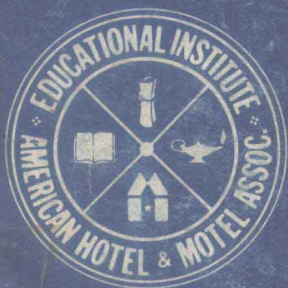


# UNDERSTANDING FEASIBILITY STUDIES

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A PRACTICAL GUIDE

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# Introduction

Not too long ago, those participating in new hotel or motel projects could be readily identified. On one side, there were traditional investors who provided the capital for the development of property. On the other, there was the professional hotelier who not only presented the proposal for the new hotel or motel, but also planned to own and operate the future property. The interests of investors and hoteliers centered on the projected success of the new property to achieve a profitable share of the somewhat general markets of hotel or motel guests.

Today, the roles of those involved with new lodging properties are not so easily defined. While most hotel and motel properties are still independently owned and operated, chain organizations now control the majority of actual guestrooms. Within these larger organizations, the owners are often no longer the immediate operators of the properties. Corporations train managers for their properties; franchisors grant specific operational formats to franchisees; and many "independent" hotels and motels are operated by management companies for owners of properties who in most cases are not professional hoteliers.

In addition, today there are real estate developers who not only initiate proposals for new projects, but also become property owners. These individuals are not typically professional hoteliers, and their reasons for development are often more varied. They are likely to consider the feasibility of a new hotel or motel proposal from the perspective of their own total investment portfolios. Operating from such a viewpoint, they may give greater weight to such factors as overall tax benefits and real estate appreciation than to the economic viability of the proposed property.

In some cases, organizations may build in a particular location because they feel it is necessary to be represented in that market. As a result, new properties may have been developed with inadequate attention to proven sources of market demand.

Further complicating the development scene today are increasingly specialized concepts for new properties that target a unique product to narrowly defined market segments, such as all-suite or economy/limited service. These specialized concepts may compete for the general market or may attract only a targeted segment.



Finally, in the past, new properties were often built to replace outdated facilities. However, in many areas today, new properties are no longer actually replacing older structures. Many of the older facilities have been replaced by newer properties or by restored and modernized downtown city hotels or motels.

Consequently, new lodging projects must be undertaken with great care. Overall development costs including land, construction, furniture, fixtures, and equipment increase each year; and, the cost of financing shows no indication of any significant decline in the near future.

Moreover, if the market for a new hotel never materializes, the facility cannot be converted to another use. Therefore, sites for new lodging properties must be carefully selected, and areas that show an insufficient market demand should be avoided.

A key element in planning for new lodging properties is the commissioning and subsequent use of feasibility studies. They can be invaluable tools to those developers, investors, and operators who intend to build a property that is profitable. To be useful, however, a feasibility study must be understood by all who act on its conclusions. This manual is designed to help that effort.

A Practical Guide to Understanding Feasibility Studies reviews the role of feasibility studies, and addresses their scope and limitations while clarifying a number of misconceptions. It covers the obligations of those who prepare feasibility studies, what can be expected when you commission a study, and how the report should be read and analyzed. By carefully using feasibility information, developers, investors, and operators may improve their overall economic and financial positions in the hospitality industry.

# What Is a Feasibility Study?

The typical study for a proposed property is commonly referred to as an economic feasibility study or, simply, a feasibility study. Both titles are erroneously applied to the vast body of reports that are commissioned by developers and prepared by consultants because the analysis made stops short of the determination of true economic feasibility. For a project to be pronounced economically feasible, the analysis must be brought to the point of return on investment (ROI). Realistically, in order to determine the ROI, consideration must be given to the total project cost, the financial structure of the deal, and the tax implications of the resulting profit or loss in the context of the owner's total portfolio. Much of that information is not known at the time of the initial study so that a final determination is not made as to the project's economic feasibility until a later stage in the overall development process.

## **Types of Feasibility Studies**

Market Studies With Operating Projections. Some feasibility reports are based on supply/demand studies and include financial projections made to the point of income before debt service. Major firms that conduct these kinds of studies refer to them as market studies with operating projections. These reports identify and quantify potential markets for proposed hotels and estimate revenues and expenses to the point of income before debt service.

A market feasibility study for a lodging project is typically conducted on a micro level. This means that the market analysis is restricted to the area in which the project site is located. Although guests are expected to come from areas far removed from the area of the project site, their potential use of the proposed property is studied through local demand generators and attractions. The potential market is analyzed by studying the reasons for transient guest visitation.

This micro level approach is successful for commercial hotels and for properties in destination areas, but not for some resort hotels or conference centers. In these cases, potential guests are usually far removed and the consultant must search for trends outside the area



of the proposed lodging site and within the areas from which the guests originate. This kind of market feasibility study is conducted on a macro level. Both micro and macro approaches cover the same basic topics and require a similar methodology, but the macro analysis may require more time and cost to complete.

