, up-scale, and upper up-scale.”<sup>33</sup>

Though there have been some reports that the marketing edge once belonging to a well-known brand has been reduced due to on-line travel agencies, the general industry opinion is that brand recognition remains a marked advantage of a chain hotel. As Richard Kelleher, CEO of Pyramid Advisors and owner of 36 hotels across the United

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<sup>31</sup> Raleigh, L. (1999, May). *International Society of Hospitality Consultants*. Retrieved from <http://www.ishc.com/library/pubs/franchise.html>

<sup>32</sup> Shankar, P. (2003, April). Hospitality: Franchising Grows Big. *Siliconindia*.

<sup>33</sup> O'Neill, J. W., & Xiao, Q. (2006). The Role of Brand Affiliation in Hotel Market Valuation. *Cornell Hotel and Restaurant Administration Quarterly*, 47, 210-223. Retrieved from <http://intl-cqx.sagepub.com/cgi/content/abstract/47/3/210>

States declares, '[Brand-name hotels] are stronger than they've ever been. Brands today bring tremendous value to the real estate, but managing them is the challenge.'<sup>34</sup>

Chain or brand hotels have also been shown to be less risky investments than independent hotels. A recent study done by a graduate student at the Massachusetts Institute of Technology compared the RevPAR volatility of chain versus independent hotels. Analyzing data which represented over 3 million rooms spread across the country from 1987 to 2003, the research indicated that chain hotels were significantly less volatile with respect to room rate, illustrated by fewer and less dramatic fluctuations in the revenue per available room. From an investment standpoint, and holding other factors like operating costs, fees and taxes stable, less volatility equates to a more reliable revenue stream for chain hotels as an asset type. A more reliable revenue stream translates into lower risk which in turn means that the cash flow streams of chain hotels should be discounted less when their value is assessed.<sup>35</sup> Therefore, cash flow risk reduction is another benefit of branding a hotel.

Once a hotel owner or developer has made the decision to affiliate a property with a national brand, the developer or owner must choose which is the most appropriate flag for the particular property. The process of selection is relatively straightforward. A primary barometer for evaluating a franchisor's or chains performance has been the volume or percentage of business generated by the system's central reservation operations. Since there is often not a uniform method of calculating these reservations, other comparative methods should supplement this barometer.<sup>36</sup> Comparing the collective fee structures is also an important element in selecting the appropriate flag.

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<sup>34</sup> Haussman, G. (2007, June 6). *Hotel Interactive*. Retrieved from

[http://www.hotelinteractive.com/index.asp?page\\_id=5000&article\\_id=7903](http://www.hotelinteractive.com/index.asp?page_id=5000&article_id=7903)

<sup>35</sup> Langlois, T. (2003). Chain Hotels versus Independent Hotels: An Analysis of Branding, Room Revenue & Volatility (Master's thesis, Massachusetts Institute of Technology, 2003). *Master's Abstracts International*. p.63.

<sup>36</sup> Raleigh, L. (1999, May). *International Society of Hospitality Consultants*. Retrieved from <http://www.ishc.com/library/pubs/franchise.html>

Often owners divide the total franchise fees to be paid over a period of ten-years by the total expected room revenue to come up with a payout rate. With this an owner can determine the overall cost of an affiliation and directly compare the estimated costs of different franchises.<sup>37</sup> It is also important to understand all of the brands included under the parent company since there may be a brand that directly competes within the same family. Perhaps the most important factor is the brand's reputation as this has an enormous effect on pricing and guest loyalty.<sup>38</sup> It is a fact that some brands provide more value to their franchisees than others, therefore quantifying this element and overlaying the aforementioned factors are important steps for a developer or owner to take in order to chose the most appropriate and profitable brand for a property.

Clearly the movement toward brand affiliation has been a powerful force within the hospitality industry. Later, this study will examine in depth the contractual relationship between the franchisee and franchisor. Yet, before delving into the details of the franchise relationship, it is important to understand another force of change within lodging industry. The following section will explore the phenomenon of market segmentation and how it has shaped the rather complicated organization of this industry.

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<sup>37</sup> Guide analyzes hotel-franchise options. (2003, April 28). *Westchester County Business Journal*, 42, 22.

<sup>38</sup> O'Neill, J. W., & Xiao, Q. (2006). The Role of Brand Affiliation in Hotel Market Valuation. *Cornell Hotel and Restaurant Administration Quarterly*, 47, 210-223. Retrieved from <http://intl-cqx.sagepub.com/cgi/content/abstract/47/3/210>

## **IV. HOSPITALITY SEGMENTS: A Brief Description**

The hospitality industry has evolved, and continues to evolve through the process of market segmentation and refinement. The more the hospitality industry understands the discerning tastes and preferences of the guest population, the further the market becomes segmented. As a result, different varieties of hospitality products grow as these organizations work to gain market share. When the industry became aware of the demand for inexpensive, no-frills accommodations, the budget hotel or motel was developed to meet this demand. As casino gaming gathered momentum in places like Las Vegas, Reno and Atlantic City, the full-service gaming resort was established. This segmentation process has in many respects contributed to and arisen from the development of new industries – i.e. Disney World and the cruise industry.

Yet, in order to understand the current state of the hospitality industry, it is important to have a cursory grasp of the way the industry is organized. Market segmentation and its byproduct, product redefinition/reinvention, add considerable difficulty to attempts at organizing and classifying the properties within the industry. Despite this on-going evolution, there are several classification methodologies being utilized which group hotels according to particular factors. Some of these factors are the room rate (up-scale vs. economy), the service level (full-service vs. limited-service), the location (urban, suburban or resort), and even the identified clientele (airport, convention, etc).

Depending on the methodology being used, the classification may include one or more of these factors. Due to the varying classification practices being utilized within the industry, this study will first present two commonly referenced methodologies. As a means of obtaining a more universal organizational understanding of the industry, the study will introduce a methodology that is meant to incorporate a more holistic perspective of the products, rate scales and service tiers.

## *Classification According to Smith Travel Research*

Smith Travel Research (“STR”) is considered one of the authorities in hospitality market research. Many potential hospitality investors, researchers and developers in the United States utilize STR for industry and market statistics. Although STR also has a number of methodologies to classify products that are dependent on a variety of factors, the clearest categorization deals primarily with hotel chains and groups properties according to the room rate scale into which it falls. As described by STR “the chain scale segments are based primarily on the actual, system-wide average room rates of the major chains (independent hotels are included as a separate category).”<sup>39</sup> Therefore, the service level and amenity level is not explicitly factored into the categorization, but rather is assumed to be reflected in the room rates. Below is a listing of the scale classification used by STR in accordance with chain hotels as well as some of the more recognizable flags that would fall into each scale – a full Chain Scale Report from STR is attached as Appendix B.

### **Smith Travel Research – Chain Scale Categories**

- Luxury
  - Ritz-Carlton, Four-Seasons, Loews, Mandarin-Oriental, Inter-Continental, St. Regis
- Upper Up-scale
  - Marriott, Sheraton, Hyatt, Westin, Sonesta, Hilton
- Up-scale
  - Courtyard, Crowne Plaza, Four Points, Residence Inn, Wyndham Hotels
- Mid-scale with Food & Beverage
  - Best Western, Holiday Inn, Ramada, Howard Johnson, Quality Inn

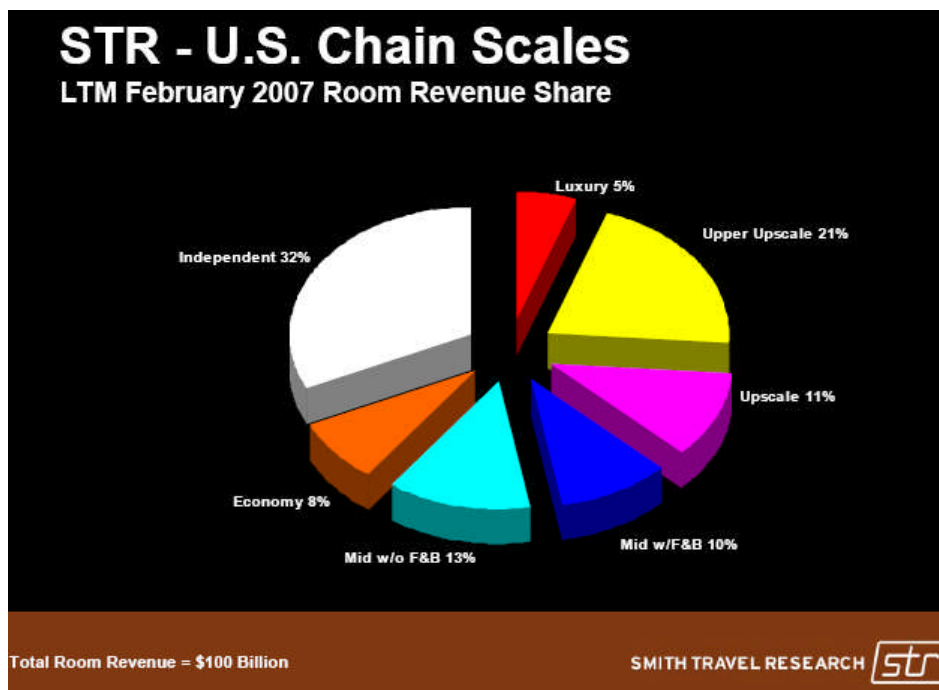
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<sup>39</sup> *Smith Travel Research*: <http://www.smithtravelresearch.com/smithtravelresearch/>

- Mid-scale without Food & Beverage
  - Comfort Inn, Hampton Inn, Fairfield Inn, Holiday Inn Express
- Economy
  - Days Inn, Econolodge, Motel 6, Red Roof Inn, Super 8
- Independents

According to STR, the current room revenue breakdown by segment is shown on from Exhibit 1 below. As is clear, Independent hotels make up the largest share of the \$100 billion room revenue, followed by the Upper Up-scale scale. The Luxury and Economy chain scales collectively are only responsible for 9% of the annual hotel room revenue.

**Exhibit 1 : Chain Scale Room Revenue Share**



Source: Bowers, B. (2007). *Lodging Industry Overview* (Rep.). Hendersonville, Tennessee: Smith Travel Research.



Because of the methodology STR uses to categorize these properties, service level and available amenities are not fully accounted for and therefore can lead to somewhat misleading groupings. For instance, an “Up-scale” urban flag may offer far fewer amenities and no food service but may have a higher room rates than a “Mid-scale” suburban hotel that offers the full range of services and amenities. Therefore, it is important to be familiar with the services that are offered by each product to understand its competitive set and to understand how a potential new hotel may compete against the surrounding options. “Mid-scale” and “Up-scale” categories are in many cases quite difficult to distinguish as the services and amenities are not uniform across category or even among particular brands.

### *The Consumer’s Classification System*

Hotels.com, along with many other consumer-focused travel and leisure services, utilizes the “star rating” methodology to categorize hotels. Their star rating is based on a combination of factors including service level, available amenities, room rate, location and physical environment. Exhibit 2 below is a description of their rating system.

## Exhibit 2 : Hotel.com Star System

### ★★★★★ 5 Star - Deluxe

These luxury hotels offer the pinnacle of service and pampering. Pristine surroundings often include manicured landscaping and famed works of art. Guests may expect multilingual concierge and/or butler services, extensive pool, spa and fitness facilities, and gourmet restaurants with world-renowned chefs. There is typically a high staff- to-guest ratio. Guestrooms feature ample space, designer linens, and special touches such as fresh flowers, champagne and flat-screen televisions. These hotels most often are located in the most desirable cities or resort destinations.

### ★★★★ 4 Star - Superior

These exclusive properties offer sophisticated interiors and personalized concierge services such as travel arrangements and activity desks. The hotels usually feature opulent restaurants and bars with acclaimed chefs. Sophisticated guest facilities often include equipped fitness and massage centers, and one or more pools. Hotels of this caliber often offer conference facilities with advanced technology and professional event planning. Guestrooms include stylish furnishings, wireless high-speed Internet access, stocked minibars and bathrobes.

### ★★★ 3 Star - First Class

These mid-level hotels most often cater to traveling executives with wireless Internet access, fax and copy services, transportation assistance and conference rooms. Hotels of this caliber usually offer reputable restaurants serving breakfast, lunch and dinner, a pool and a fitness room. Accommodations often include traditional décor with spacious work desks, and signature bedding with pillowtop mattresses. Hotels are usually located near convention centers or corporate complexes.

### ★★ 2 Star - Moderate

Typical of chain hotels, these properties offer simple, consistent services such as expanded continental breakfasts, high-speed Internet access, and cable televisions with complimentary movie channels. These value-oriented hotels often offer outdoor pools and complimentary toiletries. Guestrooms are usually accessible by exterior entrances.

### ★ 1 Star - Economy

Typical of chain hotels, these properties offer simple, consistent services such as expanded continental breakfasts, high-speed Internet access, and cable televisions with complimentary movie channels. These value-oriented hotels often offer outdoor pools and complimentary toiletries. Guestrooms are usually accessible by exterior entrances.

Source: *Hotels.com*. Retrieved from <http://www.hotels.com>

The Hotels.com rating system is valuable in that it attempts to rank specific hotels based on a variety of factors. Although it is useful in helping potential guests make a relatively simple “apples to apples” comparison of a select suite of properties in a given market, this classification methodology’s utility in understanding the industry framework as a whole is limited. For a potential developer or investor, the nuances of the industry and the level of product differentiation simply are not captured through the star rating system. Additionally, this method fails to include some of the more

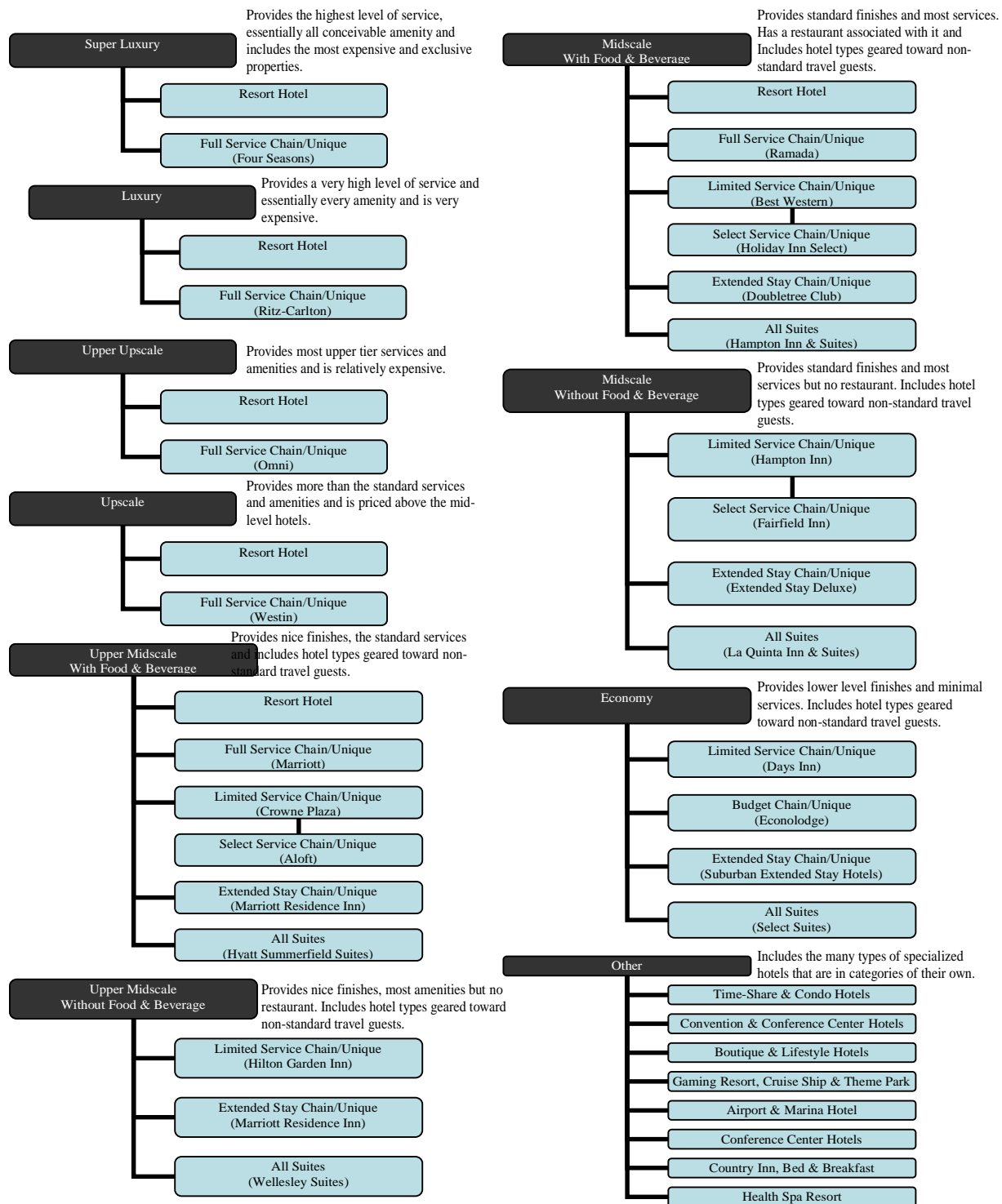
obscure hospitality typologies like time-shares and condo-hotels and is therefore incomplete.

### *An Alternative Classification Methodology*

Since neither the STR classification methodology nor the Hotels.com methodology sufficiently outline the segmentation of the hospitality industry, Exhibit 3 has been created based on a simplified version of a model presented in Rutes, Penner and Adams as well as the rating systems used in the two previously presented methodologies.

Exhibit 3 illustrates the various rate scales of hospitality products, as well as demonstrates that the same “type” of hotel may fall into more than market segment and rate scale.

### Exhibit 3 : Industry Segment Organization Chart (Alternative Methodology)



Source: Author's work incorporating information from STR, Hotels.com and Rutes, W. A., Penner, R. H., & Adams, L. (2001). *Hotel Design, Planning & Development*. New York: Architectural Press. p. 4.

The figure above is relatively self-explanatory as it generally flows according to the room rate scale presented in the STR outline. Where the categorization becomes more refined is in the Upper Mid-scale through the Economy categories. In the Upper Mid-scale category, there are several sub-segments that represent the various hotel typologies that may be found within this category. The sub-segments are generally listed in descending order according to level of amenities provided and/or room rate level assumed. Therefore, the Upper Mid-scale resort hotel typically provides more amenities and is more expensive than the limited-service hotel in the same category. In each hotel classification an example of a well-known hotel brand is listed to help illustrate the level of hotel that would typically fall into each category.

### ***New Product Types Arise from Segmentation***

The process of market segmentation has given birth to several additional hotel products that are in essence new categories. When in the early 1980s the hospitality industry became aware that certain guest populations preferred more spacious rooms with functional living areas, the all-suite hotel was developed. Steve Rushmore writes in his text *Hotel & Motel Valuations & Market Studies*:

“The all-suite hotel is based on the theory that certain types of commercial and leisure travelers do not use meeting, banquet, restaurant and lounge facilities found in most full-service hotels. Using the space allotted for these facilities as guestrooms instead could create suites with separate living and sleeping areas.”<sup>40</sup>

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<sup>40</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. p.19

Utilizing the space previously used for ancillary service allowed the all-suite hotel to create a building envelope that was more efficient and therefore a more profitable. It is also attractive to business travelers because suites allow for more room sharing and thereby reducing corporate lodging costs.<sup>41</sup>

Around the same time, the residential hotel typology grew and spawned new sub-segments. Thus far the residential hotel has branched off into the time-share hotel, the condo hotel, the bed & breakfast and the extended-stay hotel. The Extended-Stay hotel emerged in response to a specific customer group that preferred more spacious rooms for potentially longer stays. This typology spans the Upper and Mid-scale markets as is reflected in Figure 1.<sup>42</sup> Extended-stay hotels not only fit a guest demand niche, they offered unique operational and investment characteristics. “Extended-stay properties typically average 10% higher occupancy than the rest of the market, further benefiting from their below-average operating costs to generate even higher returns.”<sup>43</sup>

In an effort to capitalize on the operating efficiencies that were shown to be attainable in the extended-stay product, hospitality firms researched methods to reduce the overhead costs that are typically associated with full-service hotels. Market research indicated that many users were willing to trade amenities and services in order to get lower room rates. Thus began the era of another new (or perhaps re-branded and renamed) product line, the “limited-service hotel.” Limited-service hotels “encompass a wide variety of hotel chains, but generally refer to the mid-scale hotels without food

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<sup>41</sup> Shelton, T. (2007, May). Limited, Not Limiting: Is It Time to Start Booking Select-service Properties? *Event Solutions Magazine*. Retrieved from [http://www.event-solutions.com/magazine/may\\_2007/limited\\_not\\_limiting](http://www.event-solutions.com/magazine/may_2007/limited_not_limiting)

<sup>42</sup> Rutes, W. A., Penner, R. H., & Adams, L. (2001). *Hotel Design, Planning & Development*. New York: Architectural Press. p.159

<sup>43</sup> Rutes, W. A., Penner, R. H., & Adams, L. (2001). *Hotel Design, Planning & Development*. New York: Architectural Press. p.159

and beverage services” that a full-service hotel provides.<sup>44</sup> Since the food service in many hotel operations is marginally profitable or in some situations a loss which is rationalized as an amenity to improve occupancy, dropping the food service meant simplifying operations dramatically and thereby reducing overhead. This strategy has proven effective and the limited-service hotel typology has grown dramatically since the mid-nineties. The next section will examine the factors which contribute to the popularity and success of the limited-service market segment.

