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MAKING SENSE OF LOW CAP RATES

We've recently seen a number of hotel transactions showing capitalization rates below 5%. In fact, some major transactions were yielding cap rates of only 2% to 3%. In the past, the standard hotel cap rate generally ranged from 8% to 12%. Why are cap rates so much lower today, and is cap rate the best way to value a hotel?

What is the basic procedure for valuing a hotel or any type of income-producing property? Value is the present worth of future benefits. For a hotel, the future benefits are the net income available to pay debt service and a return on equity capital, sometimes called cash flow before debt service. There is net income produced each year during the holding period since a hotel owner generally holds the property for a number of years. To account for a number of net incomes over the holding period, they each must be discounted back to the date of value using an appropriate present worth factor. Thus, value is the present worth of future benefits.

One of the simplest methods for valuing a hotel is to use a capitalization process where the net income for just a single year is divided by a percentage rate known as a capitalization rate or cap rate. A cap rate incorporates not only a risk component, but also an assumed growth in the net income over the holding period. The chart shows the actual and projected net income for two hotels at two different points in time.

The date of value for Hotel A is 2004. The actual 2003 net income was $1,000. The projection of net income started in 2004 and assumes a moderate recovery out of a mild recession with annual increases of 15%, 10%, 5% and stabilizes at 3%. The date of value for Hotel B is 2010. The actual 2009 net income was $1,000. The projection of net income started in 2010 and assumes a strong recovery out of a major recession with annual increases of 30%, 30%, 20%, 15%, 10% and stabilizes at 3%.

Let's assume on the date of value Hotel A sold for $12,000 and Hotel B sold for $20,000. The table shows what the cap rate would be each year if the net income for the year was divided by the sales price.

The cap rate using the actual net income of $1,000 for Hotel A was 8.3% and Hotel B was 5%. These are called historic cap rates because they are based on the actual last year's net income. If we were to use the first projected year's net income the cap rate for Hotel A would be 9.6% and 6.5% for Hotel B. These are called projected cap rates.

In developing the sale price of these two hotels I assumed the same level of risk and cost of capital—the only difference as you can see is the assumed projected net income growth rate. Hotel B's cap rates are lower during the initial years, but it's projected to experience a much stronger recovery than Hotel A. This is what we are seeing in today's market: relatively low cap rates because hotel buyers are factoring a strong recovery into their projections.

A second point of illustration is the fact the capitalization rate is specific to a particular year. If you assume a growing net income, then the historic cap rate is lower than the first projected year's cap rate. In addition to these cap rates there are rates called stabilized cap rates based on the stabilized year's net income expressed in current (or deflated dollars).

So when someone tells you that a hotel sold at a 4% cap rate, you need to ask whether that is an actual historic cap rate, a first projected year cap rate or a stabilized cap rate. You also should ask about the underlying growth (or recovery) in net income over the projected period.

In a future column I will discuss how to value hotels using a 10-year discounted cash flow method, which typically will provide a more accurate valuation.

Hotel A				Hotel B			
Year	Net Income	Annual Percent Change	Cap Rate	Year	Net Income	Annual Percent Change	Cap Rate
2003	$1,000		8.3%	2009	$1,000		5.0%
2004	$1,150	15%	9.6%	2010	$1,300	30%	6.5%
2005	$1,265	10%	10.5%	2011	$1,690	30%	8.5%
2006	$1,328	5%	11.1%	2012	$2,028	20%	10.1%
2007	$1,368	3%	11.4%	2013	$2,332	15%	11.7%
2008	$1,409	3%	11.7%	2014	$2,565	10%	12.8%
2009	$1,451	3%	12.1%	2015	$2,642	3%	13.2%
2010	$1,495	3%	12.5%	2016	$2,722	3%	13.6%
2011	$1,540	3%	12.8%	2017	$2,803	3%	14.0%
2012	$1,586	3%	13.2%	2018	$2,887	3%	14.4%
			$12,000				$20,000