Hotels and Motels as Investments

Like most real estate investments, hotels and motels consist of land and improvements (e.g., buildings, permanent equipment, parking area, swimming pool). Commercial land value generally represents 10% to 20% of total property value. Hotels and motels are unique real estate investments because they contain many elements not typically found in income-producing properties. These characteristics affect the risks and the benefits associated with hotel investments and demonstrate the highly specialized nature of this type of real estate.

Unique Investment Elements

A hotel derives value from certain unique characteristics.

1. Furniture, fixtures, and equipment. This category includes guestroom, dining room, and lounge furnishings; kitchen equipment; front office and administrative equipment; and items of decor. Together these elements can account for up to 25% of total property value.
2. Retail business. Hotels require specialized, highly trained management. Because they are labor-intensive, employee wages and benefits may consume as much as 40% of gross revenues.
3. Inventories and working capital. Lodging facilities may have large inventories of expendable items such as linen, paper supplies, cleaning materials, food, and beverages. Working capital is used for house banks and a petty cash fund and to finance accounts receivable.

When valuing a hotel or motel, the appraiser must accurately define the elements to be included in the final value. For example, if the purpose of the appraisal is to estimate the value of the real estate alone, appropriate adjustments must be made to separate out the value of the furniture, fixtures, and equipment; the business value; and the cost of the inventories and working capital. All of these elements influence the risks, benefits, and value of a hotel investment.

Furniture, Fixtures, and Equipment

Furniture, fixtures, and equipment, or FF&E as they are called in the trade, are essential to the operation of a lodging facility and their quality often influences the class of a property. Included in this category are all non-real estate items that are normally capitalized, not treated as expenses.

A hotel's furniture, fixtures, and equipment are exposed to heavy use and must be replaced regularly. The useful lives of these items are determined by their quality, durability, and the amount of use. (See Table 7.1.)

The periodic replacement of furniture, fixtures, and equipment is essential to maintain the quality, image, and income of a lodging facility. Capitalized expenditures are not included in the hotel's operating statement, but they do affect an owner's cash flow, so an appraisal should account for these expenses with an appropriate reserve for replacement.

A reserve for replacement allowance can be estimated on a straight-line basis or as a percentage of the gross revenue. To estimate a reserve with the straight-line method, the estimated future replacement cost of the item is divided by its weighted-average useful life (usually 8 to 10 years). Alternatively, a replacement reserve of 4% to 5% of the gross revenue can be used to reflect both the quality of the facilities (average rate) and the use they receive (occupancy level).

In some appraisals, the value of the FF&E must be separated from the value of the real estate.[1] This separation is required in condemnation proceedings and property tax assessments, and in situations in which a lender is unable to use chattel as mortgage security. The procedure is to deduct the income attributed to the personal property from the hotel's overall net income by multiplying either the current value or the replacement cost of the FF&E by factors that represent returns on and of the FF&E. A return on the FF&E reflects the owner's cost of capital and is used with the current market value of the

[1] Members and affiliates of the Appraisal Institute should adhere to Standards Rule 1-2(e), which pertains to the consideration of FF&E in an appraisal. In certain cases, departures from the standards are permitted. Separate valuation of such items may be required when they are significant to the overall value or necessary to fulfill the purpose of the appraisal.

FF&E in place. A return of the FF&E is the same as a reserve for replacement and is based on the replacement cost of the items and their estimated useful lives.

Retail Business Value

A lodging facility is a labor-intensive retail business that depends on customer acceptance and highly specialized management skill. The tenants of an apartment or office building sign leases for one or more years, but a hotel experiences a complete turnover of patronage every two to four days. A bad reputation spreads rapidly and can have an immediate impact on occupancy.

Separating the value of a hotel's business from the value of its real estate is a controversial topic. It is difficult to determine exactly where the income attributed to the business stops and the income from the real estate begins. In an appraisal assignment in which the market value encompasses the entire property, the business is part of the going-concern value and is not separated from the real estate. However, some insurance laws, condemnation proceedings, and property tax assessments require a "pure" real estate value, which necessitates treating business value as a separate entity.

Methodologies associated with the separation of business value from total property value have been evolving over time; many different theories exist. For further information on the separation of business value, the reader is directed to the latest Appraisal Institute publications on the topic.

Inventories and Working Capital

In most instances, inventories and working capital are not included in an estimate of a lodging facility's market value. At the time of closing, any inventory on hand is normally "purchased" by the buyer on a dollar-for-dollar basis, just as fuel oil, taxes, and insurance are adjusted. Working capital is withdrawn by the seller and replaced by the buyer. This process is repeated when the property changes hands again, and the result is full recovery of all monies invested in working capital.

If an appraiser wishes to include inventories and working capital in the property value, an appropriate amount must be added to the capitalized net income.

