1997 Acta Structilia Vol 4 No 1

Extended-stay lodging: A new high-return product

Reduced payroll and supplies costs make favorable return rates possible

Peggy Berg & Mark Skinner[*]

Summary

"In the USA a relatively new real estate product called extended-stay lodging should become as established a financial asset as limited-service hotels or apartment complexes. The potential for superior financial performance is based on assumptions of tightly controlled development costs, rapid 'lease-up,' high occupancy, and low operating expenses. The lower end of the extended-stay market has been pioneered by apartment companies, while the mid-market is being promoted by hotel companies that have recently entered the picture."

Keywords: Extended-stay lodging, apartments, hotels.

VERLENGDE VERBLYF-EENHEDE: 'N NUWE KONSEP VIR 'N HOË-OPBRENGSPRODUK

Opsomming

In die VSA het die konsep van verlengde verblyf-eenhede begin posvat. Meer as 1 biljoen dollars is reeds na raming sedert 1996 tot nou in dié nuwe ontwikkeling belê. Só 'n eenheid bestaan uit 'n ten volle toegeruste woonstelletjie wat veral byval vind by persone wat vir kort of langer termyne weg van die huis moet bly. Die kombuisie is veral 'n groot pluspunt wat die huurders betref, terwyl dit vir die verhuurder lae onderhoud met 'n goeie inkomste inhou.

Sleutelwoorde: Verlengde verblyf-eenhede, woonstelle, hotelle.

* *Permission was granted by authors to publish this article in Acta Structilia. It was written by Peggy Berg, CFA, ISHC, president and Mark Skinner, MSRE, market and financial analyst of the Highland Group, Hotel Investment Advisor Group Inc. a hotel industry consulting firm based in Atlanta, GA, USA as well as the publishers of the Real Estate Review, Warren, Gorham & Lamont, Boston, USA.*

More than 1 billion dollars will be spent in 1996 and 1997 in the USA to develop a relatively new real estate product called extended-stay lodging. Within two years the product should be available in markets across the country, and the sector should become as established a financial asset as limited-service hotels or apartment complexes. Investor interest in extended-stay lodging has been generated by anticipated unleveraged internal rates of return that exceed 20% and by leveraged returns that are above 50%.

The potential for superior financial performance is based on assumptions of tightly controlled development costs, rapid "lease-up," high occupancy, and low operating expenses. At the lower end of the extended-stay market (in which average rates range from $25 to $30 per night), the use of secondary sites, often behind retail and restaurant outlets, and apartment-quality construction keep development costs relatively low. As room rates increase and the extended-stay product becomes more upscale, the use of higher value sites and improved development quality is mandated.

The lower end of the extended-stay market has been pioneered by apartment companies, while the mid-market is being promoted by hotel companies that have recently entered the picture. Some of the larger current investments are being made by newly formed public companies. The mid-market is expected to have average daily rates between $45 and $70. Currently the upper end of the market is defined by the well-established *Residence Inn* chain, which commonly has daily rates of $80 to $100. As rates increase and services are expanded, apartment operating policies are being replaced by hotel operating policies and operating costs are increasing.

A hypothetical *pro forma*

Exhibit 1 compares the statements or income and expense for a stabilized year of two hypothetical extended-stay properties: (1) an economy property and (2) a mid-priced property. Typically, an economy-price facility achieves stabilized performance after its first few months of operation. For a mid-priced facility, stabilization is likely to occur in the second year. Economy facilities tend to reach stabilized occupancy more quickly than their higher-priced counterparts because they require less marketing and have a longer average length of stay. In the lowest price economy facilities, a substantial component of the market is essentially residential. Each line item in *Exhibit 1* is categorized according to the *Uniform System of Accounts for Hotels*.

