Hotel financing
What you need to know

Choosing a valuation method

Is your project a good candidature for financing?

Financial risks

The top 4 reasons for hotel failures

Funding sources

Understanding the criteria

Hotels are considered to be a 'specialised' commercial property and, as such, the amount you may be eligible to borrow is significantly reduced when compared to other types of commercial properties. The reason for this is that hospitality businesses operate within a smaller market and can be more readily affected by poor management subsequently making them riskier investments.

Determining the amount of finance you may need for a new build or conversion can be challenging but in principal a borrower should have at least 1.5 to 2 times the amount of income to proposed interest expenses – this is known as the serviceability ratio.

The value of the property, understanding the lending criteria, key hotel metric's such as RevPAR and market and lending trends are all important conditions that need to be assessed.

Valuation
Choosing a valuation method

1. Capitalisation (CAP)

Capitalisation of Net Operating Profit is the primary method of valuation and is performed by assessing a net operating profit from historical trading performance and capitalising that into perpetuity at an appropriate capitalisation rate (yield). The capitalisation rate indicates the rate of return expected on a hotel, real estate investment property or other income-producing asset.

$$\textbf{Value} = \frac{\text{Net Income}}{\text{Capitalisation Rate}} = \frac{€500{,}000}{16\%} = \textbf{€3,125,000}$$

Particular consideration is given to historic turnover, gross profit margins and expenses calculated as a percentage of turnover.

The capitalisation rate applied to a going concern hotel will vary but is calculated as follows:

$$\textbf{CAP rate} = \frac{\text{Net Operating Income}}{\text{Cost or Hotel Value}}$$

The following conditions are also taken into account:

- The location of the property
- The quality of the asset
- Market demand and competition
- Cash flow profile which will consider the nature of the trade and opportunities/risks to the cash flow

2. Summation (lessee's and lessor's interests)

The value of a Going Concern hotel is made up of land, improvements and goodwill. The land and improvements make up the real estate value and relate to the Lessor's interest. Goodwill is the value of the business and relates to the lessee's interest. The Summation method reflects the real estate value plus the business value.

When using the summation method the valuer will determine a hypothetical rent for the hotel which will typically be 40 – 45% of the net operating profit. The value of the business is determined by capitalising the net operating profit after rent at a capitalisation rate (yield) obtained by recent business interest sales. The freehold value is determined by capitalising the net rental income at a capitalisation rate obtained from recent freehold interest sales. The value of the real estate and business value are then combined in order to provide an indicative value for the Going concern.

3. Direct comparison/comparable sales

The Direct Comparison method compares sales on a total quantum dollar basis. This method is usually performed as a check method to ensure the value derived from the Capitalisation approach reflects a value that is within the range of the sales evidence. The points to be considered in relation to both the subject property and the comparable include:

- Location,size and type of property
- Lease and tenancy characteristics·
- Rental income
- Outgoings
- Age and condition of the property and building services
- Potential for rental growth/redevelopment

4. Discounted cash flow/target internal rate of return

This method will take into account future rental predictions, covenants of the tenant, taxation, capital gains, outgoings,inflation, exit capitalisation rates, terminal value and forecast period.

5. Hypothetical Development (for development sites)

Assumptions need to be made regarding the most beneficial development for the site, the time required to obtain approvals, develop and lease, development cost, future rental income, initial yield, development profit and valuation on completion of development.

Other value ratios can include:

Per room value: Indicates the market value of each room in a hotel

$$\textbf{Per room value} = \frac{\text{Market Value of Hotel}}{\text{No. Rooms in Hotel}}$$

Multiple of room revenue: Used by hotel owners to indicate hotel efficiency. It is not widely used to determine hotel financing or profitability.

$$\textbf{Multiple of room revenue} = \frac{\text{Market Value of Hotel}}{\text{Gross Room Revenue}}$$

Hotel financing
Is your property a good candidate?

Interest rates are lower than they have ever been but without sufficient capital, it may be almost impossible to obtain a loan to finance a Hotel. Factors that a lender will use to analyse the financial strength of a property include:

Branding and positioning

The property is established and well positioned in the market. There is the ability for the property to either fill a gap in the market or penetrate a well-populated segment. Lenders also take comfort when the property has an affiliation with a recognised brand.

Experienced owner/operators

The know how and competence of operators and owners are increasingly coming under scrutiny by banks. Current experience in managing hotels, owning an existing portfolio and/or knowledge and involvement with a similar type of project will be important considerations by the bank.

Location, location, location!

Investing in a hotel location involves different considerations than it did a decade ago. Brand loyalty now plays a major part in the customer's decision about which hotel to frequent.

However certain considerations do not change: this includes access, visibility, an area's growth potential, proximity to complementary retail and a ready supply of potential customers.