General Risks and Benefits

This chapter has described three unique hotel characteristics and their potential effects on value. To develop an appropriate equity return rate, however, the appraiser must also consider several general factors related to hotel investments. The potential disadvantages of a hotel investment are competency of management, long start-up periods, food and beverage risks, rapid functional obsolescence, susceptibility to external obsolescence, and a lack of liquidity.

- Competency of management. The quality of a lodging facility's on-site management has a direct effect on the property's economic viability and value. Competent hotel management can be measured by the ability to maximize long-term revenues while minimizing long-term expenses. Any variance from this definition of competence may have a significant impact on the forecast operating results.
- Long start-up periods. Lodging facilities usually experience a one- to four-year start-up period before they reach a level of income that can support normal financing and equity requirements. Usually hotel investors are advised to budget an adequate cash reserve to carry the property until its occupancy and room rate are sufficient to produce a profit.
- Food and beverage risks. The food and beverage department carries high risk, yields low profits, and is a source of constant aggravation for most operators. Opening early for breakfast, providing room service, and extending coffee shop hours are essential for competitive reasons, but these practices erode profits for many hotels. Most operators see the food and beverage department not as a profit center, but as a necessary service provided strictly for the guests' convenience. Except for a few, high-volume banquet operations, most hotels and motels lose money on food and beverages when all expenses (administrative

and general, marketing, energy costs, property operations, and maintenance) are properly allocated. This potential income loss constitutes a major risk factor and can adversely affect a hotel's market value.

- Rapid functional obsolescence. The optimal layout, design, construction materials, and amenities of lodging facilities are constantly changing. Over the past 30 years industry standards have changed from exterior corridors to interior hallways, black-and-white televisions to color televisions (often with in-room movies), outdoor pools to enclosed health spas, live entertainment to sports bars, large ballrooms to conference centers, and hand accounting to sophisticated property management systems. With each innovation existing properties must either alter their facilities or suffer functional obsolescence. Often correcting functional deficiencies is not economically justified, and the property gradually becomes less competitive. The proliferation of new lodging products and segmentation within the market area tend to amplify the functional obsolescence of older properties. The resulting decline in competitive standing constitutes a significant risk factor for hotel investors.
- Susceptibility to external obsolescence. The events of the late 1980s and early 1990s demonstrated how external factors can adversely affect the lodging industry. Overbuilding and economic recession caused area occupancies to decline. While capacity increased, businesses curtailed commercial travel and

individuals had less disposable income available for leisure travel. The increased use of air transportation, more sophisticated communication systems, and competition from new forms of accommodations (such as time share condominiums and corporate housing) are all examples of macro factors that can cause economic obsolescence.

On a micro level, many motels constructed during the 1950s were forced out of business by the changeover from U.S. highways to modern inter-states. The deterioration of downtown areas through the 1970s and 1980s prompted many restaurants, lounges, and other places of entertainment to move to the suburbs. Uncontrollable factors such as these are a con-stant risk for lodging facilities. In most cases external obsolescence cannot be cured and the affected property experiences an immediate drop in value.

- Lack of liquidity. The sale of a lodging facility is a highly specialized transaction. Because the market is limited to comparatively few potential buyers, generating interest may take three months or longer. Once a prospective purchaser is found, many time-consuming details must be worked out. Financing and the transfer of licenses, leases, service con- tracts, and franchise agreements must be arranged, equity and tax shelter programs must be structured, and appraisals and surveys must be performed. Often the seller is forced to maintain an interest in the property by taking back purchase money financing.

There are, of course, aspects of hotel investments that help offset their negative features. The two most important advantages of such investments are favorable tax treatment and the potential for large profits.

- Favorable tax treatment. Much of the personal property within a hotel can be depreciated over a short period of time. As a result, hotels and motels generate tax shelter benefits and are attractive for syndication.
- Potential for large profits. Once the income from a lodging facility reaches the breakeven point, profits tend to increase rapidly. As this text has demonstrated, a large portion of hotel expenses are fixed and do not vary significantly with occupancy. Thus profits increase with occupancy.

The financial returns from a hotel investment are derived from the annual cash flow after debt service (equity dividend), mortgage amortization, and the potential value appreciation realized when the property is sold. Over the past 10 years, the perceived equity returns demanded by hostelry investors have ranged from a high of 20% to 25% to a low of 12% to 20%. Equity returns are influenced by a variety of circumstances, including the condition of the market, general real estate and hotel-motel risk factors, individual property risk factors, supply and demand ratios, the availability and cost of financing, and tax benefits.

Equity build-up through mortgage amortization and value appreciation are also important investment considerations. These two factors form the basis of the Ellwood method of valuation, which employs the concept of equity yield. Today's hotel investors are increasingly sophisticated, and discounted cash flow analysis, before- and after-tax equity yield calculations, and other computer techniques have become well-established procedures.

As we head into a new century, the valuation and analysis of hotel investments are bound to change as evaluation techniques become more sophisticated and data become more abundant. We are hopeful that our ability to forecast future economic results will also be enhanced and help to reduce the risk inherent in lodging facility investment.