

# THE \$1.00 ADR PER \$1,000 OF INVESTMENT RULE OF THUMB DOES IT STILL APPLY?

By Hank Staley, ISHC, CPA

On numerous occasions during my 20-year consulting career, I have heard feasibility analysts repeat the following rule of thumb: ***\$1.00 in ADR is required for every \$1,000 per room invested in a hotel project in order for a developer to realize a reasonable return.*** In fact, I have often used this guide myself in an attempt to quickly gauge the potential of a development opportunity. Yet, as with most rules of thumb, its accuracy has rarely been tested. This article attempts to prove, or disprove, the validity of the assertion.

The rule may be most applicable to limited service properties since revenue segmentation for these products varies little from market to market, e.g. over 90 percent of revenue is from rooms. My analysis therefore focused on the limited service product type.

Since certain costs are fixed, both development and operational, it stands to reason that some variation in the rule must exist at different investment levels. Accordingly, I measured the required ADR at four different levels ranging from \$45,000 to \$60,000 per room. Basic assumptions applied in the analysis were as follows;

Equity = 25%

Required leveraged IRR = 25%

Debt = 75%

First year occupancy = 60%

Interest rate = 8% per annum

Second year occupancy = 65%

Amortization period = 20 years

Stabilized occupancy = 70%

Required unleveraged IRR = 15%

Property size = 120 rooms

Ten year financial projections were prepared for each scenario. The ratios, amounts and fixed components of each line item were based on the typical operating results of limited service, mid-scale products such as Hampton Inn, Comfort Inn, Wingate Inn, etc. Obviously, operating costs vary by market and the actual results for a given property will differ to a degree.

Utilizing these parameters, the ADR necessary to achieve the required yields at each investment level was calculated. The results are as presented in the following table.

HYPOTHETICAL LIMITED SERVICE HOTEL

REQUIRED ADR TO SUPPORT EACH \$1,000 PER ROOM OF INVESTMENT

Development Costs Per Room	ADR Required to Achieve Specified Yield Levels (1998 Dollars)	ADR Required Per \$1,000/ Room Investment
\$45,000	\$60.07	\$1.33
\$50,000	\$62.60	\$1.25
\$55,000	\$65.13	\$1.18
\$60,000	\$67.67	\$1.13

From the foregoing, It appears that \$1.00 per \$1,000 is too low, as the analysis suggests a range of \$1.13 to \$1.33 per \$1,000 may be more appropriate, at least at the 70 percent occupancy level. It is interesting to note that the required ADR per \$1,000 declines as the investment costs per unit increases. This is because operating expenses generally do not vary relative to investment costs. The most sensitive variable is debt service which obviously changes in direct proportion to development costs.

The \$1.00 per \$1,000 rule can be a useful tool, particularly with respect to limited service properties. It allows a developer to quickly assess the potential of a given market for a proposed development. He or she need only gather basic competitive occupancy and ADR data from which a reasonable ADR level can be projected. This step requires some judgement given the inverse relationship between occupancy and ADR. The next step is to estimate land costs in the area which any good broker should be able to provide. Finally, the land costs are combined with the estimated improvement costs, and a comparison is made between the implied ADR that is required at that investment level and the developer s estimate of ADR potential in the market.

Clearly this is no substitute for detailed feasibility analysis, as every market is different in terms of labor costs, development restrictions, construction costs and a host of other issues. It is also highly sensitive to the assumed occupancy and changes in lending rates. Nevertheless, it is a rule of thumb that has been used for many years and still has some validity if applied correctly.

*Note: The foregoing represents a condensed presentation of the analyses conducted. Complete details and further explanation can be obtained from the author.*

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