The usual method for assessing the rental value is to determine the divisible balance

This is apportioned between landlord and tenant as, respectively, rent and retained profit

An opinion of balance

Hotel rental valuations are sometimes seen as overly complicated, but this is not the case. All that is required is a thorough understanding of the hotel market and the factors that affect trade. *David Harper* explains

Market rent is defined by the *Valuation Standards* (6th ed) (known as the *Red Book*) as: "The estimated amount for which a property, or space within a property, should lease on the date of valuation between a willing lessor and a willing lessee on appropriate lease terms, in an arm's length transaction, after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion."

When undertaking a rental valuation on a hotel, valuers are, in effect, attempting to determine what potential tenants in that particular marketplace would be prepared to pay at that time. It is essential that he or she reflects the approach adopted by potential lessees when calculating the market rent.

In most instances, the agreed rent on a hotel will be determined by the potential profitability of the property, albeit that the possible level of trade will be assessed using market evidence. Hotel rents will rarely be determined solely by comparable evidence, as is sometimes the case with other property classes. This is because it is rare for there to be two hotels in similar locations, with similar facilities, trading in a sufficiently similar manner to enable the rent offered in one to be used as a direct comparable.

Divisible balance

Most operators looking to lease a hotel will review the trading potential of the property before determining the level of affordable rent.

The usual method for assessing the rental value of a property is to determine the "divisible balance" and to apportion that amount between the landlord and the tenant.

Calculating this involves working out the EBITDA (earnings before interest, taxation, depreciation and amortisation – sometimes known as net operating profit) for the property and then deducting a number of items. These will include an annualised amount for the tenant's fixtures and fittings and a sum for working capital.

The apportionment of the divisible balance will reflect the tenant's bid. If the market is performing strongly and the property is desirable, the tenant will be prepared to offer more of the divisible balance to secure the premises. If, on the other hand, the market is weak and the demand for the property is low, the landlord will be prepared to accept a lower proportion of profit.

Lease terms

The valuer will need to take into account exactly what it is he or she is trying to value. The lease will detail the demise of the property; does it, for example, include the furniture and fittings or is any additional land

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included, such as a car park, that needs to be taken into account.

The terms of the lease may directly affect the profitability of the hotel or the desirability of the property from an operational perspective. They will therefore have a major effect upon the assessment of market rent.

Ideally, the valuer would have access to the hotel's trading accounts when assessing its rental value. Unfortunately, such access is not always an option. However, because few traditional leases provide for this information to be accessible, the assumed trading projection is normally down to the valuer's experience.

Costs and allowances

It is therefore essential that the valuer is aware of the trading experiences of similar types of hotel in the locality, so as to be able to ascertain the likely trading profile of the hotel in question.

The hotel's performance is assessed by the valuer on the values of the day, based upon the demised premises. For example, if the hotel was let five years previously and was in good condition at the time of the letting, the valuer will need to assess its trading potential in the current market. If the quality of the fit-out specification is not suitable, what capital expenditure will be required to enable the hotel to trade effectively? Alternatively, will the trading potential be discounted because of a sub-standard fit-out.

The valuer will ascertain what other hotels in the area achieve and will determine, in the light of that information, the profitability of the hotel in question.

He or she will assess the occupancy rate and the average daily rate in order to calculate the revenue generated from the use of the rooms. This will be used to obtain total revenue. Costs will then be allocated until the income before fixed charges has been assessed.

Fixed costs (except rent), including rates, management fees (where appropriate), the fittings, fixtures and equipment (FF&E) reserve (again, where appropriate) and insurance will be deducted.

Further adjustments specific to rent review valuations will then be made to the profit margin of the hotel to take into account other items; for example, working capital and the cost of furnishing the property if it has been let on a shell and core basis, with no FF&E.

The adjustment for fitting out should be made as a capital amount, probably on the basis of the cost per bedroom, so as to provide a suitable level of FF&E for the hotel type, and annualising it over a suitable period.

This allowance is deducted because the hotel will be unable to trade without FF&E; and since the hypothetical tenant will need to invest money to furnish the property, the cost needs to be taken into account.

Working capital is also an operational cost. Convention dictates that three weeks' revenue is deducted from the profit to make an appropriate allowance for this expense.

This works down to a divisible balance, which is lower than the EBITDA of the property because of the additional deductions. The divisible balance is the amount of profit from the hotel, which, as we have seen, needs to be divided between the landlord and the tenant as rent and retained profit.

The method of assessing the proportion of divisible balance that the hypothetical tenant will be prepared to pay as rent can be problematic. The valuer will need to have good knowledge of the local market. A number of variables will affect the amount that the tenant will offer the landlord: prevailing economic conditions, the demand for hotels, trading conditions – both supply and demand – as well as the quality of the asset and its suitability and positioning within the local hotel market will all come into play.

Further adjustments will be made for specific and unusual lease terms and for peculiarities in the rent review period. The wording of the lease, and the terms contained in it, will affect the rental value of the property.

The valuer must assess the resulting figure to determine whether it is in line with the general market. He or she can make use of three tests: rent as a percentage of turnover, rent as a percentage of EBITDA and, to a lesser extent, the rent per bedroom.

This review is an essential part of the valuation process. It is usual, when looking at comparable rental transactions, to adjust them as appropriate to reflect the prevalent local trading conditions, the hotel's relative size and facilities, as well as differences in dates, lease terms and the underlying demand in the market.

Too superficial

When assessing the market rental value of a hotel, the intention is to reflect what the situation would be were the property to be placed on the market on a particular day.

Although the prevalent method of assessment is the profits method of valuation, the valuer must refer, as much as possible, to market evidence. Unfortunately though, most comparable evidence that is provided as rental value per bedroom is too superficial to be more than a simple benchmark for the tone of the market.

David Harper is the founder of Leisure Property Services and author of Hotel Valuation for Investors, *EG Books*

Why this matters

Returns from hotels over the past 15 years have significantly outperformed most other property classes and these returns have proved to be attractive to traditional investors. Over the past decade, hotels have become a mainstream asset class for investors, which has led to an influx of capital into the hospitality sector.

If investors are to continue to be attracted, it is important that they are fully aware of how the market rent is assessed. In that way, the inherent risk in rental uplifts can be factored into their decision making when they determine their required returns.

Unfortunately, the practice of taking rental evidence from other hotels and making adjustments is a complex operation. It can be prone to error in the hands of anyone who is not fully aware of local trading conditions.

The earning potential of one type of hotel can vary significantly from another (whether in size, category, location, customer mix, facilities, design and layout or competition), rendering irrelevant the analysis based upon rent-per-bedroom.

A competent valuer will review the trading profile of all the competitor hotels in the area. In doing so, he or she will be able to establish a profit-methods valuation based almost exclusively upon comparable evidence, in the same way as an office valuer will assess the rent based upon prices per square foot from comparable evidence.

The rent can be set in ways that are not subject to the underlying trading potential of the particular hotel market; for example index-linked rental increases or fixed increases. Although adopting these will provide more certainty for investors, they are unlikely to offer the sort of growth that first attracted the investors.

Investors that are considering a move into the hotel market must be advised by experienced professionals These professionals can provide a breakdown on the various options for structuring the lease so that it meets their specific requirements, while still remaining of interest to future potential buyers.

Further Reading

Hotel Valuation for Investors
Harper D, EG Books

Law and Valuation of Leisure Property
Marshall H and Williamson H, (2nd ed), EG Books