Valuing hotels as business entities

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Received (in revised form): 1 October 2001

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Keywords:
hotel valuation, replacement cost, sales comparison, income capitalisation

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Abstract

This paper presents an evaluation of the theoretical context and practical application of different methods of hotel valuation, with particular emphasis on the methods related to the income-generating capacity of a hotel. The findings reveal a wide range of variation and complexity between methods, and that each method has benefits and limitations and requires adjustments and assumptions in different market conditions. However, it is concluded that the more sophisticated 'income-based' income capitalisation methods constitute the most effective basis for a framework on which to derive the open market value for a hotel as an ongoing business entity, but that one or more of the other main valuation approaches should be drawn upon in order to effect the reconciliation of a hotel's final value.

INTRODUCTION

The increase in tourism and business travel in recent decades pre-empted a growth in national and international hotel chains, and latterly the emergence of global chains and hotel brands. The growth has not only occurred in the number of chains, but also in their size, brought about on the one hand by a range of mergers, acquisitions and take-overs and on the other by a combination of franchising, management contracts and joint venture agreements resulting in a significant increase in the choice and diversity of branded hotel products available to the consumer. Examples of this include organisations such as Ladbroke and Hilton, Bass (itself now rebranded as Six Continents), Holiday Inn, and latterly InterContinental Hotels, Forte and Meridien (prior to Granada and Forte), Starwood and Westin and subsequently ITT Sheraton, which itself had relatively recently acquired Ciga and renamed it The Luxury Collection. Holiday Inn, for example, has leveraged its brand by developing Express by Holiday Inn; Sheraton likewise now has Four Points by Sheraton; Courtyard by Marriott is a similar example. In each case the strength of the parent brand adds weight to its lower-priced, more budget-oriented product. The extension of brands enables products to be more closely segmented and focused on the preferences of their target markets. As hotel companies continue their drive for increasing global consolidation, so hotel brands are becoming more available worldwide, thereby improving market awareness and expectations.

These activities have had a twofold effect on the whole area of hotel valuation. First, there has been a significant reallocation of capital in the international hotel industry, thus increasing the demand for reliable valuations to help underwrite the transactions. Secondly, the volume of transactions, together with the complexity of the international environment, has prompted the development of a more industry-related and sophisticated approach to the determination of hotel property valuations.

Historical aspects

Previous investigations of developments in hotel valuation methods are relatively limited — especially in the UK — as the major effort seems to have concentrated on the valuation of properties such as retail, industrial and office premises. Although there are similarities between hotels and other commercial properties in terms of land and buildings, hotels have particular characteristics, such as normally being 'single-use' properties (ie having little or no alternative use), requiring specific management expertise, and with a value that is directly related to their ability to generate future net income.[1]

In the early 1990s, the UK hotel industry was subjected to a number of serious valuation issues — for example, the severely reduced valuation of Queens Moat Houses — which gave rise to considerable debate concerning the underlying methodology of hotel valuations as business entities. This resulted in the publication of a number of guidelines and recommendations, notably from the Royal Institution of Chartered Surveyors (RICS), the British Association of Hospitality Accountants (BAHA) and specialist hospitality valuation firms. However, while superficially their underlying methodologies are broadly similar for the various methods, there is considerable controversy as to the reliability of any single method for general implementation in the practical situation.

Clearly, while the vast majority of hotels continue to be family-run businesses — where profit is often of secondary importance to lifestyle — the focus here is on properties where the primary motive is the maximisation of economic wealth in relation to the generation of future net income (normally defined as earnings before deducting interest and taxes) and shareholder added value.

Thus, the purpose of this paper is to propose a common valuation framework for hotel properties as ongoing business entities. Initially, the definition of 'valuation', 'market value' and 'worth' are considered, followed by an overview of the three broad approaches to valuation. The main methods are subsequently compared and evaluated in a theoretical and practical context in order to move towards an implementable framework.

DEFINITION OF TERMS

The purpose of a valuation is essentially to assess the market value in order to determine a selling price at which a property is expected to change hands on the open market.[2] The market value for hotels

includes four major components, namely the land, buildings, contents, and the business value.[3] However, there is controversy regarding the definition of market value.[4] For instance, it is argued that it is important to be aware of the difference between the 'worth' and the 'market value' of a property. The worth of a property relates to the actual value to the owner, whereas the market value is the estimated selling price the property is likely to obtain if offered on the open market.[5]

Worth and market value

The RICS uses the term 'open market value' as the valuation is made on the open market, defining open market value as: 'An opinion of the best price at which the sale of an interest in the property would have been completed unconditionally for cash consideration on the date of valuation.'[6]

THREE MAIN APPROACHES TO VALUATION

Of the numerous valuation methods available, there appears to be a general consensus that they constitute three main approaches,[7] namely the cost approach, the sales comparison approach and the income capitalisation approach.

