Rushmore on Hotel Valuations

Creator of the Hotel Valuation Methodology

Headlines from Steve Rushmore:

How to be a Hotel Buyer Rather than Merely a Hotel Bidder

When someone values a hotel, they are generally attempting to estimate its "Market Value." My newsletter this month will focus on the term "Market Value" and provide insight as to what this term really means during a sales transaction.

To subscribe to "Rushmore on Hotel Valuation" send your email address to steve@steverushmore.com or connect on LinkedIn

First- let's look at the current definition of Market Value developed by USPAP and used by many appraisers.

> **Market Value** means the most probable price at which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus.

The question I have about this definition is the term “the most probable price?” A number of years ago the definition of market value used the term “the highest price” instead of “most probable.” I believe the term “highest price” better represents the thought process of typical buyers.

Let’s start with the term “typical buyer.” In a real estate sales transaction, there can only be one buyer. Everyone else involved in the sale should be called, “lookers” or “bidders.” Too often we say, “There are a lot of buyers looking at the property.” There may be a lot of individuals interested in buying the property, but at the end of the day- there will be only one actual buyer.

Now assuming there can only be one buyer, and the seller is interested in obtaining the highest selling price, then the winning bid will be coming from someone that has valued the property higher than all the other bidders. If this bid price satisfies all the provisions contained in the definition of market value-then this winning bid represents the market value of this property.

The problem with the term “most probable” is that the term is vague and sounds like an average of say the top five bids. A seller is not going to accept the most probable price- but rather the highest price.

What actually happens during a sales transaction and how is the buyer able to compete with the other bidders and win with the highest price?

Let’s look at a sale involving a hotel. Hotels are income-producing properties that are bought and sold based on their future income expectations.

The transaction usually starts by assembling a group of bidders and providing them with financial and physical information on the property so they can put together their bids.

What does it mean when I said that hotels are bought and sold based on their future income expectations? Let me give you a basic example of how a bidder will establish their price.

Value is the present worth of future benefits. The future benefit of owning a hotel is the annual cash flow which I will call the Net Operating Income (NOI) plus the proceeds from a sale at the end of the holding period which is

Steve Rushmore is the Founder of HVS and the **Creator of the Hotel Valuation Methodology**. He has authored eight textbooks on hotel valuation and investing, along with over 350 articles on similar topics. In addition, Steve has taught thousands of industry professionals around the world. His online course- **"How to Value a Hotel"** is used by the leading hotel schools and consulting organizations. Contact Steve at **steve@steverushmore.com** or visit his website **www.steverushmore.com**

called the Residual Value. The term Present Worth is what occurs when the annual NOI plus the Residual Value is discounted at an appropriate discount rate producing the total present value. This process is typically applied by sophisticated bidders using a 10-year holding period and can be complicated to describe. For the purpose of this article, I am going to simplify the process and assume the holding period will be infinite, so we only need to project the NOI for one stabilized year, and we don't need to assume a sale at the end of a holding period. In addition, instead of applying a discount rate to a series of NOIs over the holding period, we will use a capitalization rate which represents the rate of return the bidder is looking for.

Now let's pretend you want to bid on a hotel. What is the process of establishing your bid? As described above, you need to develop an estimate of the stabilized NOI along with the rate of return you are looking for.

The Net Operating Income for a hotel is Total Revenue less Total Operating Expenses = NOI. The main source of revenue for a hotel is the nightly sale of guest rooms. The operating expenses include labor, administrative, marketing, maintenance, energy, property taxes, insurance, etc.

To estimate the NOI a typical bidder will first perform a market study to determine the hotel's competitive environment and estimate it's future annual occupancy and average rate. This will be used to project the Rooms Revenue. Other revenue such as the sale of food and beverage will be added producing an estimate of the hotel's Total Revenue.

Based on the estimate of Total Revenue- the appropriate operating expenses will be projected and deducted from the Total Revenue producing the estimate of the stabilized Net Operating Income.

Since this process is based on future projections and estimates it is not always accurate and can be biased upward or downward or in other words, it can be optimistic or pessimistic.

The second part of the valuation process is to establish the capitalization rate which represents the bidder's return requirements.

In a hotel transaction, the source of capital used to purchase the property generally comes from a lender who provides the debt in the form of a mortgage and an equity investor. The return requirement is therefore the weighted average of the returns established by the lender and equity investor or what is often referred to as the weighted average cost of capital which is also the Capitalization Rate.