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<sup>44</sup> Hortense, L. (2004). Hospitality’s #1 Pick: Low Overhead Keeps Limited-service Ahead of the Game. *Commercial Investment Real Estate Magazine*. Retrieved from [http://www.ciremagazine.com/article.php?article\\_id=94&format=print](http://www.ciremagazine.com/article.php?article_id=94&format=print)

## V. THE LIMITED-SERVICE HOTEL SEGEMENT

### *Growth of Limited-service*

Over the last twenty years, the fastest growing hotel segment has been the “limited-service” segment. Commercial Investment Real Estate Magazine reported in 2004 that “limited-service hotels accounted for 40% to 45% of non-casino new hotel openings each year since 1999.”<sup>45</sup> This segments growth is due to the consumer drive for affordable accommodations that still offer the necessary or most frequently utilized creature comforts of the full-service hotel.<sup>46</sup> As Ransley and Ingram recount in reference to the hospitality development industry of the later 1990s:

“More energy was focused on strategic planning, market analysis and financial forecasting than any other aspect of the business. Development became a process of replication and product development an issue of cost reduction and not surprisingly, the limited-service sector boomed and the full-service sector struggled.”<sup>47</sup>

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<sup>45</sup> Hortense, L. (2004). Hospitality’s #1 Pick: Low Overhead Keeps Limited-service Ahead of the Game. *Commercial Investment Real Estate Magazine*. Retrieved from [http://www.ciremagazine.com/article.php?article\\_id=94&format=print](http://www.ciremagazine.com/article.php?article_id=94&format=print)

<sup>46</sup> Shelton, T. (2007, May). Limited, Not Limiting: Is It Time to Start Booking Select-service Properties? *Event Solutions Magazine*. Retrieved from [http://www.event-solutions.com/magazine/may\\_2007/limited\\_not\\_limiting](http://www.event-solutions.com/magazine/may_2007/limited_not_limiting)

<sup>47</sup> Ransley, J., & Ingram, H. (2004). *Developing Hospitality Properties & Facilities* (2nd ed.). Oxford: Elsevier Ltd. p.8



## *The Limited-service Advantage*

There are several reasons for the success and propagation of the limited-service segment. The particulars of the limited-service advantage are enumerated below.

### **Ease of Development**

One reason that the limited-service segment of the hotel industry has expanded so rapidly is due to their relative simplicity from a development standpoint. The physical product is often far more straightforward than a full-service hotel of the same rate scale. Smaller than their full-service counterparts, limited-service hotels range from 100 - 200 rooms and incorporate far fewer ancillary spaces like meeting rooms and restaurant space, making them more efficient developments.<sup>48</sup> Additionally, the time that is required to design a limited-service hotel is also significantly shorter than the more detailed and specialized full-service brethren. Logically, with a simplistic design and shortened construction period comes a less expensive development. A limited-service hotel development may yield a cost savings on the order of 25 - 50% compared to full-service hotels.<sup>49</sup> As reported in *Commercial Investment Real Estate Magazine*, "limited-service hotels are gaining popularity because they are easier and quicker to build than full-service properties."<sup>50</sup> The article continues to cite a more than three-year planning and construction period for full-service products in Miami versus one- to two-years for limited-service. The structural, programmatic and finish-level simplicity of most limited-service hotels allow for rapid planning and construction.

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<sup>48</sup> Ninemeier, J. D., & Perdue, J. (2005). *Hospitality operations careers in the world's greatest industry*. Upper Saddle River, NJ: Pearson/Prentice Hall. .

<sup>49</sup> Shelton, T. (2007, May). Limited, Not Limiting: Is It Time to Start Booking Select-service Properties? *Event Solutions Magazine*. Retrieved from [http://www.event-solutions.com/magazine/may\\_2007/limited\\_not\\_limiting](http://www.event-solutions.com/magazine/may_2007/limited_not_limiting)

<sup>50</sup> Hortense, L. (2004). Hospitality's #1 Pick: Low Overhead Keeps Limited-service Ahead of the Game. *Commercial Investment Real Estate Magazine*. Retrieved from [http://www.ciremagazine.com/article.php?article\\_id=94&format=print](http://www.ciremagazine.com/article.php?article_id=94&format=print)

Since the vast majority of limited-service hotels are franchised by the large hospitality firms, these firms have worked hard to reduce the development process of their limited-service hotel tiers to a simple science.<sup>51</sup> The uniformity of the product and streamlined development process is a major selling point to potential franchisee partners. A property that is built in one location would typically not require significant reconfiguration to be applied to a different site. Therefore, the planning stage can be completed very quickly.

Because of how quickly, easily and inexpensively limited-service hotels can be built and operated, they appeal to the widest range of investors and developers. Limited-services projects have also proven to be easier to finance in part because of the short construction time-line. This sentiment is echoed by Mark Lomanno, president of Smith Travel Research in recent article in *Hotel & Motel Management Magazine*. Lomanno is quoted as saying, "Limited-service hotels are much cheaper to build and are easier to finance."<sup>52</sup>

### **Ease of Operation**

Limited-service hotels are by definition less expensive to operate simply because they do not offer the number of amenities or suite of services that a full-service hotel does. One service that is most frequently eliminated is the in-house restaurant. As mentioned previously, food service is generally not profitable for most hotels due to the high supply and labor expenses that are associated with food and beverage services.<sup>53</sup>

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<sup>51</sup> Ninemeier, J. D., & Perdue, J. (2005). *Hospitality operations careers in the world's greatest industry*. Upper Saddle River, NJ: Pearson/Prentice Hall. .

<sup>52</sup> Shaw, R. (2004, April 19). Limited-service Segment Builds Momentum. *Hotel & Motel Management*.

<sup>53</sup> Hortense, L. (2004). Hospitality's #1 Pick: Low Overhead Keeps Limited-service Ahead of the Game. *Commercial Investment Real Estate Magazine*. Retrieved from [http://www.ciremagazine.com/article.php?article\\_id=94&format=print](http://www.ciremagazine.com/article.php?article_id=94&format=print)

Elimination of the restaurant means significant reduction in staff, trash disposal, room-service related expenses and food service licenses that may be required. Some limited-service hotels make arrangements with adjacent restaurants to provide room service which allows them to sell room-service as an amenity still eliminate the majority of the associated overhead and restaurant construction and management costs.<sup>54</sup> Another service that is often eliminated is the turn-down service which allows the manager to minimize the housekeeping staff.

### **Comparative Risk Analysis**

The limited-service hotel segment has also been shown to stack up favorably against other hotel typologies from the standpoint of risk. A recent study published in the *Journal of Retail and Leisure Property* compared the risks associated with the development, ownership and disposition of various types of hotel products. The study first compared full-service, limited-service and hotel/condo products at the development stage. Confirming the assertions in the section above, the study found limited-service hotels to present the least initial development-related risk because of the relatively straight-forward development process, smaller scale and simpler construction. On the other hand, the study continues, the relative ease of developing a limited-service hotel equates to lower barriers to entry and therefore higher susceptibility to competition. This fact makes limited-service hotels slightly more risky from an operational standpoint than properties that are more specialized like those in the luxury segment.<sup>55</sup>

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<sup>54</sup>Shelton, T. (2007, May). Limited, Not Limiting: Is It Time to Start Booking Select-service Properties? *Event Solutions Magazine*. Retrieved from [http://www.event-solutions.com/magazine/may\\_2007/limited\\_not\\_limiting](http://www.event-solutions.com/magazine/may_2007/limited_not_limiting)

<sup>55</sup>Younes, E., & Kett, R. (2007). Hotel Investment Risk: What are the Chances? *Journal of Retail and Leisure Property*, 6, 69-78. Retrieved from [www.palgrave-journals.com/rlp](http://www.palgrave-journals.com/rlp)

In evaluating the risk associated with disposition of an asset, the study mentions obsolescence as a major factor for hard asset like real estate. According to this study, the risk of internal obsolescence or functional obsolescence tends to be markedly higher for economy and budget hotels due to the lower grade materials and construction methods used. It is assumed that hotels on the lower end of the hotel spectrum will likely deteriorate more quickly than those on the higher end.<sup>56</sup> Finally, the study explains that the level of expected obsolescence is generally factored into the discount rate when evaluating a particular property's value. Therefore, higher-end properties will incorporate a lower discount rate than those for the lower-end properties simply because lower-end properties are expected to become less competitive at a quicker rate.

The relative attractiveness of an income producing asset as an investment should not only be measured according to the risk related factors above, but should also be measured according to how well the asset performs relative to other asset types and how well it holds its value relative to other assets throughout different points in an economic cycle. Historical data shows that limited-service hotels tend to be less vulnerable to economic shocks than full-service and luxury hotels.<sup>57</sup> As evidenced by the most recent economic downturn that began in 2000, "limited-service performed better than full-service because it held its rates and occupancy."<sup>58</sup> The limited-service segment attracts significant investment because it tends to be less capital and labor intensive, while at the same time, it draws high guest retention during both peak and off-peak economic cycles.<sup>59</sup>

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<sup>56</sup> Younes, E., & Kett, R. (2007). Hotel Investment Risk: What are the Chances? *Journal of Retail and Leisure Property*, 6, 69-78. Retrieved from [www.palgrave-journals.com/rlp](http://www.palgrave-journals.com/rlp)

<sup>57</sup> Younes, E., & Kett, R. (2007). Hotel Investment Risk: What are the Chances? *Journal of Retail and Leisure Property*, 6, 69-78. Retrieved from [www.palgrave-journals.com/rlp](http://www.palgrave-journals.com/rlp)

<sup>58</sup> Alisau, P. (2003, February 3). Limited-Service Hotels Hold Their Own During Down Times. *Hotel & Motel Management*.

<sup>59</sup> U.S. Select-service Hotel Investor Survey (Rep.). (2007). Jones Lang LaSalle. p.3

## A More Profitable Product

A successful limited-service hotel is more profitable than most hotels in other segments of the industry from an internal rate of return perspective. A defining characteristic of limited-service hotels is that since it only provides a select suite of services, the operational overhead is significantly reduced. Bruce Ford, vice president of Lodging Econometrics was recently quoted saying:

“Limited-service hotels have lower operating expenses because they are very efficient...they require less staff because they are newer and have better operating technologies, such as advanced property management software and more-efficient check-in processes.”<sup>60</sup>

This only partially explains why the property operations are so efficient. As mentioned above, the lack of food service accounts for a significant amount of overhead savings. While full-service hotels generally have an operating profit margin that ranges between 20% - 35%, a limited-service hotel may have a operating profit margin of 35% - 45% or even higher.<sup>61</sup> To use a real world example, in Exhibit 4 below is a summary of the Profit & Loss reports for two hotels located in the greater-New Orleans market:

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<sup>60</sup> Hortense, L. (2004). Hospitality's #1 Pick: Low Overhead Keeps Limited-service Ahead of the Game. *Commercial Investment Real Estate Magazine*. Retrieved from

[http://www.ciremagazine.com/article.php?article\\_id=94&format=print](http://www.ciremagazine.com/article.php?article_id=94&format=print)

<sup>61</sup> Hortense, L. (2004). Hospitality's #1 Pick: Low Overhead Keeps Limited-service Ahead of the Game. *Commercial Investment Real Estate Magazine*. Retrieved from

[http://www.ciremagazine.com/article.php?article\\_id=94&format=print](http://www.ciremagazine.com/article.php?article_id=94&format=print)

**Exhibit 4 : Comparative P&L Reports**

		<i>Parent Company</i>						<i>AVERAGE Operating Profit Margin</i>
		<i>April 07</i>		<i>May 07</i>		<i>Jun 07</i>		
		<i>Revenue GOP</i>	<i>Operating Profit Margin</i>	<i>Revenue GOP</i>	<i>Operating Profit Margin</i>	<i>Revenue GOP</i>	<i>Operating Profit Margin</i>	
<b>Hotel</b>	<b>Loews Hotel (New Orleans, LA) 282 rooms</b>	\$1,488,032 \$328,855	22.1%	\$1,605,481 \$428,663	26.7%	\$1,146,580 \$212,117	18.5%	22.9%
	<b>Hampton Inn (Metairie, LA) 112 rooms</b>	\$326,929 \$152,541	46.7%	\$330,338 \$154,000	46.8%	\$299,725 \$123,814	41.3%	45%

Source: [Monthly Financial Statement (June 2007) - Hampton Inn Metairie]. (2007). Unpublished raw data. & [Monthly Financial Statement (June 2007) - Loews Hotel New Orleans]. (2007). Unpublished raw data.

Comparing the full-service high-end Loews hotel with the limited-service mid-scale Hampton Inn, it is clear that the operating efficiency of the Hampton Inn significantly exceeds that of the Loews. For each dollar of revenue that comes in to the limited-service Hampton Inn, approximately \$0.45 can be used to service the debt and provide cash flow to the owner. Taking this simple analysis one step further by assuming that both hotels are financed in a similar fashion, we can make the general conclusion that the less expensive and more efficient Hampton Inn also provides a better return on investment.

Logically, since limited-service hotels have fewer operating costs, they can break even at a far lower occupancy rate than a full-service hotel. While new efficiencies related to the management of hotels have allowed the entire industry to make significant strides in lowering the break-even occupancy (by nearly 15% over the last 25 years<sup>62</sup>), the

<sup>62</sup> Rutes, W. A., Penner, R. H., & Adams, L. (2001). *Hotel Design, Planning & Development*. New York: Architectural Press. p.viii

majority of properties in the limited-service segment can operate profitably as long as the occupancy is above 50%.<sup>63</sup> Given this low occupancy hurdle, it is clear why well located and managed properties are such highly sought after investments.

### *The Segment is Further Refined*

Considering all of the above stated characteristics, it is clear why the limited-service segment is such an exciting and popular subset of the hospitality industry. Not surprisingly, the popularity of limited-service hotels has spurred hospitality firms try to tap into sub-segments within the market to turn a profit. Recently they have succeeded in further honing the elements that have made limited-service so successful by creating what is called “Select-Service”. A “select-service” hotel generally falls into the Upper Mid-scale to Economy price range and typically cuts out many of the ancillary amenities including on-site restaurant, fitness facilities, turndown service, etc. A select-service hotel typically offers slightly more in the way of amenities and is meant to fill the space between full-service and limited-service.

With the recent success of so many boutique hotels, some select-service hotels are attempting to shed their mundane character in order to tap into a space that has previously been only populated by these boutique hotels. The emergence and appeal of the lifestyle brand is currently infiltrating all segments of the lodging industry as firms work to differentiate their products and meet the needs of latest generation of customers. As stated in a New York Times article, “the goal is to combine the design sensibility and character of a boutique hotel with the marketing and operational advantages of a brand.”<sup>64</sup> Ernst & Young noted the rise of the lifestyle brand in their 2006 Lodging Report:

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<sup>63</sup> Shaw, R. (2004, April 19). Limited-service Segment Builds Momentum. *Hotel & Motel Management*.

<sup>64</sup> Stellan, S. (2007, May 15). Hotel as Lifestyle. *The New York Times*.

“These new lifestyle brands resonate with people who expect to live increasingly stylish lives and are less interested in settling for the old-fashioned cookie-cutter lodging product. These consumers are increasingly seeking a lodging product that resembles the look, feel, and comfort of their own homes.”<sup>65</sup>

One such select-service hotel which is being rolled-out by Starwood Hotels and Resorts Worldwide, Inc. is called “Aloft.” While the Aloft represents the next generation of hotel in the select-service segment, Starwood is convinced that the innovative approach they are employing is the wave of the future. In fact, there is industry consensus that merging the operational advantages of a select-service franchised hotel with the design breakthroughs of the “lifestyle” environment represents an exciting new age in the evolution of the lodging industry. The remainder of this study will introduce the Aloft and use it as an example explore the interplay among the many involved parties throughout the development and operational stages of a select-service hotel product.

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<sup>65</sup> *The 2006 U.S. Lodging Report* (Rep.). (2007). Ernst & Young. p.7



## VI. ALOFT: The Next Generation of Select-Service

Starwood Hotels & Resorts, Inc. has recently introduced an exciting new brand that is expected to redefine the up-scale limited-service hospitality segment. The Aloft brand was conceived of by the same team that developed the W Hotels concept for Starwood, which is regarded as one of most successful new hotel brands in decades. With Aloft, Starwood envisions a brand that offers its guest superior style, design, and functionality features in comparison to its competitors, while still maintaining the affordable room rate and high comfort quotient that can be found in the limited-service segment. As one of the leading hotel and leisure companies in the world with approximately 850 properties in more than 95 countries, Starwood's announcement of Aloft hotels has fueled much excitement in the hotel industry as the company looks to rollout this unique product in the select-service segment. Starwood anticipates the first Aloft hotels to open in early 2008, with a goal of 500 properties in operation worldwide by 2012.

In Starwood's press release and marketing material, they detail some of the catalysts for the development of this product:<sup>66</sup>

- Similar to the way W Hotels was conceived, they saw the opportunity to do "something different."
- They studied psychographics as well as demographics to determine true customer needs and wants. Psychographic studies measure attitudes, values, lifestyles, and opinions, for marketing purposes.
- Consumers indicated that they are ready for a new travel product—something that's reflective of their ever-changing, on-the-go lifestyles.

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<sup>66</sup> Starwood Hotels & Resorts, Inc. (2006). *Aloft Brand Presentation* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html>

- Aloft is geared toward all ages but feel that those falling into what is known as Generation-X make up the majority of the target demographic.<sup>67</sup> And there is expected to be a rising demand for these types of hotels as those within the so-called Generation-X cohort are rapidly replacing the “baby-boomer” cohort within the workforce and travel population.<sup>68</sup> The 20-30 year old audience is the fastest growing guest demographic, driving the market in number of room nights and spend per stay.
- The target customers for limited-service hotels indicate they are generally more interested in “look and feel”. In other words, style and design make a difference to them.<sup>69</sup>
- The development community at large has made it clear that they are actively looking for a product that would be differentiated within segment.<sup>70</sup>

### *Aloft: The Prototype*

The Aloft prototype has 136 guestrooms in roughly 65,000 square feet of total hotel space, but Starwood’s senior VP of Development Chuck Tomb has said that the product is scalable from 100 rooms to 200 rooms, if necessary. As of July 2007, 25 Alofts have broken ground on construction or have been approved by Starwood. Of those 25, the lowest key count is 130, while the highest is a 200-room urban development in Brooklyn.<sup>71</sup>

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<sup>67</sup> Yancey, K. B. (2007, July 5). Guests put their two cents into the new Aloft. *USAToday*. Retrieved from [http://www.usatoday.com/travel/news/2007-07-05-aloft-side\\_N.htm?csp=34](http://www.usatoday.com/travel/news/2007-07-05-aloft-side_N.htm?csp=34)

<sup>68</sup> Hanson, B. (2006). *U.S. Lodging Industry Briefing: Presented to Corporate Travel World* (Rep.). New York, New York: PricewaterhouseCoopers. p. 21-24

<sup>69</sup> Starwood Hotels & Resorts, Inc. (2006). *Aloft Brand Presentation* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html>

<sup>70</sup> Starwood Hotels & Resorts, Inc. (2006). *Aloft Brand Presentation* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html>

<sup>71</sup> Starwood Hotels & Resorts, Inc. (2006). *Aloft Brand Presentation* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html>” Page 56.

As a select-service product, an Aloft will be able to use a lot more of the hotel's total square footage for revenue generating guestrooms, in contrast to a full-service hotel which needs to make more use of public spaces. Aloft guestrooms will average close to 500 square feet, and the total square footage of revenue-generating guestrooms will make up roughly 80% of the total hotel space. By comparison, the prototype for a 300-key full-service Wyndham hotel utilized only 60% of its net square footage for revenue generating guestrooms.<sup>72</sup> Only 617 square feet of the prototype Aloft hotel will be used for meeting space. As for the typical height for an Aloft, roughly 57 feet is what the prototype calls for, allowing for a five-story hotel. Attached as Appendix C is the full Aloft Facilities Program and Development Summary for its prototype hotel.

### ***Aloft Design Features: A "Lifestyle" Brand***

In the same way that W Hotels broke through the clutter of conformity in the up-scale hotel arena, Aloft is expected to raise the bar in the select-service category, offering urban-inspired, loft-like guest rooms, enhanced technology services, landscaped outdoor spaces for socializing by day and night, and an energetic lounge and bar scene.<sup>73</sup> With these unique features, Aloft is positioned to distinguish and distance itself from competitors in a segment they feel has become static. By and large, the select-service segment is defined by mundane style and relatively conservative sensibilities. Starwood's goal with Aloft is to redefine this segment stylistically.

The Aloft hotels brand will aim to revamp the stagnant select-service with stylish accommodations for business and leisure travelers. Design visionary David Rockwell

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<sup>72</sup> Wyndham: The Hotel That Performs. (2007). *Wyndham: The Hotel That Performs* [Brochure]. Parsippany, New Jersey: Author. Retrieved from

<http://www.wyndham.com/corporate/franchise/hotelthatperforms/main.wnt>

<sup>73</sup> Yeaton, J. Starwood's Aloft Select Service Brand Will Franchise Two New Build Hotels in Toronto and at Montreal's International Airport. *Hotel Online Special Report*. Retrieved from

[http://www.hotel-online.com/News/PR2006\\_2nd/May06\\_AloftCanada.html](http://www.hotel-online.com/News/PR2006_2nd/May06_AloftCanada.html)

and the Rockwell Group, whose award-winning projects include the Kodak Theater, Nobu and the W Union Square, are collaborating on the brand's design.<sup>74</sup>

With the Aloft hotel, from the design of the guest rooms to the environment of the public spaces and lobby, Starwood has created a “lifestyle” brand hotel, an attractive new concept in the industry that has been briefly touched upon above. The goal of the lifestyle brand is to combine the design sensibility and character of a boutique hotel with the marketing and operational advantages of a brand hotel.<sup>75</sup> A trend that began in the late 1990s in the full-service up-scale and luxury boutique segments has found its way into chain hotels and is now filtering down to the limited-service mid-scale segments, providing style and comfort at a more affordable rate. The new lifestyle brands resonate with people who expect to live increasingly stylish lives and are less interested in settling for the old-fashioned cookie-cutter lodging product.<sup>76</sup>

After mastering the lifestyle brand concept with the W Hotels, Starwood has now incorporated that same proven concept into the Aloft brand. An excerpt from Starwood’s Aloft Brand Presentation describes some of the design and public space features that truly distinguish it as a lifestyle brand and differentiate it from any brand-affiliate competitors currently operating in the select-service space:

“Infused with the DNA of W, Aloft will offer a total sensory experience, with guest lofts featuring nine-foot ceilings and oversized windows to create a bright, airy environment. The centerpiece of the room will be the ultra-comfortable signature bed, and large stylish bathrooms will complement the guest experience with oversized walk-in showers and amenities created by bliss®

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<sup>74</sup> Starwood Hotels & Resorts, Inc. (2006). *Aloft Brand Presentation* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html>

<sup>75</sup> Stellan, S. (2007, May 15). Hotel as Lifestyle. *The New York Times*.

