SHA565: Developing an Asset Management Strategy

This course includes

- Two self-check quizzes
- Two discussions
- Three tools to download and use on the job
- One scored project
- One video transcript file

Completing all of the coursework should take about five to seven hours.

What you'll learn

- Analyze the asset manager's role in building value at both the portfolio and the property level
- Develop a strategic vision for asset management
- Analyze an asset management plan for a property's long-term needs
- Model the optimal holding period and make recommendations on selling versus holding the asset

Course Description

The hotel asset manager is responsible for managing lodging investments to meet the specific objectives of ownership. The asset manager's role in building value is analyzed at both the portfolio and the property level. This course, produced in partnership with the Cornell School of Hotel Administration, focuses on the importance of developing a strategic vision for asset management, and for using the latest asset management techniques in pursuit of that strategic vision.

You will examine the role of the asset manager in real estate portfolio management and learn how to develop a strategic vision for asset management. You will also learn how to create an asset management plan designed to accomplish long-term financial goals, create forecasts, and build models that analyze sell versus hold alternatives and make optimal recommendations consistent with the asset management strategy and plan.

Jan deRoos
Associate Professor and HVS Professor of Hotel Finance and Real Estate, School of Hotel Administration, Cornell University

Professor Jan A. deRoos, on the faculty of the Hotel School since 1988, has devoted his career to hospitality real estate, with a focus on the valuation, financing, development, and operation of lodging, timeshare, and restaurant assets. He holds B.S., M.S., and Ph.D. degrees from Cornell University, all with majors in Hotel Administration. Areas of teaching expertise span the entire range of hospitality real estate topics: real estate finance; real estate principles; hotel asset management; real estate portfolio management; hotel and restaurant valuation; lodging market and feasibility analysis; hotel/resort planning and design; hotel/resort development and construction, and the analysis of timeshare/vacation ownership projects. He teaches courses in the Hotel School's undergraduate and graduate degree programs, teaches extensively in the Hotel School's executive education programs, and has developed an on-line professional Certificate in Hotel Real Estate Investments and Asset Management.

Start Your Course

Module Introduction: Portfolio Management

Asset management is fundamentally about realizing the investment goals of the owner. The asset manager manages the individual assets with these goals in mind, while the portfolio manager manages the overall investment portfolio with these same goals in mind. In this module, consider different reasons to consider real estate as part of the investment portfolio.

When you have completed this module, you will be able to:

- Explain the reasons to include real estate in investment portfolios
- Explain the role of real estate in the portfolios of different types of owners
- Explain the use of real estate in meeting the diversification needs of a portfolio
- Recommend strategies to achieve an efficient investment portfolio

Read: Real Estate and Asset Management

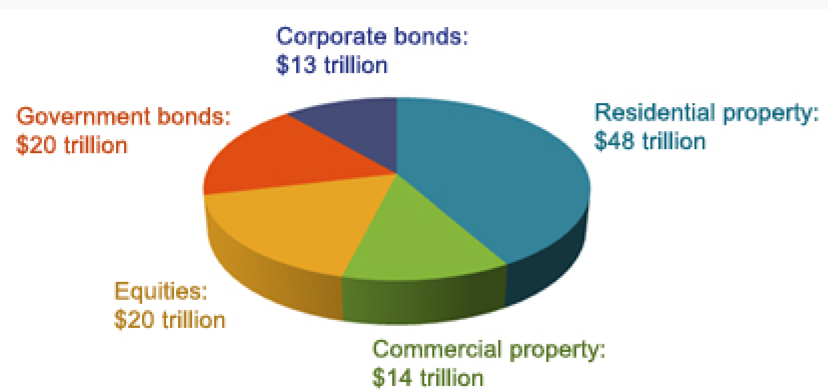
The effective management of investments involves creating a diversified portfolio of different asset types. A mixed-asset investment portfolio consists of stocks, equities, debt and debt securities, cash, and real estate. What benefits does real estate bring to an investment portfolio? Why is it included in a mixed-asset portfolio? There are four major reasons.

- Diversification
  The most important reason to include real estate is because it is a great portfolio diversifier. Real estate significantly reduces portfolio risk because of its low correlation with stocks, bonds, and cash.

- Returns
  Real estate produces lower total returns than stocks, and about the same total return as bonds. Favorably, real estate provides reliable cash returns, much higher than the dividend rates available from stocks, and roughly similar to the returns available from bonds. Due to the low correlation with stocks and bonds, real estate does provide returns when other assets are not performing well.

- Inflation
  Real estate functions as an excellent inflation hedge, much better than bonds, and better than stocks in the short term.

- Everybody does it
  Real estate is an accepted part of the investment universe. If you are going to have a large multibillion-dollar portfolio, you are going to invest in real estate, given that real estate is from 8% to 15% of the investable universe in most economies.



To summarize, real estate in a portfolio brings significant risk reductions and diversifies the portfolio. Due to these benefits, real estate has a place in portfolios, generally on the order of 8% to 15% of the portfolio's overall value.

Why do we need an asset manager? Investments in real estate must come in the form of whole, owned assets, not in the form of real estate securities for the ultimate holder of the property. As a result, someone has to manage the assets and make sure they achieve the portfolio manager's objectives for both risk reduction and returns. This person is the asset manager. Asset managers function as an extension of portfolio managers. Asset managers manage the individual assets. They make sure that the assets are performing properly and they inform the portfolio manager if the assets are not achieving the overall portfolio objectives.

Portfolio managers often lament that "asset managers don't really get it." They mean that asset managers fail to think like portfolio managers. Concerned with the performance of an individual asset, they fail to consider the asset's position in the overall portfolio and its service in meeting portfolio-level goals. At the same time, asset managers often say, "the hotel manager doesn't get it." Asset managers complain that hotel managers do not think like asset managers. Concerned with day-to-day operations, the hotel manager does not consider larger questions about the asset's status. As you will see, these complaints are not surprising once you understand that the portfolio manager, the asset manager, and the property manager all have different responsibilities.

Note: Some of the material in this section is drawn from Hudson-Wilson et al. (2005, Special Issue). Why Real Estate?. *Journal of Portfolio Management* 12-21.

Watch: Real Estate as a Portfolio Diversifier and Risk Reducer

An illustrated presentation appears below. Use this resource to enhance your understanding of how real estate reduces investment risk as part of a diverse portfolio.

Note: The numerical examples in the presentation are adapted from Hudson-Wilson et al. (2005, Special Issue), Why Real Estate?. *Journal of Portfolio Management*, 12-21.

Read: Other Reasons to Invest in Real Estate

Diversification benefits are the primary reason investors include real estate in an investment portfolio. There are, however, other reasons to consider real estate. Let's examine these other reasons in a bit more detail.

Returns

If your investment goal is high returns, it is difficult to make a case for real estate. The best case for including real estate would be returns on a risk-adjusted basis, using the Sharpe ratio (a measure of the "excess returns" achieved per unit of risk; in this case the risk-free rate is assumed to be 4.75%).