The following example will illustrate this calculation and how it is used to value a hotel.

A bidder is looking to purchase a hotel. A market study is performed along with a projection of revenue and expense producing an estimate of the stabilized Net Operating Income of $2,000,000.

The bidder finds a lender willing to provide the mortgage debt based on the following terms.

- The amount of debt will be 65% of the property's Market Value
- Interest Rate- 7.5%
- Amortization will be based on a 20-year fully amortized loan
- The loan term- 10-years
- The debt service constant is calculated to be 9.67%

The bidder also has equity investors looking for a 12% annual (cash-on-cash) return.

The following table shows the calculation of the weighted average cost of capital or what is known as the Capitalization Rate:

Mortgage	65%	x	0.0967	=	0.0629
Equity	35%	x	0.1200	=	0.0420
	Capitalization Rate				0.1049

The mortgage loan-to-value ratio is multiplied by the debt service constant. The equity component is multiplied by the desired cash-on-cash return. The weighted average of these two capital sources is the capitalization rate or .1049.

The value is calculated by dividing the Stabilized Net Operating Income by the Capitalization Rate as illustrated below.

$2,000,000		
0.1049	=	$19,066,000

Now let's look at the dynamics of an actual transaction. Remember I have been referring to this individual as the bidder, not a buyer. Also, this is not a single bidder on this hotel- there are several or many others- thus there is competition.

The broker handling this transaction asked all the bidders to submit their first-round bids and this bidder submitted $19,066,000.

The broker came back to this bidder and said there were other higher bids and to go into the second round the bid needs to go up.

So what can the bidder do to increase the next bid? The math is simple- either increase the projected Stabilized Net Operating Income or decrease the capitalization rate or a combination of both.

To increase the NOI the bidder needs to be more optimistic about the revenue projection and/or reduce the estimated operating expenses.

To lower the Capitalization Rate the bidder needs to find less expensive financing and/or reduce the equity return expectations.

In the real world what usually happens is the bidder becomes more optimistic about the NOI projections and/or reduces the equity return expectations. Occasionally you can get the lender to reduce the interest rate, extend the amortization, or increase the loan to value all of which reduces the capitalization rate.

Throughout the transaction process all the bidders that want to go onto the next round of bids are performing similar calculations- Increasing the NOI and/or Decreasing the Capitalization Rate. Therefore, the ultimate "buyer" who is paying the highest price is using the most optimistic projection of NOI and/or has the lowest cost of capital. When appraisers, lenders, and bidders involved in a hotel transaction say they want to use a “conservative” projection of Net Operating Income or financing assumptions in their valuations are not estimating Market Value. They may come up with the most “Probable Value” but this is not Market Value.

Conclusion

If you are looking to buy a hotel and there are other bidders bidding against you- you need to develop the most optimistic projection of Net Operating Income and/or have a source for the lowest cost of capital. If this is not possible- you will likely be only a looker/bidder rather than a buyer.

In the next issue of my newsletter, I will discuss how to estimate the equity component of a capitalization/discount rate and the role a “buyer’s or seller’s market” has on the equity return requirements.

To Contact Steve Rushmore
steve@steverushmore.com
www.steverushmore.com

Hotel Valuation Software- For Performing Hotel Market Analyses, Financial Projections and Valuations

HOTEL VALUATION SOFTWARE

Hotel Market Analysis & Valuation Software was developed by **Steve Rushmore** for his firm- HVS. It was then enhanced by Professor Jan deRoos of the Cornell Hotel School. This software has been the most downloaded product on the Cornell website and is used by thousands of hotel professionals around the world. It consists of three models:

- **Hotel Market Analysis and ADR Forecasting Model**
- **Hotel Revenue and Expense Forecasting Model**
- **Hotel Mortgage Equity Valuation Model.**

This software package also provides answers to a wide range of key hotel investment questions such as How much is my hotel worth? What can I do to maximize value? What is the likely impact of new competition? How much value will a refurbishment add? Is my market strong enough to support adding more hotel rooms? What is the impact of my brand adding another hotel to the market?

If your role includes responsibility for performing hotel valuations and associated financial analyses- you need to include this software in your business toolbox.

Hotel Market Analysis & Valuation Software v. 6.0 is written as Microsoft Excel files (which runs on both Windows and Apple OS X operating systems) and comes with a detailed users' guide and case study. Version 6.0 contains significant enhancements over Version 5.0 which is no longer distributed.