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Hotel Surfing in California: Which Brand Rides the Best Waves?

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Abstract
This case features R.D. Olson Development (RDOD), a prominent hotel developer that has been presented with an RFP opportunity to develop a hotel in a prime master planned development in Southern California. As RDOD works towards submitting its RFP bid, it has many things to consider, including most notably the brand that it will select for its proposal. With a quality franchisor in place, it must decide whether to pursue a high-quality select-service hotel, or a full-service hotel instead. RDOD's decision must take into account a number of variables, including and especially the interests of the other project stakeholders. The case follows the typical timeline and process for a development opportunity, specifically focusing on the feasibility work, brand selection, and strategic decision-making as RDOD prepares for its RFP response to the landowner.

Keywords
Cornell University, real estate, hospitality brand management, hotel franchising, finance, request for proposals, development, underwriting, hospitality, full-service, select-service, commercial, master planned, walkability, supply, demand, market, submarket, differentiation, site, franchise, franchisor, amenities, ADR, keys, facilities, furnishings, operating budget

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Hotel Surfing in California:

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ABSTRACT

This case features R.D. Olson Development (RDOD), a prominent hotel developer that has been presented with an RFP opportunity to develop a hotel in a prime master planned development in Southern California. As RDOD works towards submitting its RFP bid, it has many things to consider, including most notably the brand that it will select for its proposal. With a quality franchisor in place, it must decide whether to pursue a high-quality select-service hotel, or a full-service hotel instead. RDOD's decision must take into account a number of variables, including and especially the interests of the other project stakeholders. The case follows the typical timeline and process for a development opportunity, specifically focusing on the feasibility work, brand selection, and strategic decision-making as RDOD prepares for its RFP response to the landowner.

This case study incorporates the following real-estate themes and issues:

Hospitality Brand Management

Hotel Franchising

Real Estate Finance

Request for Proposals

Real Estate Development

Underwriting

Hospitality Real Estate

Hotel Surfing in California: Which Brand Rides the Best Waves?

By: Gregory Miller and Blake Evans

An e-mail arrived in Charlie Portman's inbox early on the morning of February 9, 2012 and his eyes lit up with excitement as he reviewed the attachment. The Clifton Woodruff Company (CWC) had finally placed a very coveted piece of real estate on the market via a request for purchase (RFP) to a select handful of hotel developers, including Portman's company, R.D. Olson Development (RDOD). Portman quickly forwarded the RFP documents to the other key leaders at RDOD. Later that hour, an impromptu internal meeting was called to discuss how to move forward. "Plaza De Oro is finally ready to go!", Portman thought to himself.

In the RFP, CWC asked respondents to identify in their proposals the hotel operator that they intended to work with, and expressed a desire for brand recognition. Any competing developers responding to the RFP would no doubt be aligning with major brands. Over the next two months, RDOD would select Stanfield Hotels & Inns (Stanfield), one of the world's most recognized hotel franchisors. Stanfield was eager to add another hotel in Southern California to its portfolio and the highly successful Plaza De Oro master planned development near San Diego was a very tempting proposition.

The RFP signaled CWC's desire for a full-service hotel flag[1] - a hotel that would have a three-meal restaurant, significant meeting space, and upscale amenities. While RDOD recognized the logic behind this preference, it felt that developing a high-quality select-service hotel was likely more appropriate for the site and would offer more favorable financial dynamics.

An RFP response was due in eight weeks, with presentations to follow just a week later. For RDOD, time was of the essence to conduct the necessary analysis and to make a decision. RDOD executives found themselves in a difficult position. Coming to the table with a select-service proposal would be a gamble, given CWC's interest in seeing a full-service hotel developed. There was no guarantee as to how CWC would receive the idea of a select-service hotel being developed instead. Portman's boss, Bob Olson, addressed his team as they prepared to begin work on the proposal: "We may only get one shot at this, so we better make it a good one."

R.D. Olson Development

Based in Irvine, California, RDOD was a developer of commercial real estate properties with a focus in Southern California and Hawaii. RDOD was experienced in the development of office, retail, multi-family and recreational projects and specialized in developing hospitality properties. Robert "Bob" Olson (Olson) founded RDOD in 1997, following nearly twenty years as Founder and CEO of R.D. Olson Construction, a general contractor specializing in commercial real estate. As of 2012, Olson was the President and CEO of both companies, providing a unique perspective as both a builder for third-party developers and as an owner/developer.

RDOD was very active in the years prior to the recession that began in 2008, opening

1 'Flag' refers to a hotel's brand affiliation. Hotel franchisors often have multiple flags, catering to different segments of the market.

Author

Gregory J. Miller is currently pursuing two degrees at Cornell: an MBA from the Johnson Graduate School of Management and an MPS in Real Estate from the the Baker Program in Real Estate. Miller earned a Bachelor of Business Administration degree with Distinction from Emory University's Goizueta Business School in 2004. At graduation, Miller received the Todd Whitman Outstanding BBA Achievement Award. Miller has worked for Hyatt Hotels Corporation, Intuit, The Boston Consulting Group, PKF Consulting, Marriott International, and The Kor Group. He has authored and co-authored articles for Lodging Magazine and HSMAI Marketing Review and was quoted in Hotel Management and Nation's Restaurant News. Miller is also the founder and former president of the DFW Emerging Leaders in Hospitality. Following graduation in 2015, Miller plans a career in hospitality and mixed-use development with specific interests in investments, brand creation, and international markets.

two hotels in 2007 and another in 2008. The freezing of the credit markets in 2008 and 2009 prompted RDOD to pull back on further activity until the economy improved. Starting in 2010, Olson decided that it was time to begin actively developing again, despite the opinion of many people in the industry that newly-built hotels would not be feasible for years to come. Proving its detractors wrong, RDOD opened a select-service Courtyard by Marriott in Oceanside, California in November 2011, followed by three more hotels in 2012. RDOD looked to continue its pace of opening two to four hotels per year for the foreseeable future. This velocity of growth garnered significant attention in the hotel industry – not only in California, but also throughout the country. Its recent success helped to distinguish RDOD as a developer who could get things done, even under difficult circumstances.

