Hotel Valuation

HOTEL PARTNERS
AFRICA

How a Hotel Valuation is Undertaken and What a Bank Really Needs from a Valuation

This summary paper outlines what is involved in a hotel valuation, and how it can be useful, as well as what Banks and other financial institutions should look out for when reviewing a valuation report. It is not meant to be a definitive guide. For those readers looking for more information please either contact me directly with any questions, or read the more detailed "Valuation of Hotels for Investors[1]", which provides a much fuller explanation of the hotel valuation process.

What is a Valuation?

It is amazing how often you hear the word "valuation" mentioned and yet there is not one single definition of what a valuation is. According to the Oxford English Dictionary it is "an estimation of the worth of something, especially one carried out by a professional valuer"; this seems to provide the general consensus of what a valuation is – an estimation of the monetary worth of something. Although this provides a general basis for what a valuation is, it does not provide the full picture, as the value of something will depend on the purpose and type of valuation being carried out. There is more often than not more than one "value"!

Why are Valuations needed?

Valuations are fundamental to real estate transactions. Without knowing what the market value of a property actually is, it is impossible for the seller or the purchaser to know if they are agreeing the right price for a property.

A Bank cannot gauge whether to lend on the transaction, or how much to lend, without an up to date valuation.

A Developer needs to know that the hotel will be worth more than it costs to develop and the only way to be certain of this is to commission a valuation.

An Investor, whether investing directly into the company as a principal or buying shares on a stock market, needs to know the value of the assets of the company they are investing in.

Hotel Valuation for Investors is published by Routledge and can be ordered from them directly on their website (www.routledge.com), or from all leading online booksellers.

Types of Valuation

There are a number of different reasons for carrying out a valuation, all of which may provide a different "value". This is quite normal, because the purpose of a valuation could be to provide an estimate of what something might generate if it was sold (market value), or what it would cost to rebuild (reinstatement value) and it is quite common that these will not be the same. That does not make either "valuation" incorrect.

It is therefore very important to ensure that the purpose of the valuation (and the methodology adopted) is clearly understood and corresponds with your requirements.

Market Value

Market Value is the price that the hotel would sell for if it was properly marketed. The RICS[2] defines Market Value as "The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion."

Market Value is probably the most important type of valuation for Banks, Developers and Owners, as it calculates the money that would be received if the property was sold.

When speaking with different potential buyers, they will generally discuss what a hotel is worth to them. Perhaps one hotel owner will say that they "really need a hotel in Lagos" (as it a vital but missing location for their business), or that they "already have too many hotels in the area" and therefore do not really want another – such factors will affect the price they would be prepared to pay for the hotel. All these individual "calculations of worth" will be reviewed by the valuer when assessing Market Value.

Reinstatement Value

Reinstatement Value calculates the cost of re-building the hotel in its current condition. This is a very important type of valuation and is the basis for insurance cover. It is important to note that this type of valuation rarely is the same as the market value as it deals with the cost of rebuilding the hotel, rather than what the hotel would sell for, if it were placed on the market. In strong trading areas the rebuilding costs is likely to be lower than the market value, but if the hotel is located in a poor area where trading is weak, the rebuilding value may be higher than the market value.

Book Value

Book Value is a notional assessment of the hotel for accountancy purposes. It is influenced by the purchase price/development cost and the depreciation and other accounting policies of the owning company.

Although the book value may have an impact on the price that the owners would consider selling for, it is actually more an "estimate of worth", as it is a highly individual valuation and does not reflect its value to potential purchasers.

[2] Royal Institute of Chartered Surveyors, the professional body of the real estate industry based in the UK

There is a significant difference between worth and value, mainly down to what is being calculated. A hotel might be worth US$100m to one operator, as their cost of capital is such, and their earnings potential is such, that they could afford to pay US$100m for the asset. However if they were the only party able to earn those sort of returns from the property then this calculation would be an estimate of worth, because of the individual nature of the assessment. However if a number of other people were able to earn those sort of returns, and were prepared to also offer $100m, then this calculation could become a "value", as it is representative of the wider market.

How is a valuation carried out?

Market Value

The purpose of a Market Value is to assess the price that potential purchasers would pay for a hotel. Therefore, in simplistic terms, the valuation methodology needs to reflect the same process as is adopted by potential purchases. If buyers in a certain market purchases hotels off a multiple of turnover, or on a price per key[3] basis then the valuer would need to use this methodology to undertake the valuation.

