SAMMARTINO, STOUT & LO PRESTI

Real Estate Appraisers
Analysts and Consultants

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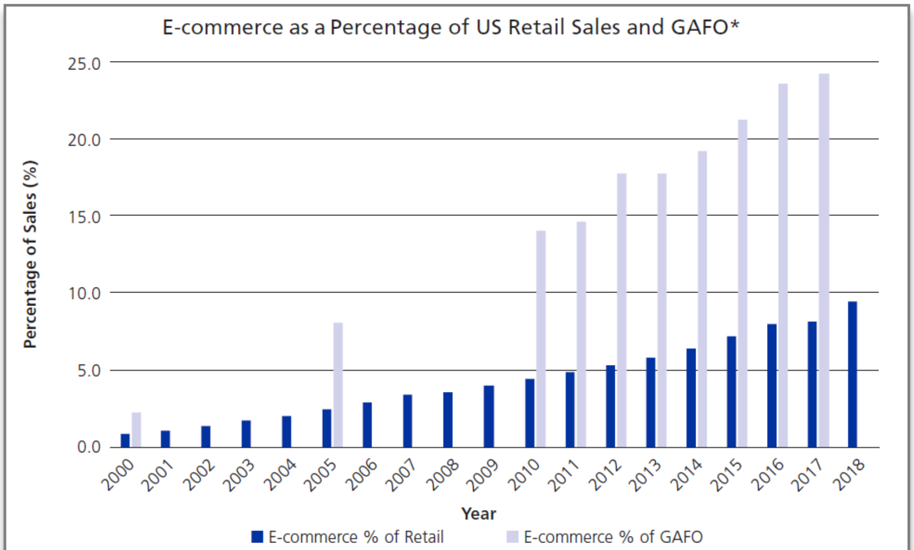
When *Market Analysis* Matters

A reliable valuation assignment includes a thorough Market Analysis of the region, neighborhood, and property type. This is particularly important in areas of transition or properties subject to changing market forces. Market Analysis lends support to selecting the appropriate capitalization rate for a real estate investment property, forecasting occupancy levels, or to uncover opportunities in a complex marketplace.

Financial Analysis and Real Estate



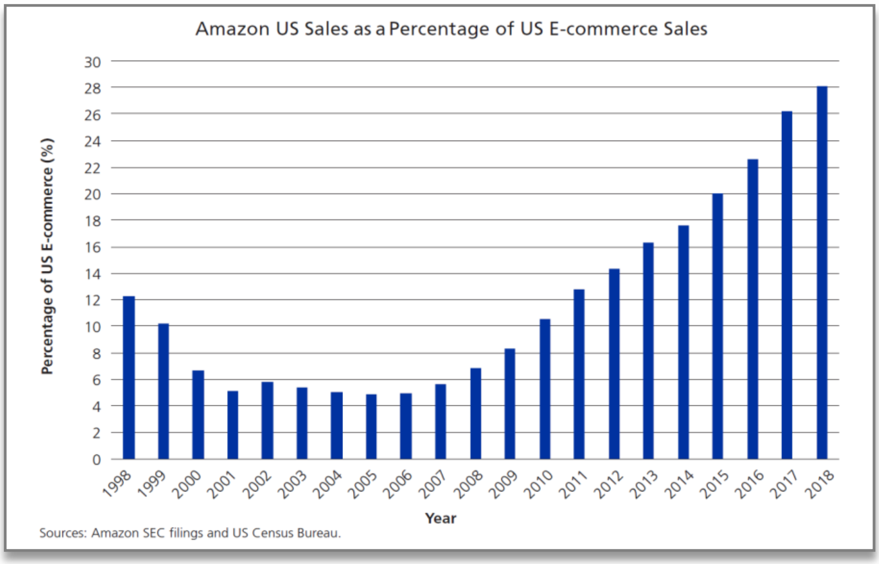
* GAFO—general merchandise, apparel, furniture, and other retail goods.

Sources: *Market Analysis for Real Estate*, 2nd edition (236), US Census Bureau, International Council of Shopping Centers, and CBRE.

Buying patterns for retail goods have changed. The rapid growth of e-commerce, fueled in large part by Amazon's success, has significantly impacted retail business and increased the risk of retail real estate. With on-going store and/or company closures by brands like Kmart, Sears, Payless Shoe Source, Toys "R" Us, Bon-Ton, H.H. Gregg, and others, the central issue is how to predict which retail property will succeed. The answer, though complex, contains just two words: ***Market Analysis***.