Charlie Portman

Charlie Portman was the Senior Director of Development and Finance for RDOD. Following his graduation from the University of New Mexico, he spent fifteen years working for various real estate developers in the Southwestern United States. A native of Santa Fe, Portman was keenly aware that hotels had a long-term impact on the community and the economy of the area that they served. For the past three years, Portman had gained responsibility for RDOD's hospitality development projects in the Southern California market. Portman was eager to make an impact at RDOD with a homerun project that would add considerable cachet to the RDOD brand.

The Clifton Woodruff Company

CWC was a major privately held real estate development company based in Atlanta, Georgia. CWC specialized in master planned developments throughout the Southeastern United States and California. Founded by four graduates of Emory University and the Georgia Institute of Technology in 1927, CWC initially focused on single-family residences in metropolitan Atlanta, Savannah, Georgia, and Knoxville, Tennessee. In the fifty years that followed, CWC grew rapidly, acquiring large pieces of land for master-plan development. In 1950, an opportunity to acquire a significant parcel in San Diego County resulted in the to be developed Plaza De Oro.

By 2012, CWC was one of the largest privately held real estate developers in the United States. The company held 70,000 acres of developable land in California alone, mostly in San Diego, Riverside, and Marin counties. In most cases, CWC would develop buildings or residences and sell ground leases, keeping fee simple interest in the land. Approximately 10% of the land that it developed was sold to other parties.

CWC was notorious for being very conservative in pursuing development opportunities, even drawing the ire of city officials for keeping land undeveloped for decades before moving forward with its development plans. Notwithstanding these frustrations, CWC's reputation for quality projects, sound judgment, and integrity was very strong. CWC's developments tended to enjoy lease/rental rates at a 10% to 20% premium over comparable sites in the same markets.

Plaza De Oro was one of CWC's most successful developments in California, garnering awards for the cohesive uses and tasteful utilization of Mexican Neoclassical-inspired architecture. As CWC was increasingly focused on international opportunities, the company became determined to complete Plaza De Oro by selling any remaining parcels to successful developers who would honor the strong reputation of the site.

Author

Blake Evans serves as vice president of finance for R.D. Olson Development, providing services including financial modeling and underwriting, market feasibility study, due diligence analysis, arranging for debt and equity funding, government agency liaison, and consultant coordination. Evans has worked in the finance industry since 2003, primarily focused on real estate. Before joining R.D. Olson Development, Evans served nearly three years as a senior financial analyst in the asset management division of SunCal Companies, a large master planned developer on the west coast. He was responsible for providing the executive management team with cash flow management analysis, project debt and equity underwriting, quarterly project status reports, and project portfolio underwriting for over 20 master planned communities in various stages from acquisition to disposition. A graduate of the University of Southern California's Marshall School of Business in 2003, Evans obtained a dual major in corporate finance and real estate finance. He also obtained, in 2008, the Certificate in Hotel Real Estate Investments and Asset Management from Cornell University's School of Hotel Administration.

The Site

Portman thought that developing a hotel in the Plaza De Oro master planned development was a no brainer. Olson shared Portman's enthusiasm, and asked him to immediately visit the site to reacquaint himself with the market to get a feel for the product type that would be most appropriate there. In the meantime, Olson would begin contacting potential franchise partners to see who might be interested in flagging the hotel.

Plaza De Oro was situated in the north San Diego County city of Golden Rivage, California. The site was surrounded by 3.3 million square feet of office space and a popular super-regional shopping center. The site was also within a mile of three different freeways. The few existing hotels in the area achieved strong rates and healthy occupancy, despite not being in the heart of Plaza De Oro. The newest hotel in the submarket was over ten years old, and Portman was confident that a new hotel in a prominent site such as Plaza De Oro could surely succeed in shifting demand away from stale product.

As Portman drove into the Plaza De Oro site, he saw a dense development with easy walkability throughout. The hotel parcel was right off of the freeway, about 20 miles from the San Diego International Airport. Portman could tell that the Golden Rivage area was its own submarket, distinct from downtown San Diego and the nearby coastal communities.

The hotel parcel was comprised of vacant land adjacent to two Fortune 1000 headquarters, within walking distance of six high-rise Class-A office buildings, a super-regional mall to the north, some light-industrial in surrounding areas, a variety of upscale apartments and high-rise condominiums, and other vacant parcels near the entrances to the development. The development included a major fitness center, over 15 restaurants, and basic neighborhood amenities such as dry cleaners and convenience store. Importantly, the regional mall's premier restaurants were located just across the street from the hotel site – a great amenity to have within such close proximity, although Portman was concerned that the hotel might lose dining revenue to these restaurants. In Portman's mind, access to the site was very good, and the hotel would have favorable visibility from surrounding roads**.** Overall, Portman was very pleased with what he saw.

CWC's RFP

CWC's RFP requested a branded hotel development proposal for a facility consisting of at least 200 rooms, with minimum meeting space of 10,000 square feet (see **Exhibit 1 – RFP Excerpt**). The brand selection and detailed facility package were left up to the RFP respondents to determine, however in the course of discussions with CWC, RDOD learned that CWC's preference was for a full-service hotel. CWC considered Plaza De Oro to be a Class-A location with major office tenants who would be drawn to a marquee property for its prestige and who would hold meetings and events in the conference space.

The backstory that influenced the need for a hotel was the considerable supply-demand imbalance that characterized the submarket. CWC's RFP noted that in 2011, businesses in Plaza De Oro generated approximately 39,000 group room nights[2] related to meetings, training events, and conferences that were not accommodated in the local hotel market. Due to the lack of sufficient hotel room and meeting space availability, these high-paying corporate groups often stayed in downtown San Diego hotels. Several companies that leased office space in Plaza De Oro were starting to grumble that CWC's long-standing promise for a hotel in the center of the development was never going to happen. Major office leases were coming due and CWC felt the need to act quickly on the hotel parcel.

