Conversations

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THE JOHN HARDY GROUP

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Where Are Development Costs Headed….

Up, Down, Maybe Both!

The following is the transcription from a prerecorded "Conversations" on May 3, 2006, which was later presented at the ULI Hotel Development Council meeting on May 11, 2006.

John Hardy: First of all welcome everybody. I really appreciate all of you putting the time into this. I know how busy everybody is and it's not a small task to get these things organized when everybody has a full-time job anyway, but hopefully you will benefit from this. Scott Hazelton, Senior Consultant for Global Insights will address the construction issues, Martin Stringfellow from the Martin B. Stringfellow Company on FF&E, Mark Woodworth, Executive VP of PKF Consulting, who has helped us a lot with the land pricing and some of the general market oversight and Jack Corgel from Cornell may be on the call. We are not sure, but if he is that's great.

If you look at the categories we are addressing it is Land, Consultants, FF&E, Construction, Technology, OS&E and then we will talk a little bit about contingencies at the end and then what our recommendations are to deal with all of this. That is how we are going to approach it. On the first part, which was what Jack and Mark provided, Mark, could you give us an introduction, explanation and explain how to interpret all the charts that you provided?

Mark Woodworth: Let me speak to the land number first and my colleague Jack Corgel, who is the Baker Chair of Real Estate up at Cornell, part of his career long focus in academia has been this whole issue of…his

specialization is in real estate and finance. He is an economist by training but he has been very focused on land pricing and has done a lot of research into land values and pricing and so forth and how it has shifted. But what the chart illustrates is the best historical data series that he has been able to come up with and that he feels comfortable represents a meaningful indication of how land prices have changed over time is a farm index that I think comes from the USDA, which basically illustrates year by year how an acre of farm land has changed. The graph that we are looking at right now but I think clearly illustrates what all of us intuitively have come to know and believe and that is land prices over the last three to five years at a minimum have been increasing dramatically. So again, even though this represents farmland Jack does believe it is a meaningful proxy for how commercial and residential land values have been growing as well. As the rest of you probably know better than I do typically the land component of a ground up development is going to be anywhere from 10% to 20% of the overall project cost. The fact that that sizable element has been escalating dramatically of late certainly has been one of the contributors to what appears to be a fairly formidable barrier to meaningful levels of new construction surfacing.

On the slide that we do have today, we pulled some data from the

Bureau of Labor Statistics. They actually track it…it's an index on a monthly basis that we have converted to quarterly values that going back to 1987 as a base year show the quarter to quarter change in some of the key components to commercial construction, those being materials for construction a general category and then lumber, iron and steel and then products that come from steel mills. We have imposed on that graphic the quarter to quarter change in available supply here in the US and importantly the supply line there represents what occurred in the top 52 largest hotel markets in the US. That data begins in 1987, thus that is why we have indexed all of the data to that point in time. Importantly in explaining the supply line graphic there is a horizontal blue line showing across the middle that represents what the average annual supply growth has been over that period of time. Interesting enough, within the top 52 largest hotel markets that number is right at 2.5% per year over this 18 or 19-year period so the line that you see here moving from left to right illustrates what the actual change in available supply was that year relative to the 2.5% average. Did that make any sense what I just said?

John Hardy: Mark, I do not understand. The numbers on the left side of the chart are different from the numbers on the right; what do they mean?

Mark Woodworth: They are basis point variation from the index.

John Hardy: Does that mean that supply is actually relatively going down?

Mark Woodworth: No. There are two things going on here. The construction data is indexed to the axis on the left. If you look at the far left side where all the data starts that is right at a hundred with 1987 being equal to a hundred. So then as we move from left to right over time that is how the index for each of those four categories has moved relative to the 1987 price.

John Hardy: Then on the left?

Mark Woodworth: That is the left. On the right that is the Annual Change in Room Supply Index. I am now looking at the right hand axis; where it says 100 that represents the long-term average annual change in supply, which as an aside is 2.5% per year. Therefore when the blue line is above the blue horizontal line that means supply is increasing at a rate higher than the long-term average and when the blue line is below the horizontal blue line it means supply is changing at a rate below the long-term average.

John Hardy: So now we are below the long-term average.

