Partial Takings of Lodging Facilities

Operational Issues Affecting Hospitality Uses

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The measurement of just compensation for partial takings is often a challenging analytical process irrespective of the type of real estate being valued, but the appraisal issues are further complicated when considering special-use properties such as lodging facilities. Hotels and motels are a unique class of real estate which are management intensive and have many businesslike components. Accordingly, the operations of the facility in its before condition must be fully understood in order to evaluate the operational constraints imposed by the partial taking.

The objective of this article is to provide right-of-way professionals with a basic understanding of the operational issues affecting lodging properties and how a partial taking can alter a facility's competitive position in the after condition. A summary of the income approach methodology is presented first to familiarize the reader with the fundamentals that dictate a property's economic performance. Once the underlying factors which determine ADR (average daily rate), occupancy, and operating expenses are understood, the focus will shift to the effects that can result from a partial taking and the corresponding impacts on the competitive positioning of a lodging facility. The principal premise advanced is that hotels and motels cater to a consumer clientele that have preconceived levels of guest expectation and quality. Even when the physical impacts appear nominal, partial takings can profoundly alter guest expectations and, thereby, have long-term impacts on the facility's revenues and expenses.

Jurisdictional differences dictate the methodology for measurement of just compensation. The principal variance is the inclusion or exclusion of an intermediary step–the value of the part taken. Federal rules measure just compensation using a before and after approach whereby just compensation is measured as the difference between the before value and the after value (the remainder). Conversely, several states and municipalities provide compensation to property owners for the part taken regardless of the impact on the remainder. While these differences are important to right-of-way professionals, they are not the central focus of this article. The principal intent herein is to identify the factors which must be considered when evaluating a partial take of a hotel or motel property so that the impacts on the remainder are properly analyzed.

AN OVERVIEW OF MARKET VALUE IN THE BEFORE CONDITION

The principal methodologies for valuing lodging facilities are detailed by Stephen Rushmore.[1] Consistent with generally accepted appraisal practice, the cost, market and income approaches are applicable. As an income producing property, however, the income approach is typically relied upon when estimating market value.

To develop fundamentally sound income projections, there are several critical requirements. First, analysts must have a comprehensive understanding of supply and demand in the market area. This includes current supply, future supply, demand generators, and market segmentation. These variables establish the framework for selection of the competitive supply, the subgroup of properties with which the subject most directly competes. Within a given market area, particularly in locations with favorable demand generators, there may be multiple lodging facilities, but not all are direct competitors due to differences in room rates, amenities, or market segmentation. A basic categorization includes budget, mid-tier, and full-service properties. However, even within these categories, there are important distinctions. An all-suites hotel, for example, may compete in the mid-tier market segment, but all-suite properties typically compete only with other all-suite hotels because of differences in the market segmentation of a traditional lodging property and an all-suites hotel.

When developing the competitive supply, consideration should be given to similarities in the physical and locational attributes of each property. A facility's size, age, amenities, proximity to demand generators, and room configurations are the principal components affecting average daily rate and occupancy. Franchise affiliation (i.e., Hilton, Holiday Inn, Hyatt, etc.) can also be a factor, depending upon location and demand generators in the market.

Once established, it is imperative to conduct detailed surveys of the competitive supply. Through these surveys, the analyst should, at a minimum, ascertain the ADR, occupancy, market mix (segmentation), amenities, principal group accounts, principal demand generators, and room mix for each of the competitive facilities. The importance of this information cannot be understated. It is essential not only for preparing the valuation of the subject in its before condition, but also for developing the framework to analyze the impacts that result from the partial taking.

After the surveys are complete, it is proper to forecast income for the subject. The projection of income is based on an estimate of the market ADR and market occupancy for the subject property. Use of rack rates is an unacceptable practice and will yield an unreliable value estimate. The average daily room rate is defined as "total guest room revenue divided by the total number of occupied rooms."[2] Rack rates are the hotel's quoted room prices prior to discounts or seasonal price adjustments and are rarely reflective of a hotel's actual performance.

The next phase of the income approach is a detailed analysis of operating costs. As stated in the introduction, hotel and motel properties are a unique class of real estate because there are many businesslike components to the operations.

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Unlike most forms of real estate, these properties are labor intensive, and guest comfort is a paramount concern. Poor management can seriously impact guest comfort, which will negatively influence occupancy and ADR.

