INVESTMENT TODAY

VALUING DISTRESSED PROPERTIES

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As more lodging properties run out of operating capital and are foreclosed upon by their lenders, it becomes increasingly important for hotel buyers, sellers and lenders to understand the techniques utilized in valuing distressed facilities.

Hotels are normally valued through a discounted cash flow technique that projects net income into the future and discounts it to the present value at a discount rate that reflects the cost of capital. Since hotels are typically financed with mortgage and equity funds, the cost of capital is the weighted average of these two financing components.

While this technique works well for hotels that have a bottom line profit, what happens when a property shows no cash flow? How do you develop a capitalization rate when financing capital is totally unavailable? These and other issues currently perplex many parties involved with distressed hotels.

Looking back at the lodging market during the 1970s, when we experienced a similar distressed environment, some important parallels become evident:

- Buyers of distressed, but well-located and functionally up-to-date hotels were generally able to reposition the properties, restructure the financing and create valuable assets.
- Lenders who provided new financing to reputable owners and operators were usually able to preserve their principal investment.
- Overbuilding and foreclosures forced lenders to stop making hotel loans. New construction was halted for approximately five years and the supply of hotel rooms leveled off and even declined. As demand caught up with supply, occupancy improved, room rates rose, profits increased and distressed hotels eventually became successful.

This look at history indicates that while the short-term may look bleak, the long-term potential for investors with sufficient resources either to buy distressed hotels or hold onto existing properties is good.

For a distressed hotel to have any value, it must also have some future income potential. As we have seen from the past, most distressed operations can be turned around over time if they possess a good location and well-maintained, up-to-date facilities. In addition, the management and owners must be competent, and sufficient capital must be available to cover operating losses for a two- to five-year period.

Assuming these turnaround criteria are in place, a 10-year projection of income and expenses should be made showing the anticipated recovery. If an infusion of capital is necessary to meet operating losses or correct physical and functional deficiencies, these amounts need to be included as cash outflows.

Since normal financing is generally unavailable for distressed hotel investments, the cost of capital can be very high. The so-called vulture funds that pursue problem properties usually look for venture capital risk returns of 25 to 50 percent. This rate of return produces a value multiplier of two to four times cash flow. If the lender stays in the transaction by restructuring the mortgage and reducing the need for expensive equity capital, the long-term property value will be enhanced over time. The following example illustrates this concept.

A 200-room hotel with a good location and facilities has suffered from the affects of overbuilding. The property was developed for a total cost of $15 million and the current first mortgage amounts to $11 million. A 10-year projection of income and expenses showed the anticipated turnaround as the local market conditions improve.

Projection Year	Net Income before Debt Service
1	$450,000
2	550,000
3	700,000
4	900,000
5	1,200,000
6	1,500,000
7	1,575,000
8	1,650,000
9	1,750,000
10	1,800,000
11	1,900,000

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If the lender wanted to sell this hotel for all cash, it probably would be forced to settle for a vulture buyer looking for a bargain price of $4 million to $5 million ($20,000 to $25,000 per room). On the other hand, if the lender was willing to sell the hotel for no cash, but structure a cash flow mortgage in which the lender received 75 percent of the net income before debt service plus 75 percent of all sale and refinancing proceeds, the value of the lender's position would be approximately $7.5 million and the equity would probably be worth about $1.2 million. This type of structure enhances the lender's position by over 50 percent while providing an annual return of 13 percent.

History has shown that patience pays off with distressed hotel investments. Waiting for a market rebound creates value that will ultimately be realized by investors willing to stick by the project. **LH**