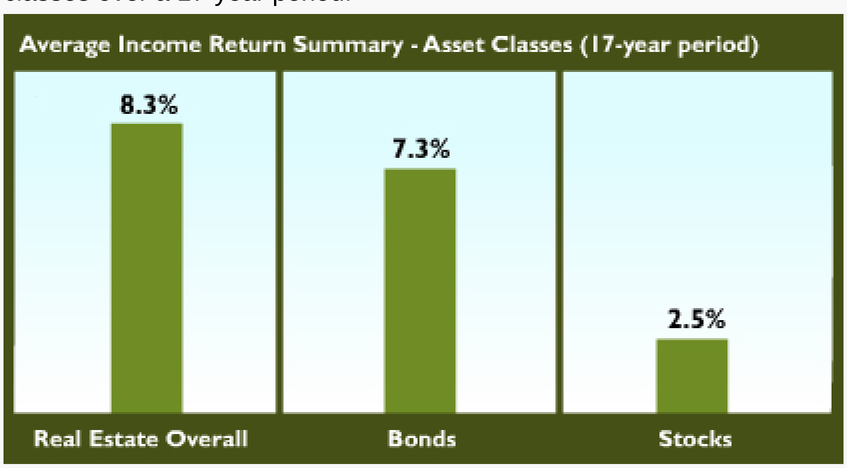
Returns and Risk-adjusted Returns Over a 17-year Period

	Return	Risk	Return Per Unit of Risk	Sharpe Ratio
Real Estate	7.89%	3.60%	2.18	0.86
Bonds	8.04%	5.10%	1.58	0.64
Stocks	13.10%	17.50%	0.75	0.47

There are some other reasons to consider having real estate in the portfolio even if the goal is high returns:

- Real estate outperforms stocks and bonds in some quarters. Due to the low correlation with stocks and bonds, in good quarters real estate has a 50% chance of higher returns than stocks and bonds.
- Conditions could change so that there is an extended period of excellent real estate performance, such as the period from 2002 until 2006.
- Some components of the real estate investment universe may outperform stocks and bonds. REITS, for example, have regularly outperformed stocks and bonds in recent years.

Finally, if you want cash returns, you want real estate. The following charts show the income returns to the major asset classes over a 17-year period.



Inflation

Real estate is a good inflation hedge. Inflation is quickly transmitted into higher rents and room rates. Hotel properties are particularly responsive to inflation, for two reasons. First, room rates adjust quickly to inflationary pressures. Second, hotels have the ability to pass through increases in expenses over the long run.

The Investment Universe

To obtain market returns, you must own a representative sample of the market. Portfolio managers must defend deviations from "owning the market," especially if their portfolio does worse than the market. Real estate is 12.2% of the investment universe in the United States. Real estate is a much larger part of many Asian economies, and is quickly becoming a large part of the investment universe in Europe and the Middle East.

Read: Investors, Risk, and Hotels

You have seen how real estate brings a diversification benefit to a mixed-asset portfolio, and how real estate can enhance returns and be an effective inflation hedge. Let's put this all together. To begin, look at different types of investors with different risk thresholds.

Risk-tolerant investors

For these investors real estate plays a very small role in the portfolio. There may be a role for high-risk, a high-debt real estate strategies for real estate owners with a great deal of debt underlying their equity position. In general, though, investors who can tolerate a great deal of risk derive little benefit from real estate in the portfolio.

Risk-sensitive investors

Real estate is a partial solution to the needs of these investors. Real estate provides significant diversification, a very good cash return, and a relative certainty of cash returns.

Inflation-sensitive investors

For investors who need cash returns to grow with inflation, real estate is a great investment. The only alternative is inflation-linked Treasuries, which provide a much lower yield.

Given these parameters, who are the natural owners of real estate?

- Pension funds
  They have a responsibility to protect their capital in the fund and not lose the capital. Therefore they are conservative, low-risk investors and they have very real liabilities. They have to pay out cash to their pension fund subscribers on a regular basis.
- Life insurance companies
  They look very much like pension funds in terms of their fiduciary responsibilities and their need to pay out cash returns, here as survivor's stakes.
- Endowments and foundations
  They need to preserve their capital and they have very high cash needs that need to grow with inflation.
- Families
  If they wish to preserve wealth for future generations, real estate is a partial solution because of its ability to be an "infinitely long-lived" vehicle and because its value grows with inflation.

What are other real estate owners' stories?

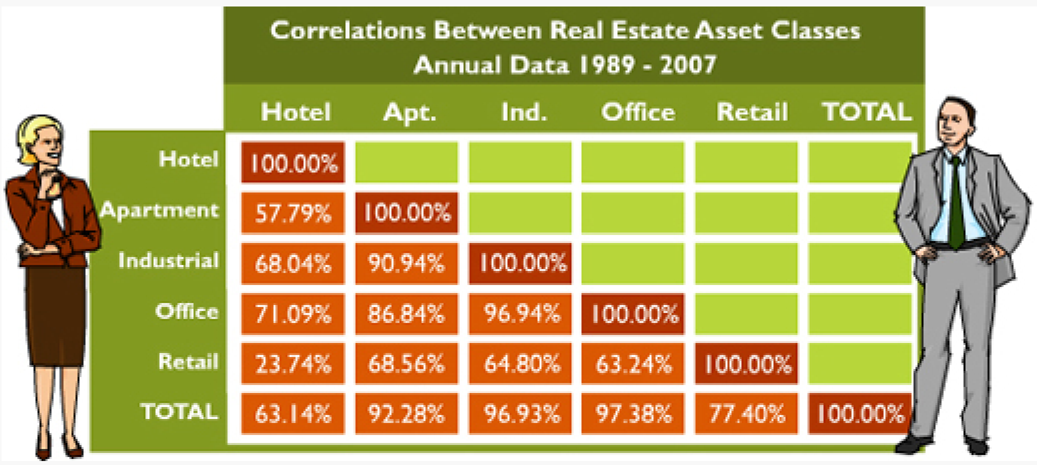
- Real Estate Investment Trusts (REITs)
  REITs exist to provide products to pension funds, life insurance companies, endowments, and families.
- Opportunity funds
  The so-called real estate funds, such as Black Stone or White Hall, play in the high-return, high-risk pond, generally providing very healthy returns to investors, and again providing a product to the natural owners.
- Commingled funds

These look very much like opportunity funds, but they invest in the low-risk, low-return pond by using very little or no debt. Again, they provide an investment product to institutional investors such as pension funds, life insurance companies, and endowments.

We've considered when and why real estate needs to be included in an investment portfolio. What role do hotels play in an investment portfolio? Why include hotels in a real estate portfolio?

First, the hotel story is fundamentally a return story. Of all the asset classes in real estate, hotels have the highest returns. There are some ways to get higher returns than in lodging, such as investments in raw land or timber. These are extremely risky, however, and they require much more specialized expertise than hotels.

Second, within a mixed real estate portfolio, hotels are much less correlated with the other real estate than the other asset classes. A very good diversification story would be to use hotels and retail within a mixed real estate portfolio to bring some diversification to their real estate.



Correlations Between Real Estate Asset Classes
Annual Data 1989 - 2007

	Hotel	Apt.	Ind.	Office	Retail	TOTAL
Hotel	100.00%					
Apartment	57.79%	100.00%				
Industrial	68.04%	90.94%	100.00%			
Office	71.09%	86.84%	96.94%	100.00%		
Retail	23.74%	68.56%	64.80%	63.24%	100.00%	
TOTAL	63.14%	92.28%	96.93%	97.38%	77.40%	100.00%

Third, hotels generally have more strategic options than other real estate. Hotels can be converted to other uses (hotel to condo, hotel to office, hotel to apartments) much easier than other real estate classes.

Finally, hotels are fun to own. We cannot ignore the appeal of owning a hotel, and owners' desire to include hotels in their portfolio.

Read: Asset Management from the Portfolio Manager's Viewpoint

Key Points

Unlike asset managers, portfolio managers focus on:

- the risk associated with an asset
- the contribution an asset makes to portfolio diversification

The portfolio manager's job is to achieve an acceptable rate of return for the overall portfolio, while simultaneously managing the risk of that portfolio. Doing so requires a thorough understanding of risk and an ability to construct an efficient investment portfolio. Portfolio managers generally don't see asset management in the same way that asset managers do. Let's take a look at why.

Consider the contrast with stocks. Part of the investment portfolio is held in stocks, and there is a stock manager whose job is to watch stock performance. If a stock such as Google or Coca-Cola or Microsoft is not performing, the stock manager simply sells the stock. You call the broker and execute your sell order. You can't do that in real estate. You can sell the real estate if it is not working for you, but that's a three- to six-month process. So the portfolio manager cannot afford to wait until a hotel performs poorly to sell.