Mark Woodworth: Right. So as we look at the data what it illustrates is if we look back to the early 90's when we were both recovering from the building boom of the late 80's and that is where you see the blue line being well above the horizontal line. It was a combination of we were recovering from that dramatic supply growth period and also recovering from the recession in the first Gulf War of the 1990-1991 period. It took the first half of the 1990's for the industry to get back to a development pace that equaled the long-term average of 2.5% per year. Then for the back half of the 1990's where you see again the blue line moving well above the horizontal blue line that was the market's response to growing profits, increased property values and as you can see at least for two of the indicators there iron and steel and steel mill products there were actually declines in the pricing in the back half of the 1990's. But then by 1999 people were figuring out that maybe we are building too much. Maybe the economy is not going to be great forever. Let's begin to throttle back somewhat. Of course, that throttle was really pulled back when the recession began in late 2000 early 2001 and then of course the events of 9/11 and everything beyond that really saw the level of supply change drop down to real close to the all-time lows that we saw back in the early 1990's. Again, the way to really

interpret that is that there were periods where supply growth was really strong and there were periods where it got back to almost zero. You can see where those cycles fell as we look back over the last 18 years. Importantly, the two or three things to perhaps walk away from this being is that you can see on the far right-hand bottom corner of the graph that that blue line is now starting to tick back up so the momentum is beginning to accelerate. But then importantly again if we had the land number to look at and then if we look at these four other lines that speak to the cost of some of the key construction material components we see that there has been a dramatic run up in pricing. Again, you guys are the experts and I am not but will these construction prices come down and if they don't what does it mean? John, I think you know if you let me I will take the whole hour talking about this.

John Hardy: This is great. It's great to see the supply information alongside the construction cost information; that is unusual to see that combined like that.

Mark Woodworth: If there was another graphic we were to impose on here a line that showed hotel incomes what we would see is a dramatic decline in profitability starting in 2001 for all the reasons that we know about and that has begun really in a V-shape fashion. It has been

ramping up dramatically the last two and a half years now but importantly in real terms we do not see property level incomes getting back to their past peak until probably 2010. Again, in real terms with profitability we are probably still three and a half to four years away from our past peak and so we think a combination of that, a combination of cap rates, which are at historic lows today are absolutely going to begin creeping up. Again, there is the interest rate growth contributor to that. There is the slowing down of hotel profitability growth and because of the topic of the day the belief that somehow construction will be accelerating going forward and again this graphic here begins to illustrate that. Therefore this is suggesting higher levels of volatility in the marketplace. Those three factors suggest that cap rates will be trickling up going forward once again making it that much more difficult to justify new development.

John Hardy: On Jack's chart, his land price chart, there are dollars of $200, $400 and $600 on the left-hand side of the chart; what does that represent?

Mark Woodworth: I'm not 100%; I believe it is dollars per acre.

John Hardy: It would be great to take your chart and project it another five years

just to look at what that would look like.

Mark Woodworth: We charge for that, not really. Actually we do charge for that. We have the supply number. What is real interesting and again I will try to be quiet here but from a forecasting perspective and we do have these econometrically driven forecasts for the 52 largest hotel markets in the US. One of the challenges right now is there is really no clarity beyond the next couple of years in terms of what is likely to happen with the economy. So because of that meaning no one has a clear vision is it going to get a whole lot better or a whole lot worse. The longer range forecasts right now they pretty well flatten out, which deals with this idea that eventually everything reverts to some kind of mean or long-term average. Right now absent a shock to the system either positive or negative it is a fairly stable outlook once you get past the next couple of years.

John Hardy: You guys have actually projected this chart forward?

Mark Woodworth: We have the supply number. We do not do this construction stuff and I have not been able to find any forecasts of that.

John Hardy: Let's go on to Martin and then Scott and we will see if at the end of this if there is a way together we could all project some prediction; it

might be interesting. Anyway, that was great Mark; thanks a lot.

John Hardy: One quick thing on consultants. We surveyed 1200 consultants and we got a significant response, 10% or 12% something like that plus I have had many phone calls with people and talked to a lot of people just informally so we have I think a pretty good sampling. What was interesting was that 90% of the consulting community has seen no more than a 10% or 15% change in their fee amounts since 2002 and they do not see any more of a change in that going forward for the next two or three years, which I was kind of surprised by. So basically the consulting category is fairly flat and there are a few, 10% of the group I would say are seeing huge increases, 25% or 30% and they tend to be consultants in places that are on fire like Washington DC, Vancouver where there are the Olympics going on or Las Vegas. They tend to be spot market really isolated examples so in general the consulting category is relatively flat and moving up somewhat. The only thing we can attribute that to is just increased competition.

If you go to the next slide you see a graph. This is the consulting category as a percentage versus total development cost in our business, which is say $150 million a year annually capital expended but representing over a billion dollars of capital that is

ongoing. So we are in the billion to billion-three range of managed capital right now of all types of projects from renovations to redevelopment projects to big ground up mixed use projects, internationally in Mexico, Central America, the Caribbean and North America primarily. I think it is a pretty good representation but I think it kind of supports what the other surveys show that the consulting category is relatively flat. Martin, then we will move ahead to yours.