<sup>76</sup> *The 2006 U.S. Lodging Report* (Rep.). (2007). Ernst & Young. Page 7.

spa. Each guest loft will also be a combination high-tech office and entertainment center, featuring wireless internet access and plug & play, a one-stop connectivity solution for multiple electronic gadgetry such as PDAs, cell phones, mp3 players and laptops - all linked to a large flat panel HDTV ready television for optimal sound and viewing.

Aloft will offer atmospheric public spaces designed to draw guests from their rooms to socialize and make friends. Guests will be able to read the paper, work on their laptops via hotel-wide wireless internet access, play a game of pool or grab a drink with friends at the re:mix communal lobby area and bar w xyz. The re:charge fitness center and splash, the indoor or outdoor pool, will give travelers options to de-stress and re-energize. Meanwhile, re:fuel by aloft, a one-stop food and beverage area will offer sweet, savory and healthy food, snacks and beverages to grab & go, 24-hours a day.”<sup>77</sup>

Finally, Starwood has developed a “sensory atmosphere” program for Aloft that further enhance the guest experience, meant to create a unique and memorable stay.

Incorporating design elements focused on the senses of smell, hearing and vision, Starwood plans to capitalize on an environmental aspect of design that is seemingly obscure yet immeasurably important to “feel” of a hotel. Below is a list of these design elements:<sup>78</sup>

- *Aroma*: The goal of the aroma system is to subtly greet the guest at various points as they travel through the property. Aloft uses a discreet dry-air system

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<sup>77</sup> Starwood Hotels & Resorts, Inc. (2006). *Aloft Brand Presentation* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html>

<sup>78</sup> Starwood Hotels & Resorts, Inc. (2006). *Aloft Experience* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html> p.31-34

that imparts just a hint of ambient scent, perfect for creating positive, lasting impressions.

- *Music:* Just like W Hotels, Aloft hotels has made music an essential element in each of its properties. Starwood has incorporated seasonally-based music throughout the public spaces designed to evoke a “great mood” in their guests. The music system of a hotel is programmed and controlled through an internet system run by Starwood’s corporate office. This eliminates the need for music management at the local level and ensures brand consistency.
- *Lighting:* Starwood believes that “lighting is essential to creating a unique environment for its guests, and brings a cozy harmony to the hassle of the daily grind.” Starwood further explains that, “the lighting program adjusts automatically throughout the day, transforming the public space over time. Large, abundant windows allow for natural light to pour in during the day; and as the day draws to a close, the interior lights alter to create a warm glow, inviting the guests to gather for a cocktail or to unwind from a hectic day.”

All together, the design features of an Aloft create a hotel that captures the “lifestyle” label that today’s travelers prefer, while maintaining the marketing and operational advantages of a major national brand.

### ***Franchising with Starwood: A Case for Franchising***

As stated above, the operational efficiencies of limited-service hotels create very attractive investment opportunities for hotel owners. Furthermore, select-service hotels, meant to capture many of the operational advantages of the limited-service segment, cater to a slightly more discerning customer and are thereby generally able to demand a slightly higher room rate. Historically, hotels in the select-service category produce some of the highest returns on investment in the hotel industry, averaging strong

unlevered returns of 10-13%<sup>79</sup>. Aloft is designed to be developed at costs similar to competitive brands in the select-service segment, yet given its unique brand identity and its differentiated guest experience, Aloft is positioned to command premium market returns.<sup>80</sup>

“The development community has been clamoring for a breakthrough product like aloft that can be easily introduced in mature markets and command a price premium,” say Ted Darnall, President of Starwood’s Real Estate Group. “We’ve worked hard with the development community to refine our product and make it both developer-friendly and a wow for our guests.”<sup>81</sup>

For the Aloft brand, Starwood has worked to simplify and streamline the development process by creating a fully documented turnkey solution for potential owners and developers. Though similar systems are in place through competitive brands, Starwood’s eagerness to enter the market quickly and with the best developer, owners and operators, has been the impetus to raise the level of development service that a franchisor would typically provide to a franchisee. Generally, the development documentation provided by the franchisor offers guidelines and sourcing information to make the development considerably easier and to ensure product consistency. These documents include architectural plans, interior layout and finish design packages and fully specified and sourced furniture, fixtures and equipment. This development “toolkit” is meant to help developers bring a project from groundbreaking to grand-opening by providing professional support in the areas of architecture, interior design,

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<sup>79</sup> Starwood Hotels & Resorts Worldwide, Inc. (2007). *Starwood Hotel Investment Report* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html>

<sup>80</sup> Starwood Hotels & Resorts, Inc. (2006). *Aloft Brand Presentation* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html>

<sup>81</sup> One Year After Launch, Starwood's aloft Hotel Brand Proves to Be a Developer Favorite; Over 100 aloft Deals in the Works and Starwood's Newest Brand, "Project ESW", Secures Nine Applications Just Days After its Launch. (2006, June 5). *Business Wire*. Retrieved from [http://findarticles.com/p/articles/mi\\_m0EIN/is\\_2006\\_June\\_5/ai\\_n16441940/pg\\_1](http://findarticles.com/p/articles/mi_m0EIN/is_2006_June_5/ai_n16441940/pg_1)

financing and operations.<sup>82</sup> Expanding on the general pros and cons outlined in the Hotel Franchising section above, the following sections detail the advantages of franchising with a successful parent company by exploring some real world example associated with the Aloft.

## **Development Advantages**

Like many other major hotel brands, Starwood generally shies away from direct development and property ownership. These companies are not capitalized or staffed to develop a multitude of properties. As mentioned above, the franchise and management business model utilized by most hotel brands allow for low-risk rapid expansion of their products. While Starwood can indeed "help" or "assist" on traditional developments tasks such as site selection, design, FF&E, cost budgets, etc., as a practical matter, they very much depend on developers to perform the lion's share of these duties. Having said that, one of the franchisor's major marketing pitches is the development and operational support services that they provide to their franchisees. Starwood asserts that the "Development Services" they have established make the development process from start to finish as smooth and easy as possible.

Dave Burrus of Burrus Investment Group, Inc., a developer of more than a dozen limited-service hotels across the United States, described the multitude of ways in which developing an affiliated flag of a proven major brand like Starwood helps facilitate a hotel's development.<sup>83</sup> To further see how partnering with a franchisor like Starwood proves to be a key asset in the development of an Aloft product, Starwood provided access to proprietary documentation that is typically only released to serious

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<sup>82</sup> Starwood Hotels & Resorts, Inc. (2006). *Aloft Brand Presentation* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html>

<sup>83</sup> Interview: Dave Burrus, President and CEO, Burrus Investment Group Inc., June 6, 2007.



potential developers and partners. A franchisor like Starwood can facilitate the development of an Aloft in the following ways:

- *Site Selection:* According to Burrus Investment Group, Inc, it is advantageous to have a working relationship with a franchisor in the site selection and design process of a development because the franchisor can provide the specific identified geographic, demographic and adjacency characteristics that should be present for a site to be successful. If a developer has a long-standing good relationship with the brand, the developer may be considered a “preferred developer”. As the preferred developer for a region, a franchisor may bring a potential deal to the developer – effectively sole-sourcing the deal. According to a representative of major franchisor Choice Hotels International, “Our primary objective is always to do business with our existing customer first...when we see a market can absorb more rooms, then our policy is to go to existing customers with our data and illustrate that we can use more rooms in the market.”<sup>84</sup> Later in the paper, we will explore in greater detail what kind of markets these products look for, and what is entailed in the site-selection process.
- *Design:* Starwood or other similar brands might also refer a developer to a particular architectural firm who they know has the ability and understanding how to design an Aloft hotel. If the developer, however, has the in-house resources or wishes to outsource the design of the hotel on their own, Starwood (or the franchisor of choice) will typically supply the franchisee with detailed prototype design layouts, signage descriptions, and many more documents to further assist the design of the project. The following are only a few of the design documents that a proven franchisor like Starwood would supply the developer:

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<sup>84</sup> Frabotta, D. (2001, September 17). Top Hotel Companies. *Hotel & Motel Management*, 216, 47. Retrieved May 28, 2007, from <http://web.ebscohost.com.libproxy.mit.edu/ehost/delivery?vid=47&hid>

- “Aloft Short Stack of Plans:” A detailed architectural design of an Aloft interior, including all room types and public spaces [see: Exhibit]
- “Aloft Differentiation Document:” Line by line document that identifies every material and finish necessary for the completion of an Aloft, in addition to which party is responsible for the procurement of each item.
- “Aloft Lighting Design Package” and “Aloft Alternate Energy Efficient Lighting Plan”
- “Prototype Drawings” and “Exterior Renderings”
- *Construction:* Like the design phase of the development, partnering with a proven franchisor proves very helpful in the construction phase of the hotel as well. The relationship of the contractor and franchisor is critical in that each party takes on different responsibilities in the completion of the project. Furthermore, a franchisor like Starwood will also supply the developer and contractor with detailed documents which are aimed at helping the contractor complete the construction on-time and on-budget. Additionally, these documents are meant to help with the difficult task of implementing the finish and design specifications correctly. Some of those documents are as follows:
  - “Aloft Construction Signage”
  - “Prototype Summary Budget”
  - “Aloft FF&E Specifications:” A critically important element in partnering with a proven franchisor is the ease they provide in supplying the hotel with its Furniture, Fixtures, and Equipment (FF&E). Movable furniture, fixtures or other equipment that are have no permanent connection to the structure of a building or utilities. Some examples of FF&E include desks, chairs, computers, electronic equipment, tables, bookcases and partitions, just to name a few. A franchisor will prefer to have every one of its hotels to be as similar to one another as possible; that means that the FF&E should be the same across each Aloft product. To make sure of this, Starwood, by partnering with national distributors, provides a “packaged

goods” program for all of the hotel’s FF&E needs as a kind of one-stop shop. While the developer is responsible for the costs of the FF&E, this 400-page document outlines in great detail every FF&E item of an Aloft hotel, and how to procure each item. This makes the developer’s job vastly easier.

- Finally, Starwood offers the “Aloft Bovis Lend Lease Leveraged Procurement Program & Pricing Information” packet that serves to provide Starwood’s development partners with access to the most cost effective means for building an Aloft hotel.
- *Financing:* As mentioned above, financing a hotel project becomes markedly easier when the hotel is to be flagged by a proven parent company such as Starwood. A franchisor like Starwood might even have suggestions to the developer as to where to obtain equity and debt funding. For all the reasons stated above, a construction lender knows the delivery advantages that building a proven franchised select-service hotel has over that of an independent hotel.

## **Operating Advantages**

As the hotel opens and begins to operate, the franchisor/franchisee relationship once again proves advantageous for the owner and/or operator of the hotel. A firm like Starwood provides services for the operations of an Aloft which are meant to help the hotel in achieving the greatest returns. As this shows in a subsequent section, the franchise fee structure is set up to align the interests of the franchisor and the owner of the hotel. It is in hotel firm’s interest to have the hotel generate the greatest amount of return to its owner; thus, the franchisor’s willingness to assist in operational needs.

The following outlines some of the various ways in which partnering with an established franchisor like Starwood proves beneficial from an operating standpoint.

Clearly, these examples relate to the Aloft but are meant to provide a general scope of benefits that a firm may provide to an operator:

- *OS&E*: One of the most important cornerstones of the limited-service hotel segment is the ease of operating and product consistency. To help carry out this concept, Starwood has compiled a comprehensive guide of standard Operating Supplies and Equipment (OS&E) for every item in the hotel. OS&E encompasses hundreds of different items, ranging from the initial pre-opening inventory of consumable products, like shampoo and soap products, to multi-year products, such as sheets and towels, to long-term purchases, like telephone and computer systems (to name only a very few items). Because of the sheer volume of items and its perpetual nature, managing the OS&E purchasing process can be at least as cumbersome as managing the purchase of FF&E. With operationally efficient hotels structured to run on lean budget, it becomes increasingly important for owner/operators to have a single point of contact to fulfill all their OS&E needs.<sup>85</sup> Starwood, like any major franchisor, provides that one-stop shop with its “OS&E Style Guide” for the owner. The guide is used by the owner as both an ordering resource and a training tool for the hotel staff. As the guide explains, not only is it clear where and how to purchase the Aloft bedding, but therein there are also instructions on how to “style” it for the next guest.<sup>86</sup> Purchase and distribution of the goods is easy with Starwood’s “StarSource,” a proprietary web based ordering platform which acts as an Aloft mega store for all OS&E needs. Much like the FF&E arrangement, the franchisor distributes the items to each hotel through nationwide companies who they have established relationships with to assure consistency and availability across the country.

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<sup>85</sup> *EC Harris.com*. Retrieved from

<http://www.echarris.com/sector/content.asp?c=2&sectionid=165&pageid=334>

<sup>86</sup> Starwood Hotels & Resorts, Inc. (2006). *Aloft Sensory/Brand/OSE/IT/F&B Overviews* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html>

- *Staffing/Operating Budget/Marketing/Pre-Opening Critical Path:* The following are detailed documents provided by the franchisor to help create a uniform operating platform among the Aloft. These documents are meant a training manuals for the management as well:
  - “Staffing Guide Roles and Responsibilities:” This lays out the full staffing plan, suggested salaries of positions, and a detailed summary of how each position’s roles and responsibilities.
  - “Prototype Detailed Budget:” This document provides the operator with a line by line look at the expected performance of a typical Aloft hotel.
  - “Aloft Marketing Plan:” One of the great advantages of franchising a hotel is the marketing power of national or international brand. The Marketing Plan offers suggestions as to how to market the hotel locally; and the document also explains Starwood’s national marketing campaign or the brand, of which the franchisee is the beneficiary.
  - “Aloft Pre-Opening Operations Critical Path:” The pre-opening of the hotel begins to take place about 3-4 months prior the official opening date. It begins with the hiring and a General Manager and sales team, and continues right up to such final day responsibilities as housekeeping training and opening announcement signage. The Critical Path document outlines in great detail each task and provides the franchisee with step-by-step instructions on how to get off the ground as smoothly as possible.
- *Technology:* Like many of the large hospitality firms, Starwood has recognized that technology has become incorporated into many aspects of people’s lives, including their leisure and travel. In psychographics studies conducted by Starwood, they learned that travelers want easy to use, intuitive self service technology. The Aloft concept was developed specifically to embrace these changing needs, by integrating best in class, state of the art technologies.<sup>87</sup> The

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<sup>87</sup> Starwood Hotels & Resorts, Inc. (2006). *Aloft Sensory/Brand/OSE/IT/F&B Overviews* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html>

beneficiaries of these cutting edge technologies are both the hotel guests and the owners of an Aloft alike. While the guest is treated to a product with technological services superior to that of comparable hotels, owners and operators are supplied with the following technological services from their franchisor, in this case Starwood:

- A Property Management System (PMS) which provides the backbone of the system for all other property software to run off.
- “Starguest Response,” a web-based, property level workflow management tool allowing the property to record, measure and resolve guest requests and issues.
- Touch & Go Kiosks in the lobby. Keeping with the Limited-service theme of the easy and comfortable hotel experience, the guests of an Aloft have the ability to swipe their card, choose their exact room with the kiosk software mapping feature, confirm their rate and get their room keys all with touch screen technology.
- *National Brand and Flag Recognition:* Perhaps the single greatest advantage of the franchisor/franchisee relationship – as compared to flagging a hotel independently – is the national brand recognition, marketing campaign, and the parent company’s central reservation services. Each of these qualities carries the advantage of increasing hotel revenues, while at the same time alleviating major line item expenses that a hotel would otherwise have to incur if operated independently. Starwood’s global brand marketing budget alone is in excess of \$100 million worldwide.<sup>88</sup>
- *Central Reservation System:* Starwood Hotels, like any major franchisor, operates a Central Reservation System (CRS) under which all online and/or phone reservation queries can be directed to their franchised hotel in the desired market for the inquiring guest. The franchised hotel’s Property Management System is

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<sup>88</sup> Starwood Hotels & Resorts, Inc. (2006). *Aloft Brochure* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html> Page 15

integrated into the CRS where all reservations through CRS will flow directly to the hotel's system. In 2006, 51% of Starwood hotels room revenue was delivered through this centralized channel.<sup>89</sup>

- *Guest Programs:* Major franchisors often times also have loyalty and preferred guest programs. These programs reward repeat customers to assure that a guest who stays in a Starwood product in one city is likely to stay with Starwood while in another city. In 2006, 44% of total room revenue was from Starwood's preferred guest members. Starwood's Preferred Guest Program was awarded the Annual Freddie Awards Program of the Year from 1999-2004, one of the most prestigious honor in the hospitality industry.<sup>90</sup> In recognition of company excellence, in June of 2007 HVS, the global hotel consulting firm, named Starwood as the lodging industry's top-performing board of directors for 2006.<sup>91</sup>

These and many other services offered by Starwood provide the hotel guest with a memorable experience, while providing the owner with design, construction, and operational advantages that they otherwise would have a hard time duplicating without the help of a major franchisor. The Aloft product looks to break through the homogeneity of the segment with its unique design, while offering developers, owners, and operators the great advantages of a franchisor-franchisee relationship.

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<sup>89</sup> Starwood Hotels & Resorts, Inc. (2006). *Aloft Brochure* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html> Page 15

<sup>90</sup> Starwood Hotels & Resorts, Inc. (2006). *Aloft Brochure* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html> Page 15

<sup>91</sup> HVS. (2007, June 5). Starwood Wins Lodging Leadership Award For Top Performing Board of Directors. *HVS Press Release*. Retrieved from <http://www.hvs.com/Jump/?nid=2778>

## **SECTION 2**

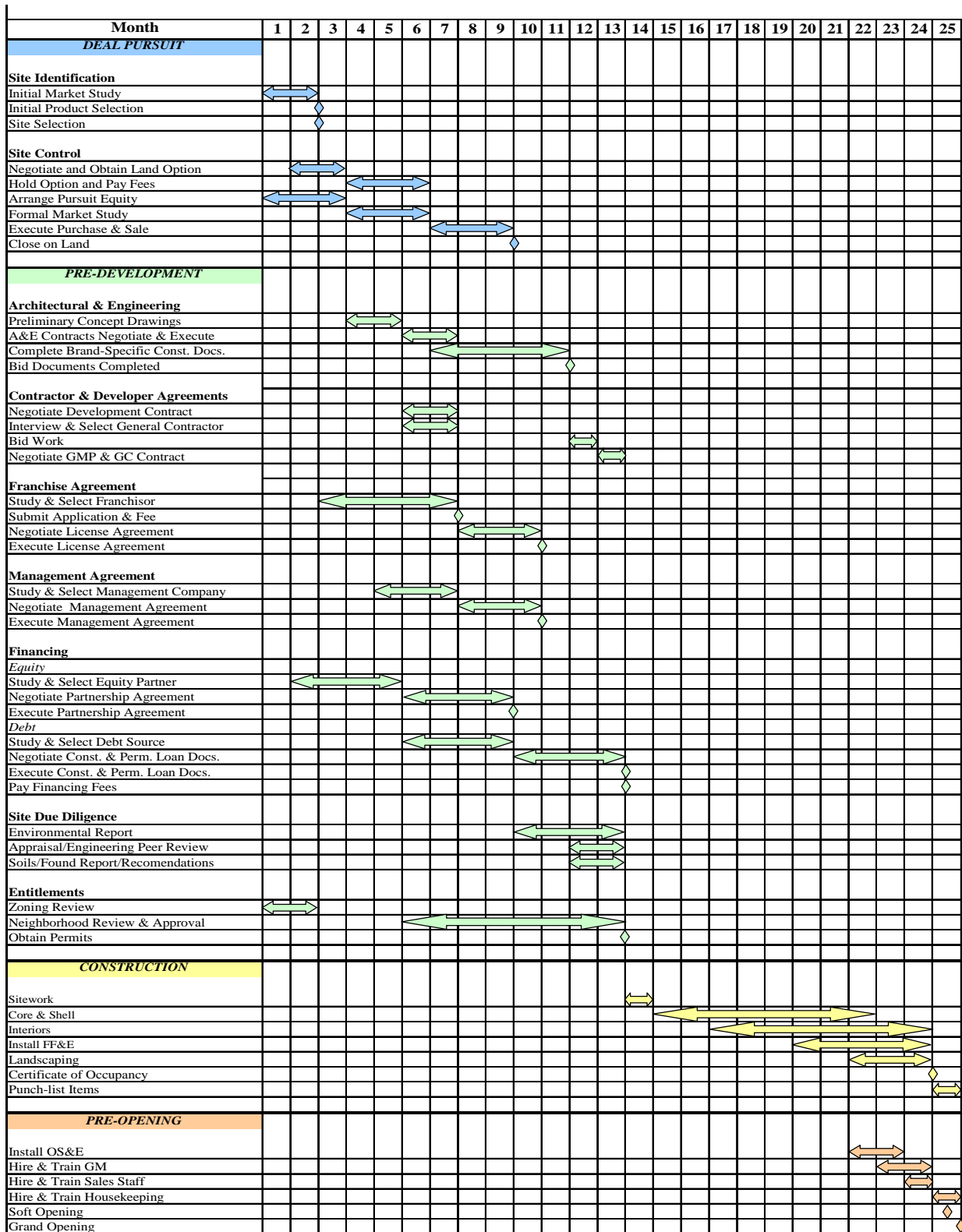
This section of the study will serve as a broad guide to the development process of a traditional select-service hotel. While much of this process parallels that of other types of real estate development, many of the development nuances in building this type of product are distinctive. Hotel development is unique from all other forms of development in a variety of ways. This section presents an overview of the total process – from the earliest stages of the deal pursuit and site identification, to the traditional financing strategies, construction, and opening of the hotel – and highlights the most pertinent issues and relationships that are associated with a select-service franchised hotel development.

