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INKUBATE KNOWLEDGE BITE - HOW TO BUILD A HIGH END, PROFITABLE HOTEL

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ABOUT INKUBATE

Inkubate is a corporate finance and hospitality development and management firm. We work with developers to come up with winning development propositions, raise funds for projects and then work with them to oversee construction, opening and management of hotels, serviced apartments and lodges. We also provide valuation and transaction support services for those buying into or selling off their interests in assets.

ABOUT THE AUTHOR

Edwin Nyanducha is a corporate finance and project management expert with over 16 years of professional experience. He holds a Bachelor of Commerce (Finance Option) and is a Certified Public Accountant. He has strong skills in feasibility studies, financial modelling, business planning, review and structuring of legal agreements, finance raising, valuation and transaction support. He works with clients to sharpen their investment proposition and maximize long term value for their interests in hospitality assets. Edwin previously worked with Deloitte and PricewaterhouseCoopers and also lectured in Strathmore University.

HOW TO BUILD A HIGH END PROFITABLE HOTEL

You have worked hard and made many investments over the years. You now feel that a hotel would be a welcome addition to your portfolio that will make you recognized around town. As you have traversed the globe, you have seen luxury and service standards that are not in this part of the world. You believe this is the time to combine luxury, high quality service and an investment that will churn out good cash flows for a long time to come.

We are with you on the vision. However, our experience in working with investors putting up four and five star hotels has demonstrated time and time again that combining luxury and profit can be a very tricky balancing affair. If you go too high on luxury and the market cannot pay for it, then you are either facing sub optimal returns and where a bank loan is involved, it may mean having very unsavory conversations with your bank manager. On the other hand, spend too little and you may get just another ran property that even passers by have trouble knowing exists.

WHAT IS A HOTEL?

A hotel is a specialized piece of real estate investments. Unlike office blocks and residential rentals, hotels are very sensitive to management and have very specific requirements. On one front, a hotel investor has to comply with various laws and regulations including public health, labour laws, alcohol licensing, tourism laws, privacy laws and a host of others. Furthermore, management of hotels is a full time headache and many investors are already very busy running other aspects of their business. In our view, a hotel is a specialized form of real estate investment where the investor must balance cash investment and very specific technical know how.

HOW DO PEOPLE CURRENTLY INVEST IN HOTELS?

Most hotel developments we are called upon to assist with typically feature the following development model:

1. A client appoints an architect who has done some work for him in the past typically a house, office or other development and asks them to design a hotel. The investor tells the architect of the type of hotel they have in mind and even asks them to check out a certain website or photos of the place they may have.
2. The architect then proceeds to develop architectural sketches and 3D renders and in the mind of the investor, they can already see the final product.
3. Next, the architect brings along his consortium of professionals that he works with and this will include a structural engineer, mechanical and electrical engineers and quantity surveyor. Some architectural firms also offer interior design services and they may also quote for the same. Some architectural firms may also advise to appoint a separate competent interior designer. In other instances, the question of the interior designer is not addressed at all at this stage.
4. Usually, design of the hotel progresses and upon approval, tendering with contractors is commenced.
5. On evaluation and award, construction of the hotel starts and it is only half way through the project that a lot of hospitality related issues keep cropping up that an investors starts looking around for a hospitality resource who comes in and disrupts a lot of the construction work and ask for modifications. Once concrete has set, any changes to accommodate day to day realities of running a hotel become very costly variations.

WHAT NORMALLY GOES WRONG

To drive the point home, I will start by actual case studies of projects we have worked on in the recent past:

1. In inspecting one hotel three months to opening, we asked the owner where was the laundry? Incredibly nobody had remembered to include a laundry which is mandatory.
2. In a serviced apartment property which was just about to open, we were shocked to discover that no provision had been made for a reception or offices yet the client was shipping in high quality tiles from Spain and top marble from Italy.
3. In another development, the architect had provided for a kitchen but no stores to serve it.

The foregoing is only a small indication of how not involving hoteliers from the very beginning can make investors spend much, much more than if they had brought in hoteliers from the beginning. Architects, interior designers and other design professionals, though competent in their various areas, are not best placed to advise on the design of a hotel. After all, how many of them are involved in running the place once it opens and that is for the rest of the life of the hotel.

