Hotel Investment Strategies

The Global Approach To Hotel Valuations

Valuing a hotel is both an art and a science. The science involves using mathematical formulae to reflect the value calculations of typical hotel investors. The art is composed of the various input assumptions that feed the formulae and produce the value. The entire valuation process is intended to mirror the results obtained when a hotel buyer and seller agree on the final price and a transaction occurs.

The evolution of hotel valuation methodology throughout the world started with a simplistic cost approach, whereby the appraiser totaled the hotel's current development cost and then made deductions for depreciation and obsolescence. Because this method failed to recognize the economics of the property itself or the surrounding market, its applicability in today's financially oriented environment significantly reduces its reliability. The sales comparison approach, through which comparable sales form the basis for the value estimate, generally produces unsatisfactory results for unique and dissimilar properties such as hotels.

The income approach is rapidly becoming the preferred hotel valuation method throughout the world. U.S. hotel investors adopted the income approach methodology during the 1950s. European hoteliers began using it in the early 1990s. With the recently realization that hotels are not always worth the money invested during their development, Asian hotel owners have now begun to shift their valuation technique from the cost approach to the income approach. Its basis is purely economic, reflecting the art and science of both hotel buyers and sellers.

In its simplest form, the income approach takes a hotel's anticipated net income and divides that number by a capitalization rate. The projected net income reflects the future economic benefit of owning the hotel, and the capitalization represents the investor's desired rate of return.

Example: If a hotel is expected to produce a stabilized profit of $1,000,000, and an investor desires a 12% return on his invested capital, then the purchase price has to be:

$$\frac{\$1,000,000}{.12} = \$8,333,333$$

The proof is demonstrated by taking the purchase price of $8,333,333 and multiplying it by the 12% desired rate of return and showing that the required stabilized profit would have to be $1,000,000.

The key to an accurate estimate of value is a proper profit projection and a supportable capitalization rate. My future columns will cover the highly complex issues surrounding the projection of hotel profits. The basics on hotel capitalization rates will be covered now.

Determining Capitalization Rates

Hotel capitalization rates are intended to reflect the rate of return on invested capital demanded by the entities financing the hotel's acquisition. The desired rate of return reflects various factors such as perceived risk, liquidity, inflation, etc. Because most hotels are financed by several entities, usually a debt lender and an equity investor, the capitalization rate is actually a weighted average of the desired rates of return.

Example: The hotel described above is going to be purchased by an investor who plans on financing the purchase price with mortgage debt representing 65% of the price and equity accounting for the remaining 35%. The mortgage lender wants to charge 10% interest and amortization on the amount loaned, and the equity investor is looking for a 12% return on his invested equity. The calculation of the weighted cost of capital (capitalization rate) is as follows:

Investors	% of Purchase Price	(×)	Rate of Return	(=)	Weighted Average
Mortgage Debt	65%		0.11		0.07
Equity	35%		0.14		0.05
Capitalization Rate					0.12

Dividing the $1,000,000 stabilized profit by the 12% capitalization rate produces the following value:

$$\frac{\$1,000,000}{.12} = \$8,333,333$$

The valuation methodology can be proven by showing that the purchase price allocation between the two sources of invested capital matches the annual rate of return requirements and the available stabilized profit.

Investors	%	Invested Capital	(×)	Rate of Return	(=)	Annual Return
Mortgage Debt	65%	$5,416,666		0.11		$596,000
Equity	35%	$2,916,667		0.14		$404,000
Total		**$8,333,333**				**$1,000,000**

As the hotel industry globalizes, investors are using more sophisticated hotel valuation techniques to reflect the economic characteristics inherent in hotel ownership and transaction structuring. The income approach is rapidly becoming the industry standard throughout the world. ◆

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