HOTELS AND MOTELS: A SHORT EXCURSION INTO THE GNARLY QUESTIONS OF HOW TO VALUE

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DEFINING TYPES OF FACILITIES, LOCATIONS, AND NATIONAL TRENDS

There are numerous categories of hotels and motels with or without franchises. They include Luxury Full Service including conventions or resorts, Mid Level Limited and Full Service and Economy Limited. Each category further complicates itself by location which includes Transient Highway and Airport, Interstate Interchange, and Destination Downtowns, Suburban Commercial, Business Parks, Industrial or Medical Centers and Resorts on the water, in the desert and usually including a golf course. From 500 rooms at a casino in Las Vegas to a Mom and Pop with 32 rooms in northern Michigan on a rural highway, the room rate (and quality) of lodging can run from $35 per night to several thousand per night.

As an appraiser, pegging your property category comes quickly with an inspection, an interview with the manager, obtained operating data for three years as well as information on franchises, contracts, and leases. And rating the functionality of the facility is almost second nature in terms of access, corridors, layout, central access to the lobby and services, elevators and the mechanicals, and whether or not the décor is dated and musty.

Back in the office, and tagging competitive facilities in the same market establishes room rates, occupancy, and the quality of competition and in the end an understanding of the market share for the subject. Ranking the subject with its competition also makes it easier to understand the actual performance of the subject over the recent past while looking to the near future “stabilized” or for an “as is” value.

General trends nationally and regionally also provide insight into the local market. This includes the business cycle and cap rates by type of facility. Luxury properties and resorts enjoy a lower rate and the limited service economy properties with higher risk and more volatility exhibit a higher cap rate and higher equity yields. The same may be said for NOI per available room. (In this respect, resorts earn the highest NOI with limited economies earning the least.) Finally, in view of national trends, your analysis of the recent financial history of the subject and its Revenue Per Available Room along with your observation of management skills, staffing and a franchise, if any, you are prepared to judge the local market for your subject with its operating data and with your comparables.

VALUATION TECHNIQUES

The question of Highest and Best Use gets answered in the research process. But often the details of each approach to value may have to be considered first. For example, although sometimes obvious, does land value likely exceed the income value of the property? Or “as is” does the income of the property support an appropriate return to the assets, first to the land, second to the improvements, third to the chattels? And finally, is there any income to allow for good will, or the intangible character of the enterprise? Indeed, does “in transition” apply to the current operation only in support of a holding period because there is no income to the enterprise? Answering these questions typically requires research from all three approaches to value.

The Cost Approach

For hotels and motels many appraisers avoid using the cost approach. With existing properties they claim difficulty with depreciation or a weakness in the economy. And yet if properly done at inspection, the depreciation of the subject for its age and wear and tear as well as any functional depreciation from age or economic obsolescence from a poor market should be understood in the appraisal process for understanding highest and best use as well as other issues.

In fact, the Cost Approach is important to properly establish excess earnings, if any, to the enterprise or good will. To claim a value for the good will straight from the NOI, as is often done in tax appeals, is misleading. Before any return to the entrepreneur’s intangible asset may be applied, there must first be established from the net operating income a return to the land, then a return “on and of” the depreciated improvements, and also a return “on and of” the depreciated furnishings, fixtures, and equipment, and then, *and only then*, may the remaining unclaimed income to the property be capitalized at a rate to indicate the value of the good will. Only the “excess earnings” to a property can be claimed and capitalized to the enterprise or good will. Simply said, it seems contrary to common sense to value good will with a trickle-down theory in the face of the Theory of Rent established in the economics of capitalism by David Ricardo.

The Market Approach

For the Market Approach the principal of substitution also applies. An informed purchaser will pay no more for the subject than the cost of acquiring another existing property with the same utility. Granted, comparisons amongst similar sold properties typically require adjustments. Although some effort may be necessary to adjust for differences, and despite some weaknesses, the range of value indications is useful when checking the income approach. How else can one be sure the income approach falls within the realm of reality? And alternatively, the Gross Income Multiplier, another reasonable measure of comparison, is a buyer’s rule of thumb tool that readily compensates for the many variables in similar properties. Without a doubt, despite some difficulties, the Market Approach is an important leg in the triad of valuation. At the least, it establishes a check and balance and reinforces the credibility of a value conclusion.

The Income Approach

Investors and bankers most often rely upon the Income Approach in buying or financing hotels and motels. They rely upon the appraiser's estimate of the anticipated future benefits of income and the capitalized benefits in dollars as a value. This involves direct capitalization of actual or market adjusted income or a projection of income years into the future discounted to a present worth (DCF).

But how does one segregate the income stream for valuing the components of the total asset value? By first taking a percentage of the income stream for FF& E and then for the Enterprise and then leaving the remainder for the real estate is nothing more than a self-fulfilling prophesy for the given that management never fails to maximize the assets, a major assumption in the income approach. In such cases, the real estate may be significantly undervalued with an overvalued underperforming performing enterprise. Properly allocating the income stream requires consideration of depreciated cost. Any buyer would consider obsolete décor and furnishings, and less than competent management or poor franchise agreements of much less value relative to the core potential of the real estate.

For management, typically 3%-4% of the gross income is allocated to the enterprise. With excess earnings available, this is appropriate. But if management fails to maximize the return to the assets, how can there be any good will or excess earnings to attach as an intangible? This can only be determined if the hard assets of the property are receiving their proper share of the net operating income before any residual is applied to the enterprise component. Estimating the hard asset component values, a standard method of allocating fair value for book keeping purposes, can readily and reasonably be determined in the Cost Approach without the use of magic wands and unsupported percentages.

Also a DCF is often presented as a seven to ten year projection based upon typical holding periods. This method, used with caution and supporting projections, is a viable method to value, but it does not necessarily improve upon how to determine the intangible component except as is often done with percentages of gross income subtracted from the NOI and then separately capitalized. Since DCF's require the use of assumptions into the future which may prove speculative, i.e. some DCF models do not or cannot account for business cycles and often project beyond the life of a current trend, then Direct Capitalization of Actual Cash Flow for an "As Is" and/or a discounted value at Stabilization can be offered as less Speculative in a down or recovering economy.

CONCLUSION

The old days of appraising with sale price per room just will not work. The complexity of the lodging industry offers ever different challenges from year to year. With cyclical trends nationally and regionally, combined with a local market, competition, efficient or inefficient management, along with various special features, and then absorbing everything to form a judgment of value for a motel or hotel remains difficult, but rewarding. In the end, this short excursion into the realm of valuing hotels and motels pleads the case for appraising with the three approaches to value, as too much reliance on just one approach can only lead to the torpedoes of worthless assumptions sinking ships.

About the Author

Dr. Lawrence J. Golicz, PhD, MAI, ASA is currently acting as an independent valuation consultant, and appraising for over forty years, Dr. Golicz has specialized in atypical and complicated property appraisals. He has had experience with all types of real estate, has performed mass appraisals of whole communities, appraised tangible property of all kinds, including machinery and equipment, and provided valuations dependent upon special purpose improvements, including sewage treatment plants, licensed land-fills, scrap metal processing, recycling facilities, power plants, refineries for gasoline and recycled oil, a whey plant, and breweries. For extensive complex properties he has participated in the appraisal of the General Motors Technical Center and the Chrysler Technical Center. Also acting as a Special Magistrate for Tax Appeals, Dr. Golicz has provided expert testimony in federal and circuit courts in bankruptcy and foreclosure as well as before the Michigan Tax Tribunal. He can be reached for further contact by email at lgolicz@tampabay.rr.com.