

# Lodging Outlook



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## The Global Approach To Hotel Valuations

By: Stephen Rushmore - MAI, CHA, CRE, president and founder of HVS International, a global hotel consulting firm.

Valuing a hotel is both an art and a science. The science involves using mathematical formulae to reflect the value calculations of typical hotel investors. The art is composed of the various input assumptions that feed the formulae and produce the value. The entire valuation process is intended to mirror the results obtained when a hotel buyer and seller agree on the final price and a transaction occurs.

The evolution of hotel valuation methodology throughout the world started with a simplistic cost approach, whereby the appraiser totaled the hotel's current development cost and then made deductions for depreciation and obsolescence. Because this method failed to recognize the economics of the property itself or the surrounding market, its applicability in today's financially oriented environment significantly reduces its reliability. The sales comparison approach, through which comparable sales form the basis for the value estimate, generally produces unsatisfactory results for unique and dissimilar properties such as hotels.

The income approach is rapidly becoming the preferred hotel valuation method throughout the world. U.S. hotel investors adopted the income approach methodology during the 1950s. European hoteliers began using it in the early 1990s. With the recent realization that hotels are not always worth the money invested during their development, Asian hotel owners have now begun to shift their valuation technique from the cost approach to the income approach. Its basis is purely economic, reflecting the art and science of both hotel buyers and sellers.

In its simplest form, the income approach takes a hotel's anticipated net

income and divides that number by a capitalization rate. The projected net income reflects the future economic benefit of owning the hotel and the capitalization represents the investor's desired rate of return.

Example: If a hotel is expected to produce a stabilized profit of \$1,000,000, and an investor desires a 12% return on his invested capital, then the purchase price has to be:

$$\frac{\$1,000,000}{.12} = \$8,333,333$$

The proof is demonstrated by taking the purchase price of \$8,333,333 and multiplying it by the 12% desired rate of return and showing that the required stabilized profit would have to be \$1,000,000.

The key to an accurate estimate of value is a proper profit projection and a supportable capitalization rate.

### Determining Capitalization Rates

Hotel capitalization rates are intended to reflect the rate of return on invested capital demanded by the entities financing the hotel's acquisition. The desired rate of return reflects various factors such as perceived risk, liquidity, inflation, etc. Because most hotels are financed by several entities, usually a debt lender and an equity investor, the capitalization rate is actually a weighted average of the desired rates of return.

Example: The hotel described above is going to be purchased by an investor who plans on financing the purchase price with mortgage debt representing 65% of the price and equity accounting for the remaining 35%. The mortgage lender

wants to charge 10% interest on a 25 year loan and the equity investor is looking for a 14% return on his invested equity.

The calculation of the weighted cost of capital (capitalization rate) is as follows:

Investors	% of Purchase Price	Rate of Return	Weighted Average
Mortg. Debt	65%	(X) 0.11	(=) 0.07
Equity	35%	(X) 0.14	(=) 0.05
Cap Rate			0.12

Dividing the \$1,000,000 stabilized profit by the 12% capitalization rate produces the following value:

$$\frac{\$1,000,000}{.12} = \$8,333,333$$

The valuation methodology can be proven by showing that the purchase price allocation between the two sources of invested capital matches the annual rate of return requirements and the available stabilized profit.

Investors	(%)	Invested Capital	Rate of Return	Annual Return
Mortg. Debt	65%	\$5,416,666	(X) 0.11	(=) \$596,000
Equity	35%	\$2,916,667	(X) 0.14	(=) \$404,000
Cap Rate		\$8,333,333		\$1,000,000

As the hotel industry globalizes, investors are using more sophisticated hotel valuation techniques to reflect the economic characteristics inherent in hotel ownership and transaction structuring. The income approach is rapidly becoming the industry standard throughout the world.