The majority of African hotel purchases are quite sophisticated in their pricing appraisals, and valuers usually undertake discounted cash flow appraisals of future income, applying the appropriate multiple to come to a capital value.

Any capital expenditure required for the hotel to achieve the projected bottom line (this should be expressed as the EBITDA - Earnings Before Interest, Taxation, Depreciation and Amortisation) is deducted to calculate the Gross Value.

It is important that the hotel earnings are brought down to a "standard" EBITDA to reflect what the notional purchaser could expect to earn, and not just adopt the prevailing trading accounts. A standard EBITDA is the level that a prospective purchaser would expect to be able to achieve, and would ignore any element of "goodwill" that would not be transferred with the sale of the hotel (i.e. individual goodwill). For example a suitable FF&E allowance (Furniture, Fitting & Equipment) must be deducted on an annual basis, without which the quality of the hotel will deteriorate, affecting the earnings capacity, and the hotel will in effect become a "wasting asset" rather than a long-term sustainable business worthy of investment.

This Gross Value is then generally translated into a price per key to ensure it is in line with market expectations.

Reinstatement Value

The Reinstatement Value is the rebuilding cost of the hotel. The cost of demolition, materials, labour, finance and the speed of construction all play a part in this valuation.

Unusual features such as ornate facades, water features or even balconies can add significant cost to the Reinstatement Value, whilst the state of the property (its level of obsolescence) will be factored into the end value. It should be noted that the value of "the land" is excluded from this type of valuation, but is included in Market Value .

[3] The word "key" is used to describe letting units. A standard room is one key and a suite with two bedrooms and a lounge is described as one key

Book Value

The methodology of undertaking a Book Valuation currently depends on the accounting policy adopted by the owner. A choice of whether to carry a book value equivalent to the hotel's historic cost (and depreciated based on its depreciation policy), or current values is down to the individual owners and does therefore not reflect the Market Value.

However as International Financial Reporting Standards (IFRS), become more widely adopted the requirement to move towards "current values" is becoming obligatory, and valuations of assets will need to be performed as per the accounting policies.

In Africa it is considered prudent, as well as sensible, to have assets valued annually, due to the market climate, and because assets which are properly maintained will appreciate in value and would make the financial statements more representative of the true value of the business' assets.

What does a Bank Require from a Valuation?

This will vary depending upon the specific terms of the loan, but in the vast majority of cases a lender will be seeking two key pieces of intelligence from the valuation report:

(i) The fall-back position, in case the loan fails and the bank needs to sell the hotel;
(ii) The ability of the business to generate sufficient free cash flow to service and repay the loan on the agreed terms.

(i) The Fall-back Position

In the event the borrower defaults on the loan, it is essential the Bank has the capability to take control of the hotel – and they will need to know what it can be sold for. It would be unfortunate if the bank had lent US$50m on a hotel, only to find it cannot be sold for more than US$30m.

It is not unusual for a bank to request a number of different valuations on different assumptions, and we briefly outline the most common below:

Market Value – This is the price the hotel would sell for, as an operating business;

Market Value with Vacant Possession – Assuming the Market Value is subject to an operating agreement (a lease or management contract between the owner and a hotel chain) then the Bank will usually request a valuation disregarding this operational agreement, so it knows the possible position should the operating agreement be terminated;

Forced Sale Value – The majority of loan defaults occur in difficult times and lenders do not always have the luxury of time to complete a sale. The Forced Sale Value (Market Value with Special Assumptions) generally adopts a number of assumptions *(including for example: the business is closed, no trading accounts are available, operating licences have been lost, a restricted timeframe to complete a sale)* to arrive at a worst case scenario;

Market Value on Stabilisation – New hotels take a number of years to optimise their trading potential. Lenders will sometimes request an assessment of the likely value of the hotel when trading has stabilised.

(ii) Cashflow projection for protection of repayments

Most bank loans will agree an interest payment schedule and the terms of the loan, as well as a capital repayment schedule.

It is important that the business can support these repayment requirements; otherwise the loan may end up in default.

This is where the Discounted Cashflow (DCF) valuation approach proves invaluable, as lenders can clearly see whether enough profit is likely to be made to support the loan.

What should a secured lender look out for in a valuation report?

There are many areas where the content of a valuation report, if written well, will help a Bank determine the real level of risk in lending against a hotel. A poorly written and researched valuation report will possibly not adequately highlight the inherent risks, merely stating the value figure.