Amazon.com, Inc. has grown from a small online book store to a digital retail giant offering most retail products, with sales approaching $200 billion. As shown on the next figure, Amazon's share of U.S. e-commerce grew from 5% in 2006 to 28% in 2018. Seismic changes are occurring in how money is spent; this is having a substantial impact on retail stores for certain goods with the general merchandise, apparel, furniture, and other retail goods group (GAFO) being impacted most. Nearly 25% of the GAFO group is now purchased online. In the age of e-commerce, a thorough and expanded Market Analysis is necessary.

In *"Appraising Retail Properties in the Amazon Jungle", The Appraisal Journal, Fall 2018,* which was co-authored by firm partner Sergio S. Lo Presti, MAI, the authors recommend expanding the traditional Market Analysis to include a Financial Analysis of a retail store's operation. The store's financial health can provide insight into the potential demand for the real estate. An appraiser can analyze financial metrics against industry benchmarks such as Gross Sales per SF; Gross Profit per SF; Net Income/Profit per SF (a.k.a. EBITDA); and Potential Rent as a Percentage of Sales, Profit or Net Income; among others. Our appraisers have the necessary professional experience to conduct this type of Market Analysis for numerous property types. Visit our website to read the full article or [click here](.).



Capitalization Rate Factors

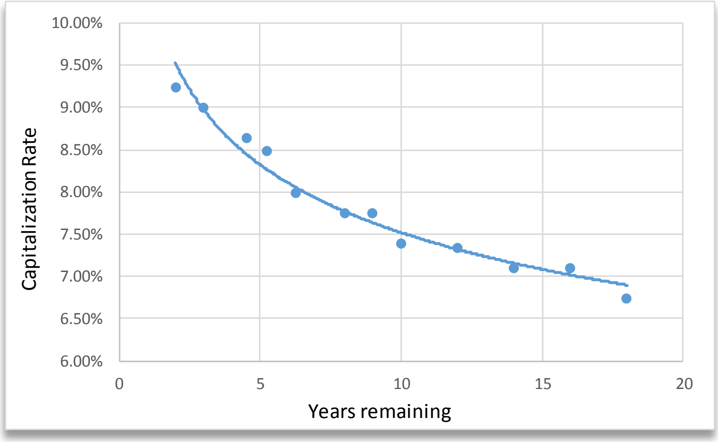
We often receive phone calls from potential clients asking: "What is the appropriate capitalization rate?" It depends. Two primary factors impacting capitalization rates are: 1) tenant quality, and 2) remaining lease term. A good example of tenant quality was uncovered during our recent appraisal of a Rite Aid drug store portfolio. Research of market sales/offerings and a review of national survey data revealed that capitalization rates for Rite Aid varies substantially from Walgreens and CVS due to differences in perceived tenant quality. A recent Net Lease Drug Store Report, published by The Boulder Group, revealed that capitalization rates for Walgreens and CVS, with 15-19 year lease terms remaining, had median asking capitalization rates from 5.7% to 5.8%. Rite Aid, however, indicates much higher capitalization rates with a median asking rate of 7.0%, despite a similar remaining lease term. Application of the low (5.7%) versus high (7.0%) capitalization rate to an assumed $100,000 net income would result in a value difference of approximately $325,000. Put another way, the overall value could be impacted by 20% depending on the appropriate capitalization rate.

MEDIAN ASKING CAP RATE BY TERM REMAINING

Term Remaining	Walgreens	CVS	Rite Aid
20+ Years	5.30%	5.30%	N/A
15-19 Years	5.80%	5.70%	7.00%
10-14 Years	6.15%	6.00%	7.30%
6-9 Years	6.85%	6.60%	7.95%
5 Years & Under	7.25%	7.10%	8.50%

Source: The Boulder Group 3Q 2018 Drug Store Report

In addition to considering the impact of tenant quality, the appraised portfolio of Rite Aid stores had 2 to 3.5 years remaining on their lease terms. Our research revealed that sales with 10-15 year remaining lease terms had capitalization rates in the mid 7% range, sales with 5-10 years remaining had capitalization rates near the mid 8% range, and sales/offerings with lease terms of 1-5 years were sold or offered with capitalization rates in the mid 8% to 9% range. The bulk of short term leased properties indicated capitalization rates near 9%.



Although varying, the correlation between tenant quality and remaining term and the appropriate capitalization rate is present among all property types. So, for a client asking "What is the proper capitalization rate?" the answer remains: it depends.