The section begins with a full time-task table of the roughly two year development process. The total time commitment of a development of this scope is obviously project and site-specific. Yet, based on corroborated information from several actual developers of these types of hotel products, a two year project schedule is reasonable, especially for the purposes of this study.

Exhibit 5 on the following page presents a generic task timeline associated with this type of development. Exhibit 5 is meant to not only serve as a simplified guide to the tasks and stages within the development process, but also as an illustrative summary of the organization of this section of the study.



## Exhibit 5 : Select-Service Hotel Development Task Timeline



Source: Interview: Charles Floca, Executive VP of Development and Construction, Hotel Investors, LLC., June 22, 2007.

## **VII. THE PROCESS: A Franchised Hotel Development**

The many of the steps involved in developing a select-service franchise hotel like the Aloft are quite similar to a development of a standard hotel, or any other type of real estate development for that matter. Although, there are some unique aspects to this form of development that by this point of the study should be evident. Hotels, unlike residential, retail, R&D or office development are not expected to be pre-leased in any significant way prior to breaking ground. Therefore, hotel developments are by their nature, speculative ventures. Additionally, the existence of the franchise arrangement and the hotel management company are two of unique elements to this type of development. To illustrate the development process that would be carried out for a product like the Aloft, this section will cover the major steps involved and will highlight steps, concerns and aspects of the process that are unique to hotel development and specifically franchised select-service hotel development. Although the development process is largely non-linear, Section Two of this study will attempt to outline the steps in as logical and task specific a way as possible.

The first part of this section will cover the deal pursuit and site identification process. Hotel development may either follow the path of “a use looking for a site” or “a site looking for a use.” The study will discuss some of the main characteristics of a site or region that a select-service product like Aloft would be geared towards and the study will look more closely at the psychographic and demographic features that Starwood recognized as the drivers for an Aloft-like product. As with all real estate, market studies are key to identifying sites, choosing product type and selling the vision to potential investors or debts sources. The site identification section below will discuss the market research that is typically done, as well identify some reliable organizations from which to procure these studies.

Once the site has been identified and a select-service hotel has been selected as the highest and best use, gaining control of the site is of the utmost importance. Much like any other real estate development project, this stage of the process requires savvy negotiating, capital and faith in the project. The chapter on deal pursuit in this section will touch briefly on this process paying particular attention to how the site control stage dovetails with the commencement of negotiations with a potential franchisor.

The next part of the study will discuss all the steps involved in the pre-development phase of constructing this kind of hotel. The architectural, engineering, permitting and site due-diligence aspects of this type of development do not differ dramatically from those of any other development. Therefore, those portions of the process will not be dealt with at length. On the other hand, the uniqueness of the franchise relationship and the selection of a hotel management operation is somewhat specialized and will therefore be explored in further detail. Additionally, the equity and debt financing aspects of hotel development are of particular interest and will be discussed in relative depth.

The final portions of Section 2 of the study will look at the unique elements of the construction process as well as the pre-opening and operations of the hotel. The hypothetical development task timeline above is meant to be a guide through the hotel development process as well as an outline of this section of the study.

## VIII. DEAL PURSUIT AND SITE IDENTIFICATION

### *The Initial Market Study*

It is unlikely that any developer would be approaching a development without any inclination as to the type of project he or she would like to build or what type of project would be appropriate in a specific location. For the most part, the initial market study or simple feasibility analysis is meant to confirm or deny the developer's suspicions about a particular development. Depending on what initiated the developer's interest in a particular project, the process being followed may either be a "site looking for a use" or a "use looking for a site. In the situation when the process is a "site looking for a use", the developer likely has a significant reason to believe that the site is available for development and may simply be considering a range of asset types or combination of asset types that would yield the most value for the underlying land. In this case, the developer would perform a "highest and best use" analysis to produce a residual land value. Of course, the highest and best use analysis must be accompanied by an assessment of the market demand, market room rates, neighborhood and governmental sentiment, construction costs and zoning allowances for that specific use prior to submitting a bid on the property or purchasing the land. In the situation where the developer has expertise with a particular asset type (use looking for a site), for instance hotels, and he/she is simply scouting for a site, specific market characteristics generally drive the site selection.

Starwood, like most hotel companies, understands their clientele intimately, and therefore has a strong grasp of the market characteristics, demographics and psychographics that should be present in a successful site. Aloft is aimed at a younger generation of traveler who is intent on experiencing an environment that offers high-end style and an engaging lively atmosphere. Yet, as a younger cohort, they remain

relatively frugal. Locating concentrated nodes of this type of traveling population has lead to the defining of specific locational site characteristics. Through reviewing the 25 approved Aloft sites, prospective Aloft developer's target markets and direct conversations with a representative of Starwood's development team, the following characteristics were identified as indicators of ideal site characteristics:<sup>92,93</sup>

- Revpar's in excess of \$70.
- Markets that are in high growth states and larger urban and suburban cities, in high barriers of entry locations, and in the path of growth or redevelopment area's that will support lodging.
- Adjacent to areas of high office concentration.
- Adjacent to an airport.
- Adjacent to major thoroughfares.
- Surrounded by casual dining restaurants, other lodging establishments, major retail, office, corporate headquarters, major leisure attractions, and/or colleges/universities.
- High-level of regionally-employed young professionals.

The site itself should have the following physical characteristics:

- 2.5 to 3.5 acre site.
- Rectangular, flat parcel with easy access and good visibility.
- Zoned for commercial/hotel use.
- Frontage along major traffic corridors in a business/commercial setting.

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<sup>92</sup> Interview: Brent LeBlanc, Vice President of Development, West, Starwood Hotels and Resorts Worldwide, Inc., July 1, 2007.

<sup>93</sup> *The Corporex Companies*. Retrieved from [http://www.corporex.com/index.aspx?page=hotels\\_home](http://www.corporex.com/index.aspx?page=hotels_home)

Much of this information is often readily available through the local tourism associations, chamber of commerce and brokerage community. Understanding what drives hotel demand on a macro level at a specific site or region is the first step in identifying whether a hotel belongs in a particular location as well as identifying the type of hotel that makes the most sense. The next step requires that the developer get the best grasp of the competitive environment of a specific site. In order to complete an initial market study and simple feasibility analysis, the developer needs to have knowledge of the competitive environment such that he/she knows the number of hotels and beds are in the competitive set and what the general room rate and occupancy figures are for those hotels. A local hotel broker is likely the best source of information of this type and a developer can expect to spend on the order of \$5,000 to obtain the requisite data for this informal study.<sup>94</sup>

The traditional elements that present logical draws for hotel developers are convention centers, business centers, tourist attractions, airports, resort locations, colleges and universities and governmental and military centers.<sup>95</sup> Though these are not requirements for a successful hotel, the existence of one or more of these within close proximity often ensures a relatively constant flow of guests and good demand for rooms. A recent article about the owner and developer of 81 franchise hotels, John Q. Hammons, sites his successful approach to identifying hotel development sites by sticking to state capitals and cities with universities as their backbone."<sup>96</sup> These present some of the adjacencies that hotels generally look for.

With respect to the limited or select-service hotel typology, these have traditionally been roadside hotels catering to the "road warrior" business traveler. In recent years, this has changed as limited and select-service hotels have made their move into urban

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<sup>94</sup> Interview: Charles Floca, Executive VP of Development and Construction, Hotel Investors, LLC., June 22, 2007.

<sup>95</sup> Interview: Mark Kucera, Executive VP of Operations, Expotel Hospitality Services, LLC., June 7, 2007.

<sup>96</sup> Higley, J. (2007, March 19). Hammons Still Finding Right Hotel Market at 88. *Hotel & Motel Management*.

locations. This move has been well received as these hotels leverage the services of adjacent hotels, restaurants and amenities but are still able to provide a less expensive alternative to the full-service hotels.<sup>97</sup> In fact, many times, a select-service hotel will purposely locate next to a full-service hotel to benefit from the overflow and value-minded customers that are willing to walk a little further.

All in all, the limited and select-service hotel product types have more placement flexibility than a luxury, full-service hotel. Their target customer is broad enough to position themselves in a number of locations based upon any of the aforementioned locale demographics. For an example of this site flexibility, as of July 2007, Starwood had announced 25 Aloft hotels in construction or approved to be built. Of the 25 hotels, eight are characterized as suburban developments, ten as urban, and the remaining seven are being labeled as airport hotel products.

### ***The Formal Market Study***

The process described above outlines the essentials of the initial market study which do not hugely differ from those of a formal market study. Developers typically work to collect as much data on their own before enlisting the services of a market research firm because the initial stages of “deal pursuit” are generally funded by the developer themselves. Once the developer has created some momentum for the project, has established a relationship with an initial equity source, and is working to push the project forward, they often will commission a more formal market study. According to Ransley and Ingram’s text, *Developing Hospitality Properties & Facilities*, the formal market study “is an appraisal of supply and demand, the factors affecting supply and demand, particular factors likely to have an impact in the future, and an assessment as

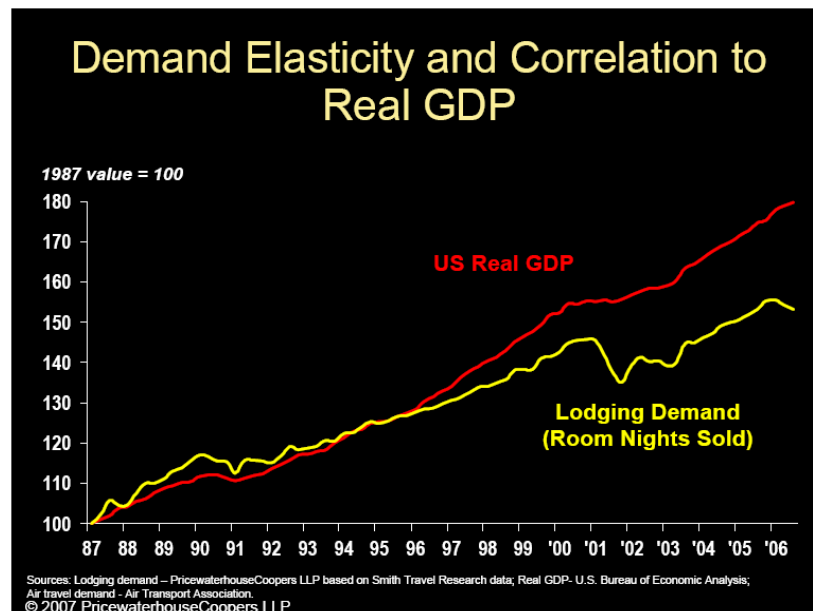
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<sup>97</sup> McMullen, S. (2004, November 15). Limited-service Hotels Creep into Urban Markets. *Hotel & Motel Management*.

to how the project proposal can exploit the opportunities in the market which are foreseen.”<sup>98</sup> There are two perspectives that are important to understand; the micro-level and the macro-level.

The micro-level focuses on a more localized perspective of supply and demand, and the drivers of that demand. The macro-level zooms out too look more at the macroeconomic and social factors that dictate demand on a larger scale. This includes fluctuations in international travel, expected long-term impacts on interest rates, and changes in viability of specific industries. National GDP is another important metric to follow when making large-scale investment and development decisions with regard to real estate as growth in the GDP has a very strong correlation to growth in the lodging industry as is shown in the Exhibit 6 below.

#### **Exhibit 6 : Lodging Demand Correlation with Real GDP Growth**



Source: Hanson, B. (2007). *The Americas Investment Lodging Summit: The U.S. Lodging Industry* (Publication). New York, New York: PricewaterhouseCoopers.

<sup>98</sup> Ransley, J., & Ingram, H. (2004). *Developing Hospitality Properties & Facilities* (2nd ed.). Oxford: Elsevier Ltd. p.27



Even factors such as changes in gasoline prices have a significant impact on the lodging industry. PricewaterhouseCoopers calculates that a 10% increase in gasoline prices has approximately .4% decrease in lodging demand.<sup>99</sup> The macro-level analyses are often compiled by the larger investment, accounting, consulting and real estate firms and will not be covered in depth in this study since it is generally outside of the scope of an analysis that a developer would be capable of or need to undertake in order to execute a typical hotel development.

A formal micro-level market study and site evaluation is often a requirement of lending sources and typically consists of a six-step process. It is a more significant expense sometimes costing upwards of \$20,000 for a comprehensive formal market study<sup>100</sup>. Steven Rushmore outlines this process in his text *Hotel & Motel Market Study and Valuations* and a similar process is describes in Ransley and Ingram's text, *Developing Hospitality Properties and Facilities*. This methodology is summarized in this section.

### **Evaluate Site & Locational Characteristics**

This is typically done through the initial market study but is gathered and quantified in a more thorough way in the formal market study. The main elements of this piece of the study are listed below and most are common elements to a site study for any type of development project:<sup>101</sup>

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<sup>99</sup> Hanson, B. (2007). *The Americas Investment Lodging Summit: The U.S. Lodging Industry* (Publication). New York, New York: PricewaterhouseCoopers.

<sup>100</sup> Interview: Charles Floca, Executive VP of Development and Construction, Hotel Investors, LLC., June 22, 2007.

<sup>101</sup> Ransley, J., & Ingram, H. (2004). *Developing Hospitality Properties & Facilities* (2nd ed.). Oxford: Elsevier Ltd. p.29

- *Size*: This refers to evaluating the lot size, required set-backs and height restrictions. All important factors in determining the square footage a particular development envelope can be.
- *Positioning*: Evaluating the site's adjacent users is another important aspect of site evaluation.
- *Access*: Assessing the access to a site helps determine the relative ease of reaching the proposed development and indicates the most logical orientation for the structure's various elements.
- *Visibility*: Again, assessing the sites visibility will indicate the relative ease of locating the property and will help in planning the orientation of the structure.
- *Relationship to Demand Generators*: This step refers to quantifying the distance and convenience that the site has to the demand generators.
- *Relationship to Other Facilities*: Understanding the relationship that a hotel has to other facilities like restaurants, shopping, fitness club, spa, meeting facilities can often determine whether a hotel can survive as a limited-service property or needs to provide the full suite of services.
- *Relationship to Competitors*: In some cases, proximity to competitors or properties of a slightly different room rate or service segment is beneficial to a hotel site. Quantifying the proximate competitors is an essential aspect of evaluating a site.

## **Quantify Lodging Demand**

Hotel appraisers and market research firms have access to data sources that deal exclusively with the hospitality industry. Firms like Smith Travel Research, HVS, PKF and Lodging Econometrics are reliable resources for not only the micro-level market studies, but also the macro-level economic analyses that will be discussed in more detail later. Local research firms are also typically useful for obtaining the requisite market studies. Many of the large commercial brokerage firms including Jones Lang LaSalle,

CB Richard Ellis and Cushman & Wakefield have local hotel specialists and appraisers that are capable of compiling the information for the formal market studies.

Quantifying lodging demand can be a little difficult, which is why enlisting the services of a local or regional consultant or appraiser is beneficial. According to hotel appraisal expert Steve Rushmore, “analyzing lodging activity and/or demand generators [allows] the appraiser [to] quantify the total room night demand in a current market.”<sup>102</sup> In order to evaluate the demand, researchers generally collect the following information:

- Tourism statistics from local tourism boards and airlines
- Employment statistics from local governmental or quasi-governmental agencies
- Traffic counts from governmental highway agencies
- Existing supply occupancy levels from source like STR

Appraisers, market researchers and consultants generally have several year’s worth of this data and have a good grasp of the micro and macro economic changes that are expected to be occurring. With this knowledge as well as knowledge about any new products that may be coming into the market, these market experts can make a determination about the future of the demand in a particular market.

### **Quantify Competitive Lodging Supply**

Quantifying the competitive room supply is relatively straightforward. Utilizing resources like Smith Travel Research, one can obtain a listing of properties in the vicinity of a proposed hotel location, their rough classification, and a relative objective report on its performance in that market. Unfortunately, STR may not have information

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<sup>102</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. p.138

on every hotel in a particular market nor will it have information on proposed hotel developments. Therefore, some “leg work” is likely going to be required of the researcher.

### **Current Supply vs. Proposed Hotel Comparison**

The art of comparing the proposed hotel against the current supply is where market researchers truly add value. In effect, a formal property appraisal combines all the information gathered above and overlays the unique characteristics of the proposed hotel. The outcome of this comparison will form the basis for the assumptions used in the financial analysis that will be discussed as the next step. Evaluating the proposed property against the existing supply of competitors may show an expected RevPAR and penetration factor that is above, in line, or below the average for the competitive set into which this property falls. Assuming the RevPAR is expected to exceed the competitive set, the appraiser believes that the new hotel will either achieve higher occupancy rates or higher room rates (or both) than its competition. If the penetration factor for this hotel is predicted to be above 100%, then the appraiser believes that the hotel will outperform its competition by drawing more than its fair share of the market – i.e. higher occupancy rates than the market as a whole.

Once a hotel has been built and is operating, contracting with STR will allow an owner to acquire a comparative report called the STAR Report. This report shows how a particular hotel is operating as compared to several other hotels that are determined to be in its “competitive set.”

## Forecast Revenue & Expenses

The comparative results obtained through the process outlined in the preceding sections will determine the expected average daily room rate of the perspective hotel, and also the expected occupancy levels throughout the year. Thus, revenue forecasts for the proposed property can be obtained through these studies. The appraiser will also import the expected operating expenses for the proposed development which are categorized according to the Uniform System of Accounts for the Lodging Industry. The Uniform System of Accounts for the Lodging Industry (“USALI”) outlines the accounting guidelines that are almost universally followed throughout the lodging industry.<sup>103</sup>

This system (USALI) essentially divides all expenses into departmental expenses, undistributed costs and fixed expenses. Departmental expenses are expenses that derive from the operations of a particular department like the food service department or beverage department. Logically, a significant portion of each departmental expense varies according to the occupancy level of the property. Therefore, this portion of each expense can be allocated to the appropriate revenue generating center and will fluctuate depending on the occupancy levels. Since that cost is considered a departmental expense it is allocated to and reimbursed from that particular department. This allows hotel operators to judge the profitability of each particular department. Breaking out departmental expenses in this manner has been the impetus for the elimination of the marginally profitable food and beverage departments in many select-service hotels.

Undistributed expenses are simply general operational expenses that also have a significant portion that may vary according to the occupancy levels. Since these

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<sup>103</sup> Popowich, L., Taylor, D., & Sydor, D. (1997). Uniform System of Accounts for the Lodging Industry: Are You Up to Date? *THE JOURNAL OF HOSPITALITY FINANCIAL & TECHNOLOGY PROFESSIONALS*, 12. Retrieved from <http://www.hftp.org/Members/BottomLine/backissues/1997/oct-nov/accounts.htm>

expenses are general operating expenses, they cannot be allocated to a particular revenue department. Finally, fixed expenses are calculated as a separate line item since they tend not to fluctuate with the occupancy. Two fixed expenses that are linked to the occupancy are the management fee and the replacement reserve. Since these two items are generally based on either a percentage of the total room revenue or the gross operating profit, they necessarily must fluctuate according to the occupancy levels. Exhibit 7 below illustrates not only a list of some of the expenses that fall into each category, but also the percentage that is fixed and variable for each expense.

### **Exhibit 7 : Operational Expense Breakdown**

<b>Expense Category</b>		<b>Percent Fixed</b>	<b>Percent Variable</b>
<b>Departmental Expenses</b>			
	Rooms	N/A	N/A
	Beverage	0%-30%	70%-100%
	Telephone	10%-40%	60%-90%
	Food	10%-50%	50%-90%
<b>Undistributed Operating Expenses</b>			
	Administrative and general expenses	65%-85%	15%-35%
	Human Resources	80%-95%	5%-20%
	Information systems	80%-100%	0%-20%
	Security	65%-90%	10%-35%
	Transportation	65%-90%	10%-35%
	Marketing	65%-85%	15%-35%
	Franchise Fee	0%	100%
	Property operation & maintenance	55%-75%	25%-45%
	Energy and utilities	80%-95%	5%-20%
<b>Fixed Expenses</b>			
	Real Estate Taxes	100%	0%
	Management Fee	0%	100%
	Insurance	100%	0%
	Replacement Reserve	0%	100%

Source: Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. p.247

Revenue is generated through several departments or income centers. As would be expected, room revenue contributes the lion's share of the revenue. Yet, many of the ancillary departments including food, beverage, television and telephone services also

contribute to the total property revenue. Hotels, unlike many other property types, are expected to run at a loss (cost more to operate than they are generating in revenue) or near break-even for the first few months of operation.<sup>104</sup> Yet, similar to other forms of development, forecasting revenue and expenses for a hotel is often done for a period of ten years to evaluate the property value.

Attached is Appendix D which illustrates a profit and loss summary of an actual Aloft hotel which shows various expense and revenue line items discussed above.

Furthermore, this appendix displays a value matrix for this particular hotel using optimistic and pessimistic exit cap rates and discount rates. The subject Aloft for this appendix is programmed as a 164-key hotel, slightly larger than the Aloft prototype of 136 rooms.

### **Estimate Construction Cost and Market Value:**

Once the revenues and expenses are forecast for a period (typically 10-years) the process of valuing the property is essentially no different than it is for any other real estate product. The forecast will serve as the inputs for a discounted cash flow model that will ultimately yield a property value. Incorporating the expected construction cost and timeline into the model will yield a land value and development internal rate of return on an unlevered basis. Finally, applying current market loan to value ratios (generally between 70% - 80%), and a range of loan interest rates, will yield the expected return on the property as levered. Limited-service hotel developers and investors try to achieve a 15-20% return on equity investment on a levered asset.<sup>105</sup>

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<sup>104</sup> Ransley, J., & Ingram, H. (2004). *Developing Hospitality Properties & Facilities* (2nd ed.). Oxford: Elsevier Ltd. p.37

<sup>105</sup> Hortense, L. (2004). Hospitality's #1 Pick: Low Overhead Keeps Limited-service Ahead of the Game. *Commercial Investment Real Estate Magazine*. Retrieved from [http://www.ciremagazine.com/article.php?article\\_id=94&format=print](http://www.ciremagazine.com/article.php?article_id=94&format=print)

One unique element that was touched on the first section under the “Comparative risk analysis” chapter is the assignment of discount rates and capitalization rates to the hotel properties. As was mentioned earlier, if there is high expected risk of a property becoming obsolete, the discount rate used in the cash flow analysis will likely be higher – as will the capitalization rate<sup>106</sup>. This will logically produce a lower value. In this sense, obsolete is defined as operational or financial obsolescence (or both). Ideally, the risk of a property becoming obsolete would be incorporated into the market study and revenue forecast.

