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Hotel Values in Transition—An Appraisal Technique for These Uncertain Times

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How does one value a hotel in a market that is in a state of transition? The income approach is generally relied upon by hotel investors and lenders in determining value, and still offers the strongest basis for value determination. However, application of the income approach is challenging during a time when there are few transactions and financing is difficult to obtain over the short term. This article discusses how a discounted cash flow analysis, which builds in a property refinancing in the future when the credit markets have returned to some normalcy and the hotel's net income has recovered, is the most appropriate way to value hotels in the current market environment.

Earnings for most hotels will be depressed in 2009, and anyone pursuing the acquisition of a hotel will anticipate a recovery in earnings over the following few years. Thus, capitalizing either historical or first year projected NOI by an overall capitalization rate will not provide an accurate reflection of value. Through careful assessment of the outlook for a hotel's earnings over the near term, one can develop a forecast of income and expense that can serve as a basis for a ten year discounted cash flow analysis.

Determining an appropriate discount rate to employ in the analysis is one of the most critical steps in a discounted cash flow analysis. An upscale, 476 room hotel, located in a well-balanced market is used as a example to illustrate how an appropriate discount rate may be determined. This hotel is expected to experience a moderate downturn during the current economic recession. A projection of income and expense has been prepared setting forth the future anticipated earnings of the property, up through a stabilized year, and one year beyond. The hotel is not expected to stabilize until the fourth forecast year due to the downturn that will negatively impact earnings in 2009, with a recovery thereafter. This market is still holding relatively well, with no new additions to supply, and thus a 6.5% decline in RevPAR and 12% decline in net operating income (NOI) is projected for the first forecast year.

The projected net income is capitalized into an estimate of market value via a 10-year, mortgage-equity discounted cash flow analysis utilizing the investment parameters that reflect the cost of capital currently available in the market. Consideration of the debt and equity return requirements is considered the most appropriate way to value an income producing property, particularly in today's environment when increased mortgage interest rates and lower loan-to-value ratios have such a major impact on capitalization and discount rates. For comparative purposes, we first apply the return requirements that were in evidence during the recent peak of the market (2006/2007), when lenders were aggressively competing for loans. A 75% loan-to-value is assumed, at a 6.5% interest rate and 30-year amortization. A terminal capitalization rate of 8.5% is employed, and an 18% equity yield is considered appropriate for the equity component. The resultant value conclusion is $171,000 a room, as set forth below.

Value Based on Investment Parameters Available at the Recent Market Peak

	Valuation Input		Valuation Output	
Stabilized Year	4		Value	$81,616,795
Inflation	3%		(Say)	81,600,000
Loan/Value	**75%**		Value Per Room	**$171,429**
Amortization	**30**	Years	Overall Discount Rate	**10.5%**
Term	**10**	Years	Cap Rate - Historical NOI	7.9%
Interest Rate	**6.5%**		Cap Rate - 1st Yr. NOI	6.3%
Terminal Cap Rate	**8.5%**			
Transaction Costs	2.0%			
Equity Yield	**18.0%**			

Applying the debt and equity return requirements that were in evidence in 2006 and early 2007 are clearly not appropriate to use in early 2009, and will result in overvaluing this hotel. But if an appraiser applies a "free and clear" discount rate to the projected cash flow, without consideration of the current terms of debt and equity capital that is exactly what will the outcome will be. Looking to investor surveys for guidance on discount and capitalization rates, and applying an overall discount rate of roundly 10.5% will result in an overvaluation.

Similarly, a case can be made that basing a value on the return requirements currently available in the marketplace will only take into account the immediate investment parameters and will result in undervaluing the hotel. In this second scenario a 50% loan-to-value ratio is assumed, which provides a 2.0 debt service coverage in the first projection year. Reflecting the significantly higher spreads to treasuries, an interest rate of 7.5% is assumed, with a more conservative 25-year amortization. This loan-to-value and debt coverage ratio reflects significantly more conservative lending terms than in the recent past. A somewhat higher equity yield of 20% is applied, reflecting greater equity yield requirements, even though the leverage and risk of paying debt service is reduced. The free and clear discount rate that equates the concluded value to the projected cash flow equates to 14.9%, as set forth below.