Economic/Financial Feasibility Studies. A financial feasibility study includes both a market and an economic study as well as a discounted cash flow analysis. A discounted cash flow analysis evaluates a return on investment by considering the cost of investment, its useful life, and the timing involved in the valuation of cash flows. The cash flow after tax plus depreciation is discounted for a period of time and at a rate of return required by the developer to determine if the project is financially feasible.

A Note about Prospective Financial Statements. The accounting profession has proposed an authoritative statement related to prospective financial statements. This statement, if approved, would go into effect September 30, 1986.

The statement distinguishes between two types of work that a certified public accountant (CPA) may perform--a compilation and an examination. A compilation involves assembling prospective financial statements based on assumptions provided by the party commissioning the study. It does not include an evaluation of the support for the assumptions underlying a forecast/projection and therefore does not provide assurance on the prospective financial statements or on the assumptions underlying such statements.

An examination involves evaluation of the preparation of the prospective financial statements as well as the support underlying the assumptions. In an examination, there is an indication whether the accountant believes the assumptions provide a reasonable basis for the projections. Consequently, the level of security or degree of certainty provided by the CPA firm is greater.

The AICPA statement also distinguishes between a financial forecast and a financial projection. A financial forecast includes: a presentation of a property's expected financial position, estimated operating results, and changes in financial position. While a financial projection presents similar financial information, it is not as definitive as the information found in a financial forecast. This is because the information found in a financial forecast is based on assumptions provided by those commissioning the study, while the

information found in a financial projection is based on hypothetical conditions suggested by those commissioning the study.

### **Myths about Feasibility Studies**

There are a number of myths surrounding feasibility studies. One myth is that there are no negative feasibility studies. This is not true. Studies have been done and will continue to be done in the future where projects have been determined to be not feasible as a result of insufficient demand, poor site location in relation to the market generators, or insufficient income generation.

However, formal, bound reports heralding unfavorable results are not necessarily written. A project that is found to be infeasible usually is reported in a brief letter to the client. Sometimes, the consultant will discover early in the study some facts that indicate that the result will be negative. When the information is communicated to the client, usually the study is stopped and no report ever completed.

Moreover, a feasibility study is usually proprietary, and unless it has been commissioned by an individual or agency in the public sector it is not available for universal perusal. Certainly one would agree that there is no reason for a developer to publicize either the positive or the negative findings of a study.

A second myth about feasibility studies is that "they all look alike." This is not true. Studies vary based on the individual project. However, it must be recognized that the consulting firms that are in the business of conducting feasibility studies must control their far-flung staff and the products they produce. One cannot deny the importance of and need for standards in such matters. They not only protect the consultant but also the persons commissioning and relying on the study for decisions affecting the development of the hotel.

One of the methods adopted is a well-defined format and, in certain sections of the study, a precise language. Outlines may be used as checklists and reminders. Even the packaging is similar for individual firms. Consequently, dissimilar projects can, at first glance at the cover and format, appear to be similar.

### **Who Should Perform a Feasibility Study?**

Feasibility studies are generally prepared by organizations such as public accounting firms, real estate companies, or management consulting firms who have been commissioned by developers. They can also be conducted by the developers themselves, or by operators or franchisors. If outside financing is involved, an independent consultant usually conducts the study.

Consultants for feasibility studies should be selected with the same care used in choosing an individual or firm for assistance in any complex and important investment. Those who conduct feasibility studies for lodging projects must be familiar with marketing, operations, and finance as well as be knowledgeable of the factors that make a lodging operation a viable enterprise. They should be able to study dynamic and changing markets, to trace and understand trends, and to recognize market opportunities for the proposed hotel or motel.

In selecting a firm to conduct a feasibility study, clients should verify the firm's credentials, ask for references, check with other users, and determine if the lending institution to be approached for project financing will accept the consultant's work. If the property is to be operated as a franchise or management contract, the company for the affiliation should approve the consultant.

### **Roles of the Developer and the Consultant**

Those commissioning a hotel feasibility study must make their goals and objectives clear to whomever conducts the study without dictating the final results.

It is important for those using a feasibility study to realize that the assumptions used by the consultant to estimate operating results are assumptions that those commissioning the study believe will actually occur. The primary purpose of a hotel feasibility study should be to advise whether or not to make the investment and proceed with the project. In many cases, feasibility studies are commissioned because the developer must have it for financing, for a franchisor, or for a potential operator or partner. Sometimes, there may be a temptation to ask for the quickest and least expensive study. However, anyone commissioning a study should request a thorough analysis appropriate for a multi-million dollar development.

