Israel IVS Forum

The Israel IVS Forum is separate to the IVSC and works to advance IVS in Israel.

This paper is not a publication of the IVSC.

International Views and Approaches

Capital and Rental Valuation of Hotels

April 2021

Robert Chess

Hotels have been one of the asset classes most damaged by the coronavirus pandemic. Assets such as hotels and shopping centres, which have witnessed a steep decline in revenues, be they permanent or temporary, illustrate the need for DCF valuations, for only DCFs have the necessary flexibilities needed to value abrupt changes to income. Like in many other aspects, the coronavirus pandemic had amplified trends that were already ongoing. In the case of valuations, academics had for decades been encouraging practitioners to fully embrace DCF. Those who find such changes to entrenched practice challenging, should note that Direct Capitalisation is itself a special case of DCF.

In the hospitality sector it had been customary for decades to employ DCF, therefore apart from an interest in the valuation of hotels, which should only be undertaken with specialist skills, we are able to learn from hotel valuations about the application of DCFs in general. Therefore we are delighted that Robert Chess, a notable practitioner and talented writer has agreed to write especially for the Israel IVS Forum this introductory paper on the subject.

ROBERT CHESS

Robert Chess has extensive experience of valuations and landlord and tenant matters in the hospitality industry. He has been actively engaged in corporate real estate business for the hospitality sector for over 30 years.

Following employment at the Imperial Group and Grand Metropolitan Robert moved into private practice where he has held senior positions at a number of firms.

Robert is now a Partner at Gerald Eve with responsibility for hotel valuations. He also has his own independent consultancy advising clients directly through his firm, Chess Associates.

Robert's involvement in the sector has seen him deal with hotel property across the UK, many European countries and as far afield as Hong Kong. He is also a member of the RICS President's panel of Arbitrators dealing with complex rental disputes. Robert has acted as an Expert Witness on a number of occasions and is often called upon to speak at conferences and to lecture in his specialisms.

He has been involved in numerous high profile single asset and portfolio valuations and has been engaged in a number of arbitrations both as Expert and Arbitrator.

Robert attained a BSc (Hons) degree in Urban Estate Surveying, is a registered valuer and Fellow of the Royal Institution of Chartered Surveyors (FRICS).

INTRODUCTION

Hotels generally fall into that category of properties referred to as trade related properties. These are properties where value arises from the existing and prospective ability of trade and thereby profit being generated. This type of property will be bought and sold for the purpose of trading profit rather than rent.

RICS guidance on the valuation of such properties can be found in the RICS Valuation Standards (Red Book).

This document represents a brief summary of the methods employed by a practicing Chartered Surveyor engaged daily in the valuation of hotels for various capital and rental purposes. In undertaking such valuation exercises, the intention of the valuer is to mimic the typical activity of the hypothetical purchaser (or lessee) in considering how to assess what to pay in capital or rental terms for the benefit of owning or leasing the property. As a result the valuation will include the property, the trading inventory (or cost of installing such inventory) and the business potential.

This is not a comprehensive practical guide to hotel valuations which would need to include advice on numerous issues and be significantly longer. It is rather an outline of the technical method with key guidance points. The value of a hotel will have regard to standard property issues such as location, configuration, size, etc. As will be seen however judgement on these factors is sublimated into the profits assessment which is a function of all of the physical and other relevant factors, such judgement on profit is combined with appropriate yield selection to form the valuation.

CAPITAL VALUATIONS

From the comments contained in the introduction it is clear that the principal method to value a hotel is one which is referred to as the "profits method". Such approach requires an assessment of what a reasonable expectation is of the potential profitability of the hotel (frequently referred to as the Reasonably Efficient Operator assessment) and then consideration of what would be paid for the benefit of such profit.

Profits based valuations are not an alternative to valuations based upon the analysis of comparable evidence. It is the analysis of comparables and market activity which informs the variables which will ultimately populate the profits valuation spreadsheet. Whether that comparable analysis is used to inform decisions about potential trade and profit or yields, it is nevertheless key to forming valuation opinions.

As potential future profit is not a fixed amount, in the way that rent may be and is likely to vary year to year the preferred profits approach to valuation is by way of constructing a Discounted Cash Flow (DCF) valuation. DCF is a recommended way of valuing variable income and is ideally suited to hotel valuation as a result.

In order to form a view as to the potential profitability of a hotel the valuer will need to consider a number of matters in addition to the usual physical matters. These will include:

- Historic trading information
- Assessment of the quality of existing brand and management
- Business demand drivers - existing and proposed
- Competition - existing and proposed
- Competitor performance

- Condition of the asset.

In order to perform the valuation the valuer will make an informed judgement as to the potential profit that the hotel will achieve. The RICS advises that valuers should be suitably experienced for the task undertaken and so an experienced hotel valuer will have knowledge of hotel performance figures from the numerous hotels previously dealt with. Such information may well be confidential but will inform the valuers judgement. There are a number of data collection agencies from whom data sets of hotel performance can be commissioned. Typically such data sample will be consolidated across five or six properties and so average performance can be seen from a selected data set. The data set selected should be similar to the subject property in terms of location, size and trade characteristics.