John Hardy: Just kind of go through the chart first if you would.

Martin Stringfellow: The chart was developed by me calling three of who I consider the trendsetters or the leaders of the industry in each of the categories; Ocean Freight, Common Carrier, Carpet, Lighting, Seating and Case Goods, the basic components of the guest room, really not relating much to public areas. Public areas sort of follow these trends. The rooms obviously represent the meatiest part of any hotel project so that is where I focused. I was surprised and I took the chart with the baseline being 2000 and the capping it off last year in 2005. Things were driven by three factors. Obviously petroleum affecting carpet, wall covering, upholstery with the foam and of course freight costs and steel affecting seating. Every chair has a steel frame basically, bed sets with the coils, bed frames,

lamps and refrigerators so petroleum, steel and fast track schedules. I honestly believe that the fast track schedules have more push. I would say maybe oil had the biggest push but other than that fast track schedules pushed the prices up faster than everything and I will explain that in a minute. One interesting note; if you see the pink line, which is the ocean freight line; it had a huge jump from 2000 to 2003. That is when a lot of stuff shifted to China. China has been building for years of course but now we are primarily China. Every category is primarily China. As the demand went up for China for ocean freight that is of course the price went up. It is basically a supply and demand issue. You can also see what happened to the case goods price as it shifted to China, the brown line at the bottom. We had a huge drop. We are paying in my opinion less for case goods now than we have in the last seven or eight years because of China because it was US-based and now China-based. Everything else as you can see drifted up. Common carrier continues to go up with the fuel prices and the fuel is not so much related to the cost of Point A to Point B. Truckload rates for example have not gone up. If you are shipping something from St. Louis to Los Angeles in 2000 it was $1.30 a mile and in 2006 it is projected to be $1.65 a mile, not that much increase. What have gone up on the fuel are these surcharges. They were 0% fuel surcharge in 2000. Currently we are at about 25% fuel surcharge

this year established by the government. That is what is getting us is the surcharge.

John Hardy: What is the surcharge on?

Martin Stringfellow: On the fuel rate. In other words, if something is costing $1000. Now it is costing $1250 or $1300 depending on the surcharge.

John Hardy: What is the surcharge for?

Martin Stringfellow: The surcharge is somehow established by the government to allow the freight companies to adjust their rates for the cost of fuel.

John Hardy: But don't they just do that in their basic rate? It seems like they are double-dipping.

Martin Stringfellow: No they don't do it in the basic rate. That is what I am saying. The basic rate from Point A to Point B has not gone up that much; it is the surcharge that is killing us and the surcharge by the way is also applicable to the ocean freight.

John Hardy: Is the basic rate regulated?

Martin Stringfellow: Yes. It is all regulated. The government is establishing the basic rate and the government is establishing the surcharge. It all, my guess, is it comes out in the wash but they are allowing them to charge more and more based upon the cost of fuel and it is in the surcharge.

John Hardy: And that is the same with ocean freight?

Martin Stringfellow: Absolutely.

John Hardy: Why has ocean freight gone down so much then?

Martin Stringfellow: Ocean freight has gone down for a couple of reasons. I was really surprised to see that. The biggest reason it has gone down is the super carriers. In 1998 and 1999 they were shipping about 2500 to 3000 containers per ship. In 2003 they went to super carriers and they are shipping 10,000 containers per ship. Let's say it has gone from 3000 to 10,000 so they are getting more containers, more 20-foot containers if you will stacked on top of these ships and the cost has come down somewhat.

John Hardy: One of the other kind of interesting things; we are looking at doing some work in Panama and they are doubling the capacity of the

Panama Canal. One of the reasons is to accommodate these super freighters.

John Hardy: Martin, the area outside the Panama Canal at least on the Pacific side I saw looked just like Long Beach. There were like 60 or 70 ships out there waiting to get in.

Martin Stringfellow: I have seen Long Beach that way during the strike. Also by the way, this jump that you see had to do with the strike. It was an increase in demand and the strike and of course they can take advantage of the strike situation.

John Hardy: How many ships do you think on an average day are waiting to get into Long Beach?

Martin Stringfellow: That's a good question. I do not know. Just from my personal observation there seems to be 10 or 12 out there. During the strike I saw at least 50.

John Hardy: The Panama Canal is interesting because obviously it is the shortest route to Europe and China and it is just like a freeway on rush hour right now.

Martin Stringfellow: It is a fantastic opportunity there for Panama. They absolutely should pursue that. I would like to invest in the Panama Canal.

John Hardy: Any other thoughts, Martin, on where you see all this stuff going?

