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How key is it to ‘be different’ in hotel real estate?

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This study looks at differentiators, from brand to location and superlatives such as “tallest” and “oldest,” to see what impact they have on a hotel’s pricing power.

By Prashant Das (/Author/31731/Prashant-Das)
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More so than other commercial real estate asset types, hotels can reap benefits of market differentiation both by superior operations and by the characteristics of their property.

Much is known about how to beat the competition through superior operations. Operational managers might dynamically change their differentiation strategy based on changing market conditions. However, it is the real estate component which tends to be an overwhelmingly large part of a hotel’s value. Yet, our knowledge about the pricing impact of real estate differentiation is very limited.

Number of floors and size of a hotel are prominent architectural features. For investors in existing assets, a property’s age could also be a differentiator. However, owners cannot easily change these features, although we show that they significantly affect the property price. In our research—conducted on a sample of nearly 5,000 hotel transactions in the U.S.—we explored how the superlative building status, such as being the tallest, the largest or the oldest, raises or diminishes value, and whether this pattern varies across contexts.

Computing-based valuation
Recent advancements in commercial real estate research affirm the utility of a statistical valuation method called “hedonic pricing.” A sample of hotel transactions are fed into computer models which incorporate market conditions, decipher the pricing pattern and disaggregate the asset price into different attributes of a hotel, such as physical and locational. The pricing model also suggests if these disaggregated price components are

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significant. This article reports salient findings which could enhance our traditional valuation framework. In particular, our study focuses on whether the superlative status has additional price implications.

Does status matter?

The brand: Beyond the impact of a brand's underlying characteristics—such as class, amenities and location type—and contrary to popular belief, we find few cases in which the brand name has significant impact on property price. So, we examined additional proxies for the status.

Location, media coverage and the buyer: Status of the location matters, although the local population often generates insignificant revenue for a hotel. Within a metro area, a CBD locality may add 40% to 85% to the price compared to a non-CBD hotel of similar characteristics. Even within a submarket of a metro, a hotel in an "affluent" locality—defined by ESRI as dominated by Caucasian, high-earning, and middle-aged married couples—generates 11% to 15% additional value. Increased mention in the media, including newspapers, TV and magazines, due to events hosted by an upper-class hotel is also associated with significant property price enhancement. These factors, clubbed with the characteristics of a hotel and market conditions, explain nearly 80% variation in hotel property prices.

Further, more active buyers—those who buy or sell hotels more frequently—tend to significantly overpay (by 0.2% to 0.3%) for hotels. Investors—usually institutional—who will not operate a hotel themselves overpay significantly (by nearly 11%) when buying it.

The high- and low-quality segments

The findings presented above offer us rather the "baseline" pricing mechanism. Despite the high accuracy of hedonic pricing models, the actual transaction prices differ from computer predictions.

Hotels that sold at prices higher than predicted by the pricing model were placed in what we call the "premium" segment. So, the hotels which sold for prices less than predicted are in the "low-quality" segment. Note that these two segments are almost equally applicable across all hotel classes—luxury, midscale, economy and so on. The attached image depicts the geographic distribution of premium and low-quality hotels.

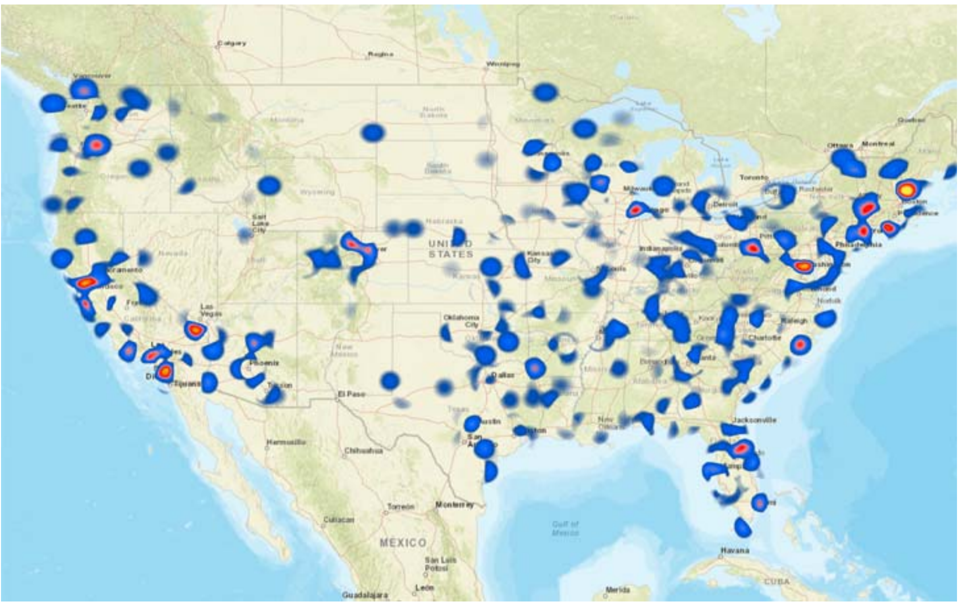

Figure 1: Geographic distribution of premium and low-quality hotels. Warm colors—usually in the center of clusters—such as yellow, orange and red suggest higher concentration of premium hotels. (Illustration: Prashant Das and ESRI)

It is clear that the premium hotels are scattered all over the map, implying that overpricing or underpricing is pervasive rather than being a metro- or regional-level phenomenon. So, what factors characterize the premium and low-quality segments?