Like any form of retailing, hotels and motels achieve success through consumer satisfaction. Minimal expectations are clean rooms and courteous service, but more substantial consumer expectations arise as properties compete at the higher end of the price spectrum. At full service hotels, guests expectations may include on-site restaurants, a full array of recreational amenities, business support services, and concierge services. Other services might also be expected depending upon location and market practice. The implication for appraisers is that each level of service correlates to additional labor, additional maintenance costs, and different management practices. Without understanding these relationships, it is possible to misstate operating expenses even when relying on historical cost information.

Operating costs are typically segregated according to the Uniform System of Accounts for Hotels recommended by the American Hotel-Motel Association. Primary expense classifications include departmental expenses (rooms, food, beverage, telephone, other), undistributed operating expenses (administrative and general, franchise fees, marketing and guest entertainment, property operations and maintenance, and energy costs), and fixed expenses (management fees, property taxes, insurance, and equipment leasing). Reserves for replacement can also be deducted prior to capitalization, but the inclusion of reserves varies by property classification (motel versus hotel), location, and investor purchase assumptions.

Expense estimates are developed from historical cost structures at the subject, industry expense guidelines, and expense comparables. Each is important to establishing credible expense forecasts, but the analyst must be certain to understand the operational needs of the hotel demanded by its rate structure and market positioning. Given the labor intensive needs of a hotel and the consumer oriented nature of the hospitality industry, it is highly probable for a hotel to be under-or over managed by its current operators. Staffing policies need to be understood, as do the services provided and their relationship to the services provided at the competitive supply. Sophisticated operators can often utilize labor more efficiently without diminishing the quality of the guest experience. It is also possible to reposition a hotel's market mix in order to generate superior revenue, but such tactical positioning can often create additional expenses which must be reflected in the pro forma if a reliable estimate of value is to be developed.

The capitalization methodology employed in the before condition is dictated by investor purchase criteria. Direct capitalization and yield capitalization (i.e., discounted cash flow analysis) are the two methods available, and both have considerable merit. However, each should typically be utilized when performing part-take appraisals because the valuation of the remainder may require sensitivity analysis that is best measured using a discounted cash flow. If this technique is not performed in the before value analysis, the ability to compare and contrast value conclusions in the after condition is diminished. While this is not uniformly necessary, and there are alternative techniques to analyzing operational impacts in the after condition, performing a discounted cash flow analysis of the subject in its before condition is good practice.

While emphasis is traditionally given to the income approach when valuing lodging facilities, the sales comparison approach is useful and appropriate. The relevance of the technique, however, is a function of the quality of the data and the similarities of the sale properties and the subject in terms of market mix, demand generators, room rates, and amenities. Since the data is generally dissimilar in one or more areas of economic performance, the sales comparison approach is best used as a cross-check to the values derived from the income approach. There are also specific problems with use of the sales comparison when valuing the remainder because the sales comparison technique is generally incapable of isolating diminutions in value resulting from a partial taking. These issues will be more fully addressed below.

VALUATION ISSUES RESULTING FROM A PARTIAL TAKING

Before conducting the valuation of the remainder after the part taken, it is essen-

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tial to understand the nature of the taking and how construction in the manner proposed (assuming a public improvement project is responsible for the taking) will affect the remainder. Common conditions which arise from a partial taking are (1) a loss of parking, (2) altered access into the property, and (3) lost landscaping. The author is also familiar with some extreme impacts resulting from partial takes. In one instance, the proposed take necessitated cutting and facing the improvements, which resulted in a loss of rooms. In another instance, a proposed freeway widening resulted in new freeway lanes that were within extreme proximity to the hotel property. The resulting freeway proximity threatened to raise substantially the ambient noise levels in the after condition. In still another instance, the proposed construction timetable was so long, and the level of construction activity so severe, that continued operation of the hotel was in doubt during the construction period because of guest comfort concerns, inadequate access, and possible loss of principal group accounts. The owners were also threatened with a loss of their franchise affiliation in addition to the loss of accommodated demand. Closure was a consideration even though closure is generally considered a death sentence for lodging facilities.

While extreme impacts can arise from partial takings, even conditions that are apparently benign can be more significant than initially perceived. The consumer-oriented nature of the lodging industry does not necessarily mean that curative measures mitigate all damages. For example, while a loss of parking at a budget motel facility could be cured through valet parking, guest expectations in the market may favor garden style walk-up parking if the facility caters to budget-oriented, transient tourists. The existence of valet service creates changed expectations in service level and rate structure, and the facility may lose accommodated demand as a result.