Replacement cost

The cost approach essentially emphasises asset replacement, ie rebuilding costs less an allowance for depreciation, and is not concerned with what the market is prepared to pay or the value of future net income that a hotel may be able to generate.[8] In addition, this method does not account for a hotel's value, either in terms of a property or as a business, as it only concentrates on the reproduction costs.[9] Furthermore, Sikich[10] points out that use of the method requires a number of highly subjective and unsustainable depreciation estimates. The method does, however, enable some account to be taken of the potential barriers to entry which might exist in a particular market, such as where new hotel development may be limited through the lack of available or affordable sites and restrictive planning policies of governmental authorities preventing developments in certain areas.

Reproduction costs

Sales comparison

In contrast, the sales comparison approach is concerned with what the market has (recently) been prepared to pay for a similar hotel property, without consideration as to the cost of replacement or future income-generation potential.[11] Rarely are two hotels directly comparable — typically there will be variations in size, quality, market positioning and facilities which render direct comparison more complex. This approach also relies heavily on current market conditions and, therefore, normally requires adjustments in order to compensate for differences between comparable hotels.[12] In cases where numerous adjustments are required, the method is unlikely to give reliable estimates of market value.[13] In Europe, reliable sales data are often difficult to obtain, rendering it necessary for hotel

Current market conditions

valuers to research property transactions exhaustively and to maintain extensive databases of transactions. However, the methodology does indicate the motivations of the real investors who constitute the market and many use this method extensively, together with the underlying information behind recent sales where available, to provide useful benchmarks.

Income capitalisation

Wealth generating capacity

The income capitalisation approach goes beyond the relative simplicity of the cost and the sales comparison approaches by attempting to relate the wealth-generating capacity of the hotel to its value.[14] This approach, therefore, includes procedures comparable to those employed by the hotel investors who constitute the market-place[15] and is generally considered to be the most appropriate for the determination of hotel valuations.[16] However, Sikich[17] adds that if a new hotel is required to be valued, the cost approach may be appropriate as the valuation cannot be based on methods relying upon the historic performance of the hotel.

INCOME CAPITALISATION METHODS

As referred to earlier, the income capitalisation approach includes numerous different valuation methods. The four main methods are the single capitalisation rate methodology (SCR), discounted cashflow analysis (DCF), simultaneous valuation formula (SVF) and band of investment method (BIM).

Single capitalisation rate

One year's net income

The SCR methodology is determined by using one year's net income and dividing it by the 'capitalisation rate' (income multiplier).[18] The capitalisation rate is based on the market, ie the capitalisation rate of a hotel that has recently been sold.[19] When using the capitalisation rate from recent hotel transactions it is important to note that different years' net incomes can be used. Some calculations may use the first year's forecast, others the previous year, the previous rolling 12 months or the forecast stabilised year's net incomes, each resulting in different capitalisation rates. For example, a price may easily reflect a capitalisation rate of five per cent on the previous year's net income, but nine per cent on the forecast first year's net income.[20] In addition to this, the heterogeneous nature of hotels has to be taken into consideration in order to make appropriate adjustments for differences in age, use, location and occupancy level.[21]

Discounted cashflow

Multi-year income projections

While the SCR method is mainly based on present performance with little or no regard to the future generation of net income (except in the determination of the capitalisation rate) and taking no account of the time value of money, the DCF analysis is calculated by using a number of estimated future net incomes. This method is calculated

on an unleveraged basis and normally uses a ten-year projection of net income and a terminal or residual value (to account for the future net income into perpetuity) that are discounted back, using an overall discount rate, to a net present value. As the DCF analysis considers the future generation of income, it accounts for the envisaged profitability of the investment, which is of considerable interest to the investor, especially if this is likely to change significantly between years. However, this method tends to ignore the current property market conditions as it purely concentrates on the future generation of net income,[22] albeit that the selection of the discount rate should reflect risk and the cost of borrowing.

Simultaneous valuation formula

The SVF method is similar in principle to the DCF analysis approach — both capitalising a multi-year net income stream into the assessed market value. However, the major difference between the two methods is that the SVF discounts through a mortgage-equity technique which takes into account factors such as interest rate, amortisation term and loan-to-value ratio, instead of using a common discounting procedure to present value to estimate the market value.[23] As both of these methods tend to concentrate on the generation of future income, they can be termed 'income-based' methods. Furthermore, the SVF method emphasises the market, and can therefore also be referred to as a 'market-derived' method.