An asset manager not well trained in portfolio management might question the portfolio manager's decision: why is the portfolio manager selling my real estate when it is doing so well? The reason the portfolio manager is selling your real estate asset is to systematically engage in a sell-high, buy-low strategy. If it is doing really well, at some point in the future it probably won't be doing really well. If the portfolio manager waits until the real estate does badly before selling it, he or she is engaged in selling-low, buying-high strategy, which is a wealth-reducing strategy. So although the asset manager is often concerned solely with the performance of the asset being managed, the portfolio manager needs to be concerned with the risk and return contributions of each asset in the context of the entire portfolio.

Consider a real estate portfolio in which there are Atlanta office buildings, Phoenix apartment buildings, and San Francisco retail centers. All of these are high-quality assets, well located in their markets. Each has been effectively managed by the respective asset managers, who recommend keeping each property. If the portfolio manager owned an equal amount of each, the portfolio would have achieved a 7.04% return, at a risk, or standard deviation, of 6.1% per year. In other words, the portfolio earns 7.04% per year return, plus or minus 6.1%.

	Return (%)	Risk (%)	Return per unit of Risk (%)

Market Neutral 33% Atlanta Office 33% Phoenix Office 33% San Francisco Retail	7.04	6.10	1.15
50% Atlanta Office 50% Phoenix Apartment	6.96	8.55	0.81
50% Phoenix Apartment 50% San Francisco Retail	7.77	4.30	1.81
50% Atlanta Office 50% San Francisco Retail	6.40	6.68	0.96
90% Atlanta Office 10% Phoenix Apartment	5.86	11.07	0.53
Adapted from "Modern Portfolio Theory Applied to Real Estate", Chapter 19 in "Modern Real Estate Portfolio Management" by Hudson-Wilson, et. al., 2000, Frank J. Fabozzi Associates.			

On the other hand, if the portfolio manager had instructed the asset manager to sell the Atlanta office buildings and keep just the Phoenix apartments and the San Francisco retail, the portfolio would have achieved a 7.77% return at a 4.3% risk. This is clearly a much more efficient portfolio. The conclusion? Even though the asset manager considers the Atlanta office building to be a very good quality building in a very good market, the portfolio manager knows the best move is to sell the property because it does not sufficiently contribute to the returns and to the diversification of the portfolio.

What if the portfolio manager listens to the recommendation of the asset manager and tries to keep the Atlanta property in the portfolio? No matter how the Atlanta office building is included in a portfolio, it doesn't work. Consider a portfolio with half Atlanta office and half Phoenix apartment. You end up with a lower return, 6.96%, and high risk. Consider 50% Atlanta office and 50% San Francisco retail. You receive even lower returns, 6.4%, and the risk is 6.68% per year. In the worst case, consider owning 90% Atlanta office and 10% Phoenix apartment. Here you receive a return of 5.86% and the risk is 11.07% per year, a dreadful combination. This last example demonstrates that portfolio managers can make poor decisions if they don't keep their eye on the ball, if they don't manage the risk while seeking an acceptable rate of return. The portfolio manager makes decisions to hold assets based not only on their absolute return levels, but also on their contribution to the diversification of their portfolio.

Read: Diversifiable and Non-Diversifiable Risk

A large percentage of portfolio management is risk management. Pension funds, insurance companies, and other investment funds often hold large portfolios of real estate. They are all interested in understanding the returns per unit of risk for their real estate holdings.

Investment risk can usefully be divided into diversifiable and nondiversifiable risk.

Diversifiable risk is risk that can be eliminated simply by owning multiple assets that are not perfectly correlated with each other- that is, multiple assets that do not rise and fall in value at the same times for the same reasons. Because it is avoidable, investors are not rewarded for taking diversifiable risk.

Nondiversifiable or *systematic risk*, is the risk that is inherent in an asset class. It can be limited, but it cannot be eliminated by holding large pools of different assets.

Diversifiable Risk:

Look at the chart below to see how diversification works to limit risk.

Example of Diversification

Year	Stock	Hotel	Equally Weighted Portfolio
1	14.0%	-10.0%	2.0
2	-10.0%	8.0%	-1.0
3	23.0%	12.0%	17.5
4	17.0%	15.0%	16.0
5	10.0%	-2.0%	4.0
6	5.0%	0.0%	2.5
7	-4.0%	12.0%	4.0
8	-5.0%	17.0%	6.0
9	8.0%	-5.0%	1.5
10	12.0%	15.0%	13.5
Average	7.00%	6.20%	6.60%
Standard Deviation	10.53%	9.64%	6.59%

Adapted from Corgel, Smith, and Ling. Real Estate Representatives, 4th edition. Chicago: Irwin McGraw Hall-Hill, 2001.

> A Note on Correlation:
>
> What does it mean to say that asset categories have a lack of correlation? Correlation is a measure of the co-movement of two sets of numbers. Do they move

> together, do they move independently of each other, or do they move in opposite directions? If they move completely together, the correlation is one. If they move counter-cyclically (one goes up while the other goes down), the correlation is -1. If their movements are completely independent (they don't follow any pattern or move together at all), the correlation is zero. Any correlation below 1 provides some diversification benefit. Correlations of zero and under zero provide a substantial diversification benefit.

Note that combining the two assets into a portfolio significantly reduces the diversifiable risk. Stocks alone attain an average return of 7% per year, but at a substantial risk (10.53% standard deviation), while the hotel alone attains a lower return (6.2%) at a lower risk (9.64%). The equally weighted portfolio, however, achieves returns below what stocks achieve alone (6.6%), but at a substantially reduced risk (6.59%). Driving the risk reduction is the lack of correlation between the stocks and the hotel. In this case, the correlation between the two is -0.15.

Examples of diversifiable risk in a portfolio of real estate include differences in the quality of management at various properties, local market conditions (Is the local market doing well? Is it performing dismally?), and changes in neighborhoods.

Let's examine the basic diversification strategies that might be employed in these cases.

Basic Diversification Strategies:

- Diversify across property type by owning apartment, retail, office, and hotel property. Combining whole assets with the "pure property type" plays off the REITs, to achieve the desired level of risk. In general, hotels and retail are the first to respond to changing market conditions; office property lags significantly behind, due to long lease terms.
- Diversify across space. Geographic diversification is rewarded by the market. Firms with concentrations in local markets trade at a discount to firms that are not concentrated. Recent academic research in international diversification suggests significant benefits from diversifying broadly across countries as well as across borders.
- Combine whole assets, equity funds, and shares of real estate securities into diverse portfolios. Each type of holding contributes to the diversification of the portfolio in different ways, and provides options to the portfolio manager.

Nondiversifiable Risk:

Nondiversifiable risk is eliminated when one "holds the market." Strictly speaking, this has not been possible in real estate due to a lack of fund products available that attempt to replicate the entire market. Given the historical lack of an "S&P 500" for real estate, investors were forced to construct a portfolio to achieve diversification using the well-known principle that the vast majority of nondiversifiable risk is eliminated by investing in as few as 20-30 assets. The continuing maturity of various real estate fund products is clear evidence of the market's desire for products that can help limit nondiversifiable risk by emulating the market.

Watch: The Efficient Portfolio

An illustrated presentation appears below. Use this resource to enhance your understanding of how to construct and use an efficient frontier.

Watch: The Efficient Portfolio in Action

An illustrated presentation appears below. Use this resource to enhance your understanding of how the efficient frontier helps managers construct an investment portfolio.

Read: Dealing with Constraints

Unfortunately, we do not live in a world where real estate capital is perfectly mobile, or where we can reassess and alter our portfolio at zero cost. Here you consider some of the constraints placed on portfolio managers hoping to alter the contents of their portfolio.