Assumptions

The economy-priced facility is assumed to have 125 guest units and a small lobby/office area. It has no pool or other public space. The property is a two-story wood-frame building with exterior corridors. Each guest room is a single bay ranging in size from 230 to 310 square feet. Each guest room has one bed, a comfortable chair, a dresser, closet area, a full bathroom, and a kitchenette with sink, full-size refrigerator, microwave, two-burner cook-top, cabinet space, and cooking and dining utensils.

The mid-priced building is a low-rise structure with ground-level parking. It could have interior or exterior corridors. The lobby/office area is larger and better appointed than the one in the economy-priced property. Guest units would range in size from 300 to 400 square feet and have a higher level of finish and better quality furnishings than do the units in the economy-priced product. However, each guest unit still has only one bed, a table and chairs, desk area, television with remote control, full bathroom, and a similarly equipped kitchenette.

Both property types have telephone systems that permit unlimited local calls and long-distance calls on a credit card basis. Guests could receive telephone calls that are transmitted directly to their room, or calls may pass through an "auto-attendant" that directs calls to guest rooms.

Front office operating hours in the economy-priced product are from 7 a.m. to 8 p.m. At the mid-priced property, the office operates from 7 a.m. to 11 p.m. Each facility provides maid service once weekly, and changes towels and removes trash twice weekly.

Revenues

Exhibit 1 assumes that stabilized occupancy in the economy-priced property is 90%, whereas in the mid-priced property stabilized occupancy is 87%. Because the mid-priced property has fewer "residential" guests, and average stays are somewhat shorter, these facilities are more subject to weekly and seasonal fluctuations in travel than are economy-priced properties. Although *Exhibit 1* reports average daily rates, rates at extended-stay facilities are typically quoted on a weekly basis. No more than two people are expected to stay in a room. In the example, the rate for the mid-priced product is the average for a modestly wide selection of room types.

In the economy product, the price for one person would be, for example, $180 to $190 per week, but the average room rate includes some nightly business at a higher rate, for example, $50 per night. The facilities would also be making some incremental charges for double occupancy. Thus, the average daily rate of $30 in the economy property implies average weekly income of $210 per week. For the mid-priced product , the average daily rate of $51,50 equates to $360 for a week. This average includes a component of transient business that is higher than that allocated to economy facilities. The transient rate is assumed to be around $70 per night, while the single extended-stay weekly rate would be in the $310 to $340 range. Total room revenue is computed as:

> Occupancy rate x average daily rate x 365 days x the number of guest rooms

At similar occupancy levels, extended-stay properties have a lower RevPar (revenue per available room per year) than hotels with similar development costs, but revenues are higher than those of apartment buildings with similar development costs. Occupancies are typically higher than in hotels, but rates are lower. Conversely, occupancies are the same or lower than those of apartments, while rates are considerably higher than apartment rents. Rooms departmental revenue represents most of the revenues of extended-stay properties, generally more than 90% of gross revenues.

EXHIBIT 1

COMPARISON OF INCOME AND EXPENSES FOR HYPOTHETICAL ECONOMY-PRICED AND MID-PRICED FACILITIES[1]

	Economy-priced facility			Mid-priced facility		
OCCUPANCY		90%			87%	
Average rate		$30,00			$51,50	
	Total	Revenue as ratio to sales	Amount per available room	Total	Ratio to sales	Amount per Available Room
REVENUE						
Room revenue	$1 222 020	91.76%	$9 855	$2 027 720	92.49%	$16 353
Telephone	$61 101	4.59%	$493	$83 548	3.81%	$674
Rentals and others income	$48 669	3.65%	$392	$81 115	3.70%	$654
TOTAL REVENUE	$1 331 790	100.00%	$10 740	$2 192 384	100.00%	$17 681
DEPARTMENTAL EXPENSES						
Rooms	$132 308	10.83%	$1 067	$216 29	910.67%	$1 744
Telephone	$52 954	86.67%	$427	$70 976	84.95%	$572
TOTAL DEPARTMENTAL EXPENSES	$185 262	13.91%	$1 494	$287 275	13.10%	$2 317