Martin Stringfellow: I think it is going to continue to go up. I think freight is going to continue to go up. A few project it into 2006 and 2007 and everybody was going up I would guess 7% to 10% a year on everything. You will see China drifting back up now. As you see from this chart it is starting to climb back as the demand has gone up. I think if we can slow down the process, if we can allow the proper lead time I think we can control that upward trend and that is what I am trying to push. If people can start schedules earlier, if you can allow a year for a project to develop the model room and then develop the production run so there are two actual phases of effort there, the model and then production. But if you can allow a year rather than ten months or six months I think you would see prices neutralize. I know people are taking advantage of myself and representing my clients when I call and I say I have to have a model room in six weeks, which requires air freight. We have spent upwards of $40,000 to fly over a model room, which costs $40,000.

John Hardy: Yes; it’s crazy.

Martin Stringfellow: If people could just slow down and think ahead you would have saved half the price of the model room. That will flatten a chart out. We have flown over projects; I will not mention any names. But around Christmas time people have to have it by Christmas and they will start flying projects over. I am talking about hundreds of rooms of stuff so there it goes; that chart starts going up. This whole world, this fast food, fast track, fast everything has probably created more of a monster of inflation honestly than I think oil.

John Hardy: I think something happened after 2001 where people just have to have everything like instantly anymore.

Martin Stringfellow: Knowing that, why not slow down and neutralize it. I did receive an RFP yesterday. They are allowing the proper times. I can't wait to get my hands on it. If you are going to allow these factories even in China; they do have some slow periods. If you can give them a year to produce it if you had that kind of time and allow them to produce during their slower periods you will take advantage of that. They will give you a discount to that.

John Hardy: Let's talk about that when we get to recommendations. Scott, do you want to take on your part?

Scott Hazelton: Sure. People expect economists to say on the one hand and on the other so I will not disappoint. If we look at what the materials forecasts and I guess the near-term outlook. The bad news is that if you paid more for materials in 2004 and 2005 you are going to pay more again in 2006. The good news is that once we get past this year and looking at 2007 and beyond things do stabilize a little bit.

If we look at Slide 12 just to set the tone; the orange line is investment in construction for non-residential buildings, which would include hotels but also industrial buildings, office buildings and so forth and the blue line is in fact housing starts. What you see that this year is a turning point for housing. The boom is over. It is not quite a bust but you are going to see a substantial drop off in residential activity but yet a fairly strong environment for non-residential. That is important as we will see in a few minutes here.

John Hardy: Scott, is that mainly single family housing that is going to be off or do you see condominiums being off too?

Scott Hazelton: I think we see condos are off too. It is really a function of affordability is what is driving this. Condos are a somewhat

cheaper alternative. Of course, the way the government works and reports data they report single family as single family but condos and apartments are lumped together. It is hard on a month to month basis to sort that out. You can over time go back and extrapolate that in fact much of the multi-family housing spending in recent years has been in fact condos but we would expect going forward it is going to become more rentals. Ironically, the total category for multi-family cannot move much but the composition can move quite a bit. We expect that it is going to be moving towards apartments in the future.

John Hardy: We are starting several mixed use developments with a condo component; that is why I am asking.

Scott Hazelton: One of the key things in the slide is to take a look at that curve from about 2001 to say 2002 or 2003; you look at 2003 to 2006 and you see there is a world of difference. In the early part of the slide we have a pretty strong level of non-residential growth, low housing. They both move together in that middle section and then they diverge again out in the later years and that is really what is going to drive a lot of the forecasts for building materials.

If we move to Slide 12, this is just a general producer price index

for all building materials. You see a real escalation in prices in 2004 and 2005 relative to the overall Consumer Price Index, a modest correction around late 2005 and then certainly recent history and we expect the future history to be 2006 higher than the overall price index but not by as much as we saw in 2004 and 2005.

To start looking at why we think things are going to start slowing down a little bit in terms of price appreciation Slide 14 is a little confusing in that we are looking at one series, that is the Industrial Materials Price Index, which has lagged three months or one quarter and we are also looking at the PPI for intermediate materials in orange. The reason for the three months lag is that typically the Industrial Materials Price Index tends to lead the intermediate materials by about three months because you are buying the goods, basically raw material goods to be turned into intermediate goods.

John Hardy: What is the difference between intermediate materials and…?