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Forecast of Income and Expense

	Historical Operating Results		Projection of Income and Expense									
	2007/08		2009		2010		2011		Stabilized		2013	
Number of Rooms:	476		476		476		476		476		476	
Occupancy:	74%		68%		70%		72%		75%		75%	
Average Rate:	$116.56		$112.10	-3.8%	$114.34	2.0%	$120.06	5.0%	$126.66	5.5%	$130.46	3.0%
RevPAR:	$85.69	%Gross	$76.23	%Gross	$80.04	%Gross	$86.44	%Gross	$95.00	%Gross	$97.85	%Gross
REVENUE												
Rooms	$14,928	58.0 %	$13,244	55.7 %	$13,906	55.7 %	$15,019	56.4 %	$16,505	57.3 %	$17,000	57.3 %
Food	8,877	34.5	8,587	36.1	9,036	36.2	9,504	35.7	10,093	35.0	10,396	35.0
Beverage	479	1.9	464	2.0	488	2.0	513	1.9	545	1.9	562	1.9
Telephone	31	0.1	29	0.1	31	0.1	33	0.1	35	0.1	36	0.1
Other Income	1,437	5.6	1,440	6.1	1,495	6.0	1,553	5.8	1,619	5.6	1,668	5.6
Total Revenues	25,752	100.0	23,764	100.0	24,956	100.0	26,622	100.0	28,798	100.0	29,662	100.0
DEPARTMENTAL EXPENSES *												
Rooms	3,403	22.8	3,384	25.5	3,524	25.3	3,670	24.4	3,843	23.3	3,958	23.3
Food & Beverage	5,787	61.9	5,782	63.9	6,011	63.1	6,249	62.4	6,526	61.3	6,722	61.3
Telephone	27	87.3	27	91.1	28	89.6	29	88.3	30	86.3	31	86.3
Other Expenses	396	27.6	403	28.0	416	27.8	430	27.7	444	27.4	458	27.4
Total	9,613	37.3	9,595	40.4	9,980	40.0	10,379	39.0	10,843	37.7	11,169	37.7
DEPARTMENTAL INCOME	16,139	62.7	14,169	59.6	14,976	60.0	16,243	61.0	17,954	62.3	18,493	62.3
U.D.O.E.												
Administrative & General	1,780	6.9	1,693	7.1	1,769	7.1	1,873	7.0	1,952	6.8	2,011	6.8
Marketing	1,936	7.5	1,841	7.7	1,923	7.7	2,037	7.6	2,123	7.4	2,187	7.4
Franchise Fee	1,493	5.8	1,192	5.0	1,252	5.0	1,352	5.1	1,485	5.2	1,530	5.2
Prop. Operations & Maint.	916	3.6	870	3.7	900	3.6	934	3.5	974	3.4	1,003	3.4
Utilities	731	2.8	730	3.1	756	3.0	785	2.9	818	2.8	843	2.8
Total	6,856	26.6	6,326	26.6	6,599	26.4	6,980	26.1	7,353	25.6	7,573	25.6
HOUSE PROFIT	9,284	36.1	7,842	33.0	8,377	33.6	9,263	34.9	10,601	36.7	10,919	36.7
Management Fee	780	3.0	713	3.0	749	3.0	799	3.0	864	3.0	890	3.0
I.B.F.C.	8,503	33.0	7,130	30.0	7,629	30.6	8,465	31.9	9,737	33.7	10,029	33.7
FIXED EXPENSES												
Property Taxes	785	3.0	838	3.5	863	3.5	889	3.3	915	3.2	943	3.2
Insurance	274	1.1	168	0.7	173	0.7	178	0.7	184	0.6	189	0.6
Reserve for Replacement	1,030	4.0	951	4.0	998	4.0	1,065	4.0	1,152	4.0	1,186	4.0
Total	2,089	8.1	1,957	8.2	2,034	8.2	2,132	8.0	2,251	7.8	2,319	7.8
NET INCOME	$6,414	24.9 %	$5,173	21.8 %	$5,594	22.4 %	$6,332	23.9 %	$7,486	25.9 %	$7,711	25.9 %

*Departmental expenses are expressed as a percentage of departmental revenues.