**CANADIAN LODGING OUTLOOK**  
**HVS INTERNATIONAL - CANADA**

May 2002	Number of Rooms	Occupancy Rate (%)		Average Room Rate (\$)		RevPAR (\$)		Room Supply % change	Room Demand % change
		2002	2001	2002	2001	2002	2001		
Nova Scotia Area	1,311	62.8%	61.1%	\$78.05	\$77.53	\$49.02	\$47.37	0.3%	3.3%
Halifax, NS	2,273	79.1%	77.6%	\$121.75	\$121.23	\$96.30	\$94.07	6.3%	8.4%
Montreal, QC	15,499	71.3%	71.7%	\$137.91	\$132.67	\$98.33	\$95.12	2.3%	1.8%
Quebec City, QC	3,805	70.8%	72.5%	\$127.49	\$121.92	\$90.26	\$88.39	2.6%	0.3%
Quebec Area	3,589	57.5%	58.6%	\$86.37	\$80.74	\$49.66	\$47.31	0.7%	-1.3%
Toronto Downtown	11,465	67.7%	75.1%	\$173.56	\$181.01	\$117.50	\$135.94	0.0%	-9.9%
Toronto North/East	5,965	66.6%	71.9%	\$101.32	\$111.00	\$67.48	\$79.81	-0.3%	-7.7%
Toronto Airport/West	9,422	66.6%	72.2%	\$116.15	\$118.75	\$77.36	\$85.74	1.9%	-5.9%
Ottawa, ON	7,902	72.8%	77.6%	\$130.19	\$133.15	\$94.78	\$103.32	2.4%	-4.0%
Ontario East	5,653	57.9%	63.2%	\$97.00	\$96.23	\$56.16	\$60.82	0.2%	-8.2%
Niagara Falls, ON	6,178	60.4%	61.3%	\$111.79	\$114.87	\$67.52	\$70.42	0.2%	-1.3%
Ontario Southwest	6,739	61.0%	62.1%	\$98.97	\$96.34	\$60.37	\$59.83	0.0%	-1.7%
Ontario North	4,464	56.9%	59.0%	\$88.75	\$86.12	\$50.50	\$50.81	-0.1%	-3.6%
Ontario Central	5,939	58.9%	59.5%	\$95.30	\$91.18	\$56.13	\$54.25	1.6%	0.5%
Winnipeg, MB	3,579	65.8%	63.5%	\$92.39	\$91.34	\$60.79	\$58.00	5.0%	8.7%
Regina/Saskatoon, SK	4,048	62.1%	64.6%	\$84.30	\$80.20	\$52.35	\$51.81	1.6%	-2.4%
Calgary, AB	7,342	69.2%	69.3%	\$110.91	\$115.55	\$76.75	\$80.08	1.0%	0.8%
Edmonton, AB	5,599	83.0%	65.2%	\$89.52	\$91.75	\$74.30	\$59.82	0.0%	27.3%
Alberta Area	6,721	55.5%	62.4%	\$87.25	\$81.44	\$48.42	\$50.82	-0.3%	-11.3%
Mountain Regions, AB	2,509	63.9%	69.0%	\$187.43	\$179.26	\$119.77	\$123.69	-6.8%	-13.6%
Vancouver, BC	12,279	69.1%	68.7%	\$141.53	\$142.12	\$97.80	\$97.64	2.6%	3.1%
British Columbia Area	5,312	52.7%	55.0%	\$80.08	\$83.09	\$42.20	\$45.70	0.7%	-3.5%
Victoria, BC	3,021	66.2%	62.7%	\$127.69	\$119.37	\$84.53	\$74.84	1.7%	7.4%
<b>Provinces</b>									
Alberta	22,140	68.0%	66.3%	\$106.45	\$109.47	\$72.39	\$72.58	-1.0%	1.6%
British Columbia	23,705	62.1%	62.4%	\$126.38	\$126.91	\$78.48	\$79.19	1.4%	0.8%
Manitoba	3,965	64.5%	62.8%	\$93.15	\$90.13	\$60.08	\$56.60	3.8%	6.7%
New Brunswick	3,087	62.9%	62.6%	\$94.51	\$89.91	\$59.45	\$56.28	0.0%	0.4%
Newfoundland	1,526	68.4%	69.6%	\$110.42	\$104.74	\$75.53	\$72.90	0.0%	-1.7%
Nova Scotia	3,584	73.1%	71.7%	\$107.89	\$107.97	\$78.87	\$77.41	2.0%	4.0%
Northwest Territories	INS	INS	INS	INS	INS	INS	INS	INS	INS
Ontario	63,288	64.2%	68.4%	\$120.68	\$124.52	\$77.48	\$85.17	0.6%	-5.5%
Prince Edward Island	937	44.7%	50.5%	\$90.18	\$83.41	\$40.31	\$42.12	0.0%	-11.5%
Quebec	23,363	69.0%	69.8%	\$129.01	\$123.38	\$89.02	\$86.12	1.7%	0.6%
Saskatchewan	5,542	57.6%	58.9%	\$79.26	\$75.87	\$45.65	\$44.69	1.1%	-1.1%
Yukon Territory	678	41.6%	48.3%	\$79.82	\$82.12	\$33.21	\$39.66	0.0%	-13.8%
Canada	151,815	61.7%	64.1%	\$103.93	\$103.52	\$64.12	\$66.36	0.9%	-2.8%

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Ontario Central	5,939	52.4%	54.5%	\$91.40	\$87.86	\$47.89	\$47.88	1.6%	-2.3%
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Saskatchewan	5,542	53.5%	57.1%	\$78.39	\$76.33	\$41.94	\$43.58	1.1%	-5.2%
Yukon Territory	678	35.2%	42.1%	\$71.88	\$76.96	\$25.30	\$32.40	0.0%	-16.4%
Canada	151,815	54.5%	56.5%	\$98.69	\$98.34	\$53.79	\$55.56	1.0%	-2.5%

# CANADIAN LODGING OUTLOOK

## DEFINITIONS

Occupancy:	The ratio of total occupied rooms to total available rooms.
Average Room Rate:	Defined as room sales divided by the total number of rooms occupied.
RevPAR:	The application of a hotel's average occupancy to its average room rate and a true indicator of the property's ability to generate revenue. It is calculated by multiplying the occupancy by the average room rate.
Number of Rooms:	The total number of rooms at participating hotels.



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The Hotel Association of Canada is a federation of provincial and territorial associations, hotel chains and suppliers with a mandate to represent members nationally and internationally and to provide cost-effective services that stimulate and encourage a free market accommodation industry.

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