The value of lodging facilities and the impacts resulting from a partial taking are also a function of market segmentation. In tourist destinations, for example, a common strategy employed by operators is to sacrifice room rate for occupancy by selling group tour packages. However, the group tour market segment is extremely competitive, and it would not be unexpected for competitive group tour facilities to alert wholesale packagers to an impending public improvement project at one of the competition.

Since wholesale packagers are ultimately concerned with the guest experience, the subject could lose market share. However, the concerns go beyond recognizing this loss. Group tour business generally has a two-to three-year stabilization trend, and group business is frequently sold two to three years in advance. If the wholesale providers redirect their clientele away from the subject property, it is highly unlikely a property will restabilize upon completion of the proposed public improvement project. The property might also experience higher marketing expenses during and after the construction as it attempts to regain its lost market share.

One common misconception is that a hotel can avert such problems by shifting its market segmentation away from group tours to other demand segments such as leisure or business. However, these demand segments also require heavy marketing to achieve full penetration. Large corporate accounts are limited in number, and convention business or meetings are highly competitive segments. Of all the demand categories, transient tourists are perhaps the easiest to recapture, but few hotels, even those in tourist destinations, can survive by catering to this demand segment exclusively.

As these examples illustrate, the impacts of a part take can be profound because the success of hotels and motels is heavily dependent on guest expectations and satisfaction. The implications for analysts confronted with partial takings of lodging facilities are twofold. First, there must be a fundamental understanding of the demand characteristics of the clientele in the before condition and the corresponding level of service expectation. Second, it must be recognized that the conditions which arise from a partial taking can alter a lodging facility's ability to remain competitive with its current competitive supply, and that management may need to reposition the asset so it competes at a different rate level or targets different demand segments. In either case, there will likely be an interim to permanent decline in gross revenue, as well as a corresponding adjustment in operational costs in the after condition.

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The challenges facing analysts at this point are considerable, and the empirical evidence to support projections of future economic performance after the take may be limited. For instance, one would be hard pressed to identify a case study in which a budget motel in a suburban resort location incorporated valet parking. However, the absence of a direct case study could be the strongest empirical data that valet parking is not a viable solution for the parking shortfall, and might indicate that if other solutions prove infeasible, the impacts on future operations would be significant.

The empirical limitations that exist when developing forecasts of future operations are surmountable, and several areas of research are valuable when evaluating the impacts resulting from a partial taking. Some of the best information can be developed through systematic interviews with local operators to ascertain possible strategies with respect to the market mix or repositioning the asset. There are also a number of empirical case studies which can be developed from analogous situations. However, caution must be used when employing case studies because different market conditions or differences in demand segmentation at the affected facility can diminish their relevance to the subject.

As noted above, discounted cash flow analysis is typically the preferred method for assessing the impacts resulting from a partial take of a lodging facility. The advantage of this technique is its ability to focus directly on the near-term revenues and expenses the property can anticipate after the partial taking. While curative measures can mitigate most, if not all, damages, a lodging facility may still experience residual damages resulting from lost market share, a decline in ADR, an increase in operating expenses, or a need to reorient market mix. Since the discounted cash flow can isolate the impact of each variable individually, it provides the best framework for estimating value in the after condition.

Unlike the discounted cash flow, the sales comparison technique is the least reliable method for estimating the value of the remainder unless the analyst takes extreme care to select sale comparables impacted by the same operational constraints as are imposed on the subject in the after condition. Though this method should not be ignored entirely, it generally proves to be of limited value, particularly when the subject is confronted with extreme changes in its operational needs.❑

SUMMARY

All part-take appraisals entail a high degree of skill and professionalism, and the problems identified in this article extend beyond hotel and motel properties. However, the unique characteristics of the lodging industry require an added degree of understanding. The failure to properly analyze market segmentation, the nature of the competitive supply, or the operational requirements of the subject in its before and after condition can result in a serious misstatement of just compensation.

It is hoped that the issues identified will assist professionals when confronted with a partial taking of a hotel or motel property. While a comprehensive study is beyond the scope of this article, the central theme is that analysts must thoroughly understand the factors underlying the economic performance of the subject. Only when these elements are properly identified and analyzed can one accurately gauge the extent to which the conditions imposed by the partial taking will affect the subject and the degree to which curative measures are feasible or capable of fully or partially mitigating damages.

NOTES

1. Stephen Rushmore, MAI, *Hotels, Motels and Restaurants, Valuations and Market Studies*, (Chicago: American Institute of Real Estate Appraisers of the National Association of Realtors, 1983).

2. *The Dictionary of Real Estate Appraisal, 3rd Edition*, (Chicago: The Appraisal Institute, 1993), page 24.

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