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[2] 'Group rooms' are rooms that are sold simultaneously in blocks (typically blocks of ten rooms or more). Examples include corporate, association, social/fraternal, religious, convention and corporate groups.

The Golden Rivage Submarket

Over the next three days, Portman met with various government officials, hotel managers, and business professionals. He compiled some of the critical information regarding the submarket, confirming data with the local economic development office. Portman learned that there were 5.9 million square feet of Class-A office space within the Golden Rivage submarket, 9% office vacancy, and 300,000 square feet of office space under construction. Portman also compiled employment and air passenger traffic data (see **Exhibit 2 – Employment and Air Passenger Traffic Data**) and noted that there were improving dynamics for each. While the passenger movements at the San Diego International Airport had fallen in recent years, they were beginning to turn the corner and it was clear that San Diego was still a highly-visited destination for corporate, group, and leisure travelers. Most critically, there were no hotels under development in the submarket, and due to hotel financing issues it was unlikely that any hotel supply would be added in the near future.

CWC had ensured that the growth of Plaza De Oro was meticulously planned from the beginning. CWC purchased 27% of the land in Golden Rivage in 1950 as a diversification from its real estate holdings in Atlanta. CWC slowly built Plaza De Oro into a highly successful development, although a prominent hotel was still missing. Despite the density in the development, its central square was just a well-trimmed field of grass, looking oddly deserted in the context of the vibrant surroundings.

After visiting Plaza De Oro, Portman drove around to all of the area hotels, viewed sample guest rooms and the common guest amenities, and then assembled a competitive set of the most comparable hotels in the area. All five of the properties in the competitive set were within five miles of the proposed hotel. The closest hotel, a Four Points, was located on the outskirts of Plaza De Oro, 1.3 miles from the hotel site. The other hotels were between three and five miles away, in B and C locations.

Table A

Competitive Set

Competitive Set

Property	Location to Hotel Site	Property Condition	Service Offering	Hotel Class	Year Opened	Rooms
Four Points	1.3 miles southwest	Renovation in 2006, tired	Select-Service	Upscale	1987	249
Courtyard	4.8 miles north	Renovation in 2011, good condition	Select-Service	Upscale	1991	156
La Quinta	2.9 miles east	Renovation in 2007, fair condition	Limited-Service	Midscale	1990	136
Holiday Inn Select	5.4 miles southeast	Renovation in 2007, fair condition	Full-Service	Upper Midscale	1997	248
TownePlace Suites	3.3 miles southwest	Renovation in 2010, good condition	Select-Service (Extended-Stay)	Upper Midscale	1999	112
						901

Portman felt comfortable that the competitive set was a good indicator for the proposed hotel. The competitive set represented the closest properties to the submarket's major demand generators. Further, these hotels were most successful in attracting the corporate demand from Plaza de Oro. While some properties were in better condition than others, all were acceptable hotel stays for the target guest profile. The major disadvantage for the competitive set was attributable to their respective locations. While all of the properties were well located along a major freeway, there were no hotels within the Plaza De Oro development itself, thus providing less direct comparability.

There was significant differentiation between the competitive hotels in terms of amenities and facilities, but the disparity was considered typical of the brand offering and did not constitute anything unusual for the market (see **Exhibit 3 – Competitive Set Amenities**). However, in terms of meeting space, there was an opportunity for a new hotel to capture group business. The two largest hotels, the Four Points and the Holiday Inn Select, each had over 9,000 square feet of meeting space. General managers for both hotels noted to Portman that the hotels were losing groups to other markets due to their aged hotel product and the lack of a large ballroom. Large groups sought ballrooms with at least 5,000 square feet. However, neither hotel could expand its meeting facilities due to space limitations. Portman knew that RDOD had an opportunity to capture a significant share of the group business in the market with a comparatively large ballroom. In addition to having superior meeting space, the proposed hotel could also have other features and amenities that would be desired in the market, including a business center and breakout meeting space.

Portman thought that the CWC hotel site was far superior to the other options, given that Plaza De Oro was considered to be a major demand generator. In fact, Portman estimated that 35% of the total demand from the five hotels was driven by Plaza De Oro. Based upon market interviews and discussions with local hotel owners, Portman further estimated that an additional 20,000 room nights per year of Golden Rivage individual corporate transient demand stayed at hotels outside of the competitive set due to sell-outs during the peak business workdays of Tuesday and Wednesday.

The Four Points was considered to be the highest-rated property in the market due to its proximity to Plaza de Oro and its highly successful targeting of high-rated demand. Despite its tired condition, the Four Points had a highly successful sales and management team that was very good at attracting business. Consequently, the Four Points would be the most significant competitor to the proposed hotel, whether the hotel was positioned as select-service or full-service.

The Four Points currently had the closest location to Plaza De Oro and the most amenities, positively impacting its rate positioning. The Four Points reportedly had a five-year average occupancy of 75% and an average daily room rate (ADR) of $145. The second-most comparable hotel, the Courtyard, had a five-year average occupancy of 76% and an ADR of $140. Among the competitive set, RevPAR[31] had fallen significantly during the 2009 economic downtown, but had recovered well (see **Exhibit 4 – Competitive Set Performance**).

Portman had confidence in the market and considered the strong hotel performance, excellent site location, limited new hotel supply, and good economic conditions as providing considerable rationale for development. Portman agreed with Olson's contention that a full-service hotel or possibly a high-quality select-service brand would work well on the site. Portman thought that whichever of the two product types they chose would immediately become the most desirable hotel in the market. Now it was time to decide on a hotel franchisor.