With the development cost arrived at and a value derived through a formal market study, the developer will have the essential materials necessary to move the project forward, entice potential equity investors, and obtain debt financing.

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<sup>106</sup> Younes, E., & Kett, R. (2007). Hotel Investment Risk: What are the Chances? *Journal of Retail and Leisure Property*, 6, 69-78. Retrieved from [www.palgrave-journals.com/rlp](http://www.palgrave-journals.com/rlp)



## IX. PRE-DEVELOPMENT

Although the distinction between what tasks are truly pre-development tasks and what tasks are effectively part of the project due diligence is somewhat difficult to make, the task timeline in Exhibit 5 illustrates the major aspects of the process that has been considered part of the pre-development phase of a hotel development for this study. As has been noted in the sections above, a select-service hotel development is not dramatically different from a generic hotel development, nor is it completely different from other forms of development. In this section, the study will look more closely at the elements of the pre-development phase that are unique or specialized for this type of project. As in other sections, the study will utilize the example of the Aloft hotel to illustrate some of these unique features, tasks or concerns.

First the study will explain briefly the finer points of the franchise contract arrangement that a developer needs to solidify in this stage of the development. As often follows in tandem or immediately after the completion of the franchise documentation, the management company relationship will be explored in relative depth. Finally, the section will take a closer look at this type of development from the financing perspective.

### *Franchise Agreement*

Perhaps the most important decision in the investment and development process of a select-service hotel is choosing the best and most important brand for the hotel. As is often the case, the most logical brand might be that of a national franchisor. This decision process must begin early in the development process, as much of the pre-

development work is contingent upon the brand standards of the hotel's franchisor. This section sets out to enumerate and highlight some of the key components to be aware of in a typical franchise agreement

The first section of this study illuminated many the vast advantages provided for the owner by franchising their hotel with a national brand. Those advantages include access to the brands marketing vehicles and reservation power; development and operational services offered by the franchisor; and the facilitation of debt and equity financing (many lenders are more reluctant to finance hotel construction or acquisition unless the property has a strong national brand), to name a few. Because of this, hotel-branding reigns supreme in the marketplace today.<sup>107</sup>

All franchisors are obligated to provide a uniform franchise offering circular (UFOC) to each potential franchise acquirer. The UFOC contains material information about a franchise operation, and is designed to assist the potential franchisee in analyzing the merits of the franchisor. As Robert Braun, senior member of The Global Hospitality Group, writes in his essay, *Hotel Franchise Agreements: Opportunities and Pitfalls*: "The UFOC provides information on all the costs of a franchise, success factors, information about the franchisor, a copy of the standard form of franchise agreement and other key matters. Potential franchisees can use the UFOC as one tool for gauging the costs of a franchised hotel and the track record of a franchisee."<sup>108</sup> Drafting and signing the UFOC is the first step in the license granting process. Within the contents of a hotel UFOC, a non-binding understanding of the terms and conditions will be laid out will be used to prepare the actual Franchise Agreement that will follow.

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<sup>107</sup> Braun, R. (2004, September). Hotel Franchise Agreements: Opportunities and Pitfalls. *Hotel Online Special Report*. Retrieved from [http://www.hotel-online.com/News/PR2004\\_3rd/Sept04\\_FranchiseAgreements.html](http://www.hotel-online.com/News/PR2004_3rd/Sept04_FranchiseAgreements.html)

<sup>108</sup> Braun, R. (2004, September). Hotel Franchise Agreements: Opportunities and Pitfalls. *Hotel Online Special Report*. Retrieved from [http://www.hotel-online.com/News/PR2004\\_3rd/Sept04\\_FranchiseAgreements.html](http://www.hotel-online.com/News/PR2004_3rd/Sept04_FranchiseAgreements.html)

One of the reasons why executing a franchise agreement has become increasingly popular is the standardization of the agreement itself within the hospitality industry. As a result, the negotiation of a franchise agreement is typically not as lengthy or detailed as the negotiation of a management agreement with a brand operator.<sup>109</sup> Similarly, limited prospects for negotiations also come with the territory when it comes to franchise agreements with national brands. Unlike the management agreement (examined more closely in the following section), where a plethora of Management companies compete for the rights to the contract, leaving the owner with negotiating leverage, it is the power of the national brand that dictates the terms and conditions of the Franchise Agreement, and they tend to be uniform and non-negotiable across the board.<sup>110</sup>

The remainder of this section will focus on the most critical components of a typical Franchise Agreement. Two actual Franchise Agreements on real hotel deals will be sourced to provide the majority of the information that follows in this section: (i) a Starwood Hotels Aloft Franchise Agreement; and (ii) a Franchise Agreement for a New Orleans hotel branded as a Hampton Inn, Hilton Hotels' limited-service product. These two Franchise Agreements confirm what much literature, as well as what many industry leaders say – namely, that Franchise Agreements on like products tend to be fairly uniform across the board, and do not offer drastic differences from one brand to the next.

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<sup>109</sup> Braun, R. (2004, September). Hotel Franchise Agreements: Opportunities and Pitfalls. *Hotel Online Special Report*. Retrieved from [http://www.hotel-online.com/News/PR2004\\_3rd/Sept04\\_FranchiseAgreements.html](http://www.hotel-online.com/News/PR2004_3rd/Sept04_FranchiseAgreements.html)

<sup>110</sup> Interview: Dave Burrus, President and CEO, Burrus Investment Group Inc., June 6, 2007.

## **Application Fee**

A very early step for an owner – after interviewing potential franchisors and receiving the UFOC – is to make the formal application for the branding rights. In many cases, this is the first step in which an owner will be charged a fee by the franchisor. Of course, different franchises carry varying degrees of brand power, thus commanding different policies on whether or not to charge for an Application Fee. In the case of Aloft, the Application Fee is equal to \$60,000 and will accompany the submission of the Franchise Application, which must be completed in full and include the financial statements of the franchisee. Further, \$10,000 of the Application Fee will immediately become non-refundable upon submission of the application. If and when the application is approved by the franchisor, the balance of the \$60,000 fee will become non-refundable.

## **Operational Fees**

Once in operation, the franchisee will pay fees for the branding rights and for the services that the franchisor provides. The fee is typically broken down into two parts: a royalty fee (sometimes called the License Fee), and a marketing and reservation contribution (sometimes referred to as a Program Fee). The licensing fee is charged by the franchisor simply for the hotel's right to operate its flag. The range for this fee is almost always between 4% and 5% of the gross revenues of room sales generated by the franchised hotel.<sup>111</sup>

The Program Fee, on the other hand, is paid to cover the franchisor's costs of various programs, services, and systems that are used to aid the franchised hotel's operating systems. To reiterate, these programs, services, and systems include (i) certain

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<sup>111</sup> Interview: Mark Kucera, Executive VP of Operations, Expotel Hospitality Services, LLC., June 7, 2007.

consumer and brand marketing, promotions, public relations and other marketing programs; (ii) marketing research and customer surveys; (iii) developing, maintaining, and supporting the reservations system; (iv) developing, operating, and maintaining technology, communications, and guest support systems utilized by the franchisor's system and the hotels operating under that system; (v) administrative costs and overhead related to the administration of these and other programs related to the brand; and (vi) other general corporate expenses. This Program Fee generally costs the hotel owner another 4% of gross room revenue, but can vary slightly.

All together, the operating fees that a franchisee of a select-service hotel – for example an Aloft – can expect to pay the franchisor is between 8% and 10% of the gross room revenue generated through hotel operations. Negotiating leverage from the standpoint of the owner could come from the geographical placement and positioning of the hotel (i.e. a highly sought after hotel for a national brand), or it could come from the brand's market position and strategy; for instance, a new brand might be willing to negotiate somewhat on the grounds that they are hoping to penetrate the market in any way possible.

## **Term**

The typical franchise agreement for a nationally branded limited or select-service hotel runs for 20 years. Transfer of License, Transfer of Equity Interests, and Termination clauses will always be included into the contract of the Franchise Agreement. They tend to heavily favor the interest of the franchisor – that is, the owner cannot transfer the license unless approval is granted by the licensor; licensor must approve all transfers of equity ownership before a transaction is completed; and licensor can terminate the agreement if the franchisee fall into default on the terms on the agreement. At the same time, the franchisee has little power to terminate the franchise

agreement until the end of the 20 year term, unless it can prove that the franchisor has defaulted on the terms of the agreement.<sup>112</sup>

### **Licensor's Responsibilities**

Upon signing the Franchise Agreement, a franchisor [Licensor] agrees to a number of responsibilities throughout the term of the license. Many of those responsibilities have already been touched upon in the services they must provide the hotel owner and operator. They include all of the development and operational services that the national brand provides the hotel owner. Critical to the franchisee, however, is that the typical Franchise Agreement lays all of these previously covered franchisor roles and services in detail.

### **Licensee's Responsibilities**

When it comes to a Franchise Agreement, greater detail is reserved for the role of the franchisee. These agreements are a way for the brand to make sure that their franchisee operates their product to the standards in which the franchisor desires. A typical contract will enumerate every way in which the hotel must comply to the standards of the brand. The following is only a sampling of the vast responsibilities that a franchisor will demand of its franchisee:

- Promptly pay the licensor all amounts due as royalties and other fees for the good and services purchased by the licensor;
- Maintain the hotel in a clean, safe, and orderly manner and in first-class condition;
- Provide efficient, courteous, and high-quality service to the public;

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<sup>112</sup> Interview: Mark Kucera, Executive VP of Operations, Expotel Hospitality Services, LLC., June 7, 2007.

- Operate the hotel 24 hours a day every day;
- Strictly comply in all respects with the brand's manual and other policies, procedures, and requirements. This includes providing the guests with everything they come to expect with the brand;
- Participate in and use those reservations services which the licensor deems to be in the best interest of the hotel; use the technology, phones, computers, and other systems that the brand require of the hotel; adopt all improvements and changes that the franchisor may call for in the future;
- Upgrading of the hotel. At any time, the franchisor and brand may require substantial modernization, rehabilitation, and other upgrading of the hotel. Franchisee is expected to participate in and incur the costs of any of these brand-wide upgrades.
- Records and Audits. Upon request, franchisee must produce any accounting and profit and loss summaries to the franchisor. Licensor may also request an audit of the financial records at any time.

### **Territorial Restrictions**

Negotiating for exclusive geographical rights is not easy for a franchisee. The national brand company does not like to constrict its expansion possibilities, meaning that a franchisee is typically granted very limited protection from competing products entering the marketplace. Franchisors will sometimes agree to some reasonable limitation on their ability to operate or license competing properties, particularly in the early years of an agreement; but in reality a hotel owner would have little recourse to prevent competing products to enter the market.<sup>113</sup>

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<sup>113</sup> Interview: Mark Kucera, Executive VP of Operations, Expotel Hospitality Services, LLC., June 7, 2007.

As one can see, a litany of roles and responsibilities are placed upon a franchisee in order to stay within compliance of the Franchise Agreement with the hotel's licensor. Maintaining the operational standards of the national brand while actively pursuing the optimal return on investment requires hotel labor intensive hotel management. The owner's choice of manager becomes the next major step in the overall development process.

### *Management Contracts & Duties*

Once the hotel has been branded with a national flag, choosing a hotel operator and negotiating the management contract becomes critically important for a hotel owner and developer. Properly selecting a management company and negotiating their management contract are vital to achieving optimum investment return and asset value. Unlike other forms of real estate, rental periods for hotels are daily; at the same time, the rates for occupancy of the property can rise or fall on short notice. Due to these unique elements of hotel operating, the overall management and labor intensiveness of the hospitality industry is foreign to other forms of real estate.<sup>114</sup> Unless the owner is equipped to manage the hotel themselves, a specialized 3<sup>rd</sup>-party manager will be selected to run the daily operations of a select-service hotel. It has become increasingly common in recent years for institutional and financial investors and private equity funds to invest in hotel assets; such investors typically aim to separate ownership of the physical hotel asset from operation of the business.<sup>115</sup>

The operator, or hotel management company, hired to run a hotel business will provide supervision, expertise, established methods and procedures, and hopefully a good track record of past performance. The operator runs the hotel for a fee according to specified

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<sup>114</sup> HVS. Retrieved from <http://www.hvs.com/Services/HotelManagement/>

<sup>115</sup> Bader, E., & Lababedi, A. (2007, June 21). Hotel Management Contracts In Europe. *Hospitality Net*. Retrieved from <http://www.hospitalitynet.org/news/4031966.html>



terms negotiated with the owner; the most common of these terms are described below in more detail. Such an agreement generally aims to maximize the return on investment for both the operator and the owner.<sup>116</sup>

There are literally hundreds of hotel management companies to choose from, and choosing the one most appropriate and understanding the key components of a management contract are essential in maximizing the asset value for the owner. Although many hotel brands provide management services, many hotel owners (especially within the limited and select-service segment) chose to employ third-party managers. A hotel owner looking for a manager of a limited or select-service product would naturally look to a management firm with experience in that product type. Each hotel segment is operated differently, and a proven track record of operations in the select-service segment provides the owner with a level of comfort. Some of the largest third-party managers include:<sup>117</sup>

- *Meristar Hospitality Corp. and Felcor Lodging Trust*: These affiliated companies manage approximately 180 properties nationally.
- *Lodgian, Inc.*: Manages over 100 properties nationally.
- *Interstate Hotels Corp.*: Manages nearly 140 properties nationally.
- *Tharaldson Property Management, Inc.*: Manages over 330 properties nationally.

With a myriad of hotel brands and products in the market, the task of choosing an appropriate management company has become an increasingly complex challenge for even the most experienced hotel owners and developers.<sup>118</sup> Before a management agreement is drafted and agreed upon, the owner and/or developer will often times

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<sup>116</sup> Bader, E., & Lababedi, A. (2007, June 21). Hotel Management Contracts In Europe. *Hospitality Net*. Retrieved from <http://www.hospitalitynet.org/news/4031966.html>

<sup>117</sup> Rutherford, D. G., & O'Fallon, M. J. (2007). *Hotel management and operations*. Hoboken, N.J: John Wiley. p. 45

<sup>118</sup> Rushmore, S. (2002, October). Performance Clauses Essential In. *Hotel Online Special Report*. Retrieved from [http://www.hotel-online.com/News/PR2002\\_4th/Dec02\\_CanadianReview.html](http://www.hotel-online.com/News/PR2002_4th/Dec02_CanadianReview.html)

hire the services of a management company in a consulting role. This consulting agreement is typically with the same manager who will eventually win the Management Contract, and their services in this capacity will begin during the pre-construction period. A manager's roles during this consulting period would include: (i) reviewing all design plans to familiarize themselves with the layout; (ii) offer recommendations to the developer for operational efficiencies; (iii) provide guidance to the designer on the overall Food and Beverage concepts, layout and design; (iv) and work as a liaison between the owner and the national brand to insure timelines are met and recording documentation is supplied to the brand. The fee structure during this consulting period can be either on a per day basis – typically ranging from \$500 to \$1,000 per day plus expenses – or in the form of a monthly retainer fee – ranging from \$5,000 to \$10,000 per month, depending on the size and scope of the development.<sup>119</sup>

After the groundbreaker, and with six months to one year of the hotel's opening, the manager will move from a consulting position and into the contracted manager of the hotel. The information provided below enumerates the most critical elements of hotel management – from the roles of the operator to the fee structure – and the contract that governs the relationship between hotel owner and manager. The contract information provided comes from contracts won by Expotel Hospitality Services, LLC, a hotel manager with 13 properties under contract in seven states; as well as from contracts approved and granted by Hotel Investors, LLC, a hotel ownership group based mostly in the Southeastern United States.

### **Staffing a Select-Service Hotel**

Staffing a hotel to properly operate the asset is one of the most important roles of a hotel Manager [for the purposes of this section, "Manager" shall refer to the management

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<sup>119</sup> Interview: Mark Kucera, Executive VP of Operations, Expotel Hospitality Services, LLC., June 7, 2007.

company hired by the hotel owner to carry out the daily operations the hotel. All other hotel personnel will be referred to by their direct title (e.g. “general manager”). The Manager shall be required to hire, train, discharge and supervise the work of the executive staff (general manager, assistant managers and department heads) of the hotel; and supervise through said executive staff the hiring, training, promotion, discharge, and work of all other operating and service employees performing services in or for the hotel. This basic staffing role is clearly defined in a typical management contract.<sup>120</sup> In the management contract, the owner will want to retain the right to approve the Manager’s selection of the hotel’s general manager, prior to the final hiring process. As laid out in the typical management contract, compensation, benefits and other terms of employment for the employees at the hotel should be generally comparable to those of similar hotels in the same area.<sup>121</sup>

The size of a hotel’s staff varies for each brand and product. As this paper examines the select-service hotel type, below is a summary of a hypothetical select-service hotel staff, once again using Starwood’s prototypical Aloft brand as the example. While the information provided below comes from the “Aloft Staffing Guide” document, the definition of select-service provides that most hotels within this segment will have a similar staffing plan.

Exhibit 8 lays out the Managerial Talent, or “Executive Staff” typically required for a select-service hotel, in the chart on the left. In the chart on the right side of the exhibit, the total remaining staffing requirements are outlined.

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<sup>120</sup> [Management Agreement Between Expotel Hospitality Services, LLC and Hotel Investors, LLC]. (2001). Unpublished raw data. Page 4.

<sup>121</sup> [Management Agreement Between Expotel Hospitality Services, LLC and Hotel Investors, LLC]. (2001). Unpublished raw data. Page 4.

## Exhibit 8 : Select-service Staffing Requirements

Managerial Talent		Line Level Talent	
<b>Salaried</b>		<b>Hourly Talent</b>	
General Manager	1	Executive Assistant/HR	1
Assist. General Manager	1	Maintenance/Porter	1
<b>Total Executive</b>	<b>2</b>	Night Auditor	1
<b>Hourly</b>		Aloha Agent	7
Sales Manager	1	Refresh/Laundry Talent	10
Accting/Payroll Sup	1	Food & Beverage Talent	4
Maintenance Manager	1	<b>Total Hourly</b>	<b>24</b>
Aloha Desk Supervisor	1		
Refresh Supervisor	1		
Food & Beverage Manager	1		
<b>Total Supervisors</b>	<b>6</b>	<b>Total FTE</b>	<b>32</b>

Source: Starwood Hotels & Resorts, Inc. (2006). *Aloft Staffing Guide* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html> Page 3 & 4

## Management Rights and Duties of Manager

Stephen Rushmore, President and Founder of HVS International, defines the role of the hotel Manager as simply: “the ability to maximize long-term revenues while minimizing long-term expenses.”<sup>122</sup> The management contract helps provide a guideline as to how to achieve said goal through the roles and rights of the chosen Manger. The roles and rights of the Manager are clearly defined early in the contract. This section of a management contract sets out which party is responsible for the numerous tasks required in operating a hotel; below are the most important items therein:

- *Term*: The initial term negotiated with the Manager sets out the length of time that the agreement is to remain in place. Different types of hotel products and brands command different terms from its Mangers. Managers in the select-

<sup>122</sup> Rushmore, S. (2002, October). Performance Clauses Essential In. *Hotel Online Special Report*. Retrieved from [http://www.hotel-online.com/News/PR2002\\_4th/Dec02\\_CanadianReview.html](http://www.hotel-online.com/News/PR2002_4th/Dec02_CanadianReview.html)

service segment are typically granted a term from 5-10 years; while upscale brands such as Four Seasons Hotels & Resorts and Ritz Carlton much longer initial terms, sometimes surpassing 50 years.<sup>123</sup>

- *General Management and Supervision*: This section will express that the Manager agrees to supervise and direct the management and operation of the hotel in the most efficient and economical manner possible. An excerpt from a real contract won by Expotel Hospitality Services in a select-service product defines their overall responsibility as Manager as such: “Manager shall have control and discretion with regard to the operation and management of the hotel for all customary purposes and the right to determine all operating policies affecting the appearance and maintenance of the hotel and the facilities, provided that the hotel is operated and maintained within approved budgets and in a first-class manner.” Finally, the owner should have language within this section of the contract which states that he or she should be consulted with and kept advised of all major programs and policy matters relating to their hotel.
- *Annual Plan*: The Annual Plan is one of the most important jobs of a Manager. It establishes the performance benchmarks to which the hotel operates for the next 12 months. It requires extensive analysis over a comprehensive period of time, and is one of the precise reasons why a hotel owner hires a specialized 3<sup>rd</sup>-party management company to operate the hotel. The Annual Plan is inclusive of the annual budget, the complete capital spending plan, and the hotel marketing plan. The typical management contract will define what is expected of the Manager for each of assignments in the following way:<sup>124</sup>
  - Budget: The Manager must submit to owner at least 60 days before the beginning of each calendar year, and estimated profit and loss statement in reasonable detail for the ensuing year.

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<sup>123</sup> Interview: Mark Kucera, Executive VP of Operations, Expotel Hospitality Services, LLC., June 7, 2007.

<sup>124</sup> [Management Agreement Between Expotel Hospitality Services, LLC and Hotel Investors, LLC]. (2001). Unpublished raw data. Pages 2 & 3.