COMPARISON OF INCOME AND EXPENSES FOR HYPOTHETICAL ECONOMY-PRICED AND MID-PRICED FACILITIES						
UNDISTRIBUTED OPERATING EXPENSES						
Administrative & general	$98 704	7.41%	$796	$169 950	7.75%	$1 371
Marketing / Sales	$33 295	2.50%	$269	$87 695	4.00%	$707
Franchise fees	$0	0.00%	$0	$87 695	4.00%	$707
Energy	$96 132	7.22%	$775	$143 732	6.56%	$1 159
Property operation and maintenance	$64 728	4.86%	$522	$118 821	5.42%	$958
TOTAL UNDISTRIBUTED OPERATING EXPENSES	$292 859	21.99%	$2 362	$607 893	27.73%	$4 902
GROSS OPERATING PROFIT	$853 668	64.10%	$6 884	$1 297 215	59.17%	$10 451
FIXED COSTS						
Property taxes	$78 664	5.92%	$636	$125 93	25.74%	$1 016
Insurance	$21 700	1.63%	$175	$34 61	21.58%	$279
Replacement reserve	$61 265	4.60%	$494	$97 523	4.45%	$786
NET OPERATING INCOME	$691 839	51.95%	$5 579	$1 039 148	47.40%	$8 380
Debt service	$303 658	22.80%	$2 449	$506 096	23.08%	$4 081
PRE-TAX CASH FLOW	$368 181	29.15%	$3 130	$533 052	24.31%	$4 299

Telephone revenue shown in *Exhibit 1* is based on the assumption of $1,50 per occupied room night in the economy-priced model, and $2,12 in the mid-priced model. These revenues would vary widely depending on the type of telephone equipment and service used. The longer the average stay in a facility, the lower the telephone revenues are likely to be.

Rentals and other income in *Exhibit 1* are derived largely from vending and commissions. Other income also includes minor amounts of interest and income from occasional sales of small items for salvage. Because extended-stay guest units include kitchens and do not offer room service, restaurants, or gift shops, vending sales can be substantial. Vending machine revenue varies according to the selection of machines offered and on the availability of alternatives, like convenience stores within walking distance. In *Exhibit 1*, miscellaneous income of a little more than $1 per room night occupied shows that the economy-priced property has limited vending, primarily soda pop machines and a sundries machine. Miscellaneous revenue in this department of just more than $2 per room night occupied indicates that the mid-priced product has a wider selection of items, possibly sundry and snack machines.

Extended-stay hotels usually offers guests laundry facilities that longer-term guests may use extensively. Revenue from washer and dryer machines can add up to a substantial component of the "rentals and other income" category.

Total revenue from all departments in the economy-priced product at stabilization is $1,3 million annually, while the mid-priced project earns almost $2,2 million in gross revenues yearly.

Departmental expenses

Rooms department expense usually includes payroll and related expense for housekeepers, laundry staff and front desk staff. Also included are linen, guest supplies, and cleaning supplies. Costs of cable television and complimentary breakfast (if offered) are also typically included in rooms departmental expenses, and when a reservation service is used, reservation charges are included. Rooms departmental expenses in the emerging extended-stay properties are expected to be in the range of 10% to 12% of room revenue, whereas rooms departmental expenses at limited-service hotels average 24% to 28% of rooms revenue.[2]

The relatively low costs of rooms department expenses may be attributed to lower levels of required service. *Exhibit 1* assumes that maid service is once per week and towels are changed twice per week, a service level that requires significantly less labour expenditure than that of a hotel that offers housekeeping. In addition longer lengths of stay result in fewer check-ins and check-outs, which enables extended-stay hotels to operate with only one person at the front desk. Front desk hours are limited, and in many facilities the manager operates the front desk shift for a period. The economy-priced product should have cable television, but might not carry premium channels. Mid-priced facilities would be expected to carry one or two premium channels. Because guests stays are relatively long, total cost of guest supplies is low. Soap is not replaced daily, and the facilities need not offer room amenities, like shampoo, mints, etc. The expense figure in *Exhibit 1* assume a limited continental breakfast at the mid-priced property, but no food at the economy-level property.