Scott Hazelton: The Industrial Materials Price Index is going to be the raw material. That is iron ore, that is raw copper, commodities and then intermediate materials is you have now turned it into something

processed so that is your steel, your copper pipe. Because of the lead time if you start seeing a drop off in the price of the materials three months ago that is going to see through to a slower price increase in the intermediate goods as they get produced. The point of the graph is that we are seeing even in the first parts of 2006 that the raw materials price index is beginning to slow. It is not turning negative. It is still a price appreciation but the rate of increase is slowing and so what is going to happen is the intermediate materials will also begin to follow suit. I think the question is why are oil prices in a construction slide? There are two reasons. One is oil goes into a lot of the things that you want like PVC pipe or at least oil eventually gets into them and secondly you have to transport the stuff to your job site and also all the machinery that you are running is running on oil and they have also got the fact that the third highest cost to an operator of heavy equipment is fuel after the cost of his equipment and the cost of his labor. Oil prices do matter in terms of the cost to construction. The bad news is easing here is a relative term. They are going to come off their peak values of probably this summer but they are not going to fall off to where we used to see them back in the early part of the decade. That also holds true for natural gas. Natural gas is important mostly because it is an energy source for refining so things like copper, aluminum, even some steel are running of

natural gas fired plants and so those prices are tremendously important. They also power electricity, which in turn powers aluminum production.

John Hardy: What is that black line that runs across then steps up?

Scott Hazelton: The red line is sort of the average price of natural gas and Henry Hubb* is a market trading term that is commonly used in natural gas. Essentially think about the overall stock market compared to the Dow Jones; one can be more volatile than the other. The average is basically taking average over the time frame so we average out the highs and the lows. I did not see what we made for a moving average but we have essentially said over the past four years the average price was this and this is how things have moved around it. The idea was to show that there is a permanent shift in the cost of natural gas going we think forward and some of that is because of the hurricanes, that some of those rigs are not online and will not come back online in the near future.

John Hardy: Haven't they lost like 15% of their total capacity?

Scott Hazelton: Exactly. Some of the rigs with a damaged deck those can be fixed but they also had some damage to lines on the ocean floor and

those simply cannot be fixed is what we are looking for out a year or two in the forecast. Also just as an economy we have become less enamored of oil as a fuel for power plants and for homes and we like natural gas because it is cleaner. We have also increased demand in sort of a permanent fashion because once you have installed your new power plant or your new furnace you are stuck with it for 20 years. So between a combination of lost supply and a change in demand patterns we have got a permanently higher cost for natural gas. PVC pipe again it is driven by demand also by the cost of materials, which is largely fuel. We do expect to have high prices through next year. Now you have got a little bit higher production then we had last year because we have brought plants online in the Gulf after the hurricanes. Homebuilding is in fact settling down so that removes some demand. However, we have got higher prices in both ethylene and chlorine and we also have a growing non-residential construction market, which will take up some of the slack for homebuilding and of course there is rebuilding from Hurricane Katrina in the Gulf, which while overall housing starts are going to drop there will definitely be some stronger than average spending in the Gulf Area to rebuild certainly in 2006 and somewhat in 2007. Now the good news here is that once you get past 2007 we have a potential stock price correction and that means downward because there will more plants coming online

both in North America and also in Asia, which largely means China. Steel markets just absolutely exploded in late 2004. Some of that was real. Some of that was just the lack of a true steel trading index; you cannot buy steel futures so the prices have to go up. You have got to jump onboard and make sure you get your contract at that price and you get a little bit of panic buying in steel that you do not see in some other commodities but you can see also that with the time when we had the combination of strong residential and non-residential growth in our economy and also the fact of very, very strong consumer spending. When you buy a new house you also buy the new washer and dryer and those are all fashioned out of cold rolled steel or hot rolled steel as well so we see this price increase through 2005 has begun to decline late last year. It is in a blip again this year but we are looking at something that is moderated compared to recent history but stronger than we have had in most of the decade.

John Hardy: Why are US prices so much higher than the rest of the world?

Scott Hazelton: Part of it is just our own capacity but probably also China has been growing and we had a lot of imports of steel from China. What we are now seeing is a US capacity that has not grown and China's capacity being used by China so we cannot import as much as we

used to and we have a high demand here. In fact, in one sense the change to non-residential from residential does push steel. We use steel structurally in houses to some degree but not to a great degree compared to most non-residential construction so in some respects the pickup of non-residential is going to push up steel prices more than say lumber or other traditional or homebuilding kinds of materials.

John Hardy: Don't they have tariffs on imported steel too?

Scott Hazelton: Yes they do.

John Hardy: That has got to affect that I would think.

Scott Hazelton: When you get to cement there has been some issues with cement in Mexico. I am not sure about steel.

John Hardy: I have a friend who is in the steel business and…

Scott Hazelton: Yes and I think we did have some issues with China. That was one of the points of the visit. When the Chairman came to the US I think steel tariffs were on the agenda. In fact, when we do this presentation for pure cost clients actually we refer to China as the

800-pound gorilla and there is a slide that shows King Kong on the Empire State Building. Because so much of the demand for these materials is driven by what does China do, what do they demand when they build for capacity? They are so large in the market and their plants are so large that they can distort prices quite quickly.

