Rushmore on Hotel Valuations

Creator of the Hotel Valuation Methodology

A New Approach to Estimate the Return on the Equity in the Mortgage-Equity Valuation Technique

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In my previous newsletters, I've highlighted the benefits of the mortgage-equity technique for valuing income properties. This time, I'm introducing a new approach that determines the return on the equity component based more on the transaction market than the financial market. It's a fresh perspective that might surprise you.

In summary, the mortgage-equity method is superior to an unleveraged discounted cash flow analysis because it not only reflects the investment rationale of both the equity investor and lender, but its accuracy is significantly enhanced through the use of easy-to-obtain and up-to-the-minute mortgage data.

As real estate appraisers, it's essential for us to step into the shoes of typical buyers and follow the same procedures they use to establish their purchase price. Most buyers we've observed start with a projection of Net Income Before Debt Service (NIBDS). They then determine how much they can borrow and the terms of the financing through the utilization of a loan-to-value ratio, a debt coverage ratio, or debt yield. This allows them to calculate the amount of annual debt service along with the yearly equity income (equity dividends).

At the end of their holding period, they estimate the proceeds from a sale of the hotel and deduct the outstanding mortgage balance and selling expenses (equity residual). They then discount the annual equity dividends along with the equity residual from the sale to the present value using an equity yield to determine how much equity they can invest. The total of the mortgage component and equity component establishes what they can pay for the property. It's worth noting that, apart from some all-cash institutional buyers who purchase properties with no debt, most real estate investors specifically consider the cost of financing in their purchase decisions.

In my previous newsletters, I have shown that mortgage information is usually highly accurate and can be obtained easily from published sources using a regression formula (see “How to Value a Hotel—A Complete Guide to the Hotel Valuation Methodology”).

The equity yield, on the other hand, can be somewhat subjective since it requires data not as readily available. Good appraisers should be having ongoing conversations with investors about their equity return requirements. In addition, appraisers can derive equity yields from sales transactions of properties appraised at the time of sale by hypothesizing market-rate debt and solving for the equity IRR.

In this newsletter, I will focus on the derivation of the equity component of the mortgage-equity technique. To keep it simple, I will illustrate the process using the band of investment method (utilizing an equity dividend) rather than a discounted cash flow (utilizing an equity yield). Both methods will produce the same results. From now on, I will use the term “equity return” rather than equity dividend or equity yield.

In simple terms, the derivation of the equity return has little to do with things most appraisers consider, like the cost of capital, risk, illiquidity, type of asset, and other financial and economic data. Rather, the equity return reflects market demand for a particular hotel asset, where demand represents the number of buyers actually looking to purchase that hotel. If many potential buyers are looking to purchase a particular hotel, equity returns will be lower. If few buyers are looking to purchase a particular hotel, equity returns will be higher.

To illustrate how this works, let’s assume you want to purchase a particular hotel and use the mortgage-equity valuation technique to establish your purchase price. You first need to evaluate the hotel's market dynamics and financial performance to project its future Net Income Before Debt Service (NIBDS). Using this information, you then work with your lender to determine how much you can borrow and what the annual debt service will be. Lastly, you need to determine what equity return you would like to have. With this information, you can estimate YOUR value of this hotel and how to start the bidding process.

Let's use some numbers:

Your projection of the future Net Income Before Debt Service is $2,000,000

Your lender is willing to lend you 75% of your value using an interest rate of 8% and a 25-year amortization, which makes the mortgage constant 9.3%.

Based on the equity return requirements of your investors- you would like to achieve a cash-on-cash equity return of 10%. A good starting point for establishing a return on equity is to assume it needs to be higher than the interest rate on the debt component.

Using a band of investment, the capitalization rate can be established using the weighted average cost of capital as follows:

	%		Percent Returns		Weighted Average
Mortgage	0.75	x	0.093	=	0.069
Equity	0.25	x	0.100	=	0.025
			Cap Rate		0.094

Dividing the NIBDS of $2,000,000 by the cap rate of .094 produces YOUR value of $21,177,000.

$2,000,000/.094 = $21,177,000

Proof of Value:

	%		Total Value		Components		% Returns		Returns
Mortgage	0.75	x	$21,177,000	=	$15,883,000	x	0.093	=	$1,471,000
Equity	0.25	x	$21,177,000	=	$5,294,000	x	0.100	=	$529,000
					$21,177,000				$2,000,000

The $21,177,000 value can be proved by showing that each component receives its desired return. The mortgage represents 75% of the total value, or $15,883,000. The mortgage constant is .093. Multiplying the amount of the mortgage times the mortgage constant produces debt service of $1,471,000. The equity component is 25% of the total value, or $5,294,000. Multiplying the amount of the equity times the 10% equity return requirement produces an equity dividend of $529,000. Adding the debt service plus the equity dividend totals $2,000,000, which is the projected NIBDS, proving that each component does receive its desired return.