In addition to using the feasibility study to obtain financing, or a franchise, or an operator, the developer will find that the feasibility study can help define important aspects of the market and possible strategies of the marketing program for the new property. Market research is time consuming and costly, but necessary if the hotel feasibility study is to examine potential markets and other aspects of supply and demand that cannot be known without thorough research.

Good communication links should be forged at the beginning stage of a feasibility study. Those commissioning the study should clarify with the consultant the following points:

- Reasons for conducting the study
- Information the feasibility report should provide
- Type of property planned such as the size, class, and range of amenities
- Dates for meetings with the consultant at specific stages of the study
- Expected date for receiving the final report

Sometimes, consultants are called upon to conduct a feasibility study for a property with a defined concept, or one that is already designed or even under construction. In these cases, the consultant determines if the defined concept or project is feasible. On the other hand, when the concept for the property is not defined, the consultant is generally asked to define the concept to suit the needs of the demand.

Those commissioning feasibility reports should work closely with the consultant during all stages of the study. Although the consultant must be allowed to conduct an independent analysis, the developer can often assist by pointing to important sources of information and introducing the consultant to key community leaders. At times, a feasibility study is conducted in a relatively short period of time and it may not always be convenient to maintain communications. Nevertheless, contact should be established, especially when significant turning points are reached during the analysis.

## **Report Content**

A feasibility report should generally accomplish the following purposes:

- Assist in obtaining financing
- Assist in obtaining and negotiating contracts for a franchise, lease, or management
- Guide the planners and architects of the facilities
- Assist in formulating operating and marketing plans
- Serve as a guide in preparing the initial capital and operating budget

To accomplish these purposes, the report usually includes the following:

- Letter of Transmittal
- Table of Contents
- Introduction
- Summary and Conclusions
- Market Area Characteristics
- Project Site and Area Evaluation
- Competition Analysis
- Demand Analysis
- Recommended Facilities and Services
- Estimates of Operating Results

In addition, the precise nature of the study and content of the report are fully elaborated in the proposal letter, or the contract worked out between the consultant and those commissioning the feasibility study.

Each of these sections of a feasibility report will be thoroughly discussed in the following chapters. The person commissioning the

study should understand what the product is in order to be satisfied that the finished report answers the questions posed as outlined in the proposal letter. We will begin with a chapter devoted to the proposal letter because this contract usually defines the scope of the feasibility study and dictates topic emphasis within the final feasibility report.





# The Proposal Letter

## WHAT TO LOOK FOR

### Items to be analyzed in the study

- Site and Market Area
- Competition and Demand
- Concept and Project (if already specified)

### Recommendations to be made by the consultant

- Concept
- Number and type of guestrooms
- Number, type, and capacity of food and beverage facilities
- Capacity of banquet and meeting space
- Other facilities and services
- Estimates of occupancy and average rate for x periods
- Estimates of revenues and expenses for x periods at current prices
- Level at which financial estimates will be made

### Limitations of scope

### Areas not to be covered

### Fee and payment schedule

### Procedure if findings are negative

Before a feasibility study is commissioned, the consultant prepares a proposal letter for the client. The primary purpose of the proposal letter is to clearly define the scope and the limitations of the feasibility study. As in any contract, the letter defines the obligations of both parties and outlines what the consultant will do in the performance of the study and what will be included in the final report.

Those commissioning feasibility studies should carefully study the consultant's proposal letter and ensure that the final feasibility report will address their unique concerns, goals, and needs. Sufficient

detail should be provided so that those commissioning the study have a clear understanding of what will and will not be accomplished in the study and what type of information will be provided in the report. Any doubts as to the stated scope and limitations of the feasibility study should be cleared up now, thus avoiding time consuming changes later in the course of the study.

### **Scope of the Study**

The scope of a feasibility study is defined by specifying the items to be analyzed and the emphasis to be placed on each of them. Here is a list of essential items usually found in most feasibility studies:

- Market Area Characteristics
- Project Site and Area Evaluation
- Competition Analysis
- Demand Analysis
- Recommended Facilities and Services
- Estimates of Operating Results

Because an entire section of a final feasibility report may be devoted to any one of these items, this manual devotes a full chapter to each of them, and outlines what kind of analysis to expect in a final feasibility report.

The degree of emphasis that a feasibility study places on any one of these items will vary from one project to another. For example, an airport hotel project may require a demand analysis that researches airline passenger traffic more thoroughly than a downtown hotel project. Highway traffic patterns are important for many types of properties but they would become a central concern for new roadside motel projects.

If those commissioning the feasibility study have already defined the hotel concept and the project parameters, then the consultant's proposal letter should state that the feasibility study will analyze market demand, critique the proposed concept and project, and recommend appropriate changes. If those commissioning the feasibility study have not already defined the hotel concept, then the