I like the timeline of what moves metals prices.

John Hardy: I think it is pretty interesting.

Scott Hazelton: I am not sure there is a lot of discussion about particular construction materials but it does show and in fact this next slide says prices are insane in metals right now. If you look at history and if you look at past crises we are high compared to any of those previous crises so we do forecast a correction in sort of the base metals and base metals I am referring to here for construction are copper and aluminum. How ridiculous can things get?

John Hardy: Copper really affects us in hotels because of all the wiring, all the plumbing and all the mechanical equipment that is using copper.

Scott Hazelton: Aluminum typically is used for the windows and door frames and the curtain wall in the high rise hotels so both of those commodities

are pretty important and copper is in fact insane right now. I went to Home Depot to buy a simple piece of pipe to replace a section in my basement and I was stunned at what they are getting for an eight-foot section of pipe. But fundamentally we do have low inventories. It has been slow to ramp up new production because let's face it this is a volatile business and nobody wants to ramp up new production immediately based upon a couple of months of perceived demand. You add to that the fact that China has been gobbling up lots of the base metals for their own manufacturing economy and you have concerns about possible supply disruptions because this stuff tends to come from parts of the world that are not terribly stable, largely places in Africa in this case and somewhat South America. Of course another copper producer is Australia and much of their copper is right now going to China and not to the US so there is a limited number of supply. However, looking at the longer-term, in fact even the nearer term high prices are reducing consumption and clearly prices will drive more production to come online and production does not mean new plants. There are plants that have idle capacity that you can ramp up without putting two to three years to build a whole new plant so near-term you can get production online.

This next slide shows what we think happens to copper prices and

in fact even now because of the high price the demand for copper is coming in line with supply and if you look at that curve and you look at past history you see exactly why producers are not always thrilled to add capacity. Because when you have that gap between supply and demand and you want to ramp up you always ramp up too much and then you end up driving prices down.

John Hardy: It is the same thing with hotel development. You start developing when the market is good and you open when it tanks.

Scott Hazelton: Exactly. We think copper is going to come into line in terms of easing price because it is coming into line with supply and demand. Cement; prices actually were pretty high in 2005. They were good if you were a producer. They were not good if you were a buyer. The good news is that we are adding more capacity most of which comes around next year. This is where we had the nice news that Mexico was I believe over-tariffing their cement so we actually get extra cement from Mexico. China has been adding capacity like crazy. They have been adding more capacity than they can possibly use so we have the probability of increased imports from China coming forward. Of course that comes with a cost too. It only makes sense to import something that bulky and that heavy when prices are high but prices are so high that it makes sense to

import it and then reduce the prices somewhat. Then longer term we are looking at slower demand growth as construction eases off so the whole thing taken together shows with the next graph that price increases we are looking at about 10% this year but the trend is toward a more sustainable level of price that we have seen over the past decade.

We are on the last couple of slides here. One is ocean-going freight. As Martin alluded to there has been a softening in that market even with energy prices being high. It is just a more efficient shipping mechanism then it used to be even a couple of years ago. You also add to that not only the bigger ships but also just improved ports so you can offload the stuff faster. We do not think that freight costs will be as high as they have been the past couple of years but even so if you compare it to stuff back in the…this is index so it is adjusted for inflation; prices are going to be much higher than they were in the earlier part of the decade. It is something that we are going to have to live with in the future.

The final slide is talking about a correction in wallboard prices. Wallboard is also called sheetrock. The good news here is that prices are going to come down quite quickly this year; in fact we might even see some price declines. It is because housing is one

of the bigger components of wallboard demand so when that falls off it has a much quicker and larger impact on wallboard than it does on things like cement and steel. I am going to work in two more items one is lumber because that is another story of I think it is important to hotels and it will be very similar to the other ones. In fact, it will be similar to wallboard in that we had tremendous price increases in 2005, 18% to 20% in lumber and plywood and then it falls off dramatically in 2006. The third thing I want to do is with labor.

John Hardy: I was going to ask you about that.

Scott Hazelton: I have got one slide that looks at just sort of US construction wages compared to total wages and you see that construction wages actually have lagged total wage growth for most of this decade.

John Hardy: It is surprising. It has not been much of a factor.

