WHAT'S THE DEAL?

How Do High Interest Rates Affect Your Motel's Value?

Anyone who has attempted to obtain financing during the last twelve months realizes that the cost of borrowing has reached record heights. The 10-12 percent mortgage interest range for hotel loans which was available in the memorable past is today pushing the 15-16 percent level. In addition, sophisticated lenders are requiring extra interest in the form of 'kickers' tied to various percentages of room revenues. Obviously, the high cost of capital must impact the desirability of a particular investment, and, for a motel, the squeeze comes in the form of a value reduction.

Lodging facilities are bought and sold on the basis of their income-generating potential. Appraisers call the procedure for estimating the value of a hotel or motel the income approach. In simple terms, the projected net income before debt serviced is divided by percentage rate representing the weighted cost of invested capital. The result of this calculation is the property's value estimate. Let's see how values changed as mortgage rates increased.

Two Years Ago—Two years ago, the 200-room subject property generated a net income of $950,000 per year. It could have been financed with an 11 percent, 25-year mortgage in an amount equal to 75 percent of market value. The 25 percent remaining would be covered with equity funds requiring a return of 18 percent. The value is calculated as follows.

Number of Rooms		200
Net Income Before Debt Service:		$950,000
Financial Structure		
Mortgage:	75% of Value	
	11% Interest	
	25-year Term (11.7%) constant)	
Equity:	25% of Value	
	18% Equity Return	
Weighted Cost of Capital		
Mortgage:	.75 × .117 =	.088
Equity:	.25 × .180 =	.045
Weighted Cost of Capital:		.133

Value: $\frac{\$950{,}000}{.133} = \$7{,}145{,}000$

Today—Assuming a 10 percent yearly inflation rate over the past two years, the net income before debt service would probably rise to $1,150,000. At the same time, interest rates also rose to approximately 15 percent. Now, what has happened to the subject's value?

Net Income Before Debt Service:		$1,150,000
Financial Structure		
Mortgage:	75% of Value	
	15% Interest	
	25-year Term (15.4%) constant)	
Equity:	25% of Value	
	18% Equity Return	
Weighted Cost of Capital		
Mortgage:	.75 × .154 =	.116
Equity:	.25 × .180 =	.045
Weighted Cost of Capital:		.161

Value: $\frac{\$1{,}150{,}000}{.161} = \$7{,}145{,}000$

It would appear that the example shows no erosion in value—the motel is still worth $7,145,000. However, a prudent investor would hope that after enduring two years of inflation and successfully increasing profits 10 percent per year, the property's value would at least stay even with inflation. In constant dollars, the subject property actually lost 20 percent of its value.

The increase in mortgage interest rates have had a definite negative effect on hostelry values. Although camouflaged somewhat by inflation, the high cost of financing takes its toll by lowering the property's overall value.

Steve Rushmore

Stephen Rushmore, MAI, is president of Hospitality Valuation Services, Inc., 61 Hilton Ave., Garden City, NY 11530.