First, portfolio managers face constraints on what can be sold. This may be due to the illiquid structures of certain investments, such as commingled funds or private equity funds. Or it may be because the portfolio contains certain "darling" assets that the owner is unwilling to relinquish.

Second, portfolio managers may face limits in how much capital can be invested at any given moment. This may be due to overall allocation targets the portfolio manager must abide by or to the execution capacity of the owner.

Third, the portfolio manager may face constraints on the structure of the portfolio that the owner is willing to hold, based on policy restrictions, benchmarking restrictions, or both.

How should the manager deal with these constraints? It may be worthwhile to try and remove the constraints. The portfolio manager can quantify the costs of these constraints by comparing the constrained portfolio with an unconstrained portfolio. A clear, quantified understanding of the costs can be the first step in constraint removal.

Alternatively, the portfolio manager can continue to perform the job while remaining aware of the constraints. First, identify investments that are impediments to improved performance. Second, identify the investments that will most improve portfolio performance. Together these two analyses provide a "road map" to identifying target acquisitions and dispositions.

Module Introduction: Asset Management

The asset manager is primarily responsible for managing individual assets. Though the asset manager plays important roles throughout the investment cycle, most of the job involves monitoring the performance and the objectives of the hotel.

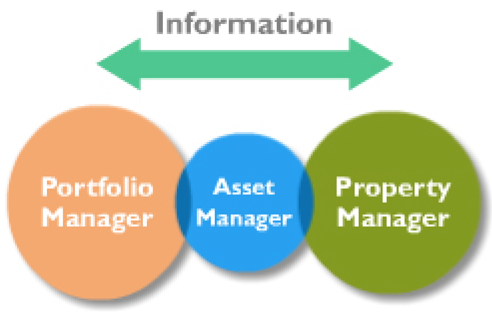
This module introduces the roles and responsibilities of the asset manager in managing a specific property. In this module you consider the importance of forecasting the highest and best use of a property as the first step in managing the asset. You then examine the key elements of an asset management plan and analyze the plan's strategic and tactical components.

When you have completed this module, you will be able to:

- Explain the asset manager's role and responsibilities in managing a single property
- Explain the role of highest and best use benchmarking in asset management
- Analyze an asset management plan developed for a specific asset

Read: Why do Asset Managers Have a Role?

What is the role of asset managers and why are they necessary? We can begin to answer the question by thinking about it graphically. Note the Venn diagram.



The three intersecting circles depict how the portfolio manager, asset manager, and property manager relate to each other. The asset manager sits in the middle, acting as a conduit between the property and the overall portfolio. All communication to the portfolio manager flows through the asset manager. The asset manager runs the asset day to day, consistent with the portfolio manager's vision and the needs of the property manager for day-to-day operations.

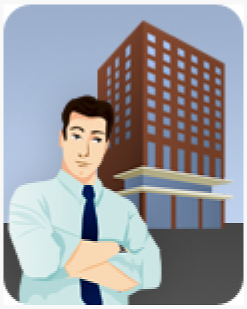
With this in mind, let's return to the original question: why do asset managers have a role? There are a number of answers.

- Portfolios are becoming increasingly broad, and hotel asset managers bring expertise about specific properties that portfolio managers don't possess.
- Asset managers can resolve many of the misalignment issues between owners and managers. At times, owners see property managers as frustrating their ability to maximize the value or the cash flows from a building. Asset managers help to resolve those problems working as the owner's representative day to day, week to week, and year to year.
- Asset managers historically had a very large role in resolving troubles with assets for owners, though as the field and the discipline have matured this has become a less important function. Asset managers still play this role for institutions, such as banks that own a property after foreclosure and need professional asset management assistance.
- Asset managers can be thought of as the voice of the physical assets. Ownership of a hotel involves many different players: the owner, the brand, the manager, the distribution channels. All want a voice in decisions affecting the hotel. The owners of the physical assets feel that they should have a very large voice in the major decisions. Many owners use the asset management function to orchestrate the efforts of the brand, the manager, and the distribution channels, all of which have legitimate roles in maximizing the value of the asset. Asset managers use their expertise to leverage and maximize the efforts of all these players to the benefit of the physical asset.

Read: Roles and Responsibilities of the Asset Manager

The asset manager's role can usefully be divided in half, between overseeing operations and managing the investment. Let's begin by considering the responsibilities that come with overseeing the physical asset and its operations. This role can be broken down into five components:

- Monitor ongoing financial performance
  It's the asset manager's job to review actual financial performance compared to both the budget and to prior years. Asset managers must also compare performance to that of other comparable properties.



- Monitor the competitive market
  It's the asset manager's job to be fully informed about relevant market conditions. They must (1) track occupancy and average rate trends, (2) track new properties being considered for development, and (3) monitor demand generators to anticipate significant increases or decreases in market demand.

- Monitor the asset
  It's the asset manager's job to regularly evaluate the physical condition of the property to anticipate capital requirements. They need to regularly evaluate the major building systems and other infrastructure for appropriateness and competitiveness. Finally, asset managers need to ensure legal compliance with health codes, life-safety regulations, and access for the disabled.

- Support and review the budgeting process
  It's the asset manager's job to play a multifaceted role in reviewing the budget. Asset managers must benchmark operations against comparable properties. They are responsible for communicating ownership expectations to property management. Asset managers review proposed budgets, marketing plans, operating plans, and capital expenditure plans for their compliance with ownership expectations. Finally, asset managers facilitate the approval of budgets, marketing plans, operating plans, and capital expenditure plans by ownership.

- Advise ownership on management issues
  It's the asset manager's job to evaluate the strengths and weaknesses of the operator. They review industry trends that may have an impact on the property management and keep ownership apprised of those trends.

Now let's consider the asset manager's role in managing the investment. This role can also be usefully divided into five components:

- Advise ownership about optimum investment strategies
  It is the asset manager's job to perform an annual strategic review, comparing properties' expected performance

to ownership's investment objectives. The asset manager must also determine the market value of properties and project future increments in market value from holding, renovating, expansion, or other strategic alternatives.

- Monitor the investment community

  It is the asset manager's job to track sales prices for comparable properties, to track capitalization rates of recent hotel sales, and to continually remain apprised of financing terms available.

- Select and oversee operators, franchise affiliations, and consultants

  It is the asset manager's job to advise ownership on appropriate franchise affiliation and management for the property, and to retain appraisers, environmental consultants, and engineering consultants as appropriate.

- Negotiate and administer contracts

  It is the asset manager's job to ensure that franchise services are provided and billed properly. The asset manager is also responsible for ensuring management contract compliance and for negotiating service and other long-term contracts that provide optimal returns to ownership.

- Approve and monitor capital expenditures

  It is the asset manager's job to create a long-term capital expenditure plan, to review annual budget proposals for consistency with the capital plan, to evaluate the impact on profitability and value of discretionary expenditures, to approve capital budgets for presentation to ownership, and to review spending requests for compliance with the capital budget.

Note: Adapted from Denton, G. A. (1999). *Hotel Asset Management at a Crossroads*, Master's thesis, Cornell University. See also Chapter 1 in Beals, P. and Denton, G. eds. (2004). *Hotel Asset Management*, East Lansing, MI: Educational Institute of the American Hotel and Lodging Association.

Read: Different Types of Asset Managers

We can identify three archetypical asset managers. A number of factors determine the type most appropriate to a given asset, owner, or situation. Let's look at the three types.

Investment Managers

These asset managers are "big picture" managers, involved heavily in strategic and long-range planning for the asset. They produce input on the cycles (buy v. sell), they perform sell-vs.-hold analyses, they model and determine the optimal holding period, they perform refinancing analyses, and they provide input on the proper capital structure.