Scott Hazelton: There was a blip in 2005 when housing really took off. The good news was typically in this decade housing has been increasing while non-residential has been relatively weak. Even when it has been growing it has been at a relatively low level. What happened last year is you really began to see a pick up in certain kinds of

non-residential construction, not so much hotels necessarily but in office in particular and some retail. So we begin to have this coinciding of both non-residential and residential demand so we had a bit of a period of late 2005 to late 2004 and 2005 where prices are higher for construction labor than for most of the economy but the forecast brings them down quite quickly in 2006. What I am looking at going through the various states and looking at we do not have metro forecast of construction labor costs. We do have one by state. That I think is of some interest to people at this meeting. Unfortunately you can only put so much information on one graph where it just looks absolutely you cannot read it. I am just trying to pick which stories I want to tell. If you are hotel builders I think you care a whole lot about New York, California, Hawaii, Florida, the certain tourist and business destinations that you worry about and Nevada is another one I think you would be worried about. But some of the really strong growth in the economy is coming in places like Idaho, Montana and so ironically Alaska is one because of energy. I would discount that for this audience, Louisiana because of the hurricane; I discount that as well for this audience. Trying to show a US average and you show four states you have really pretty well maxxed out what a graph can show so you want to pick a couple that are above average and a couple that are below average and make a story. I just have not quite nailed

down yet who I want to use as my examples. It is interesting but it does take time to go over that it might be better served with questions and answers.

John Hardy: Is that the end of yours Scott?

Scott Hazelton: That is the end, yes.

John Hardy: There are two other categories that I have not added, the backup slide. Technology in hotels is getting to be more important because the operation is getting more complex especially where they are mixed use or resorts or timeshare fractional. You can buy more functionality for less money today because of the advances in technology but you are adding more systems so the net effect is that category is going up about 10% but people are doing more. OS&E is down about 5%; it is really insignificant. Then contingencies are a favorite topic because that is always something easy for people to cut to get budgets to work out. The only thing I would recommend there is that I am probably going to give them some ranges for types of projects, renovations, redevelopment and ground up for what I would recommend that they use for contingencies. We can talk about that also. Then for the recommendations; I think we should conclude this with now that we

know all this stuff what do you do? I think that for us we are going into a lot of ground up development now for mixed use projects where it is hotel, condo, retail and the reason we are doing that is that the markets are very strong. Where we are doing it the land is very expensive and construction costs are very expensive so we are teaming up with local developers who already own land or basically residential developers that want to create some differentiation for their condominium by associating with a hotel. We want to do the same thing from our side and when we team up the economics work better. When I see residential sales falling off it concerns me a little bit but I think that the way we are doing it hopefully will be insulated because of the strength of the market and in fact we are offering a unique product.

John Hardy: Now the next question is what do we do now?

Martin Stringfellow: What do we do now? I think what we do now is honestly go back to basics the way we did it about 20 years ago John. If we can just slow the process the team gets to know each other. You will have a kickoff meeting, which we used to have and everyone knows everybody and everyone's role is defined and rules of the game can be established like design to the budget. Here is a real budget

from the owner, not a fantasy budget that is artificially lowered but here is the real budget we have to work with. Your task is to bring the design into the budget and when you make a presentation whether it be preliminary or final you will bring your best guess on a line item basis what all of these things are going to cost. So many times all of these Hollywood slide shows and toasting at these presentations without a purchasing agent involved and everyone is very pleased with it and very cursory, "Do you think we are in budget?" Yes I think we probably are. Then you find out about 99 times out of 100 no you are not in budget and then frustration sets in and so forth. If they can discipline themselves to bring the budget with them and they do not have to break it down to Scotch Guarding and what not but the sofa we think is going to be $1000 and the chair is going to be $500 or something just to give them some idea that the presentation is validated to the budget. I think if you would again bring the purchasing guy in earlier. We are typically brought in after everything has been approved. If we can be brought in during that process maybe we can help say, "Guys, it looks like we are out of line here. Why don't we make some adjustments going in?" If we can commit orders earlier as I mentioned earlier in this conversation every factory would lower their prices. If we can allow them to produce in their slow times we have had great success with that. What I am suggesting is if you

can issue the order, something that is going to take 12 to 16 weeks on a normal schedule give it twice that or three times that if you can. The more you can allow that several things happen. You lock in on your pricing and you give them time to develop the product during slow times.

John Hardy: I agree with you with all that.

Martin Stringfellow: Not every project has to be custom. Not every room on the Planet Earth has to start from scratch. Use a lamp that you have developed before. Use an entire room that you have developed before and two things happen there. The quantity goes up so it is a bigger, more negotiable nut to keep the pricing down on and you reduce purchasing fees. You reduce design fees. You reduce the executive time to approve and tweak and shop drawings and all of that stuff. On the other hand if you go in panicked, as most of my projects are the factories know this, the factories hear this, the ocean freight people and the air freight people particularly love it. They will take advantage of you. It is supply and demand and they are in demand so you are going to pay through the nose. The irony is that we sit here and we talk about the cost of a fabric or the cost of a chair or the lamp, which was $100 and really ought to be $80 and then we will spend $100 just getting it there.

