
# HOTOUR Publication for Project Development

## Ten Crucial Errors in Hotel Project Development

### Hotels: Three Strikes to Profitability?- Quick Detour on the Topic

The preconception that a hotel becomes profitable only after it has experienced three failures has persevered within the financial- and real estate sector and has been confirmed on more than the rare occasion. Is injustice being done to an entire sector? Is this merely an illusion, based on the fact that dramatic failures such as the legendary Binshof in Speyer, which gobbled up € 50 mil. for 67 rooms and cost four Bankers their job, are better remembered than dozens of successful although boring IBIS- and HILTON hotels?

It is a fact that bankruptcy statistics do not imply that hotels are especially vulnerable. But this type of real estate – an operated property - is prone to errors, since it is highly complex and thus especially risky for individuals not familiar with the sector. All stakeholders – be it the financing bank, the closed real estate fund or the institutional investor – are at the mercy of the operator.
The hotelier, himself, also enters unfamiliar territory with regard to new developments, redevelopments or the expansion of existing properties. Like all occasional builders, he often relentlessly overdraws the construction budget and is at the mercy of architects, technicians and other planners, who are just as inexperienced with regard to hotel properties.

**Error No. 1: Vain Investors**

In the Monopoly-Game-World, hotels represent the premier real estate investment. Hotel owners are “kings”. In real life, the same applies: project developers, investors and hoteliers are seduced into making mistakes out of vanity, which is only the case for a small number of other types of investments. Especially hotels within the 4- and 5- star segment are susceptible to fulfilling personal strives for prestige. Often hotels are viewed as the representative stage that allegedly provides the means to socially ennoble a career. However, especially capital intensive and complex hotels are less profitable within the first four to five years.

**Error No. 2: The wrong Team**

The expertise of an investor, who - based on his extensive travel background – believes to be experienced with regard to hotels, is by no means a guarantee for the success of a hotel. This is also the case, where architects and general management to-be are available for assistance. In order to correctly align the relevant parameters – market- and location assessment, hotel concept, size, segment, conceptual design of rooms and profitability – in the start-up phase of the project, solid expertise is necessary at an early stage, i.e. an interdisciplinary team of hotel-experienced professionals. However, such a team is only rarely taken aboard for cost saving reasons, out of ignorance or because of imprudent vanity.

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**Error No. 3: Erroneous Market Assessment**

Most well-known failed hotel properties are located in the picturesque location titled “in the middle of nowhere”. Using a whole lot of imaginary power and naivety, markets are created for locations far away from any urban centers or holiday destinations: especially estates and castles seem to be well-suited for seminar- or wellness hotels. Any investor can come up with a respective hotel at a no-name location, that is indeed successful. Without doubt, there are concepts that have a strong market even in remote locations. But these necessitate exceptional concepts! And these can only be executed by outstanding hoteliers with far above average dedication.
Errors made with regard to market assessment are also one of the main causes for failed hotel investments in city locations. In these cases the cause can be traced back to a false estimation of demand and a misinterpretation of research regarding the existing and future competitive environment.

**Error No. 4: False Assessment of Location**

For no-name locations, the business model is determined by the concept. In large and small cities, the location, as such, defines the business model. Location and size of the site represent the relevant parameters – for example, whether a small, select luxury hotel or a mega-conference hotel are built. Next to the many failed investments in eastern Germany, a noticeably high number of failed properties exist in poorly developed industrial areas, unfinished business parks, and hardly detectable side streets.
One-dimensional hotel concepts that rely solely, for example, on demand generated by neighbouring exhibition- or conference centers, are also highly risky. Another popular location-related error is a property’s designation as a hotel when no better concept for a property is found; i.e. to fill a gap.