Value Based on Currently Available Investment Parameters

Valuation Input		Valuation Output	
Stabilized Year	4	Value	$60,853,136
Inflation	3%	(Say)	$60,900,000
Loan/Value	**50%**	Value per Room	**$127,941**
Amortization	**25** Years	Overall Discount Rate	**14.3%**
Term	**10** Years	Cap Rate - Historical NOI	10.6%
Interest Rate	**7.5%**	Cap Rate - 1st Yr. NOI	8.5%
Terminal Cap Rate	**9.5%**		
Transaction Costs	2.0%		
Equity Yield	**19.0%**		

The range of value between these two scenarios, $128,000 to $171,000 per room, is significant. What discount rate is truly appropriate: 10.5%, 14.3% or something in between? When we sit back and reflect on the current reality of hotel transactions and buyers expectations, it would seem appropriate to more accurately reflect the steps that a hotel investor will take during the ownership period to maximize value. With near term depressed earnings, and the reality of making a purchase with all cash or a low loan-to-value ratio, purchasers will look to refinance the hotel once its earnings have recovered and the credit markets have returned to some semblance of normalcy. Let's build a refinancing into our discounted cash flow analysis to assess its impact on the applicable discount rate to employ in this valuation.

Assume that the purchaser enters the investment based on the currently available debt terms (50% LTV) outlined above. The annual mortgage payment based on the value conclusion is calculated as the debt service constant of .088679 times the mortgage amount of 50% x $60,900,000, or $2,698,000 per year. The forecast of net income to equity is calculated as the annual net income available for debt service less the annual debt service.

Calculation of Net Income to Equity

Year		Net Income Available for Debt Service		Total Annual Debt Service			Net Income to Equity
2009	$	5,173,000	-	$ 2,698,000	=	$	2,475,000
2010		5,594,000	-	2,698,000	=		2,896,000
2011		6,332,000	-	2,698,000	=		3,634,000
2012		7,486,000	-	2,698,000	=		4,788,000
2013		7,711,000	-	2,698,000	=		5,013,000
2014		7,942,000	-	2,698,000	=		5,244,000
2015		8,180,000	-	2,698,000	=		5,482,000
2016		8,425,000	-	2,698,000	=		5,727,000
2017		8,679,000	-	2,698,000	=		5,981,000
2018		8,939,000	-	2,698,000	=		6,241,000

The reversion, or net sales proceeds to equity, at the end of the ten-year holding period is calculated by capitalizing the 11th years NOI by the terminal capitalization rate, reflecting how the next buyer would value the hotel upon acquisition based on forward looking cash flow at that time.

Calculation of Reversionary Sales Proceeds

11th Year's Net Income	$9,207,000
Capitalization Rate	9.5%
Total Sales Proceeds	$96,916,000
Less: Transaction Costs @ 2.0%	1,938,000
Net Sales Proceeds	$94,978,000
Less: Outstanding Mortgage Balance	24,255,000
Net Proceeds to Equity	$70,722,000

The conclusion of value is checked by verifying that the required internal rates of return to the debt and equity positions are indeed achieved.[1]

The value of the debt component of $30,427,000 plus the value of the equity component of $30,428,000 equals the total value of the property, or $60,855,000, rounded to $60,900,000. The discount rate that equates the pre-debt service cash flow to the concluded value is calculated to be 14.3%, as set forth below. This rate reflects the blended cost