Band of investment method

The fourth method, BIM, is essentially concerned with the weighted average cost of capital and a single year's stabilised net income.[24] The single year's stabilised income can be defined as the '. . . stabilised level of income that would remain constant and extend over the economic life of the property'.[25]

EVALUATION OF THE METHODS

Volatility of market conditions

Which method to reflect the market

From the SCR perspective the '. . . capitalisation rates and income multipliers come directly from market indications of the relationship between income and value'.[26] Thus, by applying the capitalisation rate of recent transactions from comparable hotels this method not only reflects market conditions, but in effect also provides an indication of the volatility of the hotel industry investment cycle.[27] Despite this, the BAHA[28] argues that valuations do not need to be based on comparable data, but suggests that hotels should be valued in isolation using the DCF analysis method. The RICS[29] response is that the DCF analysis is not suitable '. . . in isolation for use in estimation of the price or value in the market-place . . .' as the method does not consider market conditions within the hotel sector and will therefore estimate the worth to the owner rather than a market value.

Practical issues

A major criticism levelled against the SCR method is the practical difficulties of finding comparable properties.[30] The less comparable the properties, the more adjustments for dissimilarities in use, age, location and occupancy level will be required, which will limit the SCR method's credibility.[31] The criticisms are reinforced by Sayce,[32] who points out that '. . . it is difficult to find theoretical support for a process which uses market evidence and interprets it on such an *ad hoc* basis'. Additional to this, there is no index relating to hotel transactions and valuations, similar to that which is available in the USA, currently available in the UK.[33] If a similar index were available, it would strengthen the credibility of the SCR method by facilitating the comparison of different transactions in order to find a comparable hotel to use for determining the capitalisation rate. Sayce[34] adds that another problem associated with the accessibility to transaction and valuation data is that many view this information as confidential, making it difficult to obtain. Market evidence collated by sales agents active in hotel sales provides a helpful indication of investor appetite and buyer motivations, however. Accetta[35] reflects on these negative issues and claims they make the SCR method inappropriate for determining the market value, and goes on to suggest the DCF analysis as a more reliable valuation method.

Past and future considerations

Future market changes

The hotel industry is highly cyclical, and hotel profits and values rise and fall rapidly as occupancies and room rates move up and down.[36] It is therefore important to consider future market changes in the valuation process, as these can have a significant impact on hotel values. If, for example, there is a major decline or increase in the national economy, this will have an effect on future demand and thus affect the value.[37] Mellen and Castro[38] suggest that methods, including multi-year forecasts, such as the DCF analysis and the SVF, accurately reflect future market changes. Additionally, Menorca[39] claims that income capitalisation approaches based mainly on past performance, such as the SCR method and the BIM, will not give a proper market value if there are major changes in the market. This theme is echoed by Willison,[40] who recommends the use of the DCF analysis and the SVF mainly during unstable conditions, as both these methods consider changes in the market, and using the SCR method only during stable conditions. This method does require a careful and knowledgeable analysis of the hotel's future projections, incorporating appropriate sensitivity analysis, before concluding upon them.

The cyclical nature of the industry makes it difficult to make future forecasts regarding revenue and expenses.[41] Furthermore, future changes in the market tend to affect hotels more immediately than other commercial real estate, as rooms sales take place on a daily basis compared to leasing out space for several years at a

time.[42] Some authors[43] contend that practitioners need a high level of expertise and knowledge of the property being valued, its market and the hospitality industry, otherwise the assumptions regarding future forecasts can result in significantly incorrect valuations.

Uncertainty of forecasted incomes

Methods based on multi-year forecasts may seem appropriate in theory, as they consider future market changes, but it is important that practitioners recognise the uncertainty of forecast incomes.[44] Many experts[45] emphasise that even one year ahead is uncertain in forecasting terms, and that it is yet more uncertain to forecast a number of years as required for the DCF analysis and SVF — thus, as the SCR method and the BIM are based mainly on past performance they are less uncertain.[46] However, Sayce's[47] response to this is that, as hotel investors are interested in future profits not past performance, valuations based on the SCR and BIM methods are less accurate. According to Mellen and Castro,[48] attempts to utilise a multi-year forecast for the BIM have been employed by valuers to make this method more accurate, but they go on to point out that '. . . once cashflows are forecast over a multi-year period the effect of compounding upon the required rates of return to the debt and equity components renders this methodology inappropriate'. Consequently, the need for a method able to use a mortgage-equity component in the capitalisation of a variable multi-year forecast arose, resulting in the development of the SVF.[49]

