Hotel Investment Strategies

# Valuing Hotels During Distressed Times

Estimating the value of a hotel is a complicated process requiring comprehensive knowledge of hotel operations combined with an understanding of the various valuation procedures and techniques. Valuing hotels during distressed times adds another dimension of difficulty requiring a historic perspective of how hotel values have fallen and recovered during similar distressed periods in the past. Today, most hotel markets throughout the world are experiencing lower occupancies, room rates, profits and probably an overall decline in value. Let's see how the hotel valuation process needs to be adjusted to handle this somewhat unique situation.

In very simple terms, the value of a hotel is the present worth of the future economic benefits accruing to ownership, which are composed of periodic cash flows plus the proceeds of an eventual property sale. These future benefits must be quantified and discounted at an appropriate discount rate. So there are two unknown factors that need to be estimated in order to determine the value of a hotel—the economic benefits of ownership and a proper discount rate.

The primary issue during distressed times is how to estimate a hotel's economic benefit. Do hotels have no value in markets where they are facing negative profits? Probably not, but the valuation procedures need to be adjusted based on historic experience.

Let's look at an example.

**Historic Operating Performance ($000)**

| | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|
| Occupancy | 75% | 80% | 55% | 56% |
| Average Rate | $125.00 | $135.00 | $114.75 | $114.75 |
| Total Revenue | $9,650 | $10,917 | $6,993 | $7,178 |
| Total Expense | $6,785 | $7,184 | $6,459 | $6,676 |
| Net Income | $2,865 | $3,733 | $534 | $502 |
| Capped at 12% | $24,000 | $31,000 | $4,500 | $4,000 |

The table shows the historic operating performance for a 200-room hotel in a market impacted by the current economic decline along with the events of 9/11. In 1999, the hotel achieved a 75% occupancy and a US$125 average rate, which produced a net income of US$2,865,000. These operating results represented a typical year for this hotel. By applying a 12% capitalization rate to this net income, the resulting value would be US$24 million.

In 2000, the occupancy of this hotel peaked at 80% as a result of the unusual travel spurt caused by the millennium celebrations. This resulted in a net income of US$3,733,000, which capped at 12% produces a value of US$31 million.

The years 2001 and 2002 were disasters. Occupancy and rate both dropped substantially, which totally decimated the hotel's net income. By applying the 12% cap rate to the actual 2002 net income, the value would calculate at US$4 million.

While hotel values tend to be volatile, they do not normally peak and plunge as illustrated by this table. In distressed markets hotel buyers and sellers tend to disregard the adversely impacted actual operating performance and focus more on the future. This is when it is important to utilize a historic perspective that factors into the projections an eventual recovery. Looking back in time, periods of distressed hotel operating performance always were followed by a recovery. The overbuilding and energy crisis of 1974 was followed by a strong recovery during the late 1970s. The hotel depression of 1991 marked the start of a huge recovery, which created record values by 1997. In most instances a distressed hotel's net income will eventually reach its historic stabilized level. The unknown is exactly how long the recovery will take.

Looking at today's situation, the reason for distress can be attributed mostly to a demand problem rather than overbuilding. This will probably mean a relatively rapid recovery as compared to the downturns of 1974 and 1991, which were largely supply related and usually requires a longer recovery period.

The following table shows the projected operating performance out to 2007 when the hotel's occupancy is expected to reach a stabilized level of 75%. This approach of projecting out the net income to an eventual recovery is utilized by most hotel buyers and sellers when the actual operating performance is atypical.

**Projected Operating Performance ($000)**

| | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|
| Occupancy | 60% | 65% | 70% | 73% | 75% |
| Average Rate | $118.00 | $124.00 | $132.00 | $141.00 | $149.00 |
| Total Revenue | $7,865 | $8,818 | $9,906 | $10,883 | $11,723 |
| Total Expense | $7,014 | $7,414 | $7,837 | $8,209 | $8,554 |
| Net Income | $851 | $1,404 | $2,069 | $2,674 | $3,169 |

Applying a discounted cash flow valuation methodology to these projections results in a value of US$21 million as of the beginning of 2003. This represents a 12% value decline since 1999, which reflects the current economic realities.

It took almost a year for hotel buyers in the United States to realize that the sellers were not going to heavily discount their prices and needed to switch their acquisition valuation approach to incorporate projected rather than historic operating performance. Most have adopted this methodology, resulting in a growing number of hotel transactions.

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