The Franchise Model

Franchising had long been a dominant business model in the hotel industry. Just as a fancy steakhouse and a fast-food restaurant catered to different clientele, hotel companies tended to offer many hotel flags representing a variety of price-points and targeted markets. This strategy had generally worked very well. As of March 2012, of the total hotel product in the United States, approximately 69% of the rooms and 58% of the hotels were franchised.[2] These assets were primarily owned by multi-unit hotel developers and institutional investors, including REITs, insurance companies, and private equity investors.

The franchising model involved an agreement between a hotel owner and a hotel brand/franchisor. The franchisor allowed the owner to develop a hotel with its features, amenities, and name recognition ('flying a hotel flag') in order to attract a steady stream of customers who sought the features and standards associated with the brand. The brand's

[3] According to *PKF Trends In The Hotel Industry 2012*, 'occupancy' is the percentage of available rooms occupied over a given period. It is calculated by dividing the number of paid guest rooms occupied for a period by the number of rooms available for the same period. 'ADR', or average daily room rate, is calculated by taking the total guest room revenue divided by total paid occupied rooms over a given period of time. In this case, students should assume that ADR is representative for a full year. 'RevPAR', or revenue per available room, is calculated by taking the total rooms revenue divided by the total number of available rooms.

responsibility was to provide an operational platform for the hotel, assist with sales and marketing efforts (principally through its reservation system), implement and revise brand standards, and strengthen the brand's competitive positioning for travelers.

In consideration of the franchisor's efforts, the franchisor received various franchise, reservation, guest loyalty, marketing, and other fees. These fees were generally based on either the hotel's revenue from its guestrooms and/or the total revenue from the hotel. Some hotel franchisors also acted as hotel operators and managed hotels on behalf of owners, also for a fee. Some franchisors managed all of their hotels, while other franchisors allowed owners to either operate hotels themselves or to engage third-party managers.

The franchise model was one that RDOD had eagerly adopted. With hotel operations not being its forte, RDOD depended upon third-party branding and management to ensure that its hotel projects were successful. But as the leader of a company that took immense pride in the quality and viability of its projects, Olson knew that selecting appropriate franchisors and managers was not to be taken lightly, as it was crucial to the firm's financial success and its long-term reputation.

Stanfield Hotels & Inns

Portman knocked on Olson's door and proceeded to go over his preliminary analysis. Few sites in the market could be profitable as a full-service hotel, but both gentlemen were confident that the Plaza De Oro site had potential. Olson had put out feelers to several major hotel franchise companies and to potential third-party management companies. For franchisors, Olson considered companies such as Hilton, Hyatt, Marriott, and Starwood. For third-party managers, Olson contacted a number of prominent companies with experience in the area. Some companies were interested, but were unable to move forward due to territorial restrictions[4], while others were holding firm on what Olson considered to be excessively high franchise and management fees. As the franchise and management fees would have considerable economic consequence, such a decision had to be carefully considered.

Franchisors charged franchise fees even if a third-party managed their hotels. These fees ranged considerably, but were generally between 4% to 6% of rooms revenues. Additional marketing fees ranged from 1% to 5% of rooms revenues.[3] Management fees generally included a base management fee of approximately 1.5% to 6% of total revenues and additional incentive fees that varied based on performance thresholds determined between the hotel owner and the manager.[4] Often, franchisors eliminated the traditional franchise fee if they were given the right to manage the hotel, thereby incentivizing the owner with lower fees.

The company that had the most interest in franchising a hotel in Plaza De Oro was a firm that RDOD had never worked with in the past - Stanfield Hotels & Inns. Stanfield had relatively limited hotel representation in Southern California, but had a significant presence in the Northeastern United States, Canada, the Middle East, Asia, and Oceania - all large feeder markets for San Diego. Stanfield had an impressive reputation for providing excellent hotel management, often winning accolades from hotel trade and consumer publications. Additionally, Stanfield had recently appointed a new CEO who was known to be aggressively pursuing new franchises in order to significantly grow its hotel coverage.

Through conversations with Stanfield, Olson learned that the company was willing to be highly flexible, both in terms of the facilities for the hotel and in terms of management fee discounts in order to secure the franchise. Ultimately, it was Stanfield's favorable terms that won over Olson. While Stanfield occasionally permitted third-party management, it

[4] Territorial restrictions define the operator's ability to operate properties at any location except in a specified area, as noted in the contract with the owner.

was best known for operating hotels on behalf of owners. As compensation for managing the Plaza De Oro hotel, Stanfield proposed a discounted 2% base management fee on total revenues. Further, Stanfield also decided to forgo its standard 8% incentive fee[55] based on operating profits before fixed charges (IBFC[6]), providing RDOD with a greater stake in hotel profitability. Stanfield proposed a five-year term, with three five-year renewals.

Stanfield was also willing to offer considerable financial incentives to RDOD if it was also chosen to manage the hotel. Stanfield was prepared to provide $250,000 in key money[76] for a Valleyview and $1,000,000 in key money for a Castletop (see flag classifications below), both of which would be payable upon the hotel opening. None of the other franchisors that Olson had considered were willing to offer more than $100,000 in key money.

Overall, compared with the alternatives, Stanfield represented what in Olson's mind was the best mix of attributes and fees. Olson maintained reservations about Stanfield's limited presence in the region; however Stanfield had an impressive pipeline building and current distribution issues in Southern California appeared to be dissipating. Over a late night telephone call, Olson informed Stanfield that RDOD wanted to move forward with the RFP with Stanfield as its proposed franchisor. The necessary paperwork would soon follow.

Full-Service Versus Select-Service

At the time, hotels were generally classified by their price-point and basic amenities and services offered, and by virtue of those attributes, as either '*full-service*' or '*limited-service*'. Full-service hotels offered a wide range of services, including spas, valet parking, and room service; however they were most defined by having a two to three-meal restaurant and significant meeting space. Limited-service hotels sometimes had some full-service amenities and services, but generally contained limited-to-no meeting space and few food offerings. Most limited-service hotels had simple architecture and interior designs. Full-service hotels were generally more expensive for travelers to stay at, and more expensive to build than limited-service hotels.