- Capital Spending Plan: The Manager must submit to owner at least 60 days before the beginning of each calendar year, estimates for the ensuing year for: (i) repairs and maintenance; (ii) expenditures for furniture and fixtures; (iii) expenditures for operating equipment; (iv) expenditures for revisions, alterations, rebuilding, replacements, additions and improvements in and to the hotel.
- Marketing Plan: The Manager must submit to owner at least 60 days before the beginning of each calendar year, the marketing plan which should include in reasonable detail the following:
  - Competitive analysis;
  - Rate and Occupancy projections;
  - Program outline and worksheets;
  - Segmentation analysis;
  - Individual booking quotas; and
  - Annual advertising schedule

As stated, the Annual Plan will be submitted to the owner 60 days prior to the start of the ensuing calendar year, and owner's approval should be given 30 days after the submission of the Plan. In the absence of approval, the Manager should operate the hotel with a temporary Annual Plan that consists of the prior year's Annual Plan modified by increasing the line item revenue and expenses by the appropriate regional consumer price index. Furthermore, after approval, the Manager will review the Annual Plan on a quarterly basis and submit (within 15 days) after the end of each calendar quarter for owner's approval, amendments, revisions, and updates to the Annual Plan as may be necessary.

- *Other Important Managerial Duties*: A managerial contract will go on to lay out in great detail the duties of a Manager, and the roles and responsibilities of both Manager and owner. The following are some of the more pertinent and

important items that make up the role of a hotel's 3<sup>rd</sup>-party Manager in a select-service product.

- Purchases: As with the hotel, all hotel expenses incurred by the Manager shall be at the expense of the owner. The role of the Manager is the control these expenses while maintaining an operational level in a first-class manner. All food, beverages, operating supplies, furniture, fixtures, equipment and other materials and supplies for the hotel shall be purchases by the Manager in the name, for the account, and at the expense of the owner at competitive prices for like quality.
- Bank Accounts: The Manager will deposit in a bank designated by the owner and in accounts in the owner's name, all monies generated by the operation of the hotel on behalf of the owner. Furthermore, the Manager will distribute and pay from this same owner's account such amounts that are required for the maintenance and operation of the hotel, including:
  - All costs and expenses of maintaining, operating, and supervising the operation of the hotel;
  - All costs and expenses of any advertising, promotion or training program;
  - Insurance premiums, legal fees, and Manager's fees;
  - All taxes, assessments and charges of every kind imposed by any governmental authority;
  - Payments required to any lender having a security interest in the hotel; and
  - All other budget items of expense.

All funds in the hotel accounts are the property of the owner, and the Manger shall deliver to the owner any and all funds in such accounts if and when directed to do so by the owner.

- *Books and Records:* As with all roles of the Manager, keeping detailed accounts and supervising the hotel's books and records is another example of why a hotel owner would hire a 3<sup>rd</sup>-party Manager as oppose to incurring the work themselves. As stipulated by the management contract, the Manager shall supervise and direct the keeping of full and adequate books of accounts and other records reflecting the results of operations of the hotel. Like all other operational expenses, the costs and expenses incurred in connection with the preparation of any statements, schedules, and other reports are to be borne by the owner. The owner has the right to examine or inspect the books kept by the Manger at any time. Furthermore, the contract should lay out these Managerial roles in regards to book keeping:
  - Every month, the Manager shall deliver to the owner a balance and profit and loss statement showing the results of operations of the hotel for the preceding month, and the year-to-date compared to the budget. In addition, the Manager will provide a monthly narrative report explaining any variance to the budget.
  - Also at every month, the Manager shall deliver to the owner a forecast for each ensuing month for the balance of the year compared to budget.
  - Owner will want to include in the contract language which states that, as soon as possible after the request thereof, the Manager will provide the owner with such reports, dates, or information as the owner may occasionally request.

### **Management Compensation**

As compensation for the services to be rendered by the Manager under the terms of the management contract, the owner will pay the Manager certain fees. The majority of hotel owners choose to hire a Manager and incur the costs of Management Fees as an



alternative to operating their hotels themselves. To these owners, the value that a professional and specialized hotel operator provides to the asset outweighs the costs of the Management Fee. While every fee structure varies slightly depending on the positioning of the hotel brand and the negotiating power of the management company, the basic management fee structures tend to be very similar across the board.<sup>125</sup> A hotel's Manager should expect a Base Fee and an Incentive Fee. Additionally, most Managers also take an active role in the asset management of the hotel, in which another fee can be generated.

- *Base Management Fee:* An annual management fee (or Base Fee) is typically equal to 3% of the gross revenues derived from the operations of the hotel for each year during the term of the management agreement. The range of Base Fees is 2% to 4%, depending on the negotiations and other fees, but 3% is the standard for the management of a select-service product.<sup>126</sup>
- *Incentive Fee:* Since the Base Fee is generated purely off top-line revenues, owners might want to also incorporate an Incentive Fee that is earned off the performance of the hotel's bottom line (i.e. Gross Operating Profit after expenses). In this sense, the Incentive Fee forces the Manager to control the expenses of the hotel, whereas the classic Base Fee is collected off the revenue line. Therefore, hotel owners might want to consider including these types of Incentive Fees (while perhaps negotiating lower Base Fees). Other forms of Incentive Fees can be negotiated, such as a formula that compares the RevPar of the hotel to that of the hotel's competitive set. Incentive fees have a greater variance from one management contract to another — as oppose to the Base Fee — and is the product of the negotiation process between owner and Manager. In a

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<sup>125</sup> Interview: Mark Kucera, Executive VP of Operations, Expotel Hospitality Services, LLC, June 7, 2007.

<sup>126</sup> Interview: Mark Kucera, Executive VP of Operations, Expotel Hospitality Services, LLC, June 7, 2007.

survey conducted by PKF Hospitality Research, only roughly 20% of all hotel owners who paid a management fee in 2005 also paid an incentive fee.<sup>127</sup>

- *Asset Management Fee:* With the rise of hotel owners and investors who have no direct hotel operating experience, it is increasingly important that they have the benefit of independent expertise in monitoring the position of their hotel asset.<sup>128</sup> This need has given rise to the 3<sup>rd</sup>-party Manager taking on a role as asset manager as well. If an owner wishes for his or her Manager to take on a more active role in the bigger picture positioning of the hotel asset, an Asset Management Fee could be assessed. Like the Incentive Fee, an Asset Management fee for a hotel's Manager is not nearly as uniform as the Base Fee for management. In a typical case, the Manager could receive a fee from 1% to 2% of the gross revenue of the hotel's annual operations.<sup>129</sup>

## Obligations of Owner

Finally, a management contract should also clearly define the roles and obligations of the owner and its relationship to the Manager. In the text above, many of these roles have already been explained from the standpoint of the hotel's operational obligations and expenses. Below is a brief summary of some of the other important roles that an owner should expect to take on:

- *Cooperation with Manager:* As is industry standard, all of Expotel's hotel management contracts explicitly states that, "Owner shall advise, consult and

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<sup>127</sup>Woodworth, R. M. Hotel Management Fees on the Rise, Incentive Clauses Triggered in 2005. *Hotel Online Special Report*. Retrieved from [http://www.hotel-online.com/News/PR2006\\_2nd/Jun06\\_HotelMgmtFees.html](http://www.hotel-online.com/News/PR2006_2nd/Jun06_HotelMgmtFees.html)

<sup>128</sup> Ransley, J., & Ingram, H. (2004). *Developing Hospitality Properties & Facilities* (2nd ed.). Oxford: Elsevier Ltd. p.101

<sup>129</sup> Interview: Mark Kucera, Executive VP of Operations, Expotel Hospitality Services, LLC, June 7, 2007.

cooperate with Manager in the formation of policy and operating standards and systems for the hotel.”<sup>130</sup>

- *Working Capital:* The owner will agree to provide and maintain working capital sufficient at all times to assure the uninterrupted and efficient operations of the hotel.
- *Taxes:* The owner will incur the cost of all taxes, and the Manager will have the right and authority on behalf of the owner to pay all taxes, assessments and charges of every kind.
- *Prompt Review of Proposals:* Finally, the owner should promptly reply in writing to any written request from the Manager for all decisions or approvals required.

## *Financing*

In this section, the study will discuss a potential process for generating the capital needed to develop a select-service property. First the study will look at the steps in partnering with an equity provider from the point of view of developer and franchisee. The second piece of this financing section will explore the unique elements associated with financing a hotel development of this type, and the on-going debt financing aspect of hotel properties.

### **Hotel Investment Risks**

Before delving into the potential forms of debt and equity financing, it is important to mention the capital markets perspective of the hospitality industry and to shed light on the investment attractiveness of select-service hotels in general.

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<sup>130</sup> [Management Agreement Between Expotel Hospitality Services, LLC and Hotel Investors, LLC]. (2001). Unpublished raw data. " Page 8.

The capital markets generally find the hospitality industry to be risky compared to other forms of real estate investments. There are several factors contributing to the perceived risk premium of hotels and other hospitality products. Each of the major sources of perceived risk will be touched on below:

- *Economically and Socially Sensitive Revenue Source*: The transitory nature of the hotel customers is a concern to lenders as the perception is that any global crisis, threat or economic “hiccup” can be catastrophic for the lodging industry. According to Steven Rushmore, these events in fact only have a temporary impact on hotel values. As Rushmore writes,

“We have learned that events such as terrorist attacks, outbreaks of flu and disasters like tsunamis have only a brief transitory effect on the hotel values. In the long run, hotels offer an excellent investment vehicle for those looking for value enhancement.”<sup>131</sup>

Additionally, the section above discusses the relative strength of the limited and select-service markets segments with respect to many of the economic shocks that followed the events that Rushmore mentions. Therefore, this risk is in many ways only a perceived risk and is particularly less valid for the select-service hotel product being explored in this study.

- *Food & Beverage*: There are also unique risks associated with the food and beverage departments of a particular hotel product. Since most hotels lose money on the food and beverage services, managing this particular amenity well is essential to minimizing its impact on the revenue.<sup>132</sup> Yet, limited-service hotels

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<sup>131</sup> Rushmore, S. (2006, June). Going Beyond RevPAR to Determine Value. *Hotels Magazine*. Retrieved from [www.hotelsmag.com](http://www.hotelsmag.com)

<sup>132</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. p.362

tend to be attractive investments in part because they typically do not offer the food and beverage service and therefore eliminate this aspect of risk.

- *Long Start-up Periods:* Unlike many office and residential properties that may require a certain amount of pre-leasing or pre-sales to take place prior to commencing construction, hospitality products are generally speculative in nature; relying on historic, current and forecasted market conditions to obtain financing for construction. As Steve Rushmore writes:

“Lodging facilities usually experience a one- to four-year start-up period before they reach an income level that can support normal financing and equity requirements.”<sup>133</sup>

- *Rapid Functional Obsolescence:* As the industry continues to evolve, guest preferences will change. Therefore, hotel products that do not remain vigilant to these changes will have difficulty competing with new properties or existing product that is well managed and has sufficient capital reserves to remain functionally relevant.<sup>134</sup> Independent select-service and limited-service hotels have a relatively high risk of becoming functionally obsolete.
- *High Operational Leverage:* Another unique risk associated with hospitality products is the result of the operation-heavy nature of the hospitality industry. Since most hotels run on such narrow operating profit margins, a small downturn in occupancy can create a much larger effects on the cash-flow available to service the debt. As Ransley & Ingram explain:

“In a typical full-service hotel, approximately 75% of the revenues support the operation, the costs of labor, food,

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<sup>133</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. p.362

<sup>134</sup> Rushmore, S., & Baum, E. (2001). *Hotel & Motel Valuations and Market Studies* (2nd ed.). Illinois: The Appraisal Institute. p.362

materials and supplies, leaving only 25% of the revenues to support capital. In an apartment, less than half of the revenues support operation, leaving over 50% of the revenue to support capital.”<sup>135</sup>

In other words, since hotels tend to have such high operational leverage, they are viewed as riskier investments. The limited and select-service hotel typology eliminates a large portion of the operational leverage that exists with a full-service hotel by simplifying the operations and narrowing the services provided. Therefore, this risk is not as much a factor for the select-service product that is being studied here.

- *Short Contractual Cash-flows*: Another source of operational risk from the point of view of the lender is a result of rapid contract turn-over. In other words, because hotels tend to have very limited long-term contracts with guests as compared to the year-long lease of a residential tenant or the multi-year lease of an office tenant, the ability to confidently predict future revenues is greatly diminished. In considering the latter two sources of risk, it is clear that a lender would put relatively more importance on the operational capacity of the owner/developer of a hotel, than they would of a residential or office product.

Reflecting on the risks stated above, it should be clear why a select-service franchise hotel is of particular interest for potential hotel developers. The select-service nature of hotels like the Aloft allows for the elimination or

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<sup>135</sup> Ransley, J., & Ingram, H. (2004). *Developing Hospitality Properties & Facilities* (2nd ed.). Oxford: Elsevier Ltd. p.81

mitigation of the food and beverage risk as well a large portion of the operational leverage risk.

Working with a reputable brand and manager mitigate most of the other risks as well. Lenders generally feel that brand-affiliated hotels are lower-risk alternatives due to their economies of scale and established infrastructure and therefore, offer more attractive mortgage terms.<sup>136</sup> The combination of the operational expertise that a franchisor demands of a franchisee as well as the operation and development assistance that the franchisor provides to the franchisee, help reassure the lender and equity investors that the project will run smoothly. Many of the services that a franchisor provides to the franchise are meant to help the franchisee or developer secure the best possible financing. Then, as with many franchisor/developers who may not have the actual management experience, the daily management tasks are contracted out to a reputable management company. The reputation of the franchisor and the management company are almost as important to the lender as the reputation and track record of the borrower.

### **Securing Debt Financing**

As with other types of development, there are different forms of debt financing. This section of the study is exploring a ground-up development of a select-service hotel. Therefore, the developer will require a construction loan as well as permanent financing for the project. Additionally, depending on the investment that the developer and equity

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<sup>136</sup> Rutherford, D. G., & O'Fallon, M. J. (2007). *Hotel management and operations*. Hoboken, N.J: John Wiley. p. 16.

partner care to make in conjunction with the loan-to-value ratio that the lender is requiring, the project may also need to utilize a mezzanine financing.

Primarily as a result of the risks mentioned above, the loan-to-value rate on hotels, especially full-service hotels, is somewhat lower than on other real estate products. Although it is entirely deal specific, the typical loan-to-value ratio does not exceed 75%.<sup>137</sup> At the development stage, loan-to-cost ratios of 60% are typically not exceeded by funding sources.<sup>138</sup> Similar to other forms of development, there are three main methods of financing a hotel development which are outlined below:

- *Construction Loan with a Take-out:* As with other product types, developing a hotel with a forward commitment from an investor to purchase the development upon completion can help the developer secure the construction loan. If the developer's intention is not to hold the property, arranging an immediate buyer commitment for the property can streamline the development process. On the other hand, this form of financing may mean that the developer will forego operational profits that would come through a longer-term hold.
- *Construction Loan and Permanent Loan:* A more traditional means of financing a development requires that the developer obtain a permanent loan prior to or concurrently with the construction loan. In this circumstance the permanent loan "takes out" the construction loan once the development is complete. In this

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<sup>137</sup> Interview: Charles Riels, Chief Financial Officer, Hotel Investors, LLC., July 10, 2007.

<sup>138</sup> Rutherford, D. G., & O'Fallon, M. J. (2007). *Hotel management and operations*. Hoboken, N.J: John Wiley. p. 9.



situation, the developer likely intends on holding the property for a longer period and will have to incorporate into the development cost, “carry capital” to support the property during the period it takes for the property to achieve the operational capacity to service the debt and the facility operations.

- *Construction Loan Conversion to a Miniperm Loan:* As a response to the one- to four-years it may take for a property to achieve the operational capacity referred to above, a developer may opt for securing a construction loan that converts to a miniperm loan upon completion of the development. This form of arrangement allows the owner to combine the construction loan with a commitment from the construction lender to carry the project for a short period after opening. Once the project has reached stabilization, the developer can refinance the property with a traditional permanent mortgage.<sup>139</sup> The downside of this type of financing is that the developer will often have to pay financing fees on the initial construction loan, the converted miniperm and the permanent loan. On the other hand, this form of financing allows the developer to lock in a commitment for a period long enough to stabilize the property while also not having to set aside a capital reserve to carry the property.

### **A Few Words on Debt Financing**

With all developments, choosing between locking into a fixed interest rate, versus gamble on a floating rate is a difficult decision. A recent journal study published in

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<sup>139</sup> Ransley, J., & Ingram, H. (2004). *Developing Hospitality Properties & Facilities* (2nd ed.). Oxford: Elsevier Ltd. p.83

Cornell Hotel and Restaurant Administration Quarterly, suggests that longer-term hotel investors would benefit from electing floating-rate debt over fixed-fixed rate. Utilizing time series analysis that extended from 1987 through 2004, the study compared the RevPAR with the London Interbank Borrowing Rate (LIBOR). The hypothesis behind the study is as follows:

“When the economy is strong, the demand for money increases, causing interest rates to increase. That is the same economic environment in which demand for leisure and business travel increases, causing hotel revenues to increase.”<sup>140</sup>

The study continues to explain that the reverse is also true – when the economy is faltering, demand for capital typically decreases, causing interest rates to decrease. Ultimately, the study found that “hotel investors who match interest payments with hotel revenues by using floating-rate debt (rather than relying on fixed-rate financing) can [more] successfully manage the financial distresses of debt.”<sup>141</sup> Furthermore, this particular study found that the correlation was strongest with limited and select-service hotels. Therefore, it would seem that floating-rate loans can be a more appropriate financing strategy for properties like the Aloft.

The CMBS market has also made a significant impact on the lending environment in the hospitality industry. As with most real estate markets, the option of going with a securitized lender versus a traditional lending source, essentially pits the attractive lending rate provided through CMBS against the flexibility generally associated with a traditional bank lender.

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<sup>140</sup> Corgel, J. B., & Gibson, S. (2005). The Use of Fixed-rate and Floating-rate Debt for Hotels. *Cornell Hotel and Restaurant Administration Quarterly*, 46, p. 414

<sup>141</sup> Corgel, J. B., & Gibson, S. (2005). The Use of Fixed-rate and Floating-rate Debt for Hotels. *Cornell Hotel and Restaurant Administration Quarterly*, 46, p. 413

According to a recent interview with a Vice President of Mortgage Lending for Merrill Lynch, because of the additional risk and need for flexibility associated with the development process, CMBS lenders are not willing to provide construction loans. Furthermore, CMBS lenders typically shy away from financing hotel products unless they have a stabilized operational history of at least a full year.<sup>142</sup> It would serve a hotel owner well to review carefully the requirements of either lending source against their long-term investment goals prior to electing a lending source.

### **Selecting an Equity Partner**

The process of selecting an equity partner for developing a hotel product is essentially the same as that for most other types of development. In the initial deal pursuit stages of the development process, a developer may or may not choose to partner with a source of equity. The decision to arrange deal pursuit equity is dependent on the developer's available funds, confidence in the project and the expected pursuit cost. In any event, it is likely that the developer will create as much project value as possible prior to engaging a deal pursuit equity partner. This value typically comes in the form of an initial market study, a study of the zoning, an architect-supplied massing study to understand the scale of the potential project, a preliminary project budget, and in some cases an option to purchase the site. Often times, the developer is unable to secure a option without the balance sheet of a well-heeled partner and therefore will need to bring in a pursuit partner for that specific purpose. Yet, once the option has been secured and the developer is fairly comfortable with the prospects of the development,

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<sup>142</sup> Interview: Shawn Conover, Vice President, Global Markets & Investment Banking, Merrill Lynch, July 12, 2007.

the need for deal-pursuit capital greatly diminishes and a more permanent source of equity is pursued.

The deal pursuit equity partner may either be replaced by a permanent equity partner, or may continue to be a minority partner in the development. In some cases where the developer and the pursuit equity partner have a working relationship and the pursuit equity partner has reasonably “deep pockets” the pursuit partner will simply remain the primary equity partner for the development. In Ransley & Ingram’s text *Developing Hospitality Properties & Facilities*, they enumerate the five main sources of equity funding as the following:<sup>143</sup>

- *Friends and Family*: This source is typically only interested in investing in relatively small scale projects.
- *Real Estate Funds*: Real Estate Funds have grown dramatically in recent years as many institutional investors have recognized the attractiveness of real estate as an investment vehicle. This source of funding will typically only be interested in larger projects where the required equity is between \$10 & \$500M.
- *High Net Worth Individuals*: High net worth individuals are frequently interested in investing in real estate to diversify their investments but also to take advantage of the income tax benefits offered by the depreciation of real assets.
- *The Public Market*: REITs have been very active investors in real estate and hospitality products. Although at the time of the writing of this text, there are significant changes in the public market with respect to recent developments in publicly traded private-equity firms and privatization of REITs, it is expected that the public market will continue to be a rich source of capital for larger-scale hospitality development and investment.

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<sup>143</sup> Ransley, J., & Ingram, H. (2004). *Developing Hospitality Properties & Facilities* (2nd ed.). Oxford: Elsevier Ltd. p.87

- *Investment Banks*: Specific opportunity funds within investment banks are great sources of equity for larger-scale developments.

Considering the subject development type of an approximately 150 room select-service hotel like the Aloft, the most appropriate equity funding source would likely either be friends and family, a high net worth individual or a real estate fund. From a developer's standpoint, identifying those parties that are comfortable with and relative knowledgeable about the hospitality industry can be as important as the terms of the partnership agreements.

Regardless of which source is utilized to obtain equity funding, it is generally a more fruitful equity partnership negotiating process for the developer if the project has a fair amount of positive momentum. Momentum may come in the form of control of a well-located site, or in the form advanced negotiations with a potential franchisor. Since expressions of interest from a potential franchisor firm (like Starwood in the case of Aloft) lends significant credence to the feasibility and attractiveness of the development, it may be in the developers best interest to pursue the franchise application prior to finalizing an equity partnership. Unfortunately, as is mentioned in the section discussing the franchise relationship above, there is a significant cost associated with the application. Additionally, the average developer will not have the balance sheet necessary to satisfy the asset requirement of many franchise applications. Therefore, it is typically necessary to have the equity partnership formed prior to approval of the application and franchise documentation.

### **Expected Returns**

As reported in the 2007 Jones Lang LaSalle Select-Service Hotel Investor Survey, equity investors target equity multiples of approximately 2.9 for select-service investments.

