

HOSPITALITY & GAMING

FOCUS ON U.S. HOTEL CONSTRUCTION COSTS

July 2020



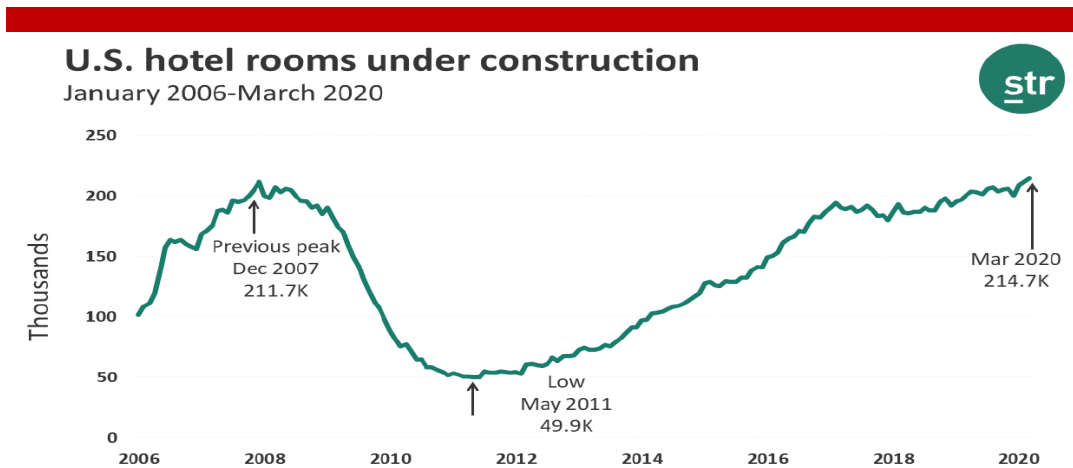
Cushman & Wakefield's Hospitality and Gaming Practice provides consulting and valuation services for new and existing hotel properties across the globe.

In the first quarter of 2020, the hotel industry across the U.S. began to be impacted by the Covid-19 pandemic. Occupancy and average rate declined rapidly and a reported 18.0 percent of the national lodging industry suspended operations. As of June 2020, the impact of the pandemic on travel and hotel use is anticipated to require a number of years to recover to 2019 levels. Along with other sectors of real estate, hotel development has begun to be impacted by the economic consequences of the pandemic. The news continues to evolve, and we are hearing of projects being shelved, cancelled, and, for those near completion, opening have been postponed.

This presentation focuses on US hotel development and is based on data and perspectives from a pre-Covid-19 environment. With a decline in construction expected in the next few years, some industry representatives anticipate a possible decline in construction costs. With the increased use of online

meeting platforms and the reduction in food and beverage services, some changes in the outlets and meeting space facilities may inspire changes in physical design with an increased integration of technology. Whether these changes will be long-term trend and how they impact development costs remains to be seen.

Despite the significant disruption in the industry since mid-March 2020, construction is continuing in many markets. Consistent with the trend in recent years, the majority of new hotel projects we have reviewed have fallen into three chain scales (as defined by STR) as Upper Midscale, Upscale, and Upper Upscale, while also dominated by four hotel companies, Accor, Hilton, Marriott, and IHG. According to STR, the industry is currently recording a record number of hotel rooms in the pipeline and projects under construction. As shown in the following graph, almost 215,000 hotel rooms were being built as of the end of the end of March 2020, surpassing the last peak in December 2007 of over 211,000.



Source: STR. 2020 © CoStar Realty Information, Inc.; compiled by C&W V&A

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FOCUS ON U.S.

HOTEL CONSTRUCTION COSTS



Approximately one-third of the hotel rooms under construction were expected to open in 2020, prior to the onset COVID-19, and equated to approximately 143,000. STR anticipates that this increase of will represent a 2.5 percent increase in the national inventory. With the evolving hotel industry performance in 2020, some of these openings may be delayed as developers wait for a stronger revenue environment.

Hotels are under construction across the U.S. Los Angeles led the name in the most rooms under construction, although New York is expected to see the greatest increase in supply (7.7 percent). As in the past, opening of new hotels typically coincides with a more competitive environment among the hotel inventory and can negatively impact short-term performance expectations. Due to the cyclical nature of the industry, hotel projects are planned, approved, and funded during improving and/or peak periods of hotel performance, which often causes the projects to open when occupancy and average rates begin to wane and even decline.

