

Canadian January 2005 Lodging Outlook



SMITH TRAVEL RESEARCH

A Crash Course In Cap Rates

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Capitalization rates, commonly referred to as "cap rates" are a much bantered about term in real estate investment. A cap rate generally indicates the return an investor expects to achieve on his or her investment, and the direct capitalization approach is a simplistic method of determining the value of a hotel. To determine the value of a hotel using the direct capitalization method the hotel's net income divided by a cap rate equates to the hotel's value:

$$\text{Net Income} / \text{Cap Rate} = \text{Hotel Value}$$

Or vice versa, when analyzing a sales transaction net income divided by the sale price equals the cap rate:

$$\text{Net Income} / \text{Sale Price} = \text{Cap Rate}$$

There are two key points of confusion when using cap rates, the first being the definition of net income, and the second being what accounting period the net income is based on.

In terms of the definition of net income, should reserve for replacement, management fees, franchise fees, debt service, and depreciation be deducted? All of which could negatively or positively affect the overall net income value based on their inclusion or exclusion therefore affecting the calculated cap rate. In today's hotel market the industry standard is to calculate net income prior to debt service or depreciation, but inclusive of a reserve

for replacement, management fees and franchise fees, with management fees and a reserve for replacement each typically equal to 3% to 5% of total revenue.

The accounting period can also significantly impact the cap rate and is an important factor to understand when analyzing sales transactions. To illustrate the potential variances in cap rates we have shown an example of a hotel with a sales price of \$15,000,000. The cap rate on this sale could potentially be reported as 8%, 10% or 12%, and all would be correct, depending on the accounting period used for the calculation.

2005, as most major markets in the country continue to post occupancy and average room rate increases, without any major upward pressure on expenses.

The reverse would be true in a market with expectations of new supply that would put downward pressure on occupancy and average room rate, or if investors have an indication of upward pressure on expenses that will erode the net income. In this case it is likely that historical cap rates would be higher than projected or stabilized cap rates.

It is always important to note however, that cap rates are not just market driven an are

	Historical 12-Month	Projected 12-Month	Stabilized
Net Income	\$1,200,000	\$1,500,000	\$1,800,000
Cap Rate	8.0%	10.0%	12.0%

Based on a sale of: \$15,000,000

This example is reflective of current market trends. We are seeing investors willing to purchase properties based on lower historical cap rates, and anticipating upside potential in net income which results in higher projected and stabilized cap rates. It is the general sentiment of the hotel investment market that 2003 was the low point in the cycle and hotel transactions reflect this expectation as investors forecast a rebound in hotel performance and increases in net income. This trend is expected to continue into

also impacted by numerous property specific factors including the property type and geographic location as well as the cost of capital and an investors perception of risk.

To conclude, cap rates are a critical element to understanding how the hotel investment market is functioning, it is important to clearly define the variables being used to calculate the cap rate to ensure all parties are on the same page.