We highlight below some of the key areas where a lender should take extra care when using a valuation report for decision making

Independence & Competence

Valuing hotels is by no means straight forward and a comprehensive valuation requires skill, care, and knowledge of both the hotel operating market and the hotel transaction market. Banks should ensure they are using a valuer with the requisite knowledge and experience.

It is very difficult to value hotels unless you are also involved in hotel transactions. The value needs to be aware of who the buyers are for any such asset and what motivates these buyers, so experience of selling hotels (indeed ideally they should work closely with hotel agents on a daily basis) is extremely valuable for hotel valuers.

The best hotel valuers are accredited RICS Valuers. The Royal Institute of Chartered Surveyors is the world-wide body that regulates Chartered Surveyors. The level of training required to become an RICS accredited valuer, combined with the requirements of their continued professional development programme, and regular checks on competence, ensures unparalleled expertise and competence, which is of paramount importance when providing valuation advice.

Assumptions

The key to any valuation are the assumptions that are adopted by the valuer. Assuming that a redevelopment has been completed, for example, gives rise to a different value than if the valuer assumes the redevelopment has not been started.

As stated earlier, ideally the Bank will be instructing the valuer and is therefore able to discuss their needs fully, ensuring suitable assumptions are made. Alternatively, if reviewing an existing valuation report, the Bank should review the assumptions that have been adopted very carefully to ensure they are suitable for their needs.

Lack of Information

The Bank should review the information contained in the report. Was the valuer provided with all the information they needed to carry out the valuation? Were there any omissions that the valuer has highlighted as important? Were there any omissions that the valuer has not highlighted, that may have impacted on the value?

Risks attached to the deal structure, tenure, branding

The bank should review the details of all the risks relating to the deal structure, including tenure, statutory enquiries and management.

For example:

- Is the property freehold or leasehold (and if leasehold are there any onerous terms)?
- Is the site wholly-owned, or are parts of the land owned by third parties?
- Does the property have the relevant statutory consents to operate a hotel (or are they at risk)?
- Is the management contract/lease fair? Could it be terminated by the operator leaving the owner stuck?

Risks attached to the trading environment, new openings, infrastructure changes,

The Bank should take great care when reviewing the risks attached to the projected cash flow, as well as to the multiplication factor adopted and the resulting valuation. In particular special care should be taken concerning the following:

- How does the future trading compare with the historic trading, and why are there any differences?
- Have they been adequately explained?
- Are there any proposed changes to the hotel supply in the area, and have these been adequately reflected in the projected trading?
- Are there any likely changes to local demand for hotel accommodation, and have these been adequately reflected in the projections?
- Are the adopted assumptions reasonable?
- How has the multiplication factor (capitalisation rate or discount rate) been calculated and does it reflect current market levels?
- How does the capital value compare with comparable transactions?
- Are there any risks inherent with the project/location/market sector that might affect capital values, over and above the trading risk inherent in the project?

All of these factors should be discussed and any issues should be clearly identified in the valuation report.

Summary

A valuation is absolutely essential for many different reasons, but the specifics of each instruction need to be reviewed to check they are suitable for your specific needs before you rely upon the valuation.

It is not unusual for a valuation for one purpose to be different from the valuation for another purpose. Indeed a hotel could be worth more to one person than it would be to another, and yet neither of these “values” may actually reflect Market Value.

It is vital that the valuation is undertaken by someone competent and experienced in the relevant hotel market and that the valuation report is read in detail, and looked at in conjunction with the trading projections.

Valuation reports can be extremely useful, not only in assessing the fall-back position if a loan defaults, or in assessing whether a hotel business can afford the terms of a loan, but also in providing enough context to allow the Bank to determine whether lending against a specific asset is a viable proposition. We recommend that regular revaluations are built into the loan terms, so the Bank can be kept informed of the value of the hotel, and can be informed if the value of the asset is deteriorating, allowing for corrective action to be taken.

About the author

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David is the author of the best-selling "Hotel Valuation for Investors", the only comprehensive valuation text on hotel valuation, providing definitive advice to hotel owners, prospective buyers, Banks, developers, tax authorities, and hoteliers on how to calculate (and improve) the value of a hotel business.

He advises the RICS on how to value hotels, indeed he is the author for ISURV, an online resource for RICS valuers, detailing how to value hotels. He is a regular speaker at various professional conferences, has written many articles on hotel property related matters and is regularly used by the BBC to comment on tourism related property matters in the UK.

He has worked in the hotel industry for many years, providing property advice all around the world, including disposals, purchases, valuations and operator selection advice, to ensure values and sales prices are optimised.

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