A hybrid of the two classifications was known as '*select-service*'. Select-service hotels were increasingly popular options for travelers, as guests were offered some full-service amenities and a higher-quality stay, but at a moderately discounted rate to a full-service hotel. Many hotel owners were fond of select-service hotels because the hotels had less expensive and more efficient operating models, relatively strong occupancies and ADRs, and were deemed to be desirable by customers.

The lending environment was also a crucial factor. Few full-service hotel loans were getting approved at the time and the full-service hotels that did secure loans generally required significant equity. The select-service model required less equity and was generally looked upon much more favorably by prospective lenders.

With seven brands, ranging from midscale properties to upper-upscale hotels, Stanfield offered hotel owners a variety of different product types. 'Castletop' was Stanfield's prominent, upper-upscale full-service brand and was located in major markets all over the world. Castletop was recognized by travelers for excellent service and high-quality accommodations, particularly for business travelers and group customers. The flag was most commonly located in city-center, resort, and upscale suburban locations and competed

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5 According to *The Cornell School of Hotel Administration on Hospitality: Cutting Edge Thinking and Practice*, median base management fees for United States chain-operated full-service and limited-service hotels are 2.75%. The incentive fee is on the low range of typical fees for chain-operated hotels in the United States.

6 'IBFC' is also known as 'Gross Operating Profit' ("GOP")

7 Key money' is a financial contribution that an operator gives to an owner at the contract's signing, or upon opening of a facility.

directly with Hilton, Marriott, Sheraton, and Hyatt Regency.

'Valleyview' was Stanfield's prominent upper-tier select-service brand. Valleyview properties offered quality accommodations, but with limited services — usually limited to a breakfast area, pool, fitness room, and a small meeting room. Valleyview properties were popular with business travelers that either could not or did not wish to pay for a full-service hotel. The flag was most commonly located in suburban, airport, and interstate locations and competed directly with Hampton Inn & Suites, Courtyard, Hilton Garden Inn, aloft, and Holiday Inn Express.

The aggregated national performance of both flags demonstrated significant above-market penetrations against their competitive sets. Furthermore, their wide distribution made the brands prominent for international travelers. However, as noted in **Exhibit 5 – Aggregated National Performance for Castletop & Valleyview Brands**, the geographic distribution of the brands in the United States trailed their respective competitors.

In order to provide RDOD with guidance as to which flag would be most appropriate for Plaza De Oro, Olson contacted Stanfield's Executive Vice-President of Development, Bonnie Aaronson, to give her the green light to conduct a detailed feasibility study, with the caveat that the study must be completed within two weeks and must provide an overview of both the Castletop and the Valleyview brands as viable alternatives. Olson added one more request – that Stanfield model the select-service option on an 'enhanced' basis, with amenities and custom finishes above and beyond that which was typical of the Valleyview flag. Olson wanted Stanfield to take the amenities of a select-service model and exaggerate them in order to give travelers a more upscale experience. For example, the restaurant was to be more reflective of the needs of the local community[7]. In Olson's mind, the hotel could provide a larger bar and lounge area than brand standards called for, a spacious fitness room with the most advanced equipment, and a pool and patio area fit for the beautiful Southern California climate. These amenities would give the hotel a full-service feel, without the burden of the full-service operational costs.

Although the construction costs would be higher than a conventional select-service hotel, Olson thought that the ADR, food and beverage restaurant and lounge projections would support the more upscale product. Regarding the meeting space, Olson noted that it was crucial that the meeting space requirement stipulated by CWC be fulfilled. While 10,000 square feet of meeting space was significantly higher than most select-service hotels of comparable room counts, Olson knew that he had no choice but to accept the meeting space minimum that CWC had imposed. He realized that the Valleyview would not be as desired by higher-rated banquet and group business and the projections would reflect that accordingly.

Olson explained to Aronson that although he wanted to consider both full-service and (enhanced) select-service options, a select-service hotel was his preference. As he explained, CWC likely wanted to hear about the 24-hour room service, an upscale restaurant and bar, and concierge, and wanted the property to be hip, prestigious and unique in order to be worthy of its inclusion in the community. But Olson argued that an upscale full-service hotel wasn't what modern business travelers necessarily demanded, even in prime locations. He continued:

> "Guests want value, freedom, and functionality. Today's seasoned business traveler is tired of being nickeled and dimed by the expected gratuity at every turn and overpriced, unsatisfying hotel meals. At Plaza De Oro, there are great restaurants right across the street! And, besides, guests are perfectly capable of parking their car, handling their bag, and finding their own room. Moreover, and perhaps more importantly, the full-service model is not what today's financing community appreciates. Lenders want efficiency, profitability, and simplicity. They're still working through portfolios littered with overleveraged full-service properties whose income and values have been crushed under the weight of the

heavy labor models and sagging margins."

With that, Olson asked Aronson to be in touch with him and Portman as soon as Stanfield's team had assembled the necessary analysis. Aaronson immediately called Richard Newman, Stanfield's internal feasibility analyst for the Southwest, in order to start the feasibility work. Coincidentally, Newman was also one of Portman's oldest friends from college. Newman would be tasked with creating a facilities program, market study, and financial projections for Stanfield's full-service Castletop brand and an enhanced version of Stanfield's select-service Valleyview brand. After two days of desktop due diligence from his office in Houston, Newman developed facilities summaries for the two brands (see **Exhibit 6 – Facilities Summaries**). Newman then left on the first available flight to San Diego.

Over the next few days, Newman evaluated the submarket, visiting various hotels and meeting with industry leaders and major employers. After a great deal of work and discussion with Stanfield's operations leadership, Newman forwarded his report to Aaronson, which included pro formas and corresponding assumptions summaries (see **Exhibit 7 – Pro Forma Input Assumptions**). Aaronson reviewed the results and sent summary reports to Portman and Olson. With Newman's studies in hand, Portman could analyze and scrutinize the operating budgets and compare them against RDOD's own internal due diligence. After reading through the documents, Portman called Newman to set up a meeting to discuss the financial projections.