Yield to the Equity Position - Current Investment Parameters

Year		Net Income to Equity		Present Worth of $1 Factor at 19.0%			Discounted Cash Flow
2009	$	2,475,000	x	0.840333	=	$	2,080,000
2010		2,896,000	x	0.706159	=		2,045,000
2011		3,634,000	x	0.593408	=		2,156,000
2012		4,788,000	x	0.498660	=		2,388,000
2013		5,013,000	x	0.419040	=		2,101,000
2014		5,244,000	x	0.352133	=		1,847,000
2015		5,482,000	x	0.295909	=		1,622,000
2016		5,727,000	x	0.248662	=		1,424,000
2017		5,981,000	x	0.208959	=		1,250,000
2018		76,963,000 *	x	0.175595	=		13,514,000
				Value of Equity Component			30,427,000

*10th year net income to equity of $6,241,000 plus sales proceeds of $70,722,000

Yield to the Lender Position - Current Investment Parameters

Year		Total Annual Debt Service		Present Worth of $1 Factor at 7.5 %			Discounted Cash Flow
2009	$	2,698,000	x	0.930850	=	$	2,511,000
2010		2,698,000	x	0.866483	=		2,338,000
2011		2,698,000	x	0.806566	=		2,176,000
2012		2,698,000	x	0.750792	=		2,026,000
2013		2,698,000	x	0.698875	=		1,886,000
2014		2,698,000	x	0.650548	=		1,755,000
2015		2,698,000	x	0.605563	=		1,634,000
2016		2,698,000	x	0.563689	=		1,521,000
2017		2,698,000	x	0.524710	=		1,416,000
2018		26,953,000 *	x	0.488426	=		13,165,000
				Value of Mortgage Component			30,428,000

*10th year debt service of $2,698,000 plus outstanding mortgage balance of $24,255,000

of capital utilized in the valuation.[2]

As previously discussed, assuming that the hotel retains its initial mortgage made at a 50% loan-to-value throughout the ten-year holding period undervalues the asset. However, this yield may be appropriate over the near term, particularly if a buyer pays all cash for an asset, and faces the risk of financing over the next few years. A "free

[1] The algebraic formula utilized to estimate market the value of a variable income stream is set forth in the Appraisal Institute's Appraisal Journal, April 1982.

[2] Note that this weighted cost of capital cannot be accurately calculated by weighting each rate of return by its pro-rata contribution, as is done in the traditional "band-of-investment" utilized in calculating an overall capitalization rate to be applied to a single year's cash flow, because of the different yield curves of the debt and equity components over a multi-year holding period.

Discounted Cash Flow Analysis – IRR Equating Pre-Debt Service Income to Value Conclusion

Year	Net Income Available for Debt Service		Present Worth of $1 Factor at 14.3%		Discounted Cash Flow
2009	$5,173,000	x	0.874672	=	$4,525,000
2010	5,594,000	x	0.765050	=	4,280,000
2011	6,332,000	x	0.669168	=	4,237,000
2012	7,486,000	x	0.585302	=	4,382,000
2013	7,711,000	x	0.511947	=	3,948,000
2014	7,942,000	x	0.447785	=	3,556,000
2015	8,180,000	x	0.391665	=	3,204,000
2016	8,425,000	x	0.342578	=	2,886,000
2017	8,679,000	x	0.299644	=	2,601,000
2018	103,916,000 *	x	0.262090	=	27,235,000
			Total Property Value		$60,854,000

*10th year net income of $8,939,000 plus sales proceeds of $94,977,000

and clear" yield of 14.3% is adequate to satisfy the equity yield requirements until debt becomes more available, but assuming that these terms remain in place throughout the holding period serves to lower the potential equity yield and undervalue the asset.

