

---

# BUYING AND SELLING HOTELS, MOTELS, RESORTS

---

Photo: Fred Marcus



*Daniel H. Lesser is a real estate appraiser and consultant based in New York City who specializes in hotel-motel valuations and feasibility studies. Lesser, a graduate of the Cornell University School of Hotel Administration, also attended the Ecole Hoteliere in Lausanne, Switzerland. Prior to his real estate activities, Lesser held both operational and administrative positions with Eurotels — Switzerland, and Hilton Hotels Corporation.*

---

## Assessing The Value Of A Lodging Property

---

*by Daniel H. Lesser*

---

**W**hen a lodging facility is bought, sold, financed, refinanced, assessed or condemned, a professional appraisal is usually required to provide an estimate of a property's market value.

The appraisal profession typically refers to market value as the highest price in cash, or terms equivalent to cash, a willing buyer would pay and a willing seller would deem appropriate for a property that is exposed in a competitive environment for a reasonable period of time.

The market value of a hotel or motel may include the value of the going concern, including business value, furniture, fixtures and equipment, and occasionally inventories and working capital. Market values are derived by applying valuation concepts and theories, and the opinion of market value is typically communicated in a written appraisal report.

In appraising real estate for market value, the professional appraiser has three approaches from which to select: a) the cost approach, b) the sales comparison approach, and c) the income capitalization approach. While all three valuation procedures are normally given consideration, the inherent strengths of each approach and the nature of the subject prop-

erty must be evaluated in order to determine which will provide supportable estimates of market value. The appraiser is then free to select one or more of the appropriate approaches in arriving at a final value estimate.

### **The Cost Approach**

The cost approach is an estimation of market value developed by computing the current cost of replacing a property and subtracting any depreciation resulting from one or more of the following factors: physical deterioration, functional obsolescence and economic obsolescence. The value of the land, as if vacant and available, is then added to the depreciated value of the improvements to produce a total value estimate.

The cost approach may provide a reliable estimate of value for newly constructed properties; however, as buildings and other forms of improvements increase in age and begin to depreciate, the resultant loss in value becomes increasingly more difficult to accurately quantify.

Knowledgeable buyers of lodging facilities generally base their purchase decisions on economic factors such as forecasted net income and return on investment. Since the cost

approach does not reflect any of these income-related considerations but rather requires a number of highly subjective and unsubstantial depreciation estimates, this approach is usually given very little weight in the hotel valuation process.

### The Sales Comparison Approach

The sales comparison approach estimates the value of a property by comparing it with similar properties recently sold in the open market. To obtain a supportable estimate of value, the sales price of a comparable property must be adjusted to reflect any dissimilarities between it and the subject property.

The sales comparison approach may provide a usable value estimate for simple forms of real estate, such as vacant land and single-family homes, where the properties are homogeneous and adjustments are few in number and relatively simple to compute. However, for larger and more complex investments such as shopping centers, office buildings and hotels, where the adjustments are numerous and more difficult to accurately quantify, the sales comparison approach quickly loses its reliability.

As with the cost approach, hotel investors typically do not employ the sales comparison approach in reaching their final purchase decisions. Various factors such as the lack of timely comparable hostelry data, hundreds of unsupported adjustments, and the general inability to determine the true financial terms and human motivations of comparable transactions usually make the results of the sales comparison approach highly questionable. Occasionally, sales comparison provides a range of values that may bracket and support the income capitalization approach. However, any reliance beyond the establishment of very broad parameters is not normally justified by the quality of data.

The market-derived capitalization rates sometimes utilized by appraisers are also susceptible to the same shortcomings inherent in the sales comparison approach. To substantially reduce the reliability of the income capitalization approach by employing capitalization rates obtained from unsupported market data not only weakens the final estimate of value, but also ignores the normal investment analysis procedures employed by typical hotel purchasers.

Since appraisers are obligated to mirror the actions of the marketplace rather than create hypothetical valuation procedures, generally the sales comparison approach is given very little weight in the hotel appraisal process.

### The Income Capitalization Approach

The income capitalization approach is based on the principle that the value of a property is indicated by the net return to the going concern, or what is also known as the present worth of future benefits. The future benefits from income-producing properties, such as hotels and motels, is the net income before debt service and depreciation, derived from a forecast of income and expense. These future benefits can be converted into an indication of the market value through a capitalization process and discounted cash flow analysis.

The procedures utilized in estimating market value by the income capitalization approach are comparable to those employed by the hotel and motel investors actually comprising the marketplace. For this reason, the income capitalization approach produces the most supportable value estimate, and is generally given the greatest weight in the hotel valuation process.

In simple terms, the income capitalization approach takes the forecasted income before interest and depreciation (as defined by the Uniform System of Accounts for Hotels) and di-

vides it by a percentage rate representing the weighted cost of invested capital. The result of this calculation is the properties value estimate. The beauty of this approach is that most of the data utilized has already been adjusted by market factors, therefore, reducing the unsupported subject content. Let's go through a simplified example:

Assume you are attempting to estimate the value of a 200-room hotel that generates a stabilized net income before interest and depreciation of \$1,000,000. Local lending institutions are offering debt money at the following terms: 12.5 percent interest rate and a 30-year amortization schedule, which yields a .128 debt service constant. Additionally, banks are willing to lend up to 75 percent of market value. The remaining 25 percent represents the equity component of the financing structure. Equity investors for this particular deal require an 11 percent cash-on-cash return. The weighted cost of invested capital produces an overall capitalization rate, which when divided into the subjects stabilized net income, yields an estimate of the property's market value.

#### Weighted Cost of Invested Capital

Mortgage .75 × .128 =	.0960
Equity .25 × .11 =	.0275
Overall Capitalization Rate	.1235

#### Derivation of Value Estimate

$$\frac{\text{Stabilized Net Income}}{\text{Overall Capitalization Rate}} = \frac{1,000,000}{.1235} = \$8,100,000$$

The following proof demonstrates that the forecasted net income is exactly sufficient to pay the required debt service on a \$6,075,000 mortgage and provide an 11 percent cash-on-cash equity dividend on a \$2,025,000 equity investment. The sum of the \$6,075,000 mortgage component and \$11,125,000 equity component results in the \$8,100,000 indicated market value by the income approach.

#### Proof of Value

Value Estimate	\$8,100,000
Mortgage Component (75%)	6,075,000
Equity Component (25%)	2,025,000
Annual Debt Service = \$6,075,000 × .128 =	\$777,600
Net Income to Equity Position:	

Stabilized Net Income before Interest and Depreciation	\$1,000,000
--	-------------

Less: Annual Debt Service	777,600
Net Income to Equity	\$ 222,400

Proof of 11% equity cash-on-cash return:

$$\frac{\text{Net Income to Equity}}{\text{Equity Component}} = \frac{\$ 222,400}{2,025,000} = 11\%$$

While the previous example assumed debt financing with a 12.5 percent interest rate, and a cash-on-cash equity dividend rate of 11 percent, these return requirements are continuously changing. Currently, I am seeing deals structured with mortgage interest rates ranging from 11.5 to 12.25 percent and equity investors requiring cash-on-cash returns of 9 to 13 percent.

The example illustrates the traditional approach for deriving an estimate of market value by dividing a property's stabilized net income by an overall capitalization rate. The overall rate is typically derived via the band of investment, a weighted average of the equity cash-on-cash return and the debt service constant. The relative simplicity of this approach allows an owner to quickly get a feel for a property's value.

**HORI**