HOW MUCH SHOULD I SPEND IN PUTTING UP A HOTEL

The question of how much to spend has two key variables: size and capacity of a hotel and level of investment into it. In terms of size, one has to ask themselves: why put 100 rooms? Or should I put up 200? Obviously, the size of a parcel of land and zoning regulations play a big part but assuming that one could build as they wish, the difference between 100 and 200 rooms is very substantial and there is need to be sure why a certain capacity is chosen.

On the issue of level of spend, one also has to be careful. If a market has a stable average daily rate, the maximum recommended spend per room should be in the range of USD 80,000 as per certain hospitality appraisal methodologies which are beyond the scope of this article. If an investor then goes ahead and spends USD 200,000 per room, this means the investor is destroying USD 120,000 per room. Multiply that loss by the number of rooms.

It is our observation that the best way to achieve a winning product is to know what prices clients are willing to pay in a market. On the back of that, an investors should then align their total development budget to market realities and then push for the best product that an investor can get through efficient design.

HOW THEN SHOULD I BUILD A HOTEL

We advise all our clients that the best way to build a hotel is to look at it as first and foremost an investment. This then leads to a number of capital questions:

- Which clientele/market is the hotel going to be serving?
- Which properties are they currently using?
- Are they satisfied with the services they are getting at those properties? If the answer is no, is it likely that they will switch to the development you want to put up?
- How much are they currently paying or they will be willing to pay?
- If you are to put up the proposed hotel, what facilities must it have?
- How much will it cost you to put up the hotel?
- What are the likely returns on investment?
- What are the risks with making the investment?

To properly address these issues, we advise our clients to first commission a market demand study. This exercises combines the market for data on who are the key producers of business in a market, their spending patterns, where they are taking their business and likelihood of them patronizing the upcoming hotel.

BUSINESS PRODUCERS

Most people outside hospitality assume that the people who bring business to a hotel are walk in customers who are called Free Individual Travelers (FIT). The truth of the matter is that globally, FIT's account for only 10% of a hotels revenue. The real injection valves are organizations that need to use hotels as a critical component of their operations. Think of tour operators who receive groups of travelers on a daily basis and need to book them somewhere either for a stop over or as part of their stay on holiday. Regional airlines will always need to have hotel rooms to lay over customers who are late or who must wait for a connecting flight in the morning.

Banks, insurance companies, trainers, NGO's, government bodies etc also have to keep bringing people together to deliberate on strategies, plans, reports and such like work. They also fly in consultants to assist with systems, policy reviews and the like.

For all of these organizations, they have to have somewhere to put up such people and have the budgets to pay for them. Accordingly, in hospitality, we look at such organizations that can predict their accommodation/meeting patterns, have the budget to pay for them and are only looking to where to take the business as the rock of hotel. The hard work then becomes how to target as much business from them as is possible. Because they are reliable sources of business, they are accordingly labelled business producers in the hospitality world. A high spending customer who only comes in four times a year, though a valuable customer, is icing on the cake but cannot be relied upon to produce returns for the hotel or meet salary, utilities and bank loan commitments.

Understanding who are the producers of business for your hotel, how much they spend (some organizations such as NGO's may be limited by the donor funding them to the maximum they can spend on hotel stay), how they make hotels compete on price and their credit terms is important in informing what type of hotel is to be build and the maximum that should be invested. Otherwise, spending more than the returns you can make in the market can lead to a serious case of investment risk – spending more than you should have.

On the back of the market demand study, seasoned hoteliers can then develop a hotel brief that will amongst others specify:

1. The recommended hotel product – A 3, 4 or 5 star product and why
2. The likely returns the hotel will achieve in the market
3. The recommended maximum investment to match returns to investment outlay
4. The facilities it must have
5. How the hotel will be cleaned and maintained in the long run – Some items of furniture, fittings and equipment may look nice at construction but can be difficult to clean, maintain or replace in the long run.

This does not mean that an investor has to put up a three star hotel whereas business in the market can support a five star property where business producers are willing to pay more. The trick is to match demand and supply. In this way, an investor at stands a decent chance of putting up a hotel that is responsive to the needs of the market and that maximizes their returns.

This is Part One of a series of articles in how to invest in hotels. Part two will look into how to assemble a design team and some of our recommendations on how to improve on the process to get the best design professionals at costs that make sense.

SERVICES BEFITTING YOU

To see how we can be of service to you or your development, contact Edwin Nyanducha on:

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