The difference in check-in and check-out traffic between most hotels and extended-stay properties makes a significant impact on operating costs. A limited-service hotel with 125 rooms and a 1,2 day average stay would have 25 000 to 30 000 check-ins and check-outs, and changes of guest room tenants annually. An extended-stay property with 125 rooms, but a four-week average stay, would have to handle only 1 000 to 2 000 of these encounters per year.

In the economy-priced model, telephone departmental expense is 87% of telephone revenues and a slightly lower percentage in the mid-priced model. This is a higher expense ratio (lower profit margin) than is typical of a hotel. In extended-stay hotels, long-distance usage is lower because they have a lower transient component, and telephone pricing is value-orientated.

Undistributed operating expenses

The category "undistributed operating expenses," in *Exhibit 1* are the overhead items required for operations. They include administration, marketing, energy, operations and maintenance, and other overhead items.

- *Administrative and general costs.* Administrative and general costs include payroll and related expenses for the general manager, accounting staff or service, security (a highly variable requirement), office supplies, travel, bad debts, commissions, and other administrative expenses. Administrative and general expenses vary widely among hotels, depending on their management structure. Limited-service hotels with 125 rooms incur approximately $1 200 to $1 600 of such expenses per room per year. The economy-priced extended-stay property in *Exhibit 1* incurs annual administrative and general expenses of only $800 per room.

  At an extended-stay property, office supplies, travel, bad debts, and commissions are minimal. Accounting is simple because there are relatively few transactions, and payroll is tightly controlled. In some cases, although not in the *Exhibit 1* models, the general manager lives on-site, reducing payroll cost. Guests processing charges are low because the number of individual guests is low. Bad debts are also low because, typically, room rent is collected in advance. Rents in extended-stay facilities, particularly in the economy segment, are often paid in cash or by check, thereby reducing credit card charges. Most extended-stay rooms are booked by individuals or a relatively small business guest's secretary. Consequently, commissions to travel agents and other third-party reservationists are relatively small. Because the mid-priced property has a higher rate of check-in and check-out and a somewhat higher level of service than the economy facility, it requires more administrative and general expenditure. However, total expense in the department is still lower than in a comparably sized hotel.

Exhibit 1 includes no expenses for property oversight and assumes that ownership handles this responsibility.

- *Marketing and sales costs.* Economy-priced extended-stay properties incur relatively low marketing and sales expenses. Marketing usually consists of (1) sales calls by the general manager, (2) a clearly visible sign advertising the product and room rates, and (3) advertisements in telephone directories. Mid-priced extended-stay facilities require more concerted direct sales efforts. In addition, as the transient component of demand for these facilities increases, they require more signage and more marketing. In *Exhibit 1*, the economy-priced extended-stay facility has annual marketing and sales expenses of $33 000, compared to $88 000 for the mid priced property. A typical limited-service hotel is likely to incur marketing and sales expenses of 5% to 6% of total revenues, only slightly more than the expenses shown in *Exhibit 1* for the mid-priced facility.
- *Franchise fees.* The economy-priced product in *Exhibit 1* pays no franchise fee. To date, facilities of this type have been reasonably well received without national branding. During the course of time, national branding is likely to become more important. The *Exhibit 1 pro forma* for the mid-priced facility pays a franchise fee equal to 4% of room revenues. The closer a facility is to a hotel product, the more likely it is to be franchised in order to obtain desired room rates.
- *Property operations and maintenance expenses.* Maintenance for the economy property is shown at about $500 per available room per year compared to more than $900 for the mid-priced property, including staffing. Both figures are within the range of limited-service hotels. The variation is caused by the size and complexity of the guest room and equipment. During the course of time, maintenance on extended-stay properties would

tend to be increased by the costs of in-room kitchen maintenance. Wear patterns for the rooms can be extended to be slightly different than in a hotel because of the extended-stay nature of the guest.