John Hardy: That's crazy.

Martin Stringfellow: Why compromise the quality when if you take your time, put it on a slow boat from China literally and save money?

John Hardy: Ok, why don't' we wrap it up. First, I appreciate everybody's contributions and it has helped me, I hope it has helped some other folks here.

MARTIN B. STRINGFELLOW COMPANY

2006 ULI HOTEL DEVELOPMENT COUNCIL

FF&E/OS&E COST CONTROL IN TODAY'S MARKET

BY MARTIN B. STRINGFELLOW

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FF&E OVERVIEW

The general trend of the FF&E industry includes spot increases in several areas particularly items which involve petroleum such as carpet, wallcovering, upholstered seating, and freight costs; and steel such as seating, bed sets, bed frames, lamps, and in-room refrigerators. Unfortunately, not much can be done about oil and steel increases other than perhaps ordering early to avoid additional price increases. Other areas such as casegoods (headboards, armoires, nightstands, dressers, tables) have not experienced as great of an impact over the last several years.

However, in general, the entire FF&E industry has suffered cost increases in recent years due to the increased demands placed on a project by fast track schedules. This added cost of fast track could be minimized if the team adhered to the following suggestions:

I. DEFINE MEMBERS OF "THE TEAM" & SHARE BUDGET INFORMATION

Forming the design and purchasing TEAM early on will save time and money in the long run because it is important that all parties are aware of the overall project. It is important that the owner share accurate information regarding the real schedule and the real budget; and that they work together in accomplishing the goals of the project. Have a "kick off" meeting or conference call with all parties involved to establish a realistic project time-line and budget goals.

II. TIME AND PRICE HAVE A DIRECT CONNECTION---SO START EARLY – AVOID THE RUSH

Starting early:

- Gives the Purchasing Agent the time to properly bid and value engineer the FF&E
- Provides price protection against inflation as orders can be committed earlier
- Allows factories to quote reduced costs based upon producing goods during slower manufacturing periods
- Allows the most economical freight resources to be utilized
- Allows the entire project to be process-driven not schedule-driven

On the other hand, “fast track” projects give factories an invitation to raise pricing to accommodate a frantic schedule. In addition, shortcuts are taken by the design and purchasing team which cause costly errors in the long run (i.e., shop drawings not reviewed & incomplete specs).

III. PRICE QUALIFY DESIGN PRESENTATIONS WITH FF&E ESTIMATES

Design to the budget and avoid the surprise of a project out of budget after designs have been developed. All design presentations must be accompanied with a line item FF&E budget from the designer. Otherwise, there can be little or no cost discipline in the selection of FF&E and possible frustrations for everyone involved to re-design to a lower expectation or raise the budget.

IV. QUALIFY FF&E RESOURCES

The Purchasing Agent should be involved in resourcing all FF&E vendor options to avoid favored vendors who cannot fulfill delivery promises or provide the best pricing.

V. UTILIZE A CUSTOM DESIGN SCHEME MORE THAN ONCE

Not every project must be “custom” in every regard. Consider using a successful guestroom design scheme on more than one project and save on FF&E costs with a larger quantity purchase plus saving design fees & time.

VI. UTILIZE A FREIGHT LOGISTICS COMPANY

Bid the overall freight to several freight logistic companies to lock in a freight cost. Freight discounts of 70% or more can be negotiated in advance.

OS&E OVERVIEW

Like FF&E, the main cause of price increases for operating supplies and equipment, would be freight cost and fast-track schedules. Several suggestions to help minimize these inflationary factors include:

I. START EARLY

- Again, ordering early will provide price protection and allow the most economical freight to be utilized. Many operating supply items are last-minute surprises and air freight (overnight) is used which adds tremendous expense.

- Also, if enough time is allowed, many of the OS&E items could be purchased from "unbranded" sources vs. the more expensive branded sources. The unbranded source in most cases manufacture for the branded sources but they do not maintain inventory for quick-ship requirements.

II. CONSOLIDATE SUPPLY HOUSES

- The best pricing can be achieved if you consolidate items from a single supply house.

III. REQUEST DELIVERED PRICING

- Freight costs can be minimized many times if the freight is included within the price as opposed to separate billing.

IV. WORK WITH SOURCES WHO HAVE DIRECT FACTORY CONNECTIONS

- Many vendors work through several levels of distribution, which adds several middlemen mark-ups.