Therefore, you would be happy to pay the $21,177,000 since it provides the desired return to both the lender and equity investors.

Now, you are ready to enter the bidding process by submitting an opening bid. Of course, it would be better to achieve higher returns, so your opening bid will probably be less than $21,177,000.

Since it is likely that the cost of your mortgage financing will stay the same, you only need to adjust your desired equity return upward. Let's now price your bid using an equity return of 17.5%. Employing the same band of investment method and only adjusting the equity return up to 17.5% produces the following valuation:

	%		Percent Returns		Weighted Average
Mortgage	0.75	x	0.093	=	0.069
Equity	0.25	x	0.175	=	0.044
			Cap Rate		0.113

$2,000,000/.113 = $17,666,000

You submit this opening bid, and after several days, the broker gets back to you and says, "Your bid is way out of the ballpark, and you need to come up with a higher bid." At this point, you have two options available to increase your bid- you can either increase the projection of NIBDS or decrease your equity dividend requirement. The cost of your debt capital is probably not going to change. You don't feel comfortable increasing your NIBDS, so you bring your equity return down to .10. This produces the $21,177,000 shown in the first example, which you submit to the broker.

At this point, if you are either the only bidder or offering the highest price, you will probably be the buyer.

However, let's assume there are other bidders, and your $21,177,000 was declined- what can you do now?

Again, you have the same two options to increase your bid- either increase your projection of NIBDS or reduce your equity dividend.

At this point, you evaluate your projected NIBDS and conclude that it is very optimistic and cannot reasonably be increased. Therefore, your only option is to further lower your equity return requirement.

If you want to stay in the bidding and lower your equity return requirement, your decision has nothing to do with the cost of capital, risk, illiquidity, type of asset, and other financial and economic data- it is merely the reality of the transaction market where the successful bidder is probably offering the highest price which comes from either being more optimistic about the projected NIBDS or has the lowest cost of capital (debt and equity) or a combination of both. In appraisal terms- that represents Market Value.

In this example, keeping your projected NIBDS at $2,000,000 and using a .05 equity dividend, your value would be $24,400,000. The highest you could bid, assuming you were satisfied with a 0% equity dividend, would be $28,800,000.

As you can see in an actual market, the equity return (either an equity dividend or equity yield) ultimately determines whether you are the winner or loser in the bidding process. If you are in a "buyer's market" where there are few or no other bidders- you can adjust your equity return upward. On the other hand, if you are in a "seller's market" with many bidders, you will need to adjust your equity return downward to be the successful buyer.

As you can see, the equity return (dividend or yield) is based more on the transaction market rather than the financial market.

Who is Steve Rushmore?

Steve Rushmore, MAI, CHA, Founder of HVS, has provided consultation services for more than 15,000 hotels during his 50-year career and specializes in complex issues involving hotel valuation, feasibility, and financing.

As a leading authority and prolific author on the topic of hotel valuations, Steve has written all five hotel valuation textbooks and two seminars for the Appraisal Institute and is known as the "Creator of the Modern Hotel Valuation Methodology." He has also authored three reference books on hotel investing and has published more than 300 articles. Steve developed the Hotel Market Analysis & Valuation Software used by HVS and thousands of hotel appraisers/consultants, owners, and lenders throughout the world.

Steve lectures extensively on hotel valuations and has taught hundreds of classes and seminars to more than 20,000 industry professionals. He is also a frequent lecturer at major hotel schools and universities including Cornell, Glion, Hong Kong Polytechnic, EHL, Florida International University, IMHI, Michigan State, Penn State, Houston, NYU, and the Harvard Business School.

Steve's most recent contribution to hotel valuation education is his online course- "How to Value a Hotel." Designed for experienced appraisers looking to specialize in valuing hotels or new valuers starting their careers, the course provides all the knowledge and tools needed to evaluate hotel markets, forecast income and expense, and value all types of hotels. For the final project, students value an actual hotel. Upon successfully completing Steve's course- students receive the Certified Hotel Appraiser (CHA) or Certified Hotel Valuer (CHV) certification recognizing their unique knowledge and skills used to value hotels.

Steve has a BS degree from the Cornell Hotel School, an MBA from the University of Buffalo, and attended the OPM program at the Harvard Business School. He held the MAI and FRICS appraisal designations and is a CHA (certified hotel administrator).

In his free time, Steve enjoys tennis, skiing, hiking, diving, sailing, and cooking with his wife (who is a trained Chef). He holds a commercial pilot's license with instrument, multi-engine, and seaplane ratings.