- *Energy expenses*. Energy expense for the economy property is shown at $706 per available room compared to $934 per available room per year for the mid-priced property. Both are conservative figures and reflect reasonable energy-efficient design and new heating and cooling units. Energy expense per room can be expected to be higher than for a traditional limited-service hotel because of the in-room kitchens.

- *Fixed costs*. *Exhibit 1* bases property tax expenditures on an assumed development cost of $30 000 per room for the lower-priced property and $50 000 per room cost for the higher-priced property. Insurance is based on general insurance levels for hotels, and varies widely. The replacement reserves reflect detailed analysis of the CapEx requirements for limited-service hotels. Because of the kitchens in these facilities, replacement reserves may need to be relatively higher than in hotels.

Financial results

The *Exhibit 1* assumptions produce a gross operating profit for the economy-priced facility amounting to 64% of total revenue, compared to 59% for the mid-priced product. These profit margins are higher than those typically found in hotels. The key items of the difference are the lower labour costs, reduced or absent franchise and management fees, reduced cost of supplies, and lower administrative costs. *Exhibit 2* compares typical departmental and undistributed operating expenses per room of economy- and mid-priced extended-stay properties and of a limited-service hotel.

Return rates

The before-tax internal rate of return on an unleveraged investment in the economy-priced property is 22%. Returns

3 & 4 assume that revenues and expenses increase by 3% annually to reflect inflation.

EXHIBIT 3

REVENUE, EXPENSE, AND CASH FLOW STATEMENT: ECONOMY-PRICED EXTENDED-STAY HOTEL[1]								
Year	-0	1	2	3	4	5	6	7
Gross revenues[a]	$0	$1 331 790	$1 371 744	$1 412 896	$1 455 283	$1 498 941	$1 543 910	$1 590 227
Total operating expensesa	$0	$639 951	$659 150	$678 924	$699 292[a]	$720 271	$741 879	$764 135
Net Operating Income	$0	$691 839	$712 594	$733 972	$755 991	$778 671	$802 031	$826 092
Debt service	$0	$303 658	$303 658	$303 658	$303 658	$303 658	$303 658	$303 658
Cash flow								
Unleveraged	$(3750000)	$691 839	$712 594	$733 972	$755 991	$778 671	$802 031	$5984519[b]
Leveraged	$(937 500)	$388 181	$408 997	$430314	$452 334	$475 013	$498 373	$3358640
Reversion calculations								
Sales prices[c]	$5 317 966							
Sales costs	$159539							
Net proceeds	$5 158 427							
Debt payment	$2 322 221							
Before tax cash flow	$2 836 206							

a Increases 3% annually
b Includes cash flow from reversion
c Based on year 8 no.1 of $850 875 capitalized at 16%

EXHIBIT 4

REVENUE, EXPENSE, AND CASH FLOW STATEMENT: MODERATELY-PRICED EXTENDED-STAY HOTEL[1]								
Year	-0	1	2	3	4	5	6	7
Gross revenue[a]	$0	$2006199	$2192384	$2258155	$2325900	$2395677	$2 467 547	$2541573
Total operating expenses[a]	$0	$1125962	$1153236	$1187833	$1223458	$1260172	$1297977	$1336917
Net operating income	$0	$880 237	$1039148	$1070322	$1102432	$1135505	$1169570	$1204657[b]
Debt service	$0	$506096	$506096	$506096	$506 096	$506096	$506096	$506096
Cash flow								