Hotel owners that plan to hold onto their assets more than a few years typically anticipate refinancing their property at a future point in time to enhance their return on equity. Hotel buyers are generally optimistic about future cash flow, and anticipate making improvements that will enhance cash flow. Once a property is stabilized they are in a position to obtain a mortgage based on a higher mortgage, and increase the positive leverage that enhances their yields. This practice is particularly relevant in today's market, when current earnings are depressed and when hotels must be purchased with all cash, through seller financing or at a low LTV. Let's see how the value of the subject hotel is impacted if a refinancing is assumed in the ten year discounted cash flow analysis.

The hotel is assumed to be refinanced at the end of the fourth projection year, based on the fifth year's, stabilized net income, projected forward from 2013 to formulate another 10-year, mortgage-equity discounted cash flow analysis. The stabilized value is determined based on the following investment parameters, which reflects a more normalized LTV of 75%, assuming that the credit markets recover and debt once again becomes available at terms that were prevalent in the 1980s and 1990s. The same 7.5% interest rate is employed due to the uncertainty of future interest rates at this time. The concluded stabilized value is $83,300,000, based on the following inputs.

Value Based on Stabilized Value at End of 4th Forecast Year or 2012

Valuation Input		Valuation Output	
Stabilized Year	4	Value	$83,305,783
Inflation	3%	(Say)	$83,300,000
Loan/Value	**70%**	Value per Room	$175,000
Amortization	25 Years	Overall Discount Rate	**11.9%**
Term	10 Years	Cap Rate - Historical NOI	9.0%
Interest Rate	7.5%	Cap Rate - 1st Yr. NOI	9.3%
Terminal Cap Rate	**9.5%**		
Transaction Costs	2.0%		
Equity Yield	**19.0%**		

At a 70% LTV, the new mortgage is $58,314,000, and the annual debt service based on a 7.5% interest rate and 25-year amortization equates to $5,171,000 at a mortgage constant of .088679. The annual net income to equity is set forth in the following chart.

Net Income to Equity Based on Stabilized Value at End of 4th Forecast Year or 2012

Year	Net Income Available for Debt Service		Total Annual Debt Service		Net Income to Equity
2013	$ 7,711,000	-	$ 5,171,000	=	$ 2,540,000
2014	7,942,330	-	5,171,000	=	2,771,330
2015	8,180,600	-	5,171,000	=	3,009,600
2016	8,426,018	-	5,171,000	=	3,255,018
2017	8,678,798	-	5,171,000	=	3,507,798
2018	8,939,162	-	5,171,000	=	3,768,162
2019	9,207,337	-	5,171,000	=	4,036,337
2020	9,483,557	-	5,171,000	=	4,312,557
2021	9,768,064	-	5,171,000	=	4,597,064
2022	10,061,106	-	5,171,000	=	4,890,106

The proceeds to equity from the refinancing at the end of the fourth year or 2012 are calculated as follows. The outstanding balance of the initial mortgage is deducted from the new loan proceeds, as well as an assumed cost of refinancing equal to 1.5% of the new mortgage amount.

Calculation of Net Refinancing Proceeds to Equity at End of Stabilized Year

Stabilized Year Value	$83,300,000
New Loan to Value Ratio	70.0%
New Mortgage	$58,314,000
Less:	
Outstanding Balance of Initial Mortgage	28,492,000
Refinancing Costs @ 1.5%	875,000
	$28,947,000

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A sale of the asset is assumed at the end of the ten-year holding period. The net proceeds to equity upon sale are calculated by capitalizing the 11th year's net income into an estimate of value, and deducting the outstanding balance of the second mortgage and the cost of sales, as follows:

Calculation of Net Sales Proceeds to Equity at End of 10 Year Holding Period

11th Year's Net Income	$9,206,836
Capitalization Rate	9.5%
Total Sales Proceeds	$96,914,000
Less: Outstanding Mortgage Balance	52,293,000
Less: Transaction Costs @ 2.0%	1,938,000
Net Sales Proceeds (Say)	**$42,683,000**