Getting Down to Brass Tacks

Newman and Portman met at a Japanese shabu-shabu restaurant for lunch the next day. During the meal, Newman explained some of the rationale behind the analysis. As he explained, most of the pro forma assumptions were based on the historical performance of newly opened Castletop and Valleyview hotels, along with the recent performance of Stanfield's California hotels. The occupancy and ADR performance assumptions reflected a moderate premium over the current performance of the competitive set. Newman informed Portman that in his view, the projections were aggressive, but achievable based on the current market conditions. Portman concurred, noting that his due diligence indicated similar market potential.

Due to the greater room count, upscale facilities, and higher-quality furnishings, the costs for the Castletop were significantly higher than for the enhanced Valleyview. Further, the soft costs were higher for the full-service hotel as the architectural, design, consulting, legal, and other fees were greater for a more luxurious and larger product. The pre-opening expenses for the full-service hotel were also considerably higher, reflecting the greater staffing requirements for the Castletop before the hotel opened. Portman was also aware that RDOD had built enough select-service hotels to have gained considerable efficiencies in construction, thereby further reducing the costs for the enhanced Valleyview.

Table B

Development Budget Summaries

Development Costs	Castletop	Valleyview
Hard Costs	$50,000,000	$32,000,000
Soft Costs	$8,000,000	$7,000,000
Land Costs	$7,000,000	$7,000,000
Pre-Opening	$2,000,000	$1,000,000
Total Costs	$67,000,000	$47,000,000

As they finished their ribeyes, Portman was also interested in discussing some issues that reached beyond the numbers. He was interested to hear how Stanfield candidly felt about RDOD's preference for an enhanced select-service hotel, in lieu of the full-service hotel that CWC appeared to prefer. Portman knew that given the limited number of full-service hotels that Stanfield had developed in the United States since 2008 (four), versus the plethora of select-service hotels that it had built during the same time (37), Stanfield, like CWC, would be eager to push for a full-service product. Newman made the pitch for full-service, noting:

> "We're not alone in wanting full-service Charlie. No one is building full-service in this market today, not even Marriott, Hilton, or Hyatt. Well, they can't at Plaza De Oro due to territorials anyways. Anyhow, this site is great. You want to build a Valleyview? Fine. You can build your fancier Valleyview with more-than-normal meeting space and call it 'full-service light.' As you've seen, Bonnie has been more aggressive with respect to the key money for Castletop. We need a Castletop in this market. Between you and I, I wouldn't be surprised if Aaronson starts funneling hotel development and renovation projects to Bob if Castletop goes through. We know that RDOD builds great hotels and your reputation is only improving in the region. And being a partner with Stanfield could mean great things when the economy improves and hotel development really heats back up in a few years. We need a partner in the West when the market gets back around. It's like surfing, Charlie. You build us a Castletop now and maybe you get a first right to build a few more in Southern California when the market recovers. You may be with your surfboard far out from the beach now, looking for that great wave of opportunity. Stanfield wants you to be riding down the wave with us when development gets back to normal. Bob would appreciate that analogy, right?"

Portman was well aware that for Stanfield, having a successful full-service hotel in the market would be a badge of honor, and that the Plaza De Oro site might be its best chance to accomplish that. Valleyview hotels were reliable successes, both from a revenue and expense standpoint. Castletop hotels, meanwhile, were somewhat more risky and subject to lower profitability during downturns. In the most recent economic recession, fourteen Castletop hotels were given back to the banks due to their owners' inability to pay debt service.

Portman did his best to explain to Newman why an enhanced select-service hotel made much more sense for RDOD, stressing that if full-service projects could secure financing at all, the rates often crushed the viability of the deal. Nevertheless, Newman was adamant, noting:

> "Here's the thing Charlie: what does CWC want? Full-service! It's a prestige issue with CWC — they want a quality hotel next to these corporate headquarters and the mall. In my view, all of the risks associated with Castletop are worth taking. Where do you and Bob want to take this company? Do you know what it will mean when you get a Castletop developed in *this* economic environment? All of the hotel companies will be in awe that you not only won a bid from CWC, but also got a full-service hotel built in the U.S., without public funding, in California of all places. And what does that do for you and your career? Charlie, I've said too much, but my words are as a friend and not on behalf of Stanfield. I still think that you should look hard at Castletop."

None of this was news to Portman, but what did resonate with him strongly was something else that Newman casually mentioned earlier during their meal – that during discussions with some people close to CWC, Newman had learned that CWC was very concerned with the ability of the selected developer to execute the proposed project and perform on a tight and strict schedule. CWC was very concerned that if the developer failed to execute the project expediently, for example through failure to obtain favorable construction financing, CWC could be impacted by office vacancies and declines in real estate values.

According to Newman, the office vacancy issues were broiling. When Newman was in the market, he spoke with Donald Bekker, the CEO of Aja Fagen Records. Aja Fagen Records was Plaza De Oro's second largest office tenant, controlling 380,000 square feet of space. The company recently issued an ultimatum to CWC, requiring that a hotel be built within the next three years, failing which it would not renew its lease.

Newman learned that part of the reason why CWC went to RDOD was due to its reputation for building hotels on time and efficiently, even though RDOD was mostly a select-service developer. CWC could not afford to wait years for full-service hotel financing to be as readily available as it had been in the past.

Portman drove with his old friend back to the airport, promising during the car ride that he would give the Castletop option more thought. Waving goodbye to Newman, thoughts flooded his mind. Was RDOD correct to push for an enhanced Valleyview? How adamant was CWC about a full-service model? Were the arguments for select-service that sounded so compelling coming from Olson's lips going to be equally compelling to CWC's ears? RDOD now had all of the financial information that it required in order to model the alternatives, but there were plenty of other issues, in various shades of gray, that needed to be considered and understood.