An inspection and management interview will need to be undertaken and is important in help in assessing the sustainability or otherwise of the historic accounting information.

From all these sources the valuer will conclude as to the reasonable market expectation of the immediate future trading profile of the hotel, along with any relevant changes required to the hotel to achieve such trade. These changes may include capital expenditure to refurbish or rebrand, or the need for new management. The valuer may conclude that the historic trading levels are unsustainably high (or low) and that the DCF needs to reflect this in some way.

In most instances the valuer will construct detailed trading forecasts for the subject property to the point at which it reaches what is regarded as a "stabilised" trading level. This may be typically two to three years and any period after that in the DCF is subject to changes by inflation only.

Analysis and presentation of hotel accounts is assisted by the near universal adoption in the hotel industry of the Uniform System of Accounting for the Lodging Industry (USALI). Such consistency enables comparison across properties of not just the key performance indicators for revenue but also the costs of running the business.

A typical layout for hotel accounts would fall to be shown by way of the following layout headings:

Keys Available
Keys Occupied
Occupancy
Average Daily Rate
RevPAR
REVENUES
Rooms
Food & Beverage
Other
Minor Operated Departments
Total Revenue
DEPARTMENTAL COSTS
Rooms
Food & Beverage
Other
Minor Operated Departments
Total Departmental Costs
DEPARTMENTAL PROFIT
Rooms
Food & Beverage
Other
Minor Operated Departments
Gross Operating Income
UNDISTRIBUTED EXPENSES
Administration & General
Marketing
Repairs & Maintenance

Utilities
Base Management Fee
Franchise Fee
Total Undistributed Expenses
Gross Operating Profit
FIXED CHARGES
Incentive Management Fee
Property Tax
Property Insurance
FF&E Reserve
Total Fixed Charges
Net Operating Income (EBITDA)

Detailed forecasts embracing all of the above variables will be undertaken by the valuer. Whilst most of the above headings are self explanatory it is worth making reference to a number for the purpose of clarity.

Keys Available: this is the number of rooms in the hotel

Average Daily Rate (ADR): Hotel rates fluctuate daily and depend on a range of drivers including night of the week, seasonality, local events, etc. The ADR is the average rate achieved (or forecast) across the entire year. This is net of VAT and other local taxes.

RevPAR: Revenue per available room. This is the combination of occupancy and ADR and is a very important figure for a hotel. Occupancy can be «sacrificed» for higher rate or alternatively may potentially be driven higher with rate cutting. The skill of the hotelier is to deliver the most profitable combination of rate and occupancy and the valuer must make an assessment of what the market would expect.

FF&E Reserve: this is a «notional» allowance (sinking fund) to build up a reserve over time to repair and renew the fixtures, fittings and equipment. Such cash reserve, if it exists, may be transferred to a purchaser and a valuer needs to be aware of this.

EBITDA: earnings before interest tax depreciation and amortisation. This is the level of the profit which is valued and excludes tax and others matters which are personal to the owning entity, incorporation of such items would prevent like for like comparison across different properties. This is often also referred to as Adjusted Net Operating Income.

Consideration needs to be given by the valuer to the style of operation of the hotel. As can be seen from the typical accounts format shown above the cost of operating each revenue stream is dealt with and the mix of revenue can heavily influence the overall profitability of the hotel. For instance, if a hotel derives the majority of its revenue from room sales then it is likely to be more profitable than one which has significant food and beverage sales as the costs involved in operating a restaurant tend to be materially higher.

Once having prepared the trading forecasts they are entered into a DCF programme. I set out below a simplified DCF valuation.

Year		1	2	3	4	5	Exit
Revenue		6,083	6,205	6,329	6,455	6,584	
EBITDA		1,786	1,822	1,858	1,895	1,933	
Adjustments		0	0	0	0	0	
Adjusted EBITDA		1786	1822	1858	1895	1933	
CAPEX		100	0	0	0	0	
Net «Cash flow«		1,686	1,822	1,858	1,895	1,933	
Discount Rate 9%							
PV Cash Flow (A)		1,547	1,534	1,435	1,342	1,256	**7,114**

Year		1	2	3	4	5	Exit
VALUATION		Year 5 “cash”	1,933			**ANALYSIS**	
Exit Yield	7%	Yield	7%			Value	
Discount Rate	9%	Discount Factor	9%			Value/ room	
			B			NIY	
Valuation	**A + B**					IRR	

The illustration above is a DCF running for five years with an assumed “exit” at the end of the fifth year. It is customary in the sector to use a ten year DCF but the above is illustrative of the working mechanics. It is also worth noting that if income growth between years 5 and 10 is inflationary only then the valuation output will be identical as the discount rate will remove inflation growth in the calculation.