Standing out by superlative features

Evidently, traditional pricing models already include a building's height, size and age, among other hotel attributes. For example, we know how much extra price comes with an additional room—all else being the same. But we do not know whether enjoying "the largest" status—for example, the highest number of rooms—has significant price implications. Similarly, we do not know the price implications of other superlative statuses such as the "tallest" or the "oldest."

Besides, there are discrete scales of superlative comparisons. For example, a hotel might either be among the tallest nationally or only the tallest in its local market. We define nationally superlative hotels as those which lie in the top 1% in terms of size, height or age. Locally superlative status is identified by comparing the subject hotel with surrounding hotels in its local trade area—for example, within 20-minutes driving distance.

We found that the locally largest status is considered an "atypical" feature. Because of their specificity, there is thin demand for such hotels. Hence, this status could diminish the price by up to 15%. On the other hand, nationally largest hotels enjoy distinctive recognition and capacity, leading up to 30% price premium. Also, if a locally largest hotel conspicuously stands out in its size within its locality, the negative effect of this status might become insignificant.

The status of being locally or nationally the tallest has a different impact on pricing. Premium hotels earn some distinction from being the tallest. Investors in this segment could use this feature as a subtle marketing or "ego-enhancing" tool, as some earlier studies have reported. However, investors in low-quality hotels see the "tallest" status as a limitation. Low-quality hotels that are "too tall" offer challenges in fire safety as well as vertical transportation and create psychological concerns.

A similar pricing pattern can be observed in hotels that are among the oldest nationally. Such hotels are usually 100 years or older. Premium-segment investors value the historic nature and assign additional valuation to such hotels. However, investors in the discount segment might be concerned about the ongoing costs involved with very old assets.

Externality of superlative hotels

We detect another intriguing phenomenon: Being locally the oldest, largest or tallest also affects the valuation of neighboring assets. Unless its vintage effect conspicuously stands out, the oldest hotel negatively affects the value in neighboring low-quality hotels. The well-recognized identity of the oldest hotel in a neighborhood could be seen as a threat to the demand for neighboring hotels. However, high-quality hotels sometimes enjoy value enhancement if another hotel in the neighborhood is locally the oldest.

Locally, the largest hotel does not significantly affect the valuation of surrounding lower-quality hotels. However, if the size conspicuously stand out, higher-quality hotels in the neighborhood might enjoy higher pricing due to another hotel that is locally the largest. This could be due to economy of agglomeration in some markets: Higher-quality hotels are able to capture demand spillovers from another large hotel in the locality which potentially attracts events on a regular basis.

Similarly, the tallest hotel in the locality often does not significantly affect the pricing in surrounding low-quality hotels. On the other hand, if the height is moderate, the rental demand from the tallest hotel might spill over to the surrounding premium hotels, which gain some value from this positive externality. However, if the tallest hotel visibly stands out, this creates a "snobbery" effect. Such a conspicuously tall hotel could be seen as overpowering the status of surrounding premium properties whose prices are, in turn, negatively affected.

Bottom line: One man's meat is another man's poison

The impact of these superlative attributes is often economically significant, but depends on the context.

A large hotel must be really large to avoid the "atypicality" pricing discounts or to enjoy pricing premium of the "largest" status. Being the tallest or the oldest enhances valuation in the premium hotels, but often diminishes value in the lower-quality hotels.

Besides, the oldest, largest or tallest hotels might create both positive and negative externality in surrounding hotels depending on the characteristics of the subject hotel. These differences might stem from economic fundamentals and, sometimes, by psychological biases of investors. While we now recognize the price implications of superlative real estate attributes, more research is warranted to improve the accuracy of such models.

Note: This article is based on the following research paper: Das, P., Smith, P. & Gallimore, P. (Forthcoming). "Pricing Extreme Attributes in Commercial Real Estate: The Case of Hotel Transactions," Journal of Real Estate Finance & Economics 151–160. DOI: 10.1007/s11146-017-9621-4

Prashant Das, Ph.D., is an assistant professor of real estate Finance at Lausanne Hotel School (EHL)- HES.SO// University of Applied Sciences Western Switzerland. Prashant has earned several internationally competitive research awards and a teaching excellence award. His research interests include REITs, CMBS, hotel valuation, and Indian real estate markets, among others. Earlier, he worked on managerial and engineering roles with several multinationals.