Troubleshooters

If the investment manager is a "big picture" manager, the troubleshooter is focused on the "small picture," often a small picture in a cracked frame. The troubleshooter is often responsible for turning around floundering hotels. Historically, a great number of asset managers fell into this category, because asset managers were often used as "salvage artists" whose job was to rescue struggling or failing hotel properties. The troubleshooter often manages the turn-around process, works on building hotel revenues, establishes appropriate expense levels, implements strategic repositioning, and positions properties for sale.

Owner-Operators

This is the most strategic of the three categories. This type of asset manager specializes in reconciling the competing objectives of owner-operators. Wearing the owner hat, they want to maximize the value of the individual investment, the hotel. Wearing the operator hat, they want to maximize the value of the management company. Reconciling these two goals is at the heart of this type of asset manager's job.

The type of asset manager or asset management skills needed varies over the life cycle of the asset. It depends on the owner's investment objectives. Finally, it has a great deal to do with the current situation faced by the property.

Watch: The Asset Management Process

An illustrated presentation appears below. Use this resource to enhance your understanding of how the asset cycle and the market cycle inform the decisions of asset managers.

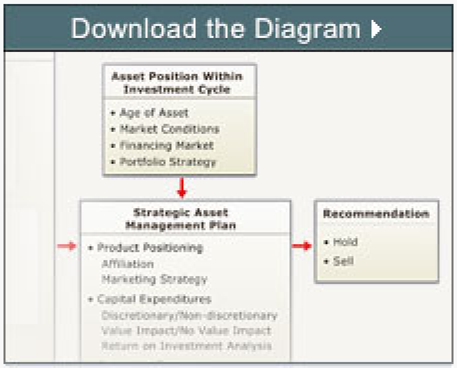
Watch: Managing a Single Asset

An illustrated presentation appears below. Use this resource to enhance your understanding of the role of the asset manager in managing a single asset.

Note: Some of the material in the presentation is drawn from Exhibit 11-9 in Chapter 11 "The Hotel Sector", from *The Handbook of Real Estate Portfolio Management*. Chapter authors are Mr. David Johnstone of Miller Global Properties, LLC and Mr. Jeffrey Duni of HVS.

Tool: Monitoring Ongoing Operations

Download the Tool



This flow chart shows how the asset manager constructs an asset management plan to monitor the ongoing operations of a hotel and to produce an investment recommendation for the owner.

Note: Drawn from Exhibit 11-9 in Chapter 11 "The Hotel Sector", from *The Handbook of Real Estate Portfolio Management*. Chapter authors are Mr. David Johnstone of Miller Global Properties, LLC and Mr. Jeffrey Duni of HVS.

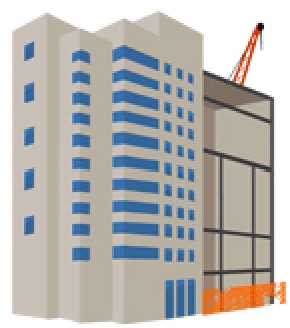
Read: Thinking Strategically about Highest and Best Use

You have seen how to produce an asset management plan for a single hotel. The process results in a strategic plan that addresses a basic question: how can the asset be better managed to increase the overall value of the hotel? A part of the asset management job that is frequently overlooked is what might be called "highest and best-use benchmarking." Much asset management takes the physical asset as a given, and then proceeds with an evaluation and analysis of that physical asset. Highest and best-use thinking asks the asset manager to think outside of the asset's physical box and consider whether it is possible to reconfigure the asset into a more profitable or beneficial use. It is important to ask this question because significant value can be added via creative redevelopment of the property. Such a redevelopment may mean building a larger hotel, or it may mean replacing the hotel with a different use, perhaps with residential apartments or condominiums. The owner, and the asset manager working on behalf of the owner, has a substantial interest in such highest and best-use questions because they can significantly increase the value of the property.

The best way to illustrate highest and best-use possibilities is through a number of examples. Consider the following real-world situations drawn from the "Daily Lodging Report, North America" (publisher: Gaming USA Corp. and HVS International).

April 2nd

A&A Hospitality LLC has filed plans with the city of Chicago to redevelop an existing 122-room Wyndham Garden Inn and develop a 320-room Element hotel from Starwood. A&A wants to demolish part of the Wyndham to make room for the new Element hotel and also plans a nine-story addition to the existing hotel. The two hotels would have a total of 502 rooms. A&A bought the Wyndham Garden Inn out of foreclosure for $10 million five years ago. The property is currently encumbered by a $19 million loan from Suburban Bank & Trust.



July 11th

The flag at the Sheraton Bal Harbour was lowered for the final time on Wednesday. The hotel has been closed in order to be demolished so that the new St. Regis Resort & Residences, Bal Harbour can be developed. Starwood Hotels & Resorts Worldwide plans to raze the old Sheraton Bal Harbour this fall to make room for the $1 billion St. Regis, which will include nearly 270 condominiums, a 182-room hotel, 36 hotel-condo units, and a presidential suite.

July 30th

Olympus Real Estate announced the opening of the 10,000-square-foot spa at the Ritz Carlton Rancho Mirage. The spa, costing $4 million, replaces a laundry facility and will take advantage of the views and sunlight available at the site. The addition of the spa will add $10 million to the value of the property.

What do these stories have in common? In each, the hotel ownership is boldly reconfiguring the use of the physical space, to change the property's "envelope." The examples also illustrate the financial range encompassed by highest and best-use strategic thinking.

In the first example, an underperforming hotel is being transformed into two hotels through a large expansion of the physical space (the nine-story addition). In the second, a valuable property (the Sheraton Bal Harbour) is being transformed into a $1 billion combination of hotels and condominiums. In the last example, a purely functional hotel laundry facility is being moved off site to facilitate the creation of a valuable spa.

Consider this final example in more detail. The value of highest and best-use strategic thinking is clear. The renovation was not the result of a problem. The laundry facility was necessary, efficient, and well run. Conventional asset management might have passed over the laundry quickly and addressed problems elsewhere. The asset management of the hotel, however, employed highest and best-use thinking. They were able to look at an efficient laundry and see a more profitable spa. They recognized that the laundry was occupying space that could be put to a higher and better use.

Done well, highest and best-use benchmarking holds the promise of dramatic improvements in hotel property returns.

Read: Calculating Highest and Best Use

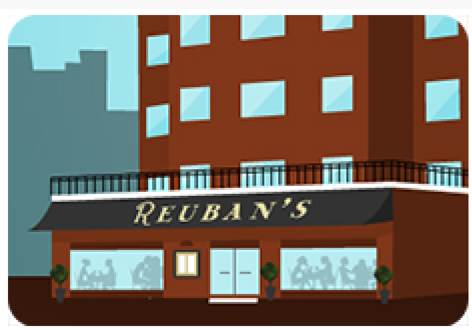
Highest and best-use analysis begins with identifying the development, redevelopment, and infill opportunities available for a specific property. The asset manager must identify a higher and better use, identifying the changes in floor-to-area ratio (FAR) that will bring concrete benefits to the property greater than the estimated costs. The asset manager must also be able to deal with local zoning laws that can make it difficult to calculate the benefits from changes in the FAR. They need to understand the entitled FAR, transferable development rights (TDRs), and FAR that might be available via a variance process.

In practice, evaluating different highest and best-use possibilities comes down to a financial analysis of the potential benefits. Let's take a look at some examples:

You have a property to develop and are considering apartments, a hotel, or mixed use. You are seeking the improvements that produce the highest "economic rent" to the land, after deducting a fair return to the building. This use produces the highest bid for the land. Let's look at the numbers:

	Possible Uses		
	Apartment Building	Hotel	Mixed Use
Cost of Construction	$320.00 per SF	$360.00 per SF	$400.00 per SF
Effective Gross Income	$72.00 per SF	$80.00 per SF	$100.00 per SF
Operating Expenses	$28.00 per SF	$32.00 per SF	$48.00 per SF
Net Operating Income	$44.00 per SF	$48.00 per SF	$52.00 per SF
Return to Building @ 12%	$38.40 per SF	$43.20 per SF	$48.00 per SF
Net Income to Site	$5.60 per SF	$4.80 per SF	$4.00 per SF

In this case, the apartment building is the highest and best use, because it produces the highest returns to the site. It does not produce the highest gross income or the highest net operating income, but due to its low operating expenses, it produces the best net income at $5.60 per square foot. Now consider an existing property where you want to determine if a change of use or significant changes in the intensity of use are appropriate. The analysis proceeds in a similar fashion, but here you need to consider the costs of demolition and lost income during construction as part of the redevelopment costs.