(Markets are Often classified as Primary, Secondary and Tertiary, see sidebar)

Market conditions

Both current and future market conditions will be assessed. Typically this would include an analysis on the investment activity in the area including the depth of the market and the identification of key players in the market. Any building activity including competition and likely additions to supply should be considered. This will allow a model of future supply and demand to enable the projection of average occupancies and rooms rates within that market.

What are Primary, Secondary and Tertiary Markets?

Primary

Key Metropolitan Centres:

Large population, typically capital cities with a diversified economic base and multiple features that generate both corporate and leisure hotel demand.

Secondary:

Regional Centres:

Regional cities that are secondary to primary locations, a population between 50,000 and 400,000 people and a diversified economic base with multiple features that generate corporate demand for hotel space. Includes leisure market areas that attract many visitors each year and are attached or part of a distinctive destination location.

Tertiary:

Regional Towns:

Have populations below 50,000 (or any population size), with a non-diversified economic base and limited features that generate corporate demand for hotel space. Includes the majority of leisure destinations.

Financial risks
the bank will consider

Development risk

This is the economic threat that a developer/investor is exposed to when converting a vacant piece of land or existing building into a fully operational hotel asset. Developing hotels is highly capital intensive and requires the ultimate harmony between all parties involved in order to secure an economically viable investment. Any setback during the development could severely impact the investment returns.

Setbacks can include cost overruns; the longer it takes to build or convert the higher the risk of cost overruns. Underestimating development costs can put a project over budget and turn an investment that looks good on paper into a disastrous investment.

Unexpected renovations and repairs on an older property can also turn your investment into a loss incurring exercise so it is important to complete your due diligence. There is also an associated time risk with the purchase of a hotel. If the hotel experiences a delay in opening there could be an associated risk with changes in occupancy rates, the cost of capital and other certain factors. If the investment was made in optimal conditions and conditions were favourable or at peak performance, any change, such as an increase in interest rates for example, could significantly reduce the return on your investment.

Operating risk

Owners are significantly exposed to the operating risk in a hotel environment. Any fluctuation in the operating performance of hotel asset has a significant impact over the net operating income available to its owner to service the mortgage and to secure a level of capital to justify a return on the investment. A severe economic downturn for example could potentially force the business and its owner into liquidation and result in lenders stepping in. However in an uplift the reward is equally positive.

Other factors attributed to operating risk include the demand and supply dynamics in a given market along with the barriers of entry for a specific asset class. An overly supplied market will inhibit the trading performance of a hotel asset but the barriers of entry such as availability of land, zoning restrictions and regulations can typically hedge against such a risk.

Development costs:

Soft costs represent approximately 30% of the cost for a new build or hotel conversion and can include architectural fees, inspection fees and permits, construction equipment, tools, project management fees, insurance, taxes, marketing, surveys and studies.

Hard costs:

In general account for 70% of the cost of your new hotel build or conversion. They include building structure costs (labour and materials), site costs (water systems, drains, fire, paving and grading), landscape, a contingency fund and overhead (staff, permits, insurance and security).

Hotel failures
Top 4 reasons why

1. Poor management

Aligning the hotel with the wrong people will almost always lead to subpar results and sometimes complete disaster. Taking time and completing your due diligence should always be part of selecting the best team for your project. One of the most expensive things you can do is hire an inexpensive amateur.

2. Negatively impacted by market cycles

Just like stocks, hotel values go up and down based on economic conditions. If you are lucky enough to get the market timing right, value fluctuations can be extremely profitable. The opposite of course can be extremely costly when you buy high and are forced to sell at the bottom of the cycle. Adequate working capital and/or the ability to work with your bank should assist in the ability to ride out any adverse conditions and hopefully recoup your investment and make a profit.

3. Lack of due diligence

Failing to see an overbuilt market environment on the horizon can lead to failure. In order to minimise your investment risk a comprehensive due diligence should be completed and include, but not be limited to a detailed review of the market, understanding the potential for new competition, research and understanding of the demand drivers for your hotel and any anticipated future changes.

4. Over-leverage with expensive capital

It is tempting to borrow as much as possible for a hotel investment however higher leverage typically results in a higher interest rate which then translates into a higher cost of capital and higher risk to the equity investment meaning a higher risk of investment failure.

Tip: Consider hiring a professional with experience in the hotel space to conduct a feasibility study.

Funding sources

Bringing hotel projects to life remains challenging but development and conversions move forward as long as money is available. Developers can explore flexible alternative funding sources:

- Whether you are considering a new build or a conversion, hotel projects affiliated with a strong brand that is recognised for its reputation and proven track record remain more attractive to lenders and there is no sign of this waning in the future.
- Considering hotel projects with smaller footprints and less extensive facilities (like economy, mid- scale and upper mid-scale properties) that are less risky due to their operating efficiencies and lower cost basis making it easier to secure finance
- Consider projects that offer unique and desirable amenities that stay ahead of market trends trendsetters attract financing.

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