Hotel Trends and an Appropriate Occupancy Analysis

Since 2010, the U.S. hotel market has seen growing occupancy and Average Daily Rates (ADR). In 2010 the national hotel occupancy level was 54.6% and has steadily increased to 66.2% by 2018. STR and Tourism Economics projects occupancy levels for 2019 to remain flat as growth in demand (+1.9%) will be offset by growth in supply (+1.9%). Furthermore, occupancy is projected to decline in 2020 to 66.1% as the growth in demand (+1.7%) will be offset by growth in supply (+1.9%). This trend is illustrated below.

U.S. Historical Occupancy Trends

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Proj. '19	Proj. '20
Occupancy	62.8%	59.8%	54.6%	57.5%	61.4%	62.3%	64.4%	65.5%	65.5%	65.9%	66.2%	66.2%	66.1%
% Change		**-4.8%**	**-8.7%**	**5.3%**	**6.8%**	**1.5%**	**3.4%**	**1.7%**	**0.0%**	**0.6%**	**0.5%**	**0.0%**	**-0.2%**

Source: Smith Travel Research, various Host Almanac Reports, PwC Hospitality Directions, HNN, & Hospitalitynet.org.

The exuberant trend in hotel occupancy and ADR since 2010 brings to mind the axiom: "Excess profits breed ruinous competition". In fact, many markets are already seeing supply outpace demand. So, how can you tell if your market is oversupplied or when will there be adequate demand for another hotel in your market? At first glance, general occupancy trends may lead you to believe that your market cannot support another hotel; however, a closer review of the appropriate data may indicate that there is adequate demand and a new hotel may be feasible. The following tables will detail part of a recent analysis we completed for an appraisal of a proposed hotel. The first table shows the overall occupancy rate for all hotels in the entire county; the second table illustrates actual room night demand.

Overall occupancy levels have declined at an annual market average rate of -2.3%. At first glance, this could lead some to believe that the hotel market is weakening. Closer analysis of the data, however, showed that Room Night Demand was growing at an average annual rate of 4.1%.

Countywide Hotel Occupancy History				
Year	2014	2015	2016	2017
Market Occupancy	58.2%	59.2%	56.2%	54.2%
% Change Market		1.7%	-5.1%	-3.6%
Annual Market Average % Change (2014 - 17)				**-2.3%**

Historic Market Demand and Occupancy Analysis				
Year	2014	2015	2016	2017
Number of Rooms	2,933	3,000	3,249	3,554
Available Room Nights	1,070,545	1,095,000	1,185,885	1,297,210
Reported Occupancy	58.2%	59.2%	56.2%	54.2%
Market Room Night Demand	623,057	648,240	666,467	703,088
Market Occupancy	73.0%	72.7%	69.0%	64.8%
Room Night Demand Change Rate		4.0%	2.8%	5.5%
Average Annual Room Night Change Rate				**4.1%**

As shown, just looking at hotel occupancy levels may present a distorted view of actual trends. In this example, hotel occupancy levels were on a downward trend only because new hotel supply exceeded new demand levels. Going forward, a slowdown in new hotel construction would reverse overall occupancy level trends with a continuation of growing room night demand. Furthermore, a more focused look at the most similar hotels in the neighborhood of the proposed hotel revealed occupancy levels well above the overall market. For 2017, the most similar comparable hotels were operating at a penetration level of 120% over the overall market (i.e., market occupancy 54.2% vs. most comparable properties at 64.8%).

Comparable Market Occupancy History						
Year	2012	2013	2014	2015	2016	2017
Market Occupancy	75.9%	73.5%	73.0%	72.7%	69.0%	64.8%
% Change Market		-3.2%	-0.7%	-0.4%	-5.1%	-6.1%
Source: Smith Travel Research	**Local Market Average % Change (2012 - 17)**					**-3.1%**

In conclusion, a cursory review of hotel occupancy levels cannot tell the whole story of whether there is adequate demand for a new hotel or a major expansion/renovation. A closer analysis of room night demand, future supply & demand trends, penetration levels, and Average Daily Rates is needed. We have developed these analytical techniques over several decades and hundreds of hotel appraisals.

About Us

Sammartino, Stout & Lo Presti, Inc., Real Estate Appraisers and Consultants, is headquartered in Erie, Pennsylvania. We are committed to providing commercial, retail, industrial, multi-family and special use real estate appraisal and consulting expertise throughout Pennsylvania, Ohio, and New York. We are the only Northwestern Pennsylvania real estate appraisal firm with MAI designated appraisers who regularly service the immediate tri-state market. The MAI designation requires education, training and experience beyond what is required for state certification. As a result, we are able to exceed our clients' expectations in a timely, concise, and reliable manner. Visit our website to learn about our services and market areas.