*10th year net income of $8,939,000 plus sales proceeds of $94,976,000

The total cash flow to the equity position is calculated as the net income before debt service, less annual debt service, plus refinancing or sales proceeds, as follows:

Forecast of Total Cash Flow to Equity

Year	Net Income Available for Debt Service		Total Annual Debt Service		Plus: Refi / Sales Proceeds		Total Cash Flow to Equity
2009	$5,173,000	-	$2,698,000	+		=	$2,475,000
2010	5,594,000	-	2,698,000	+		=	2,896,000
2011	6,332,000	-	2,698,000	+		=	3,634,000
2012	7,486,000	-	2,698,000	+	28,947,000	=	33,735,000
2013	7,711,000	-	5,171,000	+		=	2,540,000
2014	7,942,000	-	5,171,000	+		=	2,771,000
2015	8,180,000	-	5,171,000	+		=	3,009,000
2016	8,426,000	-	5,171,000	+		=	3,255,000
2017	8,678,000	-	5,171,000	+		=	3,507,000
2018	8,939,000	-	5,171,000	+	42,683,000	=	46,451,000

The net proceeds to equity over the complete ten-year holding period can now be discounted at an equity yield rate, concluding in the present value of the equity position. The value of the initial mortgage is added to the value of the equity to derive the value of the entire property as of the date of value.

The discount rate that equates the hotel's net income before debt service (free and clear cash flow) to the derived value is calculated, as follows:

The final value conclusion is $66,200,000, is 8.7% higher than the value conclusion reached without assuming a refinancing, and the derived discount rate is 13.0%, roundly 130 basis points lower than that in the 50% LTV scenario. Alternatively, the value is 18.8% lower than that derived utilizing investment parameters that were available at

Value of the Equity, Debt and Total Property

Year	Net Income to Equity		Present Worth of $1 Factor at 19.0%		Discounted Cash Flow
2009	$2,475,000	x	0.840344	=	$2,080,000
2010	2,896,000	x	0.706177	=	2,045,000
2011	3,634,000	x	0.593432	=	2,157,000
2012	33,735,000	x	0.498687	=	16,823,000
2013	2,540,000	x	0.419068	=	1,064,000
2014	2,771,000	x	0.352161	=	976,000
2015	3,009,000	x	0.295936	=	890,000
2016	3,255,000	x	0.248688	=	809,000
2017	3,507,000	x	0.208984	=	733,000
2018	46,451,000 *	x	0.175618	=	8,158,000
			Value of Equity Component		35,735,000
			Plus: Value of Initial Mortgag		30,427,000
			Total Property Value		66,162,000
			Rounded to:		**$66,200,000**

*10th year net income to equity of $46,451,000 plus sales proceeds of $53,488,000

the peak of the market, while the discount rate of 13.0% is 250 basis points higher than the discount rate employed during the recent peak investment market. If one assumes somewhat more favorable refinancing terms, such as a 75% LTV, 7.0% interest rate and a slightly lower equity yield requirement of 19%, the overall discount rate declines to 12.1%, and the value decline is reduced to 14.2%.

Value Derived by Application of Overall Discount Rate

Year	Net Income	Discount Factor @ 13.0%	Discounted Cash Flow
2009	$5,173,000	0.88509	$4,578,583
2010	5,594,000	0.78339	4,382,275
2011	6,332,000	0.69337	4,390,426
2012	7,486,000	0.61370	4,594,140
2013	7,711,000	0.54318	4,188,453
2014	7,942,000	0.48076	3,818,224
2015	8,180,000	0.42552	3,480,755
2016	8,426,000	0.37662	3,173,439
2017	8,678,000	0.33335	2,892,791
2018	103,914,000 *	0.29504	30,659,142
		Estimated Market Value	$66,158,229
		(SAY)	$66,200,000

