what's in a word?

A hotel's worth is oftentimes not reflected in its value, and the difference can be inflammatory. **Trevor Ward** and **David Harper** discuss the semantics

As the number of branded hotels in Africa increases, so too does the probability that a hotel asset transaction market will emerge, as investors see the opportunity to purchase well-designed, well-managed hotels.

But sometimes there is nothing quite as contentious as valuation. Whilst some might think that this contention would be just part of the negotiation between a buyer and a seller, when the Kenyan government sold The Grand Regency Hotel in Nairobi, the then-Finance Minster lost his job. The Kenyan people had become increasingly sensitised to the actions of government and there was a backlash against what was seen as an incorrect price for a publicly owned hotel.

The sale, to a foreign purchaser, was at a price of around US $44 million, and this was perceived – particularly by opposition politicians and the media – to be far too low. "Valuations" of $114m were quoted, and this transaction went on to form part of the larger Goldenberg scandal.

However, there was no real evidence to suggest that anything untoward had occurred, but that didn't stifle the cry of "it's worth far more than that!" And there's the rub – what's a hotel worth? And what's the difference between worth and valuation?

The main criticism valuation professionals would have of the Grand Regency affair was that it occurred "off market"; one party made an offer that was accepted instead of the sale being opened up to bids in a transparent manner, which meant that there could be no certainty that a better price could not have been obtained from someone else.

What is value?

The key question is, "what is value?" Market value is defined as "the amount an asset will sell for on a specific date between a willing buyer and willing seller, where each party had acted knowledgeably, prudently and without compulsion." The key points to note in this formal definition of market value are a willing buyer and seller, both of whom are being advised well, and therefore have knowledge of what it is all about. If either the buyer or the seller does not have good advice then there is no certainty that they will not pay too much or accept too little for the hotel.

It is important to differentiate between "market value" and "worth". A hotel may be worth more to one owner than another (for example, they may have cost savings that they can benefit from, they may have a specific tax benefit that could be exploited, or it is an area where they have a special need for a hotel) and these "worth calculations" only form one part of the market value assessment. There is no compunction for a buyer (especially if professionally advised) to pay what the seller considers to be the "full worth" if the market, and the prospective purchaser's advisors, are dictating a lower price.

Sometimes transactions occur at non-market value prices. However, this is generally when one party (in relationship to that specific transaction) did not act prudently, knowledgeably, or was forced to sell at an inopportune time – a sale intended to enforce debt obligations, initiated by a lender who "wants out", is a prime example of that. If someone needs to sell, then potential purchasers will usually realise they are dealing with an "unwilling" seller and will take advantage of the situation to make a lower offer.

How are valuations carried out?

An evaluator's job is to reflect what the market would pay for an asset if it were openly marketed. In terms of a hotel they would need to look at who was likely to buy that category of property and how much they would pay. Different buyers use different methods to calculate what they can pay for a trading entity (ranging from a price per bedroom to a multiple of turnover) but the two most universally used approaches are the income capitalisation method and the discounted cashflow approach.

There are technical differences to each approach but, in essence, they both predict the likely earnings for a hotel, which are extrapolated and a value is attached to this income stream. This projected income stream reflects a hypothetical operator unless a lease or management contract is in place, in which case the likely income received, taking into account the specific operator, is used as the basis.

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The projections and multiplication factors (yields) will be compared and contrasted with all relevant comparable transactions – if any exist – to assess the final value, which is then compared with market transactions on a price-per-bedroom basis to analyse the overall reasonableness of the valuation figure.

It is the level of experience of the evaluator and their access to market data, along with their skill and judgement that will determine the accuracy of their valuation.

However, a hotel evaluator is basing his work on the trading ability of the asset, and therefore the valuation figure doesn't always bear any resemblance to the cost of developing the asset, or its book value. A purchaser of a hotel will always be looking at the cash flow potential, and if that cash flow today, at the time of the sale, is down on what is was when the hotel opened (perhaps because of increased supply in the market), then it is almost inevitable that the value will also have decreased.

How can a valuation be confirmed?

Checking that a valuation figure is correct can be extremely difficult. From an owner's perspective no two hotels are identical as the value is dependent on location, facilities, condition, local demand, local supply, trading profile, customer base, and a hundred other variables which affect the business' ability to generate profits, and no two hotels completely share the same trading profile.

A skilled evaluator, with detailed experience in the local area, would be able to analyse trading levels and likely values if the hotel were placed on the market at that time. That said market value is determined by market sentiment, which in the hospitality industry changes rapidly. It is therefore extremely difficult for an evaluator to keep up with market sentiment unless they are thoroughly immersed in transactional business and aware of the sentiments and thought processes of the most active people in the market.

However, the only way to be 100% sure of the value of an asset is to ask an experienced hotel agent (preferably a chartered surveyor) to widely market the property and sell the property on your behalf. At the end of the day, whether you are talking about value or worth, the only true figure of either is what someone is prepared to pay for it.

In the African context, outside of southern Africa, the valuation and asset transaction markets are very immature. Sellers are typically irrational when they put their hotels up for sale, assuming that it must be worth more than they built it for, or bought it for. Often, they have run the property into the ground,and a purchaser will have to spend money on refurbishment and basic maintenance.

Only once the transaction market picks up and there is more information to work with (the news is that one of the largest hotel owners on the continent is currently marketing a portfolio of hotels to gauge investor appetite), will asking prices be more akin to true value. Ai

David Harper is a Director of the UK-based Leisure Property Services (www.leisurepropertyservices.com). Trevor Ward is the Managing Director of Lagos-based W Hospitality Group (www.w-hospitalitygroup.com)