Consider a hotel with a well-established, profitable, and beneficial coffee shop. The coffee shop works well for the hotel, but the asset manager has noticed that a growing elite national steakhouse chain has been performing excellently in other markets. The asset manager approaches the chain and proposes changing the existing coffee shop into a steakhouse. The asset manager knows that to make this change work, the steakhouse needs to provide net rents in excess of a fair, unleveraged, "cash-on-cash" return. For example, if net rents are more than 10% of the gross per square foot, the change makes sense.

Let's look at some numbers for the steakhouse in this property:

Rate Calculation					
Steakhouse gross sales per SF				$550	
Times: Rental rate-percentage of sales				6.0	%
Equals: Net rent per SF				$33	
Return Calculation					
Cost per gross square foot of building				$200	
Times: Gross square foot (GSF) to gross leasable square foot (GLSF) multiplier				1.2	
Equals: Total cost per GLSF				$240	
Implied "cash-on-cash" return	=	$33/$240	=	13.8	%

Contrast this to continuing with the coffee shop:

Rent Calculation					
Coffee shop gross sales per SF				$150	
Times: Rental rate-percentage of sales				6.0	%
Equals: Net rent per SF				$9	
Return Calculation					
Cost per gross square foot to remain competitive				$100	
Times: GSF to GLSF multiplier				1.2	
Equals: Total cost per GLSF				$120	
Implied "cash-on-cash" return	=	$9/$120	=	7.5	%

The "cash-on-cash" return is 13.8%, substantially better than the asset manager's 10% target, and substantially better than continuing with the coffee shop. The asset manager should now verify that the uses anticipated are allowed under the zoning code, or if not allowed as-of-right, that there is a process by which the use could be entitled. The asset manager should also look at long-term supply and demand trends, keeping in mind that today's hot restauranteur may be tomorrow's "so last year."

Read: The Midlantic Chain Hotel

In the activity "Managing a Single Asset," you learned why and how the asset manager creates an asset management plan. Now it is time to see what one of these plans looks like. Consider the Midlantic Hotel, a chain hotel located somewhere along the middle of the eastern seaboard in the United States. The Midlantic is 13 years old, the current ownership having taken possession 12 years ago. It is a 400-room hotel with 14,000 square feet of meeting space.

The hotel is located in the suburbs of a growing metropolitan region, though the hotel is clearly adjacent to, not in, the region's major growth corridor. The hotel is operated by a respected brand. The hotel's performance has been troubling over the last couple of years due to poor economic conditions, with overall performance trending downward. Measures have been taken by hotel management to reverse this trend.

The asset manager has spent considerable time compiling an asset management plan for the Midlantic. Aware of the declining performance, he set out to discern the causes and to devise a plan of action to insure a performance correction. In creating the plan, he takes into consideration a thorough analysis of the asset's performance, the investment goals of ownership, and the asset's position within the investment cycle. All of this is designed to inform a sell-vs.-hold recommendation to the owner, and the asset management plan must provide evidence to support the final recommendation.

Read: Elements of the Asset Management Plan

The asset management plan is a key tool for the asset manager. A well-produced plan presents a clear overview of the property and a plan of action to realize the ownership's investment goals. It should contain both a strategic vision and tactical recommendations to realize that vision.

Let's take a look at the components of an asset management plan. It is often remarked that a strong asset management plan should be like the Cliffs Notes version of a good book, only shorter. It should be clear, concise, and analytical: a tool for understanding the hotel. A well-designed asset management plan allows the asset manager to communicate up to ownership and down to the property manager.

Asset management plans include the following features:

Property summary: Most plans start with a property summary, including a great deal of physical data about the hotel, including the date it was built, the nature and date of renovations, etc.

Executive summary: Following the property summary is a very brief condensation of the remainder of the plan. This tells the reader what is in the plan and where it can be found. In general, the property summary and the executive summary should appear on the first page of the report. The remainder of the items need not appear in any particular order.

SWOT analysis: A classic strategic planning device, carefully naming and analyzing the strengths, weaknesses, opportunities, and threats.

Major plans and actions: Here the asset manager generally picks a short list of things that are deemed of top importance for the coming year. This only includes the major plans and actions; it is not a laundry list.

Exit strategy: How long do we intend to continue to hold this asset? What is the expected outcome of a hold-versus-sell analysis?

Next comes a wealth of data that supports the plan itself, including:

Market overview: Answers to key questions, including how is this market? Where is the market headed? What are the relevant supply and demand trends?

Competitive supply overview: Analyzes the competitors, describing what they look like and their strengths and weaknesses relative to this property.

Performance overview: A historical overview of the subject property, including financial and guest service outcomes. This may also include a one- or two-year projection of expected performance.

Capital overview: Capital expenditures historically followed by a concise, 5- to 10-year summary of the anticipated capital needs of the building in the near and medium term.

Key data overview: This includes a great deal of detail about number of food and beverage (F&B) outlets, number of seats within those F&B outlets, number of square feet of meeting space, other facilities of the hotel, contact information for key personnel on property, an abstract of the management contract, abstract of the debt, and financing. These should be abstracts of data you like to have at your fingertips so that you don't have to pull out the actual documents every time you need the information.

All of this should add up to a 10- to 20-page asset management plan. A longer document becomes cumbersome, and a shorter document will not provide the needed level of detail.

Tool: The Midlantic's Asset Management Plan

Download the Tool

Midlantic's Asset Management Plan

The asset manager has now created the asset management plan for the Midlantic Hotel. You should read the plan before proceeding to the next asset. You will then analyze the plan in some detail.

Download the Midlantic's Asset Management Plan from the link above.

Watch: Analyzing the Plan's Strategic Recommendations

An illustrated presentation appears below. Use this resource to improve your ability to read and analyze an asset management plan.

Watch: Analyzing the Plan's Tactical Recommendations

An illustrated presentation appears below. Use this resource to improve your ability to read and analyze an asset management plan.

Module Introduction: Sell-vs.-Hold Decisions

A key part of the asset manager's job is to provide a sell-vs.-hold recommendation for the hotel asset. This involves carefully considering the investment goals of the owner, the condition of the hotel, and the behavior of the market. It also involves the use of tools designed to determine the optimal holding period in a variety of circumstances. This module considers the sell-vs.-hold analysis in detail.

When you have completed this module, you will be able to:

- Outline the three classes of variables (type of investor, type of asset, type of market) that influence decisions on when to dispose of a property
- Examine the specific factors that influence whether to sell or hold an asset
- Explain the tools used to decide whether to hold or sell a property
- Model the optimal holding period and make recommendations on selling versus holding the asset

Read: Different Asset Managers with Different Investment Goals

As you've seen, the asset manager compiles an asset management plan that includes a recommendation on whether the property should be sold or continue to be held, and if held for how long and under what conditions. In making the recommendation of sell vs. hold, the asset manager must first consider the goals of the investor or owner.

Let's take a look at three different types of owners.

A Return Maximizer

This investor takes two main approaches. The investor *buys* individual assets that are so-called distressed assets, assets at the bottom of the market cycle. The return maximizer makes changes to allow the asset to gain in occupancy and rates, and thus to increase in value. In the case of the down market, the only "action" taken may be having the patience to wait for a market improvement.