According to Cummings Construction Management, in the beginning of 2020, construction employment had finally reached its approximate pre-recession levels. Despite a larger number of construction and trade workers, the construction industry still reported labor shortages due to the large volume of active projects, and labor costs, as a result, had continued to rise. As hotel construction activity in 2019 rose, the total amount of other property types of construction, including residential, commercial, manufacturing, and healthcare, declined.

With the increases in construction costs and the competitive for good sites, alternative hotel development projects continue to gain traction. The redevelopment of historic hotels into luxury lodging, particularly in urban areas, are value-add projects pursued by developers. The feasibility of these projects can be enhanced with public incentives, historic tax credits, and opportunity zone programs. The upgrading of existing lodging is also happening at different levels of the chain scale. Repurposing older exterior corridor hotels to boutique properties in high barriers-to-entry markets or smaller markets can extend the useful life of the asset. Conversions of older properties to focused-service hotels to be affiliated with a new brand is also becoming a common practice.

And in mixed-use projects, hotels are often key components, particularly those with for-sale residential components. Hotels can add a halo effect that enhances the pricing of residential units supporting the development of both types of real estate.

Although construction activity is anticipated to decrease significantly for the rest of 2020, we believe that this construction cost data is still an important metric for investors and developers. Using actual project data from development budgets and other industry sources, Cushman & Wakefield has compiled per-room project costs for six major categories: (1) Land, (2) Hard Costs, (3) Soft Costs, (4) Working Capital, Pre-Opening and Supplies, (5) Furniture, Fixtures, & Equipment, and (6) Development Fee for the three most prolific STR Chain Scale properties. Composite budget data from recent hotel projects is shown in the per-room chart. We have excluded the Economy chain scale due to insufficient data. Note that the information presented in this piece is based on projects in our internal database. The range of projects changes from year to year and reflects a snapshot of information for the current environment.

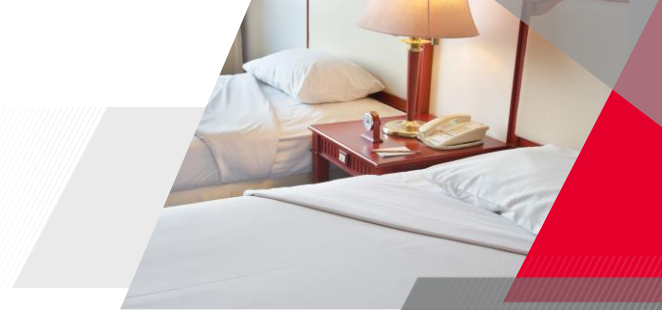
	Midscale	Upper Midscale	Upscale	Upper Upscale	Luxury
Land					
Min Per Room	\$4,000	\$2,000	\$2,000	\$15,000	\$17,000
Max Per Room	\$28,000	\$110,000	\$147,000	\$95,000	\$455,000
Average	\$19,000	\$25,000	\$31,000	\$35,000	\$146,000
Average % of Total Cost	7%	10%	10%	7%	7%
Hard Costs					
Min Per Room	\$84,000	\$49,000	\$59,000	\$132,000	\$543,000
Max Per Room	\$153,000	\$269,000	\$519,000	\$430,000	\$1,487,000
Average	\$113,000	\$169,000	\$173,000	\$270,000	\$845,000
Average % of Total Cost	72%	69%	68%	66%	64%
Soft Costs					
Min Per Room	\$2,300	\$2,000	\$3,000	\$17,000	\$121,000
Max Per Room	\$33,000	\$47,000	\$94,000	\$111,000	\$515,000
Average	\$16,000	\$22,000	\$23,000	\$55,000	\$270,000
Average % of Total Cost	10%	8%	8%	12%	18%
Working Capital, Pre-opening and Supplies					
Min Per Room	\$2,500	\$700	\$100	\$1,400	\$3,100
Max Per Room	\$2,500	\$13,000	\$18,000	\$30,000	\$60,000
Average	\$7,300	\$6,000	\$6,000	\$13,000	\$20,000
Average % of Total Cost	1%	1%	1%	2%	1%
FF&E					
Min Per Room	\$9,000	\$6,000	\$9,000	\$22,000	\$80,000
Max Per Room	\$14,000	\$38,000	\$33,000	\$94,000	\$204,000
Average	\$12,000	\$24,000	\$21,000	\$38,000	\$125,000
Average % of Total Cost	8%	10%	10%	10%	7%
Development Fee					
Min Per Room	\$3,500	\$1,500	\$400	\$2,900	\$28,100
Max Per Room	\$4,000	\$17,000	\$38,000	\$27,000	\$80,000
Average	\$4,000	\$10,000	\$11,000	\$13,000	\$58,000
Average % of Total Cost	1%	2%	2%	2%	5%
Total					
Min Per Room	\$121,000	\$94,000	\$94,000	\$198,000	\$813,000
Max Per Room	\$197,000	\$402,000	\$622,000	\$574,000	\$2,125,000
Average	\$147,000	\$175,000	\$235,000	\$409,000	\$1,630,000

