What's the Deal By Daniel Lesser
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Beware the limitations of hotel cap rates

(The views and opinions expressed in this blog are strictly those of the author.)

A capitalization rate, or cap rate, is a ratio that can be used to estimate the value of income-producing properties. Put simply, a cap rate is the percentage of net operating income (NOI) to property asset value. For example, a US$1.0 million sale price of a property that produces an annual net cash flow of US$90,000 results in a calculated capitalization rate of 9.0% ($90,000/$1,000,000).

A comparatively lower cap rate indicates less risk associated with an investment, while a relatively higher cap rate points toward more risk. Factors considered in assessing risk include creditworthiness of a tenant; term of lease; durability of the income stream; quality and location of the property; capital markets/debt availability; and general volatility of the market.

Use of a cap rate implies a durable and stable income stream, either in place or projected. It is important to note that unlike investors of other types of commercial real estate, such as office and multifamily, sophisticated hotel investors do not typically formulate pricing decisions using a single cap rate applied to one year's NOI, whether actual or anticipated. Given the lack of long-term leases and the unique feature of a continuous re-pricing of the leasing of transient hotel rooms, theoretically lodging assets never stabilize.

Furthermore, while other property types can produce more stable, annuity-type income, hotel investors are typically an optimistic group who seek value-enhancement opportunities. To establish pricing on such prospects, hotel investors primarily rely upon a discounted cash flow (DCF) analysis that factors in a new sponsor's perceived upside during an assumed holding period. In practice, the value conclusion produced by a DCF analysis for a hotel then is used to measure and calculate the implied cap rate or rates, based upon historic actual and/or projected NOI.

While applying a direct cap rate to a prospective hotel investment may be useful for back of the envelope calculations, beware of the limitations produced by this approach. Throughout my career, I have come across terrific lodging investment opportunities priced at 2% cap rates as well as terrible deals available at 10% cap rates.

For example, I have seen low cap rate deals that reflect investment at a fraction of replacement cost indicating potential upside through a successful business plan. Alternatively, I have encountered high cap rate deals that reflect asset value meaningfully greater than replacement cost with substantial downside risk associated with factors such as new supply coming into the market and/or demand generators relocating.

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