Residual value

Significance of residual value

The residual value is the value that a property is most likely to have by the end of a projected period.[50] In DCF analysis, the residual value is based on the projected final year's net income divided by the terminal capitalisation rate.[51] The BAHA[52] recommends DCF analysis as the most useful method of valuation, one of the reasons being that this method includes the residual value. The residual value is also included in the SVF and, according to Martin,[53] this makes these methods beneficial to the investor as residual value adds value to the investment — although the BAHA[54] argues that the residual value is not a very important component of the estimated market value. The RICS[55] responds to this by stating that in some valuations the residual value accounts for as much as 50 per cent of the estimated market value. The difficulty here is that the residual value may account for a significant proportion of the estimated market value, but it is based on an uncertain (distant) ultimate year's net income estimate. Therefore, techniques which are employed to reduce the risk of error in determining the long-term earnings potential of the hotel are important in deriving the residual value.

Weighted cost of capital

The main motive for investing in the hotel industry is the return on investment.[56] The mortgage-equity element recognises that many

investors in the hotel industry purchase hotels with a relatively small amount of cash and a larger amount of mortgage financing. Consideration of this element gives weight to the amount and terms of available mortgage financing and to the required rate of return to attract adequate equity capital.[57] Both the BIM and the SVF consider the weighted cost of capital, and therefore meet the interest of a hotel buyer.[58] Determining the discount rate within the DCF method should also take into account the weighted cost of capital and so-called 'market forces'.

Ease of calculation

The BIM, SCR and DCF methods are relatively simple to describe and compute, while the SVF is a more complex method which includes a large number of variables.[59] Several authors[60] emphasise that using complex valuation methods requires a high level of knowledge and expertise to ensure that all reasonable variables form relatively accurate estimates, as even the smallest misjudgments can result in erroneous value conclusions.

Calculation implications

In the past the recommendation for valuation methods was that they should be easy to use; however, in today's complex environment there is a trend towards more sophisticated methods.[61] Some 15 years ago, Jaffe[62] determined that the development of computer technology would have a great impact on valuation methods and make complex valuation methods easier to use. In addition, Sayce[63] stresses that valuers cannot claim that valuation methods are too complex, as they have been computer literate for a long time and, furthermore, instructions on complex valuation methods have been included in their education for several years. Other experts[64] point out that valuers, in addition to having knowledge of how to use the methods, have to support all input assumptions fully, as small misjudgments may give erroneous value conclusions. Each of the methods discussed above requires several adjustments, and this makes the valuation process very subjective.[65] Valuation methods that use fewer variables and do not require many assumptions should, perhaps, be preferred, but these are relatively unsophisticated and not used alone by practising hotel investors and funders, except for hotels that are accepted as trading under stable market conditions. However, they do provide what can be described as a 'quick and dirty' guide to the hotel's value and are used to benchmark the final result. However, as the DCF and SVF methods include a large number of variables, it can be concluded that these valuations should be viewed more critically to ensure the validity of the underlying assumptions used in arriving at each step.

CONCLUSIONS

Developing a valuation framework

As the foregoing discussion has indicated, the comparison of hotel valuation methods reveals a wide range of variations across the different approaches. The income capitalisation methods take into

account the nature of hotel properties and, at first sight the simple SCR and BIM methods would appear to be the most straightforward to use and convincing when determining the income capitalisation value of a hotel. However, their overall lack of sophistication has resulted in them being used as little more than rules of thumb in today's market-place, except when valuing hotels in what are acknowledged to be stable markets.

In contrast, the DCF method and its more sophisticated counterpart, the SVF method — with its inclusion of a wide range of variables — offer a more robust result. This said, the SVF method presents valuers with a considerable challenge, as marginal misjudgments in one or more of the many assumptions required to be made can have a disproportionate impact on the analysis and lay the method open to potentially unrealistic valuations. However, while from a theoretical viewpoint the complexity of such 'income-based' income capitalisation methods mitigates against their application in the practical situation, their comprehensive inclusion of financial and market factors provides a more rigorous and rounded basis on which to determine valuations. This inclusion, together with significant knowledge and understanding of current hotel market conditions — and the resources to undertake extensive research and analysis of a hotel's particular competitive market and future trading prospects — provide a compelling basis on which to develop a valuation framework for hotels as business entities.

Reconciling market values

The final element in the valuation process is the reconciliation of the values indicated by the three methods: sales comparison, replacement cost and income capitalisation. While practising hotel valuers and many international hotel investors and financiers appear to place greater emphasis on the income-based income capitalisation methods derived through the DCF or SVF process, they normally take one or both of the other methods into account, especially in a more volatile or changing market. This enables the open market value of a hotel to be derived in a way that places the primary weight on the capitalisation of future net income, while recognising the effects of the market through real transaction evidence and ensuring that the costs of developing a hotel of equal utility are not out of balance.

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