*Compiled by Cushman & Wakefield Hospitality & Gaming Group

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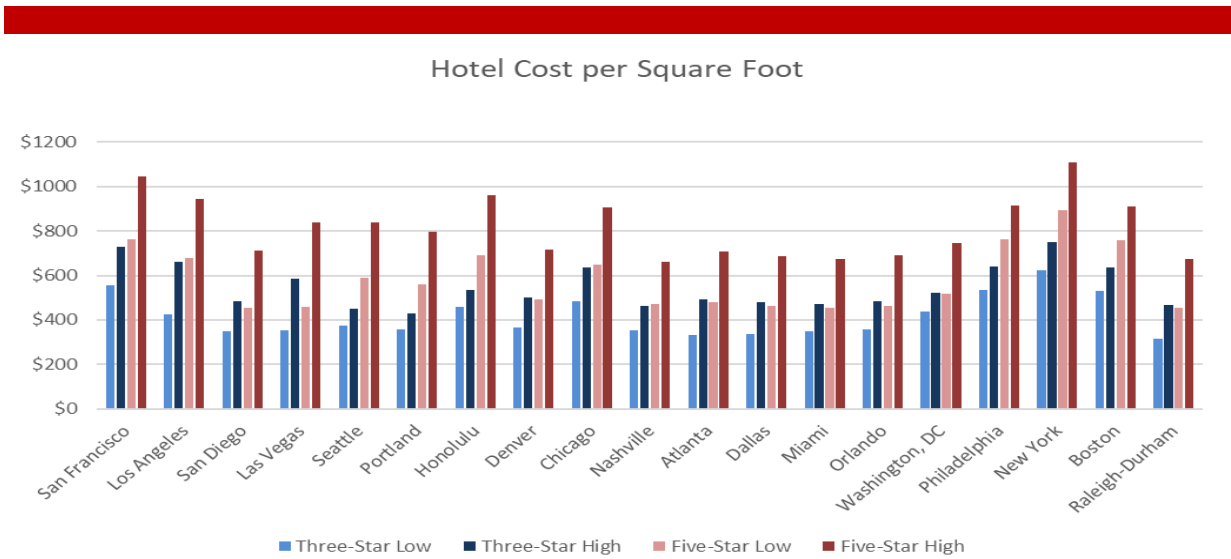
HOTEL CONSTRUCTION COSTS



The data represents broad category ranges and should be used as a general guide only. The per-room data compiled by Cushman & Wakefield represents projects across the US. Specific amounts from project budgets are sometimes difficult to validate, as individual developers may account for the same items in different categories and geographical costs can vary over 100.0 percent from one part of the country to another. For example, it may cost more to build an Upper Midscale hotel in a downtown Eastern gateway city than an Upper Upscale hotel in a secondary Midwest market. Data for per square-foot construction from Cummings Construction Management for 4th Quarter 2019 illustrates the range of costs.

purchased many years ago or inherited. Other developers assign a value to the land basis as part of the equity of a project.

- On a national average basis, the land component from the most recent data is 9.0 percent of the total development budget. Land as percentage of the total budget has declined with the increase in hard construction costs. In some urban areas, we continue to see more negotiations of long-term ground leases as landowners seek to retain some income from their property which happen to be attractive sites for hotel development.



Source: Cummings Construction Management

Without consistent cost budget categories across the industry, some development budget line items such as equipment and fixtures can bleed from one category to another. Materials or fixtures may be included in certain categories by developers based on their expected depreciation. We have established a consistent allocation of the items to the represented categories for this analysis.

The **Land** component in the construction budgets is represented by different financial contributions as determined by the developers. Some land components are direct market-based site acquisitions while other property may have been

Hard Costs are the largest portion of hotel development and depending on the location and type of construction can vary widely for the same property type. Limited-service hotel projects can range from wood-frame, three story projects in secondary markets, to steel frame, Class A high-rises in major urban areas. The range of these per-room costs can be five times higher from the low- to high-end of the per-room range. The impact of Covid-19 on construction costs is still evolving, however, there is growing industry sentiment that construction costs may come down as development projects are postponed, halted, or cancelled. We are tracking the impact of the moderating US hotel performance trends on hotel development and hard costs.

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FOCUS ON U.S.