Or, the investor *develops* new assets in markets with recovering fundamentals. The goal is to capture the spread between the cost of construction and the market value of a new hotel.

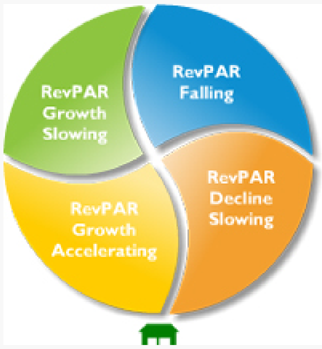
When the sources of value creation are mostly exhausted, the investor sells the asset. Essentially, the return maximizer is a "flipper" looking to hold in the short term and realize the greatest increase in value possible. John Dough, our equity fund investor from Black Hall, is a return maximizer. Black Hall engages in classic return maximization by turning assets over quickly and realizing short-term increases in value.

A Portfolio Risk Manager

This investor buys a collection of assets that, taken together, are expected to exhibit a particular cyclical path. The portfolio risk manager actively manages the combination within the portfolio to follow this path even as real estate markets cycle. This investor happily rides the cycle in risk-manager fashion. Sophie Smith, our insurance company investor for AIGH, is a portfolio risk manager. AIGH is looking for long-term, consistent returns, and assembles an investment portfolio accordingly.

Inflation Hedger

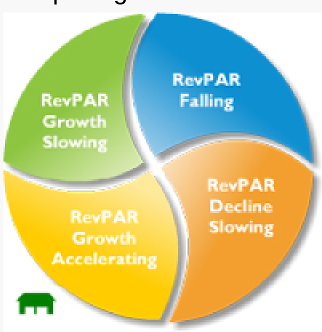
This investor identifies assets and markets with characteristics that enhance the likelihood of effective and favorable transmission of inflation. The inflation hedger invests in such assets and markets to ensure that the portfolio's capacity to hedge does not diminish over time.



Read: Different Types of Assets

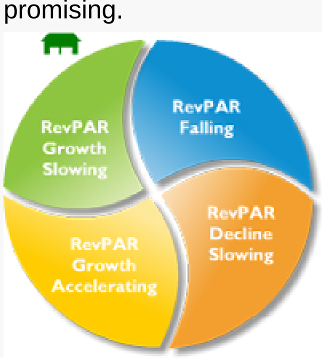
The investment goals of the owner are a key factor in the sell-vs.-hold decision. Two other factors also need to be considered: the condition of the asset and the condition of the market. Put another way, the position of the hotel in the asset cycle and in the market cycle both significantly influence our analysis.

Let's begin with a property just emerging from a down period in the market. It is at 6:30 in the market cycle, just past the bottom, with the market just beginning to rise. The question is, should you hold or sell the hotel? Unless there are other compelling reasons to sell the property, it makes absolutely no sense to sell at the bottom of the cycle.



But what about when you move a little bit past 6:30, to 8:30? Everybody knows you are in the fat part of the cycle, and everybody knows you haven't hit the peak. Certain assets that may be short-term holds, such as the Midlantic Hotel you analyzed earlier, would be ideal candidates for sale at this point. Sell those assets and immediately turn around and buy the assets that you want to hold long-term. As a matter of fact, most firms would pre-identify assets that would be candidates to sell in the right market condition and target those assets they would like to buy for the long-term.

On the other hand, if you have a hotel that is a good long-term hold candidate, a hotel that has not yet grown into its potential, even the fat part of the market would be unlikely to tempt you to sell. The returns from holding would be more promising.



The calculus becomes quite different once you move up to 11:30 on the market cycle. Here you're at the top of the market. You know there is still some more upside, but you don't know how much. You don't know when the bubble is going to burst. This is when you have your absolute best pricing power. You can harvest the equity from your short- or medium-term holds because there won't be another opportunity to sell for a very long time.

The property that was growing into its potential at 8:30 now becomes a more likely candidate to sell. As soon as the market goes to one o'clock, the market shrinks. Sellers offer for sale at last year's high price, and buyers make purchase offers at next year's low price; the spread between the asking and offer prices becomes extremely wide and the transaction market falls apart.

In each of these decisions, the condition of the asset and the position in the market cycle influence the decision to sell or to hold hotel property.

Read: Who Sells and Who Holds

You have considered three different investors: a returns maximizer, a portfolio risk manager, and an inflation hedger. Let's consider what they might do with different types of assets in different types of markets.

Consider three types of assets: first, a revitalized hotel, purchased at the bottom of a market cycle and now producing above-market returns. Second, a hotel leased to a property manager under a long-term lease. Third, a dwindling hotel, which has lost market share because of increased competition from newer, better-located hotels.

Consider also three different market conditions: first, a stable market with rising fundamentals, second, a rising market, and third, a falling market.

Let's examine who wants to sell and why.

The Returns Maximizer

As we have seen, returns maximizers are interested, not in long-term holds, but in selling. Unsurprisingly, these investors sell the revitalized asset (this is the core of the return maximize strategy). They sell the leased asset, particularly if they created the lease. Finally, they sell the dwindling asset. One possible caveat: the investor might hold the revitalized and the dwindling assets in a rising market if the rise was expected to be swift. In this case, the returns from holding until the market improved could dominate the (transaction cost-adjusted) returns from redeploying the capital.

The Portfolio Risk Manager

As you have seen, portfolio risk managers are interested in the contribution of individual assets to achieving portfolio goals. These investors hold assets if they provide (at least) market returns and have "useful" behavior (for example, if the market or property type provides diversification benefits). With this in mind, portfolio risk managers hold the revitalized asset if the market or property type meets the current allocation criteria. They sell the leased asset (in fact, they would be unlikely to ever invest in the leased asset). And they sell the dwindling asset, even if it is a desirable property or in a desirable stage of the market cycle, because the portfolio risk manager needs assets that make (at least) market returns.

The Inflation Hedger

As you have seen, inflation hedgers are interested in holding properties, such as hotels, that respond well to inflation. They would be the least likely of the investors to decide to sell. They are particularly attracted to credit assets with indexed, triple-net leases. For these investors, asset type and market condition are secondary to the asset's inflation hedging.

The takeaway? Context counts. When asset managers consider sell-vs.-hold recommendations, they need to thoroughly understand the property, thoroughly understand the market, and most importantly, thoroughly understand the investment goals of the owner.

Note: Adapted from "Hold versus Sell Decisions", Chapter 3 in "Modern Real Estate Portfolio Management" by Hudson-Wilson, et. al., 2000, Frank J. Fabozzi Associates.

Read: The Disposition Decision

> *"I wake up every day with everything for*
> *sale everywhere*
> *and convince myself to hold."*
>
> *-attributed to Sam Zell, real estate guru*

You are an asset manager who has been asked to make a recommendation on the future of a hotel. It may seem like the logical way to proceed would be to begin with the hotel "as is," then consider whether it makes financial sense to sell the hotel. Indeed, this is the way many asset managers perform their jobs.

It makes more sense, however, to begin the analysis from the other end. Asset managers should begin with this question: should I sell this hotel property now and redeploy the capital in other investments, or do I get a better return by continuing to operate the hotel as it is? Posing the question this way challenges the asset manager to regularly consider whether the capital tied up in a hotel is capital wisely invested. So the sell-vs.-hold analysis should always begin with the benefits of disposing of the hotel now.

An effective sell-vs.-hold analysis must go beyond a simple sell-or-hold calculation. You must also consider a number of other possible situations. Consider these four different scenarios.

First, should the hotel be sold now? Does it make sense to sell the hotel and redeploy the capital elsewhere? The analysis of sell-today provides a benchmark for all subsequent analysis. It is a bona fide estimate of the equity cash flow from selling the property. It includes the gross selling price and deducts the fees and remaining mortgage balance to arrive at the net cash flow that equity would expect from a sale in the near future.

