Hotel Value vs. Replacement Cost

Every so often I like to look at the current relationship between a hotel's market value and its replacement cost. This information is useful in setting strategies for new hotel development, acquisitions, when to buy and when to sell. It can also forecast volatility.

A hotel's market value is the price at which it will sell in an open market where buyers and sellers are acting in their own self-interest without any pressure to buy and sell, and with full knowledge of the market. Market value for a hotel is generally estimated through an income valuation model where future net income is capitalized into value.

Replacement cost is the total development cost to build a hotel including the acquisition of the land, construction of the improvements and furnishing the property with furniture fixture and equipment.

I have been tracking the relationship between a hotel's market value and its replacement cost since 1987 for two different classes of hotels- Luxury Hotels and Mid-Price Hotels. The following graphs show the change in market value and replacement cost over this period of time.

Inset the two Graphs

Before we evaluate each of these two graphs- a brief review of hotel economic trends over this period of time might be helpful.

-Between 1987 and 1989- the U.S. hotel industry was booming. The Savings and Loan industry coupled with highly favorable income tax benefits fueled a huge building spree during this period.

-A massive recession and crash occurred in 1990-1991 when the S&L Industry had experienced severe financial problems. Travel slowed, hotel values declined and the overbuilding sent hotel occupancies falling.

-The recovery between 1992 and 2000 was show- with hotel values peaking in 2000.

-The events of 9/11 coupled with another recession- drove hotel values down again. A turn-around occurred in 2003 and by 2007 hotel values peaked at record levels.

-With the bubble bursting in the housing and banking industries in 2007 and 2008- hotels values went into a free fall with many markets seeing declines of 30 to 50%. Today we are slowly starting to recover.

Value vs. Replacement Cost- Luxury Hotels

The peaks and valleys in value for the luxury hotels track exactly the overview of U.S. hotel values described above. Between 1989 and 1996 luxury hotel values were below replacement cost. They rose above replacement cost starting in 1997 and actually remained either above or equal to replacement cost throughout the period. Generally, luxury hotels were able to hold their value relative to replacement cost. Because of the high cost of developing luxury hotels, this segment seldom becomes overbuilt which is the factor that usually causes wide swings in value and depresses value below replacement cost.

Value vs. Replacement Cost- Mid-Price Hotels

Between 1987 and 2010 the value of mid-price hotel was often below replacement cost. This is largely due to the relative ease in developing these types of hotels. Financing is usually relatively available, land cost is typically not excessive, and the hotel brands are pushing these types of products. As a result, during good times when values should be rising rapidly, developers are building too many mid-price hotels which causes overbuilding and values stop rising and in some markets will actually decline.

The relationship between market value and replacement cost ties together in the following manner. When value is greater than cost- it is a good time to build new hotels because the cost of entry is lower than the value achieved when the hotel opens. When hotel values are less than replacement cost- it is better to purchase an existing hotel because new development is not economically feasible since the value create when the hotel is complete would be less than its cost. We are currently experiencing a period where value is less than cost- so we are seeing little new hotel development. This type of relationship is a form of barriers to entry for new development. The graphs seem to indicate that a more favorable value/cost relationship is developing for luxury hotels as compared to mid-price hotels- so if financing is available we might see more interest in this segment as we move into the recovery.

With the limited supply of new hotels expected to enter the market over the next several years coupled with rapidly rising values fueled by the recovery we will probably see the market value line for most segments rise above replacement cost in the near future.