HOTEL CONSTRUCTION COSTS



Construction costs continue to escalate. The Turner Building Cost index in 2019 reported an average cost increase of 5.5 percent, similar to the 5.6 percent rise in 2018. An ongoing shortage of skilled tradespeople continues to put pressure on development costs. Overall, 2019 marks the eighth year in which construction costs grew above inflation.

- In contrast to more expensive labor, the price of many building materials fell in 2019. The cost of lumber and gypsum notably declined with the softness in the residential home building market.
- Steel demand was unexpectedly strong in 2019 and, according to the website tradingeconomics.com, steel prices reached a peak in May 2019 before declining and again spiking in December. Steel is currently under pressure from effects of the coronavirus outbreak, with major steel plants cautious about restarting operations amid sluggish demand. Global steel consumption is now expected to fall 25.0 percent this year as the Indian and global economies struggle to recover from the impact caused by the Covid-19 pandemic. Meantime, renewed tensions between the U.S. and China have increased downward pressure on prices.
- The use of off-site modular construction of guestroom units, is increasing. Industry professional consider this process to be beneficial in the faster completion of a project but not necessarily having a cost differential to traditional stick building.
- Tech solutions are considered the best resource for reducing costs. Construction is considered one of the least automated industries in the U.S. The increased use of apps for project management, monitoring, and training, robots for simple repetitive tasks, and drones for inspections are being slowly adopted. The challenges of building as a result of the pandemic are viewed as an opportunity to develop new technology and practices.

Soft costs include entitlement and permit costs, financing costs, franchise fees, due diligence, legal, insurance, and property taxes. Financing

Costs, and sometimes entitlement costs, are typically the largest component of soft costs. Projects in urban and more environmentally sensitive areas often have high entitlement costs and longer pre-development periods with higher holding costs. Note that we include architectural and engineering fees in the hard cost category.

- As with all aspects of business, the Covid-19 pandemic has impacted the construction industry. Personal protection practices, staggered work shifts, and social distancing are slowing the construction process. McKinsey & Company anticipates the higher costs associated with the new work environment will escalate indirect construction costs by 15 to 30.0 percent.

FF&E costs include guestroom and public space furniture and can include soft goods. Individual development budgets account for FF&E in different categories. For example, we may be provided with budgets showing carpeting, bathroom fixtures, laundry and kitchen equipment, and technology systems as hard costs, while other budgets include some of these items in the FF&E category. These differences contribute to the wide range of per-room amounts.

- Design standards have crept up in all hotel product categories in recent years and the strong hotel performance from 2012 to most of 2019 supported reinvestment in properties.
- One of the fallouts from the Covid-19 pandemic is the postponement of capital projects and PIP (Product Improvement Plan), most for six months, though this may be extended. Capital projects and new construction are likely to be rethought for the next several months. The impact on FF&E costs is uncertain at this time.

Working capital and pre-opening expenses are critical to the success of a property but are sometimes excluded from development budgets. The initial operating supplies and inventory and hiring of the pre-opening staff are a relatively small component of hotel development, ranging on average from 1.0 to 4.0 percent of the total

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FOCUS ON U.S.

HOTEL CONSTRUCTION COSTS



budget. These costs are part of opening a hotel and experienced developers include in these costs the dollars expected to be spent on technical services, pre-marketing, staffing, and starting up the operating.

We also include a category for **Development Fee**. More and more, we are seeing an allocation of the project budget directly to the development team. The fee accounts for the costs of the initial pre-construction coordination work and administering of the project, including payroll, technical services, travel, and other expenses. The development fee is not related to any actual profit from the project expected to be generated upon the successful completion of the construction.

CONCLUSION

National hotel RevPAR growth had decelerated over the last several years and, prior to the Covid-19 pandemic, was anticipated to continue to moderate through at least 2021. However, starting at the end of the Q1 2020, hotel performance declined to an unprecedented level. Industry participants generally anticipated a three- to five-year recovery back to 2019 operating levels depending on the market and property. The decline in hotel operating performance is expected to be challenging for construction financings for new projects, while some projects will likely continue to be pursued with the expectation that the future date of opening will coincide with a recovery and support a successful hotel performance ramp up. Other projects may get cancelled, postponed, and re-conceived entirely.

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Changes in hotel design particularly in food and beverage outlets, public areas, and meeting spaces, as well as the integration of more technology, may provide for longer term shifts in construction costs and timelines. In the short term, the disruption in supply and demand for construction labor and materials may reduce development costs. A reduction in proposed hotels under development may reduce some supply concerns and help markets recover in the current environment. We are in a period of shifts and uncertainties and will continue to monitor the impact of the recent changes on the hotel construction environment.

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