

## Hotel Investment Strategies

## Beware Of Hotel Cap Rates

Whenever a hotel transaction takes place the first thing industry participants want to know is the sales price per room and the cap rate. The information acts as benchmarks for determining the health of the hotel industry and developing parameters and pricing trends for future transactions.

The sales price per room is a relatively straightforward calculation: the sales price is divided by the number of rooms. For example, if a 100-room hotel sells for US\$10 million the price per room would be US\$100,000. Care must be taken to use the correct room count and to adjust for unique factors that could impact the sales price such as the need for a significant renovation, highly favorable financing or a distressed seller. The need for the buyer to perform a large renovation tends to decrease the purchase price. Very low interest rate financing often will inflate the sales price, while a distressed seller sometimes can produce lower pricing.

A "cap rate" is the shorten term for capitalization rate. It expresses the percentage relationship between the net income of the hotel and its sales price. For example, if a hotel has a net income of US\$500,000, and it sells for US\$5 million, its cap rate would be 10%. A cap rate is similar to the price earnings multiple used to evaluate stock pricing for public companies. Cap rates for hotels usually range between 10% and 12%. If a hotel sells at a cap rate of less than 10% it might be assumed that the seller got a very favorable price. On the other hand, if a hotel sells at a cap rate of more than 12% many people assume that the buyer acquired the hotel at an attractive price. These broad generalizations are sometimes not valid as will be described shortly.

The key to the derivation of a cap rate that will permit an accurate cross comparison with cap rates derived from other hotel sale transactions is the employment of a consistent net income definition. Not only should the calculations leading to the net income be precisely defined, but also the period of time the net income covers must be concurrent. The table below illustrates these two concepts.

A 200-room hotel situated in a distressed but recovering market sold on October 15, 2002, for US\$19 million or US\$95,000 per room. The table shows portions of the income and expense statement for the calendar year 2001, the trailing 12-months ending September 30, 2002, and the projected operating results for the calendar year 2003. During 2001 this hotel was adversely impacted by poor economic conditions plus the events of 9/11. The resultant net income was \$1,514,000. Occupancy and room rate started to recover during 2002, and the trailing 12 months posted a 65% occupancy at a US\$120 average rate, which produced a net income of \$2,173,000. Further recovery was projected for 2003 with the occupancy increasing to 72% and the average rate reaching US\$130. This revenue level is expected to produce a net income of \$3,112,000. Assuming the US\$19 million sales price, the table shows that if the 2001 net income were used to calculate the cap rate it would equate to 8.0%. The trailing 12 months' cap rate is 11.4%, and the projected 2003 cap rate would be 16.4%. Since there is no standard definition for selecting the time period used for calculating a cap rate, it is obvious that when comparing rates from different sales, the period of time the net income covers must be concurrent. Generally, the trailing 12-months is the preferred time period for mature and stable hotels.

Based on recent sales prices it was not unusual to see 2001 hotel cap rates in the 5% to 8% range for good quality hotels that were expected to recover quickly over the next several years. Furthermore, a 14% to 17% cap rate appears appropriate for what might be considered a fairly aggressive projection.

The calculations producing the net income also need to be consistent. For example, does the net income include a management fee and/or a reserve for replacement? If so, how much? These calculations utilized a 4% reserve for replacement. If a 5% reserve were employed, the cap rates would be different again. The table illustrates the three cap rates if the income before fixed charges were used. It also shows the resulting cap rates if one of the four fixed charges were not included in the net income calculation. Depending on the period selected and the definition of net income the cap rate for this US\$19 million hotel sale ranges from 8% to 19.9%. Needless to say, placing any reliance on derived cap rates requires a careful and consistent approach. ♦



**By Stephen Rushmore, MAI, CHA,** president and founder of HVS International, a global hotel consulting firm with offices in New York, Miami, Denver, San Francisco, Vancouver, Mexico City, London, New Delhi, Singapore, São Paulo and Toronto. Mr. Rushmore can be contacted at 1.516.248.8828 Ext. 204.

	2001	Trailing 12 Months 9/30/02	Projected 2003		
Number of Rooms	200	200	200		
Occupancy	58%	65%	72%		
Average Rate	\$115	\$120	\$130		
	(\$000)	(\$000)	(\$000)		
Total Revenue	\$5,431	\$6,301	\$7,485		
Departmental Expenses	\$1,697	\$1,769	\$1,841		
Undistributed Operating Expenses	\$1,706	\$1,780	\$1,866		
Income Before Fixed Charges	\$2,028	\$2,752	\$3,778	Cap Rate	Cap Rate
		10.7%	14.5%	10.7%	19.9%
Fixed Charges					
Management Fee	\$163	\$189	\$225	8.8%	17.6%
Property Tax	\$103	\$106	\$109	8.5%	17.0%
Insurance	\$31	\$32	\$33	8.1%	16.6%
Reserve for Replacement	\$217	\$252	\$299	9.1%	18.0%
Total Fixed Charges	\$514	\$666			
Net Income	\$1,514	\$2,173	\$3,112	8.0%	16.4%
Sales Price	\$19,000,000				
Price Per Room	\$95,000				