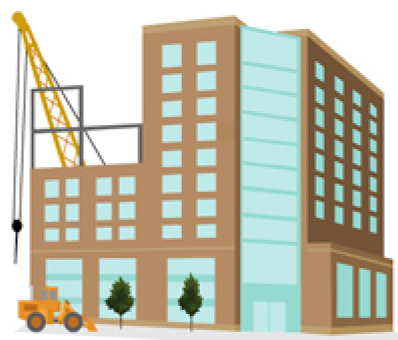
There may be a number of reasons to sell the hotel, some of them driven by considerations that have little to do with the hotel's financial performance. Maybe the owner has immediate cash flow needs, or the hotel no longer meets the diversification needs of the owner's portfolio. But the analysis here is concerned with the financial performance of the hotel. Can the capital invested in the hotel achieve a greater return invested elsewhere? If the answer is yes, sale of the hotel may be indicated.

Second, should the hotel continue to operate as is? Here the analysis is focused on the equity cash flows from continuing to own the property for a finite number of years plus the equity cash flow from selling the property in the future. The analyst compares the present value of the equity cash flow from continuing to hold with the equity cash flow from sale today.

Properly done, the comparison is now very easy: the largest cash flow indicates the preferred course of action. If the cash flow from selling exceeds the present value of the cash flows from continue-as-is, selling is indicated. If not, continue to operate as is.

Third, should the hotel be repositioned? The analyst compares the estimated cash flows from selling with the value of the asset if it is repositioned. For example, what if the hotel invests in meeting the needs of upscale guests and alters its marketing accordingly, seeking a different, upscale customer base? What would be the likely financial impact of this repositioning? If the repositioning improves returns, it may change the asset manager's sell-vs.-hold recommendation.

Fourth, should the hotel be redeveloped? This scenario compares the estimated cash flows from selling with the value of the asset if it were redeveloped. What if the hotel undertakes a substantial redevelopment, altering the physical structure and possibly even the purpose of the asset? What would be the likely financial impact of this redevelopment? If the redevelopment improves returns, it may change the asset manager's sell-vs.-hold recommendation.



A thorough sell-vs.-hold analysis begins with the benefits of selling the property and compares those benefits with the benefits of operating as is, of repositioning, or of redeveloping the hotel.

Watch: The Basic Sell-vs.-Hold Analysis

A sell-vs.-hold analysis is not as straightforward as it may seem. A thorough analysis involves carefully considering the costs and benefits of a range of sell and hold options. An illustrated presentation appears below. Use this resource to develop your understanding of the different sale and hold possibilities.

Read: Calculating Whether to Dispose or Continue to Operate

In SHA561, The Financial Analysis of Hotel Investments, we introduced the Hungerford Hotel in North Carolina. TarHeel Development, a small but growing hotel developer in the Research Triangle around Raleigh, Durham, and Chapel Hill, was interested in opening a new Hungerford Hotel.

Their developer, Alexandra Rodriguez, determined that the investment would provide sufficient returns to TarHeel, to the operator, and to the lender. The project was approved and the Hungerford Hotel opened as planned.

Five years have passed since the Hungerford's opening. TarHeel's owner, Brenda Chang, has requested that Christopher Trotman, TarHeel's VP for asset management, provide a recommendation: should TarHeel sell the Hungerford now or should it continue to hold the hotel? If the recommendation is to hold, Ms. Chang wants Trotman to recommend an optimal holding period for the hotel.

Chris knows that he needs to produce a sell-vs.-hold analysis, and that this analysis will need to compare the returns of three scenarios: selling the Hungerford now, operating the Hungerford as is, and renovating the Hungerford and then continuing to hold. To determine the optimal holding period, he needs to calculate the marginal rate of return. Finally, he must perform these analyses in different types of market conditions.

Watch: Optimal Holding Period

An illustrated presentation appears below. Use this resource to learn how to plot the optimal holding period for a property using the marginal rate of return for each year.

Read: The Renovation Decision

Now let's add some complication to our financial analysis. Instead of considering the return from selling versus the return from continuing to hold, let's consider a renovation. You can sell the hotel for $25 million today. The property can undergo a substantial renovation for $20 million. The renovation will require an additional equity investment of $5 million.

Renovate vs. Continue "As Is"

Compare the after-tax cash flows assuming the renovation with the after-tax cash flows without the renovation.

Year	5	6	7	8	9	10
ATCF Assuming Renovations $21,859		$555	$658	$763	$871	$21,859
-						
ATCF Assuming No Renovations $10,720		$616	$660	$706	$751	$10,720
Incremental Cash Flow $11,139	($5,000)	($61)	$2	$57	$120	$11,139

IRR in Incremental Cash Flows = 17.6%

The incremental cash flows show the change. As you can see, it takes a while after the renovation for the cash flows to catch up, but they eventually surpass the cash flows without renovation. The cash flows from the final sale are substantially greater. All told, the IRR on the incremental cash flows is $17.6%. If this is above the equity hurdle rate, it makes sense to pursue the renovation. Note that this IRR is the IRR for the incremental funds invested for the renovation, not for the entire property.

Sell Today vs. Renovate and Hold

To determine whether holding the property with the renovation is a good investment overall, the asset manager needs to compare hold-renovate with selling today. Here you see the cash flows for that analysis. Note that this decision is framed differently than the Renovate vs. Continue "As Is" scenario. Here the decision is about giving up the ATCF from sale today plus investing additional funds to renovate the hotel. The returns are the cash flows from operations of the renovated property and the greatly increased cash flow from sale five years in the future.

Year	0	1	2	3	4	5
ATCF From Sale Today	($7,098)					
-						
ATCF From Renovation	($5,000)	$555	$658	$763	$871	$21,859
Incremental Cash Flow	($12,099)	$555	$658	$763	$871	$21,859

IRR in Incremental Cash Flows = 16.5%

The IRR on the incremental cash flow is now 16.5%. If this is above the hurdle rate, it makes more sense to hold and renovate than to sell today.

Watch: Case Study: The Hungerford Hotel

An illustrated presentation appears below. Use this resource to interpret the optimal holding period for the Hungerford Hotel in a variety of markets.

Click Play to Listen

Jan deRoos
HVS Professor of Hotel Finance and Real Estate
School of Hotel Administration, Cornell University

Listen: Thank You and Farewell

Hi, this is Jan deRoos again. We now have the tools necessary to develop a strategic vision for a hotel property, a vision designed to realize the investment goals of different owners. Once the asset management strategy is in place, good asset managers use a number of different tactics to realize their goals. These tactics of asset management are considered in "Achieving Hotel Asset Management Objectives." If you haven't already done so, I hope you will take that course as well.

Stay Connected

Supplemental Reading List

The Center for Hospitality Research provides focused whitepapers and reports based on cutting-edge research.

"Hotel Asset Management: Principles and Practice." (2004) - Beals, Paul & Denton, Gregory

Educational Institute of the American Hotel and Lodging Association, eds.

A "how-to" book, containing solid, practical advice. New edition in 2008.

"The Negotiation and Administration of Hotel and Restaurant Management Contracts." (1988) - Eyster, James J

3rd Edition.

The classic reference, with a new edition by deRoos & Eyster in 2008.

http://www.hamagroup.org - Hospitality Asset Managers Association

The association for professionals dedicated to the enhancement of hotel and hospitality assets.

"Modern Real Estate Portfolio Management." (2000) - Hudson-Wilson, Susan

Frank J. Fabozzi Associates, ed.

A technical treatment of real estate portfolio strategies and tactics, well grounded in modern finance theory.

" Hotel Investment Handbook." - Rushmore, Tarras, & Ciraldo

(See especially Appendix 3.) Freely available for download.

This is the classic hotel investment treatment. Thanks to the authors for placing this in the public domain.