Burning the Midnight Oil

Later that night, with a computer screen the scene of a flurry of financial models, RFP documents, and market information, Portman integrated the information that he had sourced from Stanfield with the data that he had produced himself.

Portman used development timelines of 24 months for both the Valleyview and the Castletop, as per the construction schedules provided by RDOD's team. Portman assumed that the construction would commence at the start 2013 and be completed by the end of the year. While the Valleyview property would take a few fewer months to build, Portman assumed a calendar year 2014 opening for both properties in order to maintain consistency with the pro formas. Then, he took the operating budget assumptions and facilities information that Stanfield had provided and built out a separate five-year investment pro forma for each of the two brands, assuming an exit at year five in both cases. For the time being, Portman assumed full RDOD ownership, without joint ventures or other equity partners, which Olson considered very likely to be the case.

To come up with reasonable financing assumptions, Portman spoke with several potential lenders to feel out the terms upon which they could secure financing for both a construction loan and a permanent loan. Although the Castletop brand would be more difficult to finance, Portman did find lenders who would extend financing under the right circumstances (although what the 'right circumstances' were remained uncomfortably uncertain). He knew that the financing terms available would differ for the two brands, recognizing the spread in perceived risk, so he reflected these differences in his underwriting. Ultimately, Portman utilized the following debt assumptions:

Valleyview	Construction Loan	Permanent Loan
LTV Ratio	65%	70%
Interest Rate	7.0%	6.5%
Term	3 years	10 years
Amortization	N/A	25 years
Cap Rate Assumption	N/A	7.75%

Castletop	Construction Loan	Permanent Loan
LTV Ratio	55%	60%
Interest Rate	8.0%	7.5%
Term	3 years	10 years
Amortization	N/A	25 years
Cap Rate Assumption	N/A	7.00%

Table C

Debt Assumptions

Portman assumed a refinancing with the permanent loan commencing in year four and reflected refinancing proceeds at the end of year three. Upon the resale of the hotel at the end of year five, 2% of closing costs were assumed.

With this information lined up, Portman was able to calculate the return metrics for the two project alternatives, including NPVs, equity multiples and five-year IRRs. For the exit scenarios, he assumed an 7.0% cap rate for the Castletop and 7.75% for the Valleyview. In order to be conservative, Portman used a discount rate of 10.5% to calculate the net present values of both potential projects and decided to use the stabilized income in year 3 to acquire permanent financing.

His work yielded a characteristically well-polished financial model that summarized all of the information that they had assembled during the previous weeks. But again, Portman's mind turned to all of the other issues regarding the project that weren't apparent in a financial model - issues that RDOD had to carefully consider.

One Box, Two Proposals

Portman spent the final days prior to the RFP response due date preparing the proposal and considering what had taken place over the course of the previous few weeks. In-depth market studies were conducted, architectural renderings were produced, and the RFP response was carefully crafted. The RDOD team was confident that they were pursuing a sound strategy if they went with either flag, but they were apprehensive about CWC's response to a proposal that would not completely fulfill its requests. As a result, RDOD had prepared two studies - one as a Castletop and one as a Valleyview. It was time to decide on a flag.

Meeting one last time, Portman and Olson discussed the key questions: How should RDOD prioritize its desire for profit, strategy, relationships, and long-term reputation? How would this growing, but relatively small development company take a giant step forward in this project? Was choosing a Castletop to appease CWC and Stanfield a good enough reason to take on additional risk?

Portman and Olson looked out of Olson's office window, southwest to the California sun and the Pacific Ocean, with two proposals in their hands and one UPS box. In two hours, one proposal would go in the box and the other would go into the recycling bin.

Exhibit 1

RFP Excerpt

Property Description: 5.8-acre site on the northeast corner of Broadview Drive and Sequoyah Boulevard.

Land Cost: Seven Million Dollars ($7,000,000).

Scope and Design: Hotel with at least 200 rooms with service parking. CWC maintains approval rights of architecture (exterior and interior), amenities, meeting space, and site planning. CWC requires an internationally recognized hotel brand with upscale facilities, services, and amenities.

Zoning: Site is fully zoned for hotel and complementary uses (H-4). CWC does not anticipate needing any zoning changes for this project, based on the requirements noted in this document.

Additional Attributes: CWC requests at least 10,000 square feet of meeting space to handle social events for the north San Diego residents as well as corporate meetings and functions for the area businesses. The meeting space is required to be between the previously mentioned figures and is non-negotiable. The hotel should include at minimum a three-meal restaurant, an exercise facility, and an outdoor pool. Other upscale full-service amenities befitting the hotel and local clientele are also desired.

Other Comments: As part of your findings and proposal, we would appreciate your view as to the type of hotel facility that would best serve the needs of Plaza De Oro and present a marquee hotel to further enhance the reputation and prestige of our development.

Exhibit 2

Employment and Air Passenger Traffic Data

Local Employment Trends

Year	Employment	Unemployment Rate
2006	63,300	3.5%
2007	62,200	4.0%
2008	61,400	4.3%
2009	54,000	7.2%
2010	56,200	6.8%
2011	58,600	6.3%
2012F	61,000	4.5%

Source: Local Economic Department interviews

Passenger Trends: San Diego International Airport

Year	Passengers	Percent Change
2005	17,372,521	6.1%
2006	17,481,942	0.6%
2007	18,326,734	4.8%
2008	18,125,633	-1.1%
2009	16,974,172	-6.4%
2010	16,889,622	-0.5%
2011	16,890,722	0.0%

Source: San Diego International Airport

Amenities Comparison	Four Points	Courtyard	La Quinta	Holiday Inn Select	TownePlace Suites
Rooms	249	156	136	248	112
Three-Meal Restaurant	X	*breakfast only*		X	
Complimentary Continental Breakfast			X		X
Hotel Lounge				X	
Meeting Space (SF)	11,257	800	250	9,478	0
Largest Meeting Room (SF)	3,000	800	250	2,601	0
Room Service				X	
Business Center		X			
Pool	X	X	X	X	X
Exercise Room	X	X	X	X	X
Complementary Wireless Internet	X	X	X	X	X
Complementary Parking	X		X		X