**Error No. 5: Premature Concept**

Problem-hotels generally have another thing in common: they lack a well thought-out concept, which is stringently based on the correct assessment of the market, potential demand, and the location. Often, personal tastes of members of the project team are taken into consideration rather than focusing on the needs of the market and the expectations of potential guests. This relates less to matters of taste, which are bothersome but have on a minor effect on revenue and risk. Much rather, this concerns major faults with regard to the conceptual design, such as, for example, a site in an industrial area with a planned first-class, 150-room hotel and conference center rather than a one-star IBIS BUDGET hotel, which much more appropriately meets the needs of the market in the given location.

**Error No. 6: Investment Costs Too High**

This fundamental error in the conceptual design – for the quite typical example of the above-mentioned first-class hotel located in an industrial area – naturally has a negative effect on profitability: demand from within the low-priced segment for the given location cannot help meet the debt service payments necessary to finance a hotel built for the high-end market.
This error is – to a great extent – a consequence of error No. 1: many owners cannot or do not want to understand the simplicity of an economy hotel located in a simple area and therefore unnecessarily increase the investment outlay every time an update meeting with the planners takes place.

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**Error No. 7: Exceeding the Construction Budget**

Even in the case where the conceptual design matches the location, excessive real estate prices as a result of lacking expertise, professionalism and discipline during the planning- and construction phases are often the root of the problem. The nature of a hotel operation is already characterized by high fixed costs, especially personnel expenses. Moreover, hotels generally require a start-up phase of up to four years until market stability is reached. If investment costs – depending on the concept and location – exceed 25% to 30% of potential revenues, the situation becomes critical.

**Error No. 8: Choosing an Unsuitable Operator**

The selection of an unsuitable operator has driven hotels into bankruptcy on more than the rare occasion. Reputable hotel operating companies are able to identify critical projects right from the start and will decline these without hesitation. In the 90's – characterized by "wild" project developments and 100%-financing – even hotels that would not stand a chance under normal circumstances found expansion-crazed operators. Driven by the idea of entering new markets and locations and new revenue potential, these were willing to accept excessively high fixed lease payments as early as the planning phase by means of so-called technical-assistance agreements. Within the past economic situation in 2008/2009, the lease payments are no longer achievable. Renegotiations and operator changes reveal the market-conform lease payment much too late.

**Error No. 9: Inappropriate Financing**

Failed properties were often inappropriately financed, as well, the main reasons being: excessive costs for site acquisition, interest rates too high, equity portion too low, critical real estate fund-models.

Many private hoteliers often use loans on overdrafts for the purchase of furniture and smaller inventory as a means of financing once the initial loan has been exhausted. As a result of development loans issued by the KfW that are amortization-free in the beginning, many hoteliers cheat themselves and, once the amortization becomes due, are confronted with severe liquidity problems.

Holiday resorts sold as partial ownership shares or as closed real estate funds through KG (limited partnership) - or BGB-shares often suffer from the fact that too many parties are involved and that all want to have a say without having the relevant expertise. Until a group of a hundred dentists, lawyers and butchers have decided to build a new wellness-area, other competitors will already be a step ahead of the game.

**Error No. 10: Neglecting the Start-Up Phase**

Depending on the location and the concept, hotels will experience a start-up phase of up to four years until a stable occupancy level is reached and a sufficient number of guests can be contractually secured on a sustainable basis. In these first couple of years, the hotelier will most likely not be in a position to pay the full lease-amount or meet debt service payments – a fact that is often not taken into consideration for the financial structure of the investment or for developing the business plan. This often throws off private hoteliers.

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**Conclusion**

Failed properties are often a result of management errors made by developers (aside from treacherous intentions). Thus, errors No. 3 to 10 cannot be made, if errors 1 and 2 are avoided.

A hotel represents a very complex operating property with comparatively low initial returns and an increased risk in the first years of operation. Conceptual mistakes can only be compensated for when the location is exceptional.

A professional team, however, will provide a good basis for minimizing risks during the critical start-up phase and for protecting the value of the property. In the long run, a hotel in the right location with the right concept and the right operator is a better investment in terms of value appreciation than any office real estate investment.

Source: Fidlschuster