The average hold period for an equity investor is approximately 5-years and the target going-in capitalization rate is slightly above 9%.<sup>144</sup> This lends support to the assertion earlier in the study that limited & select-service properties tend to achieve slightly higher capitalization rates than their full-service luxury counterparts which are reporting cap rates in the high 7% range.<sup>145</sup> With mortgage rates in the 6% range, ground-up development internal rates of return on equity are typically targeted at closer to 20% on a levered basis.<sup>146</sup>

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<sup>144</sup> U.S. Select-service Hotel Investor Survey (Rep.). (2007). Jones Lang LaSalle.p.5

<sup>145</sup> Mellen, S. (2007). *Real Estate Investment Capitalization Rates*. New York: HVS International

<sup>146</sup> U.S. Select-service Hotel Investor Survey (Rep.). (2007). Jones Lang LaSalle. p.5

## **X. HOTEL CONSTRUCTION**

Exhibit 9 below is a Summary Budget for a generic Aloft hotel. While the total cost of construction will obviously be project-specific, Exhibit 9 is provided by Starwood to potential developers of an Aloft hotel as a guide to the estimated costs associated with this select-service product.

## Exhibit 9 : Aloft Hard & Soft Construction Cost Summary

<b>aloft Cost Summary</b>		<b>136 Keys</b>	
June 14, 2007		<b>68,231 GSF</b>	
	<b>Budget</b>	<b>Budget Per Key</b>	<b>Budget Per GSF</b>
<b>Land</b>	<b>Not Included</b>		
<b>Financing, Real Estate Taxes, Working Capital</b>	<b>Not Included</b>		
<b>Site Work</b>	<b>Not Included</b>		
<b>Building Construction</b>	<b>\$ 11,500,000</b>	<b>\$ 84,559</b>	<b>\$ 168.55</b>
Trade Costs	10,000,000	73,529	\$ 146.56
General Conditions & Fee	1,500,000	11,029	\$ 21.98
<b>Operating Supplies &amp; Equipment</b>	<b>\$ 561,649</b>	<b>\$ 4,130</b>	
Guestrooms	227,658		
Public Areas & Back of House	212,478	1,562	
Food & Beverage	28,981	213	
Purchasing Fee - 3%	14,074	103	
Freight, Warehousing, & Inflation - 11%	55,003	404	
Tax - 5%	23,456	172	
<b>Laundry &amp; IT</b>	<b>\$ 619,903</b>	<b>\$ 4,558</b>	
Information Technology - Including Tax, Freight	545,312	4,010	
Laundry Equipment - Including Tax, Freight, Install	74,591	548	
Kitchen Equipment - Included in Construction	-	-	
<b>Furniture, Fixtures &amp; Equipment</b>	<b>\$ 995,338</b>	<b>\$ 7,319</b>	
Guest Rooms - Including Vanities	602,157	4,428	
Guest Room Corridors	61,875	455	
Public Area	181,400	1,334	
Purchasing Fee	40,000	294	
Freight & Warehousing - 8%	67,635	497	
Tax - 5%	42,272	311	
Installation - Included in Construction	-	-	
<b>Professional Fees</b>	<b>\$ 490,000</b>	<b>\$ 3,603</b>	
Architects & Engineers	400,000	2,941	
Testing/Inspections	50,000	368	
Miscellaneous	40,000	294	
<b>Permitting, Legal &amp; Insurance</b>	<b>\$ 225,000</b>	<b>\$ 1,654</b>	
Insurance	75,000	551	
Legal Fees	50,000	368	
Municipal & Utility Fees	50,000	368	
Permits	50,000	368	
<b>Project Management</b>	<b>\$ 175,000</b>	<b>\$ 1,287</b>	
Salaries & Wages	150,000	1,103	
Travel & Expenses	25,000	184	
<b>Pre-Opening</b>	<b>\$ 400,000</b>	<b>\$ 2,941</b>	
<b>Contingency - 3%</b>	<b>\$ 449,007</b>	<b>\$ 3,302</b>	
<b>Total</b>	<b>\$ 15,415,897</b>	<b>\$ 113,352</b>	

Source: Starwood Hotels & Resorts, Inc. (2007). *Aloft Summary Budget* [Brochure]. White Plains, New York: Author. Retrieved from <http://development.starwoodhotels.com/flash.html>

The cost summary details the approximate hard costs for this type of select-service hotel as well as many of the associated soft costs. [Attached as Appendices E & F are the FF&E and OS&E Summary Budgets in more detail]. Although this is simply a proposed budget, it is a useful resource to help understand the relative size and scope of the investment from an equity and debt standpoint in an Aloft hotel or similar select-



service product. According to this document, the proposed project cost exclusive of land, financing, site work and development fees is approximately \$15.5M, or \$113K per key. After incorporating these omitted line items into the budget, one can assume the project's total development cost to increase about 20%-25%, or in this case a new total of around \$19M-\$20M.<sup>147</sup>

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<sup>147</sup> Interview: Charles Floca, Executive VP of Development and Construction, Hotel Investors, LLC., June 22, 2007.

## XI. PRE-OPENING AND OPERATIONS

This section will briefly discuss some of the unique tasks associated with opening and operating a select-service hotel like the Aloft. Although essentially all operational and pre-opening responsibilities fall on the shoulders of the management company that is selected to manage the property, it is important for the owner and franchisee to understand the process and tasks involved. The section below will discuss in more detail the essential elements of the pre-opening and operational stages of this form of hotel development and ownership.

### *Pre-Opening*

The pre-opening tasks typically fall into the hands of the management company, although essentially all of the pre-opening tasks are outlined prior to the pre-opening and their costs are quantified in the Pre-Opening Budget and incorporated into the overall development budget. This pre-opening budget is mutually agreed upon by the owner/developer, and the manager and in many cases based off of a Pre-opening Plan (also know as Pre-opening Critical Path) provided by the franchisor. The pre-opening plan may include the following items:

- *Pre-construction of Model Rooms:* Once the core and shell of the property has been constructed the section of the project has become weather-tight, model rooms are frequently constructed. The construction of these model rooms serve not only as marketing tools for the sales staff, but they also allow the developer in consultation with the builder and consultants to make any last minute adjustments to the layout or finishes in the rooms. Since the pre-construction of

these rooms requires out-of-sequence trade construction in relation to the project as a whole, model rooms can be expensive to construct.<sup>148</sup>

- *Technology Infrastructure Installation:* The installation of the technology infrastructure is also a major element of the pre-opening requirements. This refers to on-line and in-house hotel booking systems, computerized payroll and accounting systems, credit card charge systems, supplier accounts, stock control systems and guest ledger review systems, among others. In addition to implementing these systems, it will also be necessary to provide training to the staff on how to utilize these systems.<sup>149</sup>
- *Pre-opening Marketing Plan:* Significant importance is placed on the pre-opening marketing effort for any new hotel. The marketing plan generally includes local and regional advertising, public relations, promotion among trade organizations and printed collateral. It is also necessary for the marketing plan to allocate resources for the sales representative's expense account.<sup>150</sup> As mentioned previously, the franchisor assesses a marketing fee in return for their considerable national and international marketing efforts.
- *Pre-opening Staff Plan:* This document outlines who is hired, when each staff member is hired, what each staff member's salary and bonus is, and what their responsibilities are. For a select-service hotel like the Aloft, there are comparatively few hires that must be in place well before opening.<sup>151</sup> The general manager (GM) is normally the first person to be placed on salary. The steps taken in hiring the GM is undertaken by the hotel manager, but the final approval from the owner is typically reserved, as this position is the most important in the hotel's operations. Following the hiring of a GM, an in-house

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<sup>148</sup> Rutherford, D. G., & O'Fallon, M. J. (2007). *Hotel management and operations*. Hoboken, N.J: John Wiley. p.22.

<sup>149</sup> Ransley, J., & Ingram, H. (2004). *Developing Hospitality Properties & Facilities* (2nd ed.). Oxford: Elsevier Ltd. p.238

<sup>150</sup> Ransley, J., & Ingram, H. (2004). *Developing Hospitality Properties & Facilities* (2nd ed.). Oxford: Elsevier Ltd. p.239

<sup>151</sup> Interview: Mark Kucera, Executive VP of Operations, Expotel Hospitality Services, LLC, June 7, 2007.

sales representative in next to come onto salary. These two individuals (GM and sales rep) typically are hired approximately three- to six-months prior to the opening date. Within a month of opening, an assistant general manager is typically hired along with the house-keeping staff.

- *Staff Training and Departmental Procedures Plan*: Incorporated within the Pre-opening Staffing Plan or as a separate element of the Pre-opening Plan, are the schedules and procedures for training all employees and for managing each department. The franchisor typically provides lengthy documentation on these topics and it is the responsibility of the management company and the general manager to operate in accordance with these documents.<sup>152</sup>
- *Operational Supplies & Equipment*: The manager, with the franchisor's guidance, must compile a list of the necessary OS&E items that will be needed prior to opening and the schedule for ordering such items. It is essential that the manager understand the lead time for these items in order to ensure that the proper supplies are available in time for the opening. The manager must also quantify the cost of such purchases and create a general re-ordering/re-stocking plan for the operational stage going forward. This task is a time-consuming and complicated one that is made much easier by the guidelines that the franchisor provides through their development services.<sup>153</sup>
- *Establish Vendor Relationships*: Establishing relationships with vendors of the various OS&E suppliers is another essential component to the pre-development plan. Whether to communicate delivery and payment procedures or to coordinate scheduling for future deliveries, establishing a working relationship with all third-party vendors is an essential task to be completed during the pre-opening stage.

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<sup>152</sup> Interview: Mark Kucera, Executive VP of Operations, Expotel Hospitality Services, LLC, June 7, 2007.

<sup>153</sup> Rutherford, D. G., & O'Fallon, M. J. (2007). *Hotel management and operations*. Hoboken, N.J: John Wiley. p.23.

- *Installation & Warehousing of OS&E:* Another task that needs to be accounted for during the pre-opening of a hotel is the installation and warehousing of the OS&E.
- *Pre-Opening Budget:* The elements described above are all essential elements in devising the pre-opening budget.

This list represents some of the many tasks that face the operator/manager prior to the opening of the hotel. Because the pre-opening period is an extremely hectic time due to the combination of construction being completed, FF&E being installed, OS&E being delivered and management establishing procedures and training staff, communication among all parties is essential. It is especially important that the manager keep the owner abreast to each stage of the pre-opening critical path.

## *Operations*

Once construction is completed, the FF&E is in place, the OS&E has been ordered and normal operations have been established, the general manager effectively takes charge of all day-to-day operations. As was discussed at length in Management Agreement section, ideally the manager and owner have monthly or quarterly meetings to assess the performance of the hotel and to make any necessary operational adjustments. It is the manager's responsibility to operate the hotel per the management agreement and the franchisor standards.

Although the owner is somewhat hands-off in the operational phase, he/she is in no way a passive investor. The owner should constantly be researching the hospitality industry in search of methods of increasing revenue, improving operating efficiency and to maximize the penetration factor. As mentioned earlier, internal (functional) and external (locational) obsolescence is one of the biggest risks for the limited and select-

service hotel product. Therefore, the more informed the owner is about the movements in the market and the ever-changing and fickle nature of the customer base, the better positioned he/she will be to protect the asset and their investment.

There may still remain some additional tasks for the owner. The owner must remain vigilant to make sure that the management company is providing the services that were stipulated in the management contract. Additionally, as was mentioned in the Financing section, depending on the form of debt financing the owner/developer placed on the property, he/she may have to convert the construction loan, refinance or sell the property all together. And finally, an owner must be prepared to react to changes in the market. Allocating a healthy reserve and keeping an exit strategy close at hand is essential for developers of any type of property. Therefore, the owner must be prepared to sell, redevelop, re-brand or reposition a property in response to changes in the external environment.

## XII. CONCLUSION

The hospitality industry is complex and the issues an investor or developer may face are similarly complex. Yet, in the current state of the lodging industry, many of these issues can be simplified and risks can be averted by following the broad outline described above. Selecting the appropriate lodging product type for a specific market is the first and most essential step. In many cases, for freshman developers as well as seasoned veterans, a franchised select-service life-style hotel product is the most prudent product type.

This study has demonstrated that select-service hotels offer an ideal combination of operational efficiency, cyclical economic stability, ease of financing, and profitability. Additionally, by embracing the franchise structure, a developer can leverage the collective resources of a large brand and sizable network to further improve the likelihood of success for a particular project. And finally, following in the footsteps of the W hotels, infusing products with the life-style brand environment should not only differentiate the product, but also allow the developer to capitalize on the influx of hotel consumers looking to break away from the static conformity of the existing stock of hotels.

Before investing into or developing lodging properties, it is critical to have a full understanding of the nuances of the hotel product segments, the specific ideal market characteristics, the competitive supply, the demand generators, the operational advantages and pitfalls, and finally, the full scope of the development process involved. It was the goal of this study to provide a pedagogical guide to the industry and to shed light on some of the intricacies of the lodging business in its current incarnation.

# APPENDIX A - Major Hotel Companies and Affiliated Brands

		<i>Parent Company</i>						
		<i>Starwood Hotels &amp; Resorts Worldwide, Inc.</i>	<i>InterContinental Hotel Group</i>	<i>Global Hyatt</i>	<i>The Hilton Family of Hotels</i>	<i>Marriott Inc.</i>	<i>Wyndham Hotel Group</i>	<i>Choice Hotels International</i>
	<b>Super Luxury</b>							
	<b>Luxury</b>	<ul style="list-style-type: none"> <li>The Luxury Connection</li> <li>St. Regis</li> </ul>	<ul style="list-style-type: none"> <li>Intercontinental</li> </ul>	<ul style="list-style-type: none"> <li>Grand Hyatt</li> <li>Park Hyatt</li> </ul>	<ul style="list-style-type: none"> <li>The Waldorf Astoria Collection</li> <li>The Conrad</li> </ul>	<ul style="list-style-type: none"> <li>Ritz Carlton</li> </ul>		
	<b>Upper Upscale</b>	<ul style="list-style-type: none"> <li>Le Meridien</li> <li>The W</li> </ul>		<ul style="list-style-type: none"> <li>Hyatt Regency</li> <li>Andaz</li> </ul>	<ul style="list-style-type: none"> <li>The Hilton</li> <li>Double Tree</li> <li>Embassy Suites</li> </ul>	<ul style="list-style-type: none"> <li>Renaissance</li> </ul>		
	<b>Upscale</b>	<ul style="list-style-type: none"> <li>Westin</li> </ul>	<ul style="list-style-type: none"> <li>Crowne Plaza</li> </ul>	<ul style="list-style-type: none"> <li>Hyatt</li> </ul>	<ul style="list-style-type: none"> <li>Hilton Garden Inn</li> </ul>	<ul style="list-style-type: none"> <li>Marriott</li> </ul>	<ul style="list-style-type: none"> <li>Wyndham Hotels</li> </ul>	<ul style="list-style-type: none"> <li>Cambria Suites</li> </ul>
	<b>Upper Midscale w/F&amp;B</b>	<ul style="list-style-type: none"> <li>Sheraton</li> </ul>		<ul style="list-style-type: none"> <li>Hyatt Summerfield Suites</li> <li>Hawthorn Suites</li> </ul>	<ul style="list-style-type: none"> <li>Homewood Suites</li> </ul>	<ul style="list-style-type: none"> <li>Courtyard</li> <li>Residence Inn</li> </ul>		
	<b>Upper Midscale w/o F&amp;B</b>	<ul style="list-style-type: none"> <li>Aloft</li> </ul>	<ul style="list-style-type: none"> <li>Hotel Indigo</li> </ul>	<ul style="list-style-type: none"> <li>Hyatt Place</li> </ul>				
	<b>Midscale w/F&amp;B</b>	<ul style="list-style-type: none"> <li>Four Points</li> </ul>	<ul style="list-style-type: none"> <li>Holiday Inn</li> <li>Staybridge Suites</li> </ul>		<ul style="list-style-type: none"> <li>Hampton Inn</li> </ul>		<ul style="list-style-type: none"> <li>Ramada</li> <li>Howard Johnson</li> </ul>	<ul style="list-style-type: none"> <li>Quality Inn</li> <li>Clarion</li> </ul>
	<b>Midscale w/o F&amp;B</b>		<ul style="list-style-type: none"> <li>Holiday Inn Express</li> <li>Candlewood Suites</li> </ul>		<ul style="list-style-type: none"> <li>TownePlace Suites</li> <li>Fairfield Inn</li> </ul>	<ul style="list-style-type: none"> <li>Baymont Inn &amp; Suites</li> <li>Wingate</li> <li>AmeriHost</li> </ul>	<ul style="list-style-type: none"> <li>Comfort Inn &amp; Suites</li> <li>Sleep Inn</li> <li>Main Stay Suites</li> </ul>	
	<b>Economy</b>			<ul style="list-style-type: none"> <li>Microtel</li> </ul>		<ul style="list-style-type: none"> <li>Spring Hill Suites</li> </ul>	<ul style="list-style-type: none"> <li>Days Inn</li> </ul>	<ul style="list-style-type: none"> <li>Rodeway Inn</li> <li>Econo Lodge</li> <li>Suburban</li> <li>Extended Stay Hotel</li> </ul>

Rankings based on the combined chain scale rankings of STR and Hotel & Motel Managements' 2007 Hotel Franchise Report



# 2007 STR Chain Scales

<b>LUXURY</b>	COLONY CONRAD FAIRMONT HOTEL FOUR SEASONS HOTEL SORTEL INTERCONTINENTAL LORENS LUXURY COLLECTION MANDARIN ORIENTAL PAN PACIFIC PREFERRED THE PENINSULA GROUP PRINCE HOTELS ST. REGIS REGENT HOTELS RITZ CARLTON STARHOTELS W HOTELS THE WALDORF-ASTORIA COLLECTION	<b>UPSCALE</b>	ADAMS MARK ALOTT AMERISUITES ASTON AVRES CAMBRIA SUITES CHASE SUITES CLUB MED COAST HOTELS USA COURTYARD HILTON GARDENINN GROWME PLAZA FOUR POINTS HARRAH'S HAWTHORN SUITES HAWTHORN SUITES LTD HOMewood SUITES HOTEL INDOGO HYATT PLACE HYATT SUMMERFIELD SUITES OUTRIGGER RADISSON RESIDENCE INN RESORTQUEST HAWAII SIENA SUITES SPRINGHILL SUITES STAVRODE SUITES WOODFELD SUITES WOODFORD SUITES WYNDHAM HOTELS XANTHER APARTS & RESORTS	<b>MIDSCALE W/F &amp; B</b>	ROMANTIC HOTEL WESTMARK SUNSHINE RESORT WESTCOAST WYNDHAM GARDEN HOTEL	<b>MIDSCALE W/O F &amp; B</b>	AMERIHOT AMERINN BAYMONT INNS & SUITES BRAND OND HOMESUITES CAROT LODGE CANALWOOD HOTEL CLUBHOUSE INNS OF AMERICA COMFORT INN COUNTRY SUITES COUNTRY INN & SUITES DRURY INN DRURY LODGE DRURY PLAZA HOTEL EXTENDED STAY DELUXE FAIRFIELD INN HAMPTON INN HEARTLAND INN HOLIDAY INN EXPRESS INSUITES HOTELS LA QUINTA INNS LA QUINTA INNS & SUITES LESS INN OF AMERICA MANSTAY SUITES PHOENIX INN RAMADA LIMITED SHILO INN SIGNATURE INNS SILVER CLOUD SLEEP INN TOWNSHIP SUITES WELLSLEY INN WELLSLEY SUITES WINGATE INN	<b>ECONOMY</b>	1 <sup>ST</sup> INTERSTATE INN ADMIRAL BENDOW AMERICA'S BEST INNS AMERICA'S BEST SUITES AMERICA'S BEST VALUE BLOODED HOST INN COUNTRY HEARTH INN CRESTWOOD SUITES CROSS COUNTRY INN CROSSLAND SUITES DAVIS INN	<b>DOWNTOWN MOTOR INN</b>	E-Z-8 ECONOLODGE INNS OF AMERICA EXEL INN EXTENDED STAY AMERICA FAMILY INNS OF AMERICA GOODNITE INN GREAT WESTERN HOMEGATE HOMESTAY STUDIO SUITES HOWARD JOHNSON EXP INN INNSPERP INNOVAL INTOWN SUITES JAMESON INN KEY WEST INN KNIGHTS INN LENGTON HOTEL SUITES MASTER HOST'S INN MASTERS INN MONTOSH MOTOR INN MOTEL 6 MOTEL 6 NATIONAL 9 PARK INN PASSPORT INN PEARLREE INN RED CARPET INN RED ROOF INN ROADSTAR INN RODEWAY INN SAVANNAH SUITES SCOTTISH INN SELECT INN SELECT SUITES SHOVELY'S INN STUDIO 6 STUDIO PLUS SUBURBAN EXTENDED STAY HOTELS SUN SUITES HOTELS SUPER 8 THREE T LODGE TRAVELLODGE VANGUARD WINDY INN
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# APPENDIX C – Aloft Facilities Program and Development Summary

## 136-Room Prototype: facilities program and development summary



GUEST FLOORS						
	Sub-total Gross Area/Use (Sq. Ft.)	% of GSF	GSF / Per Key	Sub-total Gross Area/Use (m <sup>2</sup> )	% of Gross m <sup>2</sup>	Gross m <sup>2</sup> / Per Key
First Floor	5,091	7.5%	37.0	473	7.5%	3.44
Typical Floors - 2-5	52,879	77.5%	389.0	4,913	77.5%	36.14
	57,970	85.0%	426.0	5,386	85.0%	39.58
	NSF Total GSF			Net m <sup>2</sup> Total Gross m <sup>2</sup>		
FIRST FLOOR						
Guest Corridor	618			57		
Stairs(2) & Elevators	419			39		
Net Guest Room Area	3,595			334		
	4,632	5,091		430	473	
TYPICAL FLOORS						
Guest Corridor	1,735			161		
Housekeeping	203			19		
Telephone/Electrical	66			6		
Stairs(2) & Elevators	419			39		
Net Guest Room Area	9,604			892		
	48,108	52,879		4,469	4,913	
<b>GUEST FLOOR TOTALS</b>	<b>52,740</b>	<b>57,970</b>		<b>4,900</b>	<b>5,316</b>	