Reversion Analysis

11th Year's Net Income	$9,206,836
Capitalization Rate	9.5%
Total Sales Proceeds	$96,914,000
Less: Outstanding Mortgage Balance	52,293,000
Less: Transaction Costs @ 2.0%	1,938,000
Net Sales Proceeds (Say)	**$42,683,000**

*10th year net income of $8,939,000 plus sales proceeds of $94,976,000

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When all is said and done, the question that arises is, if a mortgage-equity discounted cash flow analysis is performed that does not overtly take into consideration a refinancing, what is the enhanced loan-to-value ratio that will equalize the mortgage-equity DCF value to the value based on a refinancing, assuming all other investment parameters remain the same. Through an iterative process we determined that a 62.5% loan-to-value ratio at a 7.5% interest rate and 25 year amortization will yield the same value as the refinancing scenario where an initial mortgage is assumed at a 50% LTV and a second mortgage is assumed at a 70% LTV. In essence, the 63% LTV represents a weighted LTV over the ten-year holding period. The valuation input and output is illustrated below.

Value Derived Assuming Refinancing at the End of the 4th Year at a 75% LTV

	Valuation Parameters			
			Value	$66,219,406
Stabilized Year	4		(Say)	$66,200,000
Inflation	3.0%		Value per Room	$139,076
Loan/Value	**63%**		Overall Discount Rate	**13.0%**
Amortization	25	Years	Cap Rate - Historical NOI	9.7%
Term	10	Years	Cap Rate - 1st Yr. NOI	7.8%
Interest Rate	7.5%			
Terminal Cap Rate	9.5%			
Transaction Costs	2.0%			
Equity Yield	19.0%			

The benefit of this analysis is that it illustrates that a higher loan-to-value ratio than is currently available, and thus a lower discount rate than what can be supported through a simple weighted cost of capital, can be employed when appraising a hotel in today's uncertain market.

Value Derived Assuming Refinancing at the End of the 4th Year at a 75% LTV

	Valuation Input		Valuation Output	
Stabilized Year	4		**Value**	$70,000,000
Inflation	3.0%		**(Say)**	**$70,000,000**
Loan/Value	75.0%		Value per Room	$147,059
Amortization	25	Years	Overall Discount Rate	**12.1%**
Term	10	Years	Cap Rate - Historical NOI	**8.6%**
Interest Rate	7.0%		Cap Rate - 1st Yr. NOI	**7.4%**
Terminal Cap Rate	10.0%			
Transaction Costs	2.0%			
Equity Yield	19.0%			

Conclusion

Deriving a current estimate of market value based upon the income approach requires developing a multi-year forecast that reflects a buyer's anticipation of a recovery in net operating income as well a refinancing in the future, when credit markets normalize. Assessing the appropriate terms to use in this appraisal process requires a careful consideration of future potential net income based on a hotel's external market conditions and internal factors such as product competitiveness and revenue and cost structures. A carefully developed forecast of income and expense can be capitalized into an estimate of market value based upon current debt and equity return requirements, coupled with a forecast of a refinancing at greater leverage in the future. Undertaking this analysis reveals that discount rates have risen from their recent lows, depending upon the amount of net income recovery projected and the anticipated terms of refinancing. However, with the anticipation of a refinancing in the future, discount rates lower than what may appear applicable based on current rates of return are appropriate. These variables must be selected with thoughtful consideration of the type of lodging product being appraised, and the quality and durability of the projected net income over the mid and long term.

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About the Author

Suzanne R. Mellen is the Managing Director of the San Francisco office of HVS, heading the Consulting & Valuation and Gaming Services divisions. She has been evaluating hotels and associated real estate for 31 years, has authored numerous articles, and is a frequent lecturer and expert witness on the valuation of hotels and related issues. Ms. Mellen has a BS degree in Hotel Administration from Cornell University and holds the following designations: MAI (Appraisal Institute), CRE (Counselor of Real Estate), ISHC (International Society of Hospitality Consultants) and FRICS (Fellow of the Royal Institution of Chartered Surveyors).

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