The HVS Hotel Valuation Approach- Appraising Hotels During Challenging Times

These are challenging times for hotel appraisers. Hotel transactions are occurring infrequently, and when they do- many times the price represents liquidation value or a forced sale rather than market value. Hotel financing is almost impossible to obtain so many transactions are structured using all equity instead of the normal debt and equity. Projected net income is generally lower than historic net income so derived capitalization rates are unreliable. Simply, all the traditional hotel valuation approaches don't work in today's market.

HVS, the world's largest hotel consulting organization, is frequently called upon to value hotels in today's uncertain market. Even if there are no transactions occurring or active buyers in the marketplace, hotels do have value and we must still derive a value from this limited data. It became obvious about six months ago that the neither the traditional cap rate approach nor the 10-year discounted cash flow technique would work during these difficult times. We had to mirror the actions of typical hotel buyers and reflect how they would structure their acquisitions. Based on our extensive research HVS developed a totally new approach to valuing hotels which produces highly accurate values even when there is little or no market data. Numerous hotel buyers and sellers who have reviewed the HVS Hotel Valuation Approach- agree that it represents the current standard for valuing hotels.

The basis for the HVS Hotel Valuation Approach is a standard 10-year discounted cash flow (DCF) using a mortgage/equity, weighted cost of capital rate of return. However, unlike the traditional 10-year (DCF) where the underlying financing is assumed to continue throughout the full 10 years, the HVS Approach assumes the initial (unfavorable) financing is replaced after 3 to 5 years with new debt obtained at more favorable terms. It is this refinancing assumption that truly reflects the current market environment because a typical hotel buyer today would be lucky to obtain any amount of debt financing. Most likely, a hotel buyer will initially have to use all equity.

Let's go through an example to demonstrate hotel the HVS Hotel Valuation Approach actually works.

Assumptions:

-Date of Value:	January 1, 2009
-Assumed Refinancing	January 1, 2012
-Initial Financing	
-Mortgage	50% loan to value
-Interest	7.5%
-Amortization	25 years
-Initial Terminal Cap Rate	10%
-Transaction Cost	2%
-Equity Yield	19%

Net Income Before Debt Service (per room)

2009	$6,675
2010	$5,556
2011	$5,181
2012	$5,728
2013	$7,210
2014	$9,433
2015	$11,593
2016	$11,940
2017	$12,298
2018	$12,667

Using the standard 10-year DCF and the assumed 50% financing- the initial value of the hotel would be $73,000 per room. The initial mortgage would be $36,000 per room. The resulting debt service is $3,225 per room.

In 2012, the hotel is refinanced with the following mortgage:

-Mortgage-	70% loan to value
-Interest	7%
-Amortization	25 years

The value of the hotel in 2012 using this new financing structure would be $108,000 per room. The replacement mortgage would be $76,000 per room. The resulting debt service is $6,442 room. The owner receives $41,000 per room in refinancing proceeds.

The HVS Hotel Valuation Approach combines these two financing structures in the following manner:

Year	Net Income Available for Debt Service	Total Annual Debt Service	Plus: Refi/Sales Proceeds	Total Cash Flow to Equity	Present Worth of $1 at 19%	Discounted Cash Flow
2009	$6,675	$3,225		$3,450	0.8403	$2,988
2010	$5,556	$3,225		$2,331	0.7062	$1,646
2011	$5,181	$3,225		$1,956	0.5934	$1,161
2012	$5,728	$3,225	$41,104	$43,606	0.4987	$21,745
2013	$7,210	$6,442		$768	0.4195	$322
2014	$9,433	$6,442		$2,991	0.3521	$1,053
2015	$11,593	$6,442		$5,498	0.2960	$1,524
2016	$11,940	$6,442		$5,856	0.2487	$1,367
2017	$12,298	$6,442		$6,225	0.2090	$1,224
2018	$12,667	$6,442	$60,271	$66,496	0.1756	$11,676
				Value of Equity Component		$44,619
				Plus: Value of Initial Mortgage		$36,369
				Total Property Value		$80,998

Here is how this structure works. Each year the hotel is expected produce the Net Income Available for Debt Service (column #2). From those amounts the owner has to pay debt service (column #3) based on the initial mortgage financing and the new financing as of 2012. Column #4 shows the financing proceeds that occurs in 2012 and the sales proceeds in 2018. The cash flow to equity is totaled in column #5. The 19% equity discount rate is in column #6 and the discounted cash flow is column #7. The total of the discounted cash flow of $44,619 represents the total value of the equity on a per room basis. The initial mortgage of $36,369 is added to the equity amount to produce a total property value of approximately $81,000 per room.

The value of $81,000 per rooms assumes the typical buyer would be able to obtain a 50% mortgage to purchase the hotel. It is more likely, a buyer today would have to purchase the hotel using all equity. If this is the case, the value would decline to $70,000 per room because the initial 50% debt financing would be eliminated. Appraisers who use the traditional DCF and assume an all equity structure over the 10-year projection period would produce a value of $55,000 per room which grossly understates the true market value of this hotel.

The HVS Hotel Valuation Approach produces an estimate of “Market” Value- which assumes a willing seller and sufficient time to complete a transaction. Under the

assumption of a forced sale or an unwilling seller facing foreclosure, our estimate of Market Value needs to be reduced by 20% to 50% and represents what is know as "Liquidation" Value. Most of the transactions that will occur over the next six to twelve months probably represent Liquidation Value not Market Value.