PUBLIC SPACES						
	Sub-total Gross Area/Use (Sq. Ft.)	% of GSF	GSF / Per Key	Sub-total Gross Area/Use (m <sup>2</sup> )	% of Gross m <sup>2</sup>	Gross m <sup>2</sup> / Per Key
Recreation	2,079	3.0%	15.3	193	3.0%	1.42
Other Public	3,469	5.1%	25.5	322	5.1%	2.37
	5,548	8.1%	40.1	515	8.1%	3.73
	NSF Total GSF			Net m <sup>2</sup> Total Gross m <sup>2</sup>		
Recreation	-			-		
Pool	1,500			139		
Workout	579			54		
OTHER PUBLIC	2,079	2,285		193	212	
Lobby	3,069			285		
Men	158			15		
Women	167			16		
Entry Foyer	75			7		
	3,469	3,813		322	354	
<b>PUBLIC SPACE TOTALS</b>	<b>5,548</b>	<b>6,098</b>		<b>515</b>	<b>567</b>	

FUNCTION SPACE						
	Sub-total Gross Area/Use (Sq. Ft.)	% of GSF	GSF / Per Key	Sub-total Gross Area/Use (m <sup>2</sup> )	% of Gross m <sup>2</sup>	Gross m <sup>2</sup> / Per Key
Meeting Room	690	1.0%	5.1	64	1.0%	.67
	NSF Total GSF			Net m <sup>2</sup> Total Gross m <sup>2</sup>		
MEETING ROOMS						
Meeting Room Storage	93			9		
Meeting Room	524			49		
<b>MEETING ROOMS TOTAL</b>	<b>617</b>	<b>678</b>		<b>57</b>	<b>63</b>	

GUEST ROOM MATRIX				
	KING	KING ACC	Q/Q	Q/Q ACC
Level 1	7	-	5	-
Level 2	19	1	10	1
Level 3	19	1	10	1
Level 4	19	1	10	1
Level 5	19	1	10	1
<b>TOTALS</b>	<b>83</b>	<b>4</b>	<b>45</b>	<b>4</b>
64% King Guest Rooms      36% Queen/Queen Guest Rooms				

BACK OF HOUSE						
	Sub-total Gross Area/Use (Sq. Ft.)	% of GSF	GSF / Per Key	Sub-total Gross Area/Use (m <sup>2</sup> )	% of Gross m <sup>2</sup>	Gross m <sup>2</sup> / Per Key
Administration	567	0.8%	4.1	53	0.8%	.38
Food Service	483	0.7%	3.6	45	0.7%	.33
Housekeeping	527	0.8%	3.9	49	0.8%	.36
Other BOH	1,911	2.8%	14.1	178	2.8%	1.31
<b>BOH TOTAL</b>	<b>3,488</b>	<b>5.1%</b>	<b>25.7</b>	<b>324</b>	<b>5.1%</b>	<b>2.39</b>
	NSF Total GSF			Net m <sup>2</sup> Total Gross m <sup>2</sup>		
ADMINISTRATION						
Recep/FO/Rev Max Area	320			30		
Data Center	121			11		
Storage	75			7		
	516	567		48	53	
FOOD SERVICE						
F&B Pantry	211			20		
Dry Storage	228			21		
	439	483		41	45	
HOUSEKEEPING						
Laundry	479			45		
	479	527		45	49	
OTHER BOH						
Engineering Office/Shop	105			10		
Employee Break/Lockers	221			21		
Toilets	38			4		
Main Mechanical	321			30		
Main Electrical	123			11		
General Storage	165			15		
Pool equipment/Storage	105			10		
Service Corridor / Circulation	661			61		
	1,739	1,911		162	178	
<b>BACK-OF-HOUSE TOTALS</b>	<b>3,173</b>	<b>3,488</b>		<b>295</b>	<b>324</b>	

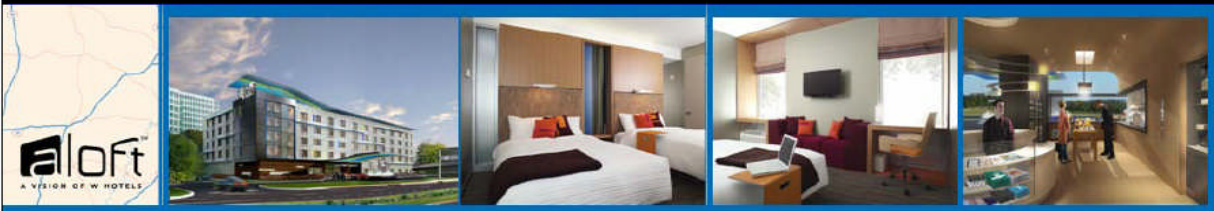
  

SUMMARY FACILITIES		
	Pt. / Sq. Ft.	m / m <sup>2</sup>
Keys	136	136
GSF/Key	502	46.64
NSF Meeting Space	617	57.32
Revenue Generating NSF/Total	78.2%	78.2%
ROOM TYPE		
King	280	15'w x 18'6"d
King Accessible	404	19'w x 15'd
Queen/Queen	327	17'6" w x 18'6" d
Queen/Queen Accessible	449	13'6" w x 28' d
BUILDING DATA		
Typical Parapet Height	3'6"	1.07
Top of Roof	54'	16.46
Max Height	57'6"	17.53
BUILDING AREA		
First Floor Area	15,990	1,468
Typical Floor	13,061	1,213
Number of Typical Floors	4	4
Total Typical Floors	52,879	4,913
Overall Building Width	245'5"	74.80
Overall Building Depth	109'11"	33.50
Height of Building	57'6"	17.53
Number of Stories	5	5
Total Building Area	68,234	6,339
SITE AREA	2.4 Acres	388'w x 272'd
		9,804
		118.3m x 82.9m
PARKING DATA		
Spaces Including Accessible	150	150

## APPENDIX D – Sample Aloft Profit and Loss Analysis & Valuation

Aloft	Annual-Yr 1		Annual-Yr 2	Annual-Yr 3	Annual-Yr 4	Annual-Yr 5	
Year	2008		2009	2010	2011	2012	
# of keys	164		164	164	164	164	
Rooms Available	59,860		59,860	60,024	59,860	59,860	
Rooms Occupied	37,930		39,827	41,932	43,099	43,099	
ADR	\$ 149.80		\$ 157.29	\$ 165.15	\$ 170.11	\$ 175.21	
Occ %	63.4%		66.5%	69.9%	72.0%	72.0%	
RevPar	\$ 94.92		\$ 104.65	\$ 115.37	\$ 122.48	\$ 126.15	
<b>Room Revenue</b>	<b>5,681,832</b>	93.6%	<b>6,264,220</b>	<b>6,925,224</b>	<b>7,331,462</b>	<b>7,551,406</b>	
<b>Food Revenue</b>	<b>135,724</b>	2.2%	<b>143,867</b>	<b>152,499</b>	<b>161,649</b>	<b>171,348</b>	
<b>Beverage Revenue</b>	<b>123,278</b>	2.0%	<b>129,442</b>	<b>135,914</b>	<b>142,710</b>	<b>149,845</b>	
<b>Telephone Revenue</b>	<b>8,838</b>	0.1%	<b>8,838</b>	<b>8,838</b>	<b>8,838</b>	<b>8,838</b>	
<b>Other Income</b>	<b>123,766</b>	2.0%	<b>126,241</b>	<b>128,766</b>	<b>131,341</b>	<b>133,968</b>	
<b>Total Revenue</b>	<b>6,073,437</b>	100.0%	<b>6,672,608</b>	<b>7,351,241</b>	<b>7,776,000</b>	<b>8,015,405</b>	
<b>Room Expense</b>	<b>996,661</b>	17.5%	<b>1,026,561</b>	<b>1,057,358</b>	<b>1,089,078</b>	<b>1,121,751</b>	
<b>Food Expense</b>	<b>149,971</b>	110.5%	<b>154,470</b>	<b>159,104</b>	<b>163,877</b>	<b>168,794</b>	
<b>Beverage Expense</b>	<b>59,871</b>	48.6%	<b>61,667</b>	<b>63,517</b>	<b>65,423</b>	<b>67,385</b>	
<b>Communication Expense</b>	<b>28,448</b>	321.9%	<b>29,301</b>	<b>30,180</b>	<b>31,086</b>	<b>32,018</b>	
<b>Other Expense</b>	<b>81,917</b>	66.2%	<b>84,375</b>	<b>86,906</b>	<b>89,513</b>	<b>92,199</b>	
<b>Comp F&amp;B Expense</b>	-	0.0%	-	-	-	-	
<b>Total Department Expense</b>	<b>1,316,869</b>	21.7%	<b>1,356,375</b>	<b>1,397,066</b>	<b>1,438,978</b>	<b>1,482,147</b>	
<b>Undistributed Expenses</b>							
<b>Administrative &amp; General</b>	<b>422,908</b>	7.0%	<b>435,595</b>	<b>448,663</b>	<b>462,123</b>	<b>475,987</b>	
<b>Marketing</b>	<b>259,714</b>	4.3%	<b>267,505</b>	<b>275,530</b>	<b>283,796</b>	<b>292,310</b>	
<b>Franchise Fees</b>	<b>539,774</b>	8.9%	<b>595,101</b>	<b>657,896</b>	<b>696,489</b>	<b>717,384</b>	
<b>Energy</b>	<b>215,208</b>	3.5%	<b>225,968</b>	<b>237,267</b>	<b>249,130</b>	<b>261,587</b>	
<b>Maintenance &amp; Repair</b>	<b>204,223</b>	3.4%	<b>210,350</b>	<b>216,660</b>	<b>223,160</b>	<b>229,855</b>	
<b>Total Undistributed Expenses</b>	<b>1,641,826</b>	27.0%	<b>1,734,519</b>	<b>1,836,016</b>	<b>1,914,698</b>	<b>1,977,121</b>	
<b>G.O.P.</b>	<b>3,114,742</b>	51.3%	<b>3,581,714</b>	<b>4,118,159</b>	<b>4,422,324</b>	<b>4,556,136</b>	
<b>%</b>	<b>51.3%</b>		<b>53.7%</b>	<b>56.0%</b>	<b>56.9%</b>	<b>56.8%</b>	
<b>Management Fee</b>	<b>242,937</b>	4.0%	<b>266,904</b>	<b>294,050</b>	<b>311,040</b>	<b>320,616</b>	
<b>Income Before Fixed Expenses</b>	<b>2,871,805</b>	47.3%	<b>3,314,810</b>	<b>3,824,109</b>	<b>4,111,284</b>	<b>4,235,520</b>	
<b>Profit %</b>	<b>47.3%</b>		<b>49.7%</b>	<b>52.0%</b>	<b>52.9%</b>	<b>52.8%</b>	
<b>Fixed Expenses</b>							
<b>Rent &amp; Leases</b>	<b>22,660</b>	0.4%	<b>23,793</b>	<b>24,983</b>	<b>26,232</b>	<b>27,543</b>	
<b>Property Taxes</b>	<b>100,008</b>	1.6%	<b>105,008</b>	<b>110,259</b>	<b>115,772</b>	<b>121,560</b>	
<b>Insurance</b>	<b>315,000</b>	5.2%	<b>330,750</b>	<b>347,288</b>	<b>364,652</b>	<b>382,884</b>	
<b>FF&amp;E Reserve</b>	<b>121,469</b>	2.0%	<b>200,178</b>	<b>294,050</b>	<b>311,040</b>	<b>320,616</b>	
<b>Total Fixed Expenses</b>	<b>559,137</b>	9.2%	<b>659,730</b>	<b>776,579</b>	<b>817,695</b>	<b>852,604</b>	
<b>Net Operating Income</b>	<b>2,312,668</b>	38.1%	<b>2,655,080</b>	<b>3,047,530</b>	<b>3,293,589</b>	<b>3,382,916</b>	<b>REVERSION VALUE</b>
							\$ 42,286,448
	<b>Pessimistic</b>	<b>Optimistic</b>					
<b>Exit Cap</b>	<b>9%</b>	<b>6.5%</b>					
<b>Discount Rate</b>	<b>12%</b>	<b>9.5%</b>					
<b>Market Value</b>	<b>\$ 29,406,588</b>	<b>\$ 41,279,498</b>					

## APPENDIX E - FF&E Summary








**aloft FF&E Summary**  
June 14, 2007

**136 Keys**  
**68,231 GSF**

<b>GUESTROOMS &amp; CORRIDORS</b>		<b>BUDGET</b>	<b>PER KEY</b>
Studio King		\$ 362,879.61	\$ 2,668.23
Studio Double Queen		\$ 226,257.50	\$ 1,663.66
Corridors		\$ 61,874.88	\$ 454.96
Attic Stock	2.0%	\$ 13,020.24	\$ 95.74
<b>Sub Total Guestrooms &amp; Corridors</b>		<b>\$ 664,032.22</b>	<b>\$ 4,882.59</b>
<b>PUBLIC AREAS</b>			
PUBLIC AREAS			
Lobby		\$ 128,821.78	
Meeting & Fitness (Tactic & Re:charge)		\$ 13,120.98	
Outdoor & Pool Area (Backyard & Splash)		\$ 20,989.00	
Admin / BOH		\$ 5,107.47	
FF&E Lamping Allowance		\$ 10,000.00	
Public Areas Attic Stock	2.0%	\$ 3,360.78	
<b>Sub Total Public Area</b>		<b>\$ 181,400.01</b>	<b>\$ 1,333.82</b>
<b>Sub Total FF&amp;E</b>		<b>\$ 845,432</b>	<b>\$ 6,216.41</b>
<b>Other</b>			
Purchasing Fee		\$ 40,000.00	
Receiving - Warehousing - Freight	8.0%	\$ 67,634.58	
Tax	5.0%	\$ 42,271.61	
Installation - Allow \$110,000 - Included in Construction Budget			
<b>Subtotal Other</b>		<b>\$ 149,906.19</b>	
<b>Total FF&amp;E</b>		<b>\$ 995,338</b>	<b>\$ 7,318.66</b>

# APPENDIX F - OS&E Summary

    							
OS&E Summary							
June 14, 2007							
					<b>Total</b>	<b>Rooms:</b>	<b>136</b>
						<b>Rooms:</b>	<b>136</b>
OS&E Categories			Per Rm. \$	Total \$\$			
Accounting			\$99	13,434			
Guest Room Floors ice machines ( Assumes use of refuel freezer only)			\$0	0			
Office Furniture & Equipment (Assumes in ff & e)			\$0	0			
Employee Facilities			\$18	2,419			
Engineering			\$42	5,700			
Rooms			\$63	8,614			
Guestrooms			\$1,674	227,658			
Aloft Beds ( Assumes bedframes are carried in the FF&E Budget )			\$682	92,731			
Refresh (Housekeeping)			\$213	29,029			
Laundry			\$7	1,000			
Remix (Public Area)			\$14	1,953			
Human Resources			\$25	3,360			
Security			\$18	2,405			
Uniforms			\$90	12,175			
Rinse			\$5	657			
In touch			\$4	500			
Radios & Pagers			\$7	1,000			
Recharge			\$260	35,427			
Splash			\$15	2,073			
<b>Sub Total Operating &amp; Other</b>				<b>\$3,236</b>	<b>440,136</b>		
FOOD & BEVERAGE SUPPLIES							
	Seats	Mtg Rm Sq. Ft.	Per Rm Cost	Per Seat Cost	Per Sq. Ft. Cost		
Banquets		678			\$10	6,556	
Refuel						10,225	
Lobby Bar -W XYZ Bar						9,700	
Kitchen		678				2,500	
<b>Sub Total Food &amp; Beverage</b>						<b>28,981</b>	
<b>Sub Total All Supplies</b>						<b>\$3,449 469,117</b>	
Purchasing Fee ( Paid by Ownership )					3.0%	14,074	
OTHER							
Pick N Pack - Guestroom Only					\$25 per key	3,400	
Warehousing& install					3.0%	14,074	
Freight					6.0%	28,147	
Sales tax					5.0%	23,456	
Inflation					2.0%	9,382	
<b>Total OS&amp;E Project Budget</b>				<b>\$4,130</b>	<b>561,649</b>		
facilities summary							
136 Guest Rooms- 87 King, 49 Doubles			Refuel - 24 hour food pantry				
Mtg Space - Tactic (1 meeting room 678 SF)			WXYZ Bar - Full service lobby bar				
Recharge - Fitness Facility (579 SF)			In Touch- Business Center				
Splash - Indoor Pool ( 1500 SF)			Parking- 150 spaces				
Budget Assumptions							
Ice service is via freezer in refuel, no ice machines required							
Assumes office furniture is in ff & e and includes filing cabinets as part of set up							
Assumes bed frame is carried in ff & e budget, mattress in os & e							
Assumes any decorative throw and/pillows for beds are carried in ff & e budget.							
Assumes Pool table in Remix in covered under ff & e budget							
Plasmas for remix are budgeted in IT; guestroom, associate facilities & meeting room tv's are in os & e							
Assumes all light bulbs are covered under ff&e and gc budgets.							
Assumes lease of copier & fax machines as required							
Assumes banquet chairs & tables are carried in ff & e							
Assumes banquet linens are not required or will be rented							
Assumes any payroll timeclocks & accessories to be carried in IT budget							
Assumes lockers are in GC budget							
Assumes vanity mirror is not wall mount. If mounting required, install carried in gc budget							
Assumes inkeepers & evacuation & all brand required life safety sign signage to be part of interior signage package.							
Assumes ada pool lift is covered in gc budget							
Assumes initial wash of linen & terry to be done in house during staff training							
Assumes no cooking in kitchen based on brand allowance							
Assumes no room service							
Assumes no costs for set up of all refuel vending equipment							
Assumes per brand direction that no entrance mats are required. Function is incorporated into design of entryway							

## GLOSSARY OF HOSPITALITY TERM DEFINITIONS

Below is a brief summary of terminology which is unique to the hospitality and lodging industry:

- **ADR:** The Average Daily Room Rate is total room revenue divided by the number of rooms sold.
- **Amenity Creep:** Amenity creep refers the tendency of lower tier products to continuously incorporate additional amenities and services into their offerings so as to obtain a competitive advantage. Ultimately, amenity creep can move a lower-scale product into a higher classification because of the additional amenities and the price premium that must be charged to pay for the additional amenities.
- **EBITDA:** This acronym stands for Earnings Before Interest, Taxes, Depreciation and Amortization and it is essentially the term used for the net operating income (NOI) for the hospitality industry.
- **Fair Share:** This term refers to the percentage of the rooms in a market that a particular hotel represents. If a market has 1000 rooms, and a particular hotel has 100 rooms, that hotel's fair share of the market is 10%.
- **FF&E:** FF&E refers to the Furniture, Fixtures and Equipment that are incorporated into the decorative finishes within a hotel.
- **Franchisee:** In this study, the franchisee can refer to either the developer of the underlying real estate that will ultimately become branded with a specific hotel brand, or the owner of such hotel. For instance, the developer of a hotel property becomes a franchisee once they have executed a franchise or license agreement with a particular hotel company to affiliate their property with a particular brand.
- **Franchisor:** In this study, the franchisor refers to the hospitality company that controls the hotel brand. For instance, Starwood controls the Sheraton hotel brand and is thus a franchisor of that hotel brand.
- **GOP:** GOP or Gross Operating Profit is essentially the total revenue net of operating expenses.
- **Market Share:** A hotel's market share refers the percentage of the markets demand that a particular hotel captures.
- **Occupancy:** As with other segments of the real estate industry, occupancy refers to the room supply divided by the room demand. A healthy hotel market should have a occupancy level of between 65% and 75%.
- **Operating Profit Margin:** The operating profit margin (sometimes referred to as "profit margin") is the percentage that is the result of dividing the operating profit by the total revenue. The higher the percentage is, the operating efficiency the property has.



- **Operating Profit:** The operating profit of a hotel is found by subtracting the total operating expense from the total revenue.
- **OS&E:** The OS&E is the operating supplies and equipment associated with running a hotel. This may include items like towels, sheets and even specialized letterhead.
- **Penetration Factor:** The penetration factor which is a measurement of a specific hotel's performance in relation to the market at large, is found by dividing the market share by the fair share. If a hotel is doing better (or expected to do better) than the market on average, then the penetration factor will be above 100%. If it is not "holding its own", it will be less than 100%. Penetration factors are often calculated according to any segment of the guest population.
- **Rack Rate:** The Rack Rate at a hotel is the published rate for a particular category of room. This is a non-discounted rate and is usually the highest rate the hotel can charge for that category of room.
- **RevPAR:** RevPAR, or Revenue Per Available Room, is the total room revenue divided by the total number of rooms. It is also calculated by multiplying the occupancy by the room rate.
- **Room Demand:** This refers to the number of rooms that have been sold in a particular market or combination of markets for a particular period of time.
- **Room Night:** The majority of hotels sell rooms by the day (or night). It essentially refers to a particular room on a particular night. Therefore, the most basic unit of measurement in the hotel industry is the room night.
- **Room Supply:** This refers to the supply of rooms available in a particular market or combination of markets. It may also refer to the supply of rooms in a market for a particular period of time. In this case, the room supply is the number of rooms in the market multiplied by the number of days (or nights) within the time period of interest. For example, a market with 1,000 rooms has a 365,000 room supply for a particular year.
- **Spend per Stay:** This refers to the amount of money spent per stay, which includes not only room revenue, but also amenity related expenditures.
- **Uniform System of Accounts for the Lodging Industry:** The USALI provides definitive standards for hotels to classify, organize, and present their financial information. By limiting the degree of variation in the preparation of financial data, comparability is enhanced and the resulting output is suitable for the needs of users such as investors and industry associations. The system is structured using the principles of responsibility accounting, enabling senior management and owners to evaluate the performance of departmental managers and supervisors based on revenues and costs within their control.

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