REVENUE, EXPENSE, AND CASH FLOW STATEMENT: MODERATELY-PRICED EXTENDED-STAY HOTEL[1]								
Unleveraged	$(6250000)	$880 237	$1039148	$1070322	$1102432	$1135505	$1169570	$8726986[b]
Leveraged	$(1562500)	$374 141	$533 052	$564 226	$596 336	$629 409	$663474	$4350521
Reversion calculation								
Sales prices[c]	$7 754 979							
Sales costs	$232 649							
Net proceeds	$3 870 369							
Debt payment	$2 322 221							
Before tax cash flow	$3 651 960							

a Increases 3% annually
b Includes cash flow from reversion
c Based on year 8 no.1 of $1 240 575 capitalized at 16%

Before-tax internal rates of return for a typical limited-service hotel that costs $45 000 per room to develop and that operates at a stabilized occupancy of 75% at an average room rate of $55, are about 15% on an unleveraged basis. Under the same financing assumptions applied to the extended-stay properties, leveraged returns on equity for typical limited-service hotels would be about 30%. The primary reason for relatively high rates of return on extended-stay properties are the low operating expenses possible in extended-stay facilities when compared to the transient "short-term" hotels. Revenue statistics and rates of return are compared in *Exhibit 5*.

EXHIBIT 5

RETURN ON INVESTMENT COMPARISON FOR HYPOTHETICAL HOTEL PROPERTIES[1]

Lodging product	Economy-price Extended-stay	Mid-price Extended-stay	Typical limited-Service hotel
Development cost per room	$30 000	$50 000	$45 000
Gross revenue	$1 331 790	$2 192 384	$1 882 000
Gross operating profit (net operating income as% of total revenue)	64%	59%	42 to 50%
Pre-tax cash flow	$386 181	$533 052	164 000

RETURN ON INVESTMENT COMPARISON FOR HYPOTHETICAL HOTEL PROPERTIES[1]			
Lodging product	Economy-price Extended-stay	Mid-price Extended-stay	Typical limited-service hotel
Before tax internal rate of return on equity			
Leveraged	51%	39%	30%
Unleveraged	22%	19%	17%

Conclusion

Given the present level of investment in extended-stay lodging product, this type of facility is expected to be a force in the real estate market. As this product type has evolved, it has moved away from the apartment model and closer to the hotel model. However, for long-term viability, extended-stay lodging must find its own niche. That niche could be considered a subset of the hotel industry or an independent real estate product, but extended-stay properties cannot be highly profitable if they are operated as hotels.

The basic concept of the extended-stay product is that a guest staying several weeks to several months gets the highest value for his or her lodging dollar by staying in a furnished efficiency unit that has all utilities, including telephone. Guests in these facilities consider kitchens to be important, but they will do without expensive personnel-based services. The product must be carefully tailored for people who need lodging for periods of one week to several months.

Extended-stay properties can afford to offer tremendous price-value to their guests as long as their service level remains low. According to Smith Travel Research's Host Report, total payroll and related expenses at limited-service hotels average 26% of total revenues. A limited-service hotel like the one profiled in this article would normally employ about 20 full- and part-time personnel. Staffing for an extended-stay hotel of the same size is in the range of 10 to 14 individuals so that total payroll expenses are reduced to approximately 15% of total revenues. The savings in payroll, coupled with reduced costs of operating supplies, enable extended-stay hotels to provide excellent value to extended-stay guests.

Consumers want extended-stay facilities for many reasons. These include corporate training assignments, equipment installations, relocations, short-term assignments, trips to handle family matters, etc. Until recently, no existing product type was well-suited for this purpose.

It is difficult if not impossible to rent an apartment for a few weeks or only a few months. If they can be found, such apartments are unfurnished or poorly furnished, and often they do not have utilities and telephone service in place. Hotels, on the other hand, are well-suited for stays of one to five nights, but lack convenient kitchen facilities for longer stays. They are also expensive.

The underserved market and the possibility of strong potential returns from extended-stay lodging is expected to result in a national roll-out of these facilities.

---

1 Source: The Highland Group

2 Smith Travel Research, Host Report (1996)

3 Source: Smith Travel Research Host Report (1995)