What can be seen is that the valuation comprises the sum of the present value of the cash flow period (A) plus the present value of profit at the assumed exit year capitalised by the exit yield (B). The resultant valuation can be analysed by considering the net initial yield, net reversionary yield, IRR (internal rate of return) and value per room. All of these are useful comparators when considering the market evidence.

The exit yield is derived from market analysis of transactions and the discount rate is assessed by adding inflation to the exit yield. Many valuers will also consider the addition of a “risk premium” to the discount rate to reflect the perceived risk of achieving the forecasts. The weighted cost of capital can also be considered when constructing the discount rate, but whatever method is chosen a consistent approach is required to the valuation and analysis of the comparable transaction evidence.

It can be seen that the DCF provides flexibility to make judgements about future cash flow, and associated risk profiles, which can incorporate not only changing profits from investment but also external matters such as expected major events which could generate business.

Other factors which the valuer may need to consider in assessing hotel value may include, for instance the presence of a Management Agreement. Such agreements can be for extended periods and may not be terminable upon a sale or have a substantial breakage fee. If that is the case then the valuation will need to consider the valuation «encumbered» by the terms of the agreement.

Franchise agreements are also common in the sector. Such agreements although relating to property are between the franchisor and franchisee and the valuation would normally consider the property to be unencumbered even if terminating such agreement upon sale reduces the net proceeds to the seller. It may not have any impact on the valuation whether the hypothetical purchaser could or would wish to take advantage of seeking to continue with the same, or alternative franchise.

Often in the hotels sector market valuations are commissioned requiring the valuer to make «Special Assumptions». A common special assumption for a new hotel development would be to assume that the hotel has reached trading stabilisation and this advice can be given in present day or future values. A valuer needs to have sufficient experience when considering requests for valuations subject to special assumptions to know how to deal with a special assumption request that may ask for a valuation assuming a certain level of trade has been achieved.

If offering valuation advice for loan security purposes one may be asked to value on certain «default type» special assumptions such as assuming a restricted marketing period or assuming the hotel is closed and that accounts may not be available. In these circumstances the DCF can be amended have regard to a perhaps a new build up period for the business if it is assumed to be closed or a revision to the yield to have regard to a restricted marketing period.

It can be seen that DCF calculations are very helpful when dealing with special assumptions due to the inherent flexibility that they offer.

RENTAL VALUATIONS

The technical approach to rental valuation is very similar to capital valuations. The valuer will make a decision as to what the stabilised year business would be at the date of rental valuation. To arrive at the market rental value a number of deductions from the EBITDA are made and these are as follows:

- An allowance for inventory. In most cases the lessee of the hotel will be the owner of the inventory and so in order that the rent excludes these items the capital value of the inventory is assessed and a simple % return on that figure is deducted from profit.

- Working Capital. Typically two weeks revenue other than room revenue is also deducted as a tenant's allowance. This can vary materially dependent on the operational style of the hotel.

- Improvements. If there are tenant's improvements to disregard one way of reaching a rental valuation is by making an amortised allowance of the cost of the improvements against the calculated profit. Another way to disregard tenant's improvements would be to build up a trading profile which is of the unimproved property.

The derived profit figure after the tenant's allowances is referred to as the "divisible balance" in other words the balance from which the hypothetical market of potential tenants will bid a rent for the property. The amount of tenant's bid will depend upon the terms of the lease as well as other supply and demand factors and is usually expressed as a percentage bid. The range of bids will vary across markets, hotel types and lease terms but would usually fall within a range of 50% to 75% of the divisible balance. 75% being typically the top of the range for the most desirable of hotels in a key location.

Once again market analysis provides comparable rental evidence which is often compared on a rent per room pa basis.

With very homogenous hotel product such as that which exists in the branded budget sector then some valuers will rely heavily on the comparison on a rate per room pa basis as the revenue mix across and between the comparable evidence is very similar reducing the variability of the analysis. Nevertheless, this is generally regarded as a secondary method of valuation.

If valuing a property subject to lease where the use is as a hotel then the rent can be valued using the "normal" investment approach. The valuer needs to be aware of the possible value in the reversionary interest of the hotel with vacant possession as this may indicate value greater than an assumption of reversion to simple open market rental value.

SUMMARY

Any valuation advice should comply with the requirements of the RICS Valuation Standards (red Book).

Valuing hotels requires specialist knowledge and detailed understanding of the operational business of the hotel. Care needs to be taken in regard to understanding whether the property has appropriate licences to operate as well as the usual planning consents. Small matters such as whether the inventory is owned and can be transferred upon a sale can be a trip hazard to watch out for.

Valuing hotels is made much easier with a full disclosure of information and a full understanding of the market in which the hotel operates.

The Israel IVS Forum is an association of senior property professionals and stakeholders in Israel. Our aims are to advance adoption of International Valuation Standards (IVS) in Israel and to disseminate international best practice within the Israeli profession. We hold regular webinars and publish international best practice papers in both English and Hebrew. Please visit our website at www.ivsforum.org