

8-1988

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Recommended Citation

deRoos, J. A. (1988). Development in the '80s: The facts of life after tax reform [Electronic version]. *Cornell Hotel and Restaurant Administration Quarterly*, 29(2), 10-12. Retrieved [insert date], from Cornell University, School of Hospitality Administration site: <http://scholarship.sha.cornell.edu/articles/168/>

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Development in the '80s: The Facts of Life After Tax Reform

Abstract

U.S. hotel development now consists of deals that are built to make money, not tax breaks. Here's a look at the many complications that can beset hotel developers.

Keywords

hotels, tax reform, hotel development, revenue, acquisition, liability

Disciplines

Hospitality Administration and Management

Comments

Required Publisher Statement

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Development in the '80s:

The Facts of Life after Tax Reform

U.S. hotel development now consists of deals that are built to make money, not tax breaks. Here's a look at the many complications that can beset hotel developers

by Jan A. deRoos

NO ONE in the hotel business needs to be told that times have changed. Twenty years ago, a hotel operator could take a standard design, build it on almost any site, and make money. The hotel business was not concentrated, and the barriers to entry were relatively low. Today, each project must be carefully matched to its site, the industry is highly concentrated, and the barriers to entry are getting higher all the time.

But it's still possible to make money developing hotels. Otherwise there wouldn't be so many developers. In this article, I'll discuss how each phase of hotel development has changed in the past few years. In each of the steps—land acquisition, conceptual planning, preliminary approvals, working drawings, construction and project administration—the changes have made project management far more complex. Even the post-construction punch list requires planning beforehand.

Formerly a project manager for Houston-based Mariner Hotel Corporation, Jan A. deRoos is an assistant professor of properties management at the Cornell School of Hotel Administration. This article is drawn from a presentation the author made at Cornell.



Site Acquisition

Quite simply, good sites are hard to find. Most of the prime sites are gone, and you can easily find yourself in a deal involving a poor site. Yet the cost of a site can make all the difference in whether your project will make economic sense. Construction costs per room are fairly standard, depending on the type of property you're building. But acquisition costs are a major variable, ranging from \$15,000 to \$45,000 per room. As a result, site costs can effectively determine the average room rate you'll need to make your project succeed.

There aren't too many bargains, either. Landowners know how much their site is worth before you ever get there. If you don't want to pay a premium for a site, there are two strategies for keeping your land costs down. You can roll the dice by trying an emerging geographic market and hope that development catches up with you. Or you can be part of a planned, mixed-use development.

Each strategy has its risks and rewards. If you choose the right emerging market, you can be first on the block to make a profit. If you guess wrong, you go down in flames, and no one will touch the property. Likewise, a mixed-use development gives you a built-in base of demand, but you may be buried so deep in it that no one else can find you. In this case, make sure your feasibility study makes an accurate prediction of the occupancy based on the demand generators. Too often, the accounting firm preparing the study fails to take a close look at the firms within the development and tends to overstate demand.

Liability. Many sites contain surprises buried beneath the ground. The EPA has taken a strict-liability approach to sources of underground contamination. You own the property; you own the problems. This policy makes lenders nervous, because the cost of a clean-up can sometimes exceed the value of the note. These problems, whether chemicals in the soil or buried tanks, must be factored into the site

costs. The real issue here is to find the problems or ascertain that there aren't any prior to purchasing the land, rather than discovering them after you've built.

Concepts

Segmentation is inescapable today, because markets are so crowded. Your concept must fill a market niche. If you misread your feasibility study and miss the niche, your project probably won't survive.

Your project should look and feel like it belongs where you're putting it. So make sure your concept fits the parcel.

Dealing with City Hall

Preliminary approvals have become an important step in project design. A host of local government agencies will want to have a say about your project. In Austin, Texas, I dealt with 14 different agencies in six months. Do not get too far along with your design before you receive approvals, or you may end up with a project that cannot be built.

Some of the big preliminary approvals will involve hydrology, traffic, and greenbelts. These days municipalities want you to manage your storm water on site. You can no longer just let the water run off. Often the city will dictate how you will handle the water, whether in a holding pond or by letting a portion of your parking lot flood temporarily.

LIDs and RIDs. You will have to buy into a land-improvement district (LID) and a road-improvement district (RID) to cover the costs of public roads and utilities near your project. You also may have to pay for a traffic analysis to quantify the amount you should "contribute" to the RID.

Greenbelts are a given in any project now. You must have a site that is larger than your project. Landscaping is worth doing; it makes your project look better, and the cost is relatively low.

Particularly in the western U.S., development review boards have the final say on your design. Communities have decided how they want their new buildings to look, so your project must fit their ideas or you don't build. Sometimes the design requirements will make your project unfeasible.

Because of the complexity of the preliminary-approval process, I recommend that you do not close on the land until it's clear your project will be approved. You can usually get a 30-day "look" at the property if you put down a refundable deposit. Once you've gone

that far with the landowner, you probably can get an additional 90-day look with a nonrefundable deposit. If you don't have preliminary approval by then, you paid the deposit as a cost of doing business. But you're not stuck with land you can't use.

Working Drawings

We use several approaches to selecting a general contractor, depending on the particular project. If timing is critical, we will negotiate with a contractor, paying the cost of the work plus a fee. If we have the luxury of extra time, we will bid the project to six to ten general contractors. This process adds six to eight weeks to the project, but usually saves five to ten percent of the cost of building the hotel.

The amount of documentation on working drawings has grown amazingly. For a Marriott hotel, we had 21 consultants for various areas, including menu, sound, light, uniforms, interior and exterior design, and graphic design. For a full-service hotel, all this consulting work can cost eight to ten percent of construction costs, and in a limited-service property, four to five percent.

All of these consultants require coordination, and the burden falls entirely on the owner. Most people can coordinate the big items quite well, but it's the minor things that are often overlooked—like making sure there's electric service where the signs will be. Missing these items can cost a lot of money.

Litigation. Because of the prevalence of litigation, consultants often want to take the path of least liability, instead of making decisions in the owner's best interest. You're paying them for decisions, but they don't want to make them. So you must insist that the consultants take responsibility for decisions within their expertise. You do this by writing a tight scope-of-work document.

In some cases, I have been forced to deal with a firm based on its ability to get insurance, rather than its ability to get the job done. I can think of a fine