For more information as to what Steve is up to these days- www.steverushmore.com

Important Websites for Performing Hotel Market Studies and Valuations

www.howtovalueahotel.com -Over 350 downloadable articles, books, software, and courses related to hotel analysis, valuations, investing, and finance- most are free.

www.certifiedhotelappraiser.org - If you appraise hotels consider becoming a Certified Hotel Appraiser- The world's only certification for hotel appraisers. Set yourself apart from all other appraisers with this professional certification.

www.iaha.org - International Association of Hotel Appraisers- Where the world's leading hotel appraisers come together to exchange ideas and enhance the hotel valuation methodology and procedures.

www.hotellearningonline.com - Hotel Learning Online- Learn how to perform a hotel market analysis, make financial projections, and value a hotel using the latest version of Hotel Market Analysis & Valuation Software.

www.hotelvaluationsoftware.com - The most widely used software for performing a hotel market analysis, financial projections, and valuations.

Become a Certified Hotel Appraiser/Valuer

If you currently appraise hotels or want to learn how, obtaining a Certified Hotel Appraiser (CHA) or Certified Hotel Valuer (CHV) certification will distinguish you from all other appraisers.

Created by Steve Rushmore, CHA, MAI, the CHA and CHV certifications can be earned based on your hotel valuation experience or by completing Steve's online course, "How to Value a Hotel."

More than 250 hotel appraisers and valuers worldwide have achieved this prestigious certification, which is ideal for those seeking to specialize in hotel valuation.

In addition, these certifications are also important differentiators for hotel consultants, asset managers, operators, brands, owners, and lenders to demonstrate your unique qualifications.

Certified Hotel Appraiser

Certified Hotel Valuer

For more information on the Certified Hotel Appraiser (CHA) and Certified Hotel Valuer (CHV) certifications, click here:

www.certifiedhotelappraiser.org

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

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.

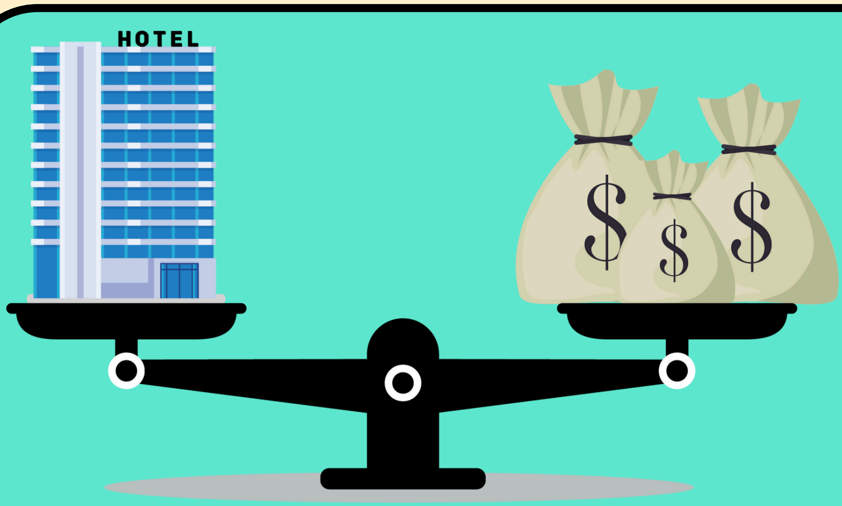
Hotel Market Analysis & Valuation Software v. 6.0 is written as Microsoft Excel files (which runs on both Windows and Apple OS X operating systems) and comes with a detailed users' guide and case study. Version 6.0 contains significant enhancements over Version 5.0 which is no longer distributed.

HOTEL VALUATION SOFTWARE

For More Information on Hotel Market Analysis and Valuation Software

Go Here:

https://hotelvaluationsoftware.com/



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Learn "How to Value a Hotel" from the creator of the Hotel Valuation Methodology

Hi- I'm Steve Rushmore and I would like to tell you about my online course- **"How to Value a Hotel."** It teaches how to perform a hotel valuation using my **Hotel Valuation Methodology**. Designed for experienced appraisers looking to specialize in valuing hotels or new valuers starting their careers, this course provides all the knowledge and tools needed to evaluate hotel markets, forecast income and expense, and value all types of hotels. For the final project, students value an actual hotel.

You will be working with the latest version (6.0) of my **Hotel Market Analysis and Valuation Software-** three powerful software models that have become the hotel industry standard for hotel valuations and investment analysis throughout the world. By the end of the course, you will be able to perform your own hotel market analysis and valuation plus many other applications.

The course consists of video lectures, readings, hands-on software case studies, quizzes, and a final project valuing an actual hotel. It should take about 20-35 hours to complete.

Most importantly, I will play a vital role during your learning process- through the wonders of Zoom- you can reach out to me with your questions and I will personally assist. After completing the course, I will also be available to mentor your professional development. Hopefully, this will be the start of a long-term friendship.

Upon successfully completing the course and final project you will receive the **Certified Hotel Appraiser (CHA)** or a **Certified Hotel Valuer (CHV)** certification. These certifications recognizing your hotel valuation skills will set you apart from other appraisers and consultants. For more information: www.hotel-learning-online.com

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