Note: Xs denote the presence of the amenity at the hotel

Exhibit 3

Competitive Set Amenities

Competitive Set Performance				
Year	Rooms	Occupancy	ADR	RevPAR
2007	901	72.7%	$155.00	$112.69
2008	901	70.0%	$161.00	$112.70
2009	901	63.1%	$134.00	$84.55
2010	901	68.7%	$130.00	$89.31
2011	901	71.5%	$135.00	$96.53
Year-to-Date 2/11	901	69.0%	$129.00	$89.01
Year-to-Date 2/12	901	74.0%	$136.00	$100.64

Exhibit 4

Competitive Set Performance

Hotel Brand	Total North American Properties (YE 2011)	Total Non-North American Properties	Occupancy	Average Daily Rate	RevPAR	Penetration on Competitive Set
Castletop	210	580	68.2%	$125.51	$85.60	117.9%
Competitve Set Average	372	251	63.1%	$115.10	$72.63	100.0%
(Doubletree, Marriott, Hilton, Hyatt, Renaissance, Sheraton, Westin)						
Valleyview	250	315	67.2%	$99.52	$66.88	119.1%
Competitve Set Average	331	77	62.1%	$90.41	$56.14	100.0%
(aloft, Courtyard, Hilton Garden Inn, Hyatt Place)						

Exhibit 5

Aggregated National Performance for Castletop & Valleyview Brands

Exhibit 6

Facilities Summaries

Facilities Summary

Proposed Castletop Hotel Plaza De Oro

Guest Rooms	Number	Percentage
Kings (350-380 SF)	100	40%
Double Queens (380-400 SF)	90	36%
Concierge Level (420 SF)	40	16%
Suites (550-1,500 SF)	20	8%
Total	250	100%

Food and Beverage Outlets	# of Seats
Restaurant (Three-Meal)	65
Lobby Lounge	20

Meeting Space/Conference Center	Square Footage
Ballroom (divisible by 8 sections)	7,000
Other Meeting Space	6,000
Total	13,000

Other Amenities	Notes
Business Center	separate room
Concierge Lounge	--
Room Service	in room
Spa Services	in room
Bell Service	includes shuttle service within a 5-mile radius
Gift Shop	300 SF
Swimming Pool	Exterior, includes slide and whirlpool
Shuffleboard Court	--
Three-Hole Mini Golf and Putting Area	--
Rooftop Patio and Yoga Lawn	--
Fitness Room	1,000 SF

Facilities Summary

Proposed Valleyview Hotel Plaza De Oro

Guest Rooms	Number	Percentage
Kings (300-320 SF)	100	50%
Double Queens (320-340 SF)	90	45%
Suites (500-700 SF)	10	5%
Total	200	100%

Food and Beverage Outlets	# of Seats
Restaurant (Breakfast Only)	35
Lobby Lounge	6

Meeting Space/Conference Center	Square Footage
Ballroom (divisible by 8 sections)	7,000
Other Meeting Space	3,000
Total	10,000

Other Amenities	Notes
Business Center	in lobby
Gift Shop	100 SF, next to front desk
Swimming Pool	Exterior, includes whirlpool
Fitness Room	500 SF

Exhibit 7

Pro Forma Input Assumptions

	Castletop	Valleyview
General Inputs		
Available Rooms (Daily)	250	200
Available Rooms (Annually)	91,250	73,000
Occupancy Percentage	Year 1: 63% Year 2: 70% Year 3+: 75%	Year 1: 68% Year 2: 73% Year 3+: 78%
Occupied Rooms	*occupancy * annual available rooms*	
Average Daily Room Rate (ADR)	Year 1 - $180, increasing with inflation	Year 1 - $150, increasing with inflation
Revenue Per Available Room (RevPAR)	*occupancy * ADR*	
% RevPAR Growth	*increase from prior year*	
General Inflation Assumption for Pro Forma	*increase of 3% per year*	
Revenues		
Rooms	*RevPAR * occupied rooms*	
Food and Beverage - Restaurant and Lounge Outlets (per occupied room)	Year 1: $25 Year 2: $30 Year 3: $35 (increasing with inflation thereafter)	Year 1: $8 Year 2: $10 Year 3: $12 (increasing with inflation thereafter)
Food and Beverage - Banquets (per occupied room)	Year 1: $40 Year 2: $45 Year 3: $50 (increasing with inflation thereafter)	Year 1: $10 Year 2: $12 Year 3: $14 (increasing with inflation thereafter)
Other Operated Departments	$350,000 increasing with inflation	$50,000 increasing with inflation
Departmental Income		
Rooms (% of departmental revenue)	75%	80%
Food and Beverage - Restaurant and Lounge Outlets (% of departmental revenue)	15%	20%
Food and Beverage - Meetings & Banquets (% of departmental revenue)	35%	40%
Other Operated Departments (% of departmental revenue)	95%	95%
Undistributed Expenses		
General & Administrative (% of total revenue)	6.5%	7.0%
Marketing (% of total revenue)	7.0%	6.0%
Operations & Maintenance (% of total revenue)	3.0%	3.0%
Utilities	3.0%	3.0%
Fixed Costs		
Property Taxes	$400,000 in year one, rising at 2% annually	$300,000 in year one, rising at 2% annually
Insurance	$250,000 in year one, rising at 2% annually	$200,000 in year one, rising at 2% annually
Management Fees	*2.0% of total revenue per year*	
FF&E Reserves for Replacement (% of total revenue)	Year 1: 3% Year 2: 4% Year 3+: 5%	Year 1: 3% Year 2: 4% Year 3+: 5%
Permits	$60,000 in year one, increasing with inflation	$50,000 in year one, increasing with inflation
Other Fixed Costs	$140,000 in year one, increasing with inflation	$100,000 in year one, increasing with inflation

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