CANADIAN LODGING OUTLOOK HVS INTERNATIONAL - CANADA

January 2005	Number of Rooms	Occupancy Rate (%)		Average Room Rates (\$)		RevPAR (\$)		Room Supply % change	Room Demand % change
		2005	2004	2005	2004	2005	2004		
Nova Scotia Area	1,196	42.3%	35.3%	\$73.61	\$67.61	\$31.14	\$23.87	0.6%	20.6%
Halifax, NS	2,077	42.5%	40.4%	\$104.68	\$102.03	\$44.49	\$41.22	2.7%	8.0%
Montreal, QC	13,696	45.1%	46.2%	\$107.90	\$108.36	\$48.66	\$50.06	1.0%	-1.2%
Quebec City, QC	3,630	46.5%	39.8%	\$113.10	\$102.68	\$52.59	\$40.87	0.0%	16.9%
Quebec Area	3,327	45.1%	42.7%	\$88.00	\$83.94	\$39.69	\$35.84	0.6%	6.2%
Toronto Downtown	11,182	48.3%	50.9%	\$137.80	\$132.55	\$66.56	\$67.47	0.7%	-4.4%
Toronto North/East	6,437	44.8%	46.2%	\$109.15	\$108.16	\$48.90	\$49.97	-6.5%	-9.4%
Toronto Airport/West	6,317	69.6%	67.6%	\$109.25	\$111.95	\$76.04	\$75.68	6.2%	9.4%
Ottawa, ON	6,937	45.1%	46.2%	\$125.10	\$122.01	\$56.42	\$56.37	0.5%	-1.9%
Ontario East	3,693	42.8%	38.9%	\$87.11	\$83.64	\$37.28	\$32.54	0.0%	10.2%
Ontario Southwest	8,639	46.1%	45.7%	\$88.10	\$83.54	\$40.61	\$38.18	1.7%	2.6%
Ontario North	5,638	41.5%	39.1%	\$73.28	\$72.75	\$30.41	\$28.45	-0.1%	6.0%
Niagara Falls, ON	6,211	25.8%	28.2%	\$98.76	\$89.42	\$25.48	\$25.22	4.4%	-4.5%
Ontario Central	7,501	45.2%	44.6%	\$101.38	\$98.95	\$45.82	\$44.13	-1.2%	0.2%
Winnipeg, MB	4,044	47.6%	44.7%	\$86.77	\$84.17	\$41.30	\$37.62	0.0%	6.5%
Regina/Saskatoon, SK	4,054	52.6%	48.9%	\$90.91	\$89.01	\$47.82	\$43.53	1.0%	8.6%
Calgary, AB	7,723	49.9%	48.1%	\$104.41	\$101.95	\$52.10	\$49.04	-0.7%	2.9%
Edmonton, AB	6,004	49.1%	50.7%	\$97.88	\$96.24	\$48.06	\$48.79	2.2%	-0.9%
Alberta Area	6,612	56.3%	47.0%	\$85.81	\$84.03	\$48.31	\$39.49	2.2%	22.2%
Mountain Regions, AB	2,150	44.1%	47.2%	\$157.68	\$157.03	\$69.54	\$74.12	0.9%	-5.9%
Vancouver, BC	11,846	48.2%	45.6%	\$109.01	\$103.98	\$52.54	\$47.41	-1.1%	4.6%
British Columbia Area	9,459	39.0%	41.2%	\$121.37	\$113.31	\$47.33	\$46.68	0.4%	-5.1%
Victoria, BC	3,277	34.3%	35.4%	\$79.13	\$76.42	\$27.14	\$27.05	3.1%	-0.1%
Provinces									
Alberta	22,489	51.0%	48.4%	\$101.17	\$99.94	\$51.60	\$48.37	1.4%	6.9%
British Columbia	26,245	45.1%	44.2%	\$122.19	\$118.06	\$55.11	\$52.18	0.6%	2.7%
Manitoba	4,752	47.6%	44.9%	\$85.18	\$82.60	\$40.55	\$37.09	0.0%	6.0%
New Brunswick	2,614	42.7%	39.7%	\$89.07	\$87.48	\$38.03	\$34.73	0.0%	7.7%
Newfoundland	1,521	38.7%	45.7%	\$103.57	\$100.06	\$40.08	\$45.73	0.0%	-15.3%
Nova Scotia	3,273	42.4%	38.2%	\$93.35	\$88.26	\$39.58	\$33.72	1.2%	12.4%
Northwest Territories	66	INS	INS	INS	INS	INS	INS	INS	INS
Ontario	61,626	46.4%	46.4%	\$109.07	\$107.01	\$50.61	\$49.65	0.6%	0.6%
Prince Edward Island	889	31.0%	31.1%	\$62.14	\$65.03	\$19.26	\$20.22	0.0%	-0.1%
Quebec	21,582	45.8%	45.6%	\$116.70	\$115.11	\$53.45	\$52.49	0.7%	1.1%
Saskatchewan	5,741	47.6%	44.8%	\$84.68	\$83.46	\$40.31	\$37.39	1.0%	7.3%
Yukon Territory	181	INS	INS	INS	INS	INS	INS	INS	INS
Canada	150,979	43.5%	42.3%	\$94.93	\$92.58	\$41.29	\$39.16	0.7%	3.4%

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DEFINITIONS

Occupancy:	Rooms sold divided by rooms available.
Room Revenue:	Total room revenue generated from the sale or rental of rooms.
Average Daily Rate (ADR):	Room revenue divided by rooms sold.
Room Revenue Per Available Room (RevPAR):	Room revenue divided by rooms available (occupancy times average room rate will closely approximate RevPAR).

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