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Making Alan Greenspan Your Partner

Stephen Rushmore, MAI, CHA, CRE

HVS INTERNATIONAL
372 Willis Ave.
Mineola, NY 11501
516.248.8828 ph
516.742.3059 fax

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Hotel Investment Strategies

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Between November 1998 and November 1999 the value of your hotel was adversely affected by the federal government to the tune of approximately 10%. While United States Federal Reserve Board Chairman Alan Greenspan was controlling inflation through monetary policy, he was indirectly reducing your cash flow by increasing mortgage interest rates. Assuming you were unable to offset this erosion of profits by either raising revenues or lowering expenses, it was likely the value of your hotel has dropped. Let me explain how this happens.

One of the ways the Federal Reserve Board controls U.S. inflation is by adjusting the interest rates. As interest rates go up, borrowing goes down and there is less money available to buy commodities, which in turns keeps prices from rising. While interest rates are somewhat market-driven, the Federal Reserve does control what is called the "discount rate." This is the rate charged by the Reserve Banks when they extend credit to your neighborhood bank. When the stock market anxiously awaits the results of the monthly Federal Reserve meeting, they want to know whether this discount rate has been raised or lowered.

In most instances, all financial interest rates tend to rise and fall in tandem with the discount rate. The following table shows each time the federal discount rate has changed since July 1992, along with the resulting interest rates for some of the other money market instruments:

Money Market Rates

	Federal Discount Rate	% Chg	Fed Funds	% Chg	Prime Rate	% Chg	Hotel Mortgage	% Chg
7/2/92	3.00%		3.76%		6.02%		9.47%	
5/17/94	3.50	16.7%	4.01	6.6%	6.99	16.1%	9.38	-1.0%
8/18/94	4.00	14.3	4.47	11.5	7.51	7.4	9.50	1.3
11/16/94	4.75	18.8	5.29	18.3	8.15	8.5	9.64	1.5
2/2/95	5.25	10.5	5.92	11.9	9.00	10.4	9.14	-5.2
1/31/96	5.00	-4.8	5.56	-6.1	8.50	-5.6	7.79	-14.8
10/15/98	4.75	-5.0	5.07	-8.8	8.12	-4.5	7.47	-4.1
11/19/98	4.50	-5.3	4.83	-4.7	7.89	-2.8	7.60	1.7
8/25/99	4.75	5.6	5.07	5.0	8.06	2.2	8.19	7.8
11/18/99	5.00						8.80	7.4

Between 1992 and 1995 the Federal Reserve increased the discount rate four times going from 3% to 5.25%. They then lowered it twice to 4.5% in November 1998, and today we are back up to 5%. At the same time, the federal funds and the prime rates practically mirrored these changes. The hotel mortgage interest rates as reported by the American Council of Life Insurance followed a somewhat similar track, rising during the early 1990's as the Fed moved interest rates higher, falling in the mid-90's when credit loosened and then rising again at the end of the decade when the Fed started increasing the discount rate again.

So how does the Federal Reserve control the value of my hotel? Let me show you with a simple example:

Hotels are valued by buyers and sellers using a valuation method known as the income approach where the hotel's projected profit is divided by a percentage rate called a capitalization rate to arrive at a value. The capitalization rate is essentially the cost of capital used to acquire the hotel which is generally made up of mortgage financing and equity capital.

Let's assume you were buying a hotel last October 1998. Its projected profit for the next 12 months is US$1 million. As an investor you are looking for an 11% return on your equity. The current interest rate for hotel loans is 7.47% and you can borrow 65% of the purchase price. The capitalization rate is the weighted cost of the capital used for the purchase of the hotel:

Mortgage: 65% x 7.47% = .0485
Equity: 35% x 11.0% = .0385
Capitalization Rate .087

Dividing the projected profit by the capitalization rate yields the value:

$$\frac{\$1,000,000}{.087} = \$11,500,000$$

Between October 1998 and November 1999, the Federal Reserve increased the discount rate three times, which raised the cost of hotel mortgages to 8.8%. When this interest rate is inserted into the formula and the other variables are held constant, the hotel's value falls US$1,050,000 or approximately 10%:

Mortgage: 65% x 8.8% = .0572
Equity: 35% x 11.0% = .0385
Capitalization Rate .0957

Dividing the projected profit by the capitalization rate yields the value:

$$\frac{\$1,000,000}{.0957} = \$10,450,000$$

Of course, there are many offsetting factors which also impact value such as increasing profits or changing the equity returns. But the bottom line remains: part of your hotel's value is controlled by the Federal Reserve which, can raise or lower the sales price of your hotel investment at their whim. ♦

By Stephen Rushmore, *MAI, CHA, CRE, 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 and Singapore. Mr. Rushmore can be contacted at 1.516.248.8828 Ext. 204.*