

## Valuing hotels

### Transcript of presentation to Profithotel 2006 conference in Poland

My name is Ian Graham and I am based in the UK currently but, during the last 30 plus years, I have worked in the hotel industry in more than 60 countries in Europe, Middle East Africa, Asia, North America and the Caribbean. I have some, but limited, experience of the Polish hotel market.

For the last three years, I have been leading a virtual consultancy, working with some of the best independent consultants serving this industry, and engaged by clients such as Starwood Capital, Louvre Hotels, Kempinski Hotels & Resorts and De Vere Hotels in helping them unlock strategic advantage.

I have valued hotel companies and hotels throughout my career and I have seen more valuations by third parties than is good for anyone. What I want to do in the next 20 minutes is share some of the learning from these experiences with you.

I am first and foremost a hotelier – a graduate of the hotel school at the University of Surrey in the UK; but I am also a Fellow of the Institute of Chartered Accountants of England and Wales. For most of my career, I have focused on enabling decision makers make rational, value adding decisions, based on facts as expressed by numbers. And one of the lessons of my last thirty years is that there can be too many numbers, too much analysis, too much reliance on models. This is particularly the case in the arena of valuation. You will employ an analyst, or consultant, who loads data into a complex model and out pops a valuation. Your lender relies on these numbers, you need these numbers but I want today to spend almost no time on the numbers themselves, or the model.

Rather I want us to spend the few minutes allotted to me reminding ourselves what we are trying to accomplish and what elements need to be incorporated into the thinking. Some of this is numbers; most of it are ideas, concepts, intelligent thinking.

So my presentation takes the form of suggesting what value is and then we'll look at what assets contribute to value. I'll discuss some of the methods used to value hotels and then from my experiences I will highlight some of the areas of valuation to which one needs to pay particular attention.

#### What is value?

Value is in the eye of the beholder. As far as the buyer or seller of an asset is concerned, its **value** is the value that they put on the asset. The basis of this value may be the historic cost paid, or the amount of money invested over time, or the value that a similar asset sold for. The value can be rooted in the real world or be entirely disconnected from other peoples' reality. The **market value** is the value that consenting adults would agree to buy and sell. Its likely to be below the maximum value attributed by the seller but above the minimum value attributed by the buyer. It's the result of negotiation – a unique process between two individual organisations at a point in time. The market value is time based and is specific to the two parties involved. **Fair value** is a more general concept to recognise the value that two parties *might* exchange. It's not related to any one individual's goals and ambitions or emotions. It's likely to be lower than market value but it could be higher than market value. So we have to be careful when we talk about value – is it specific to a single buyer or seller, specific to a single transaction or general.

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## Components of value

Let's look at the components of value in a hotel business. I am going to suggest to you that the value of a hotel business is composed of five separate but interlocking elements, each of which needs to be considered. They are the physical assets, the financial assets, the customer assets, the partner assets and the organisation assets. We're going to look at each of these briefly.

My proposition to you is that at any one point of time, value is being created, or value is being destroyed, in each of these five areas. The current owner or operator will be better skilled at adding value in some of the areas but probably not in all of them. The opportunity for a buyer is to identify the areas in which they can add more value than the current owner or operator, whilst also recognising where they risk losing value compared to the current owner or operator.

### Physical assets

A hotel company's physical assets are those we most naturally associate with valuation

- the land on which the hotel sites
- the buildings that make up the hotel
- the plant and equipment that make the building into a functioning hotel
- the furniture fixtures and equipment that enable the guest and customer to have the designed experience
- the technology base that allows the business to communicate with the customer
- the inventories that enable the various product elements of the offering to be assembled.

In many ways, this is the easiest element of the valuation - you can see, touch and feel these assets. You can determine whether they have been well maintained, whether there is unrealised value because the asset is not being leveraged fully, whether cash needs to be put aside for maintenance capital, for health and safety capital, for brand compliance capital or expansionary capital.

### Customers

The second group of assets that should be included in a valuation are customer assets – to what extent does the hotel or the hotel company have good ongoing relationships with business or leisure customers – with group coordinators or loyal individuals. What relationships does the hotel management have with conference and event organisers and with the members of the health or spa club?

These relationships are the foundation of tomorrow's business - if the relationships exist and are positive then value can be attributed to future cash flows; if the relationships are weak or don't exist there must be inherently more risk to the future cash flows.

If there is a current brand on the hotel – Holiday Inn, Best Western or Novotel - to what extent is the brand providing those relationships and thus how important is the current brand to the future value. Would a change in brand bring more value because it opens up new different customers, or would a change in brand put value at risk because the relationship with key customers, key segments, will be put at risk? These may not be easy questions to ask, still less easy answers to obtain. But I suggest it is vital to both ask the questions and obtain the answers if value is to be properly attributed to future revenue streams.

### Partners

The third asset category that needs to be considered is the partners engaged with the business. In the first place this will require an evaluation of the management team and the employees.

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What qualities does the management team have, and what skills and experiences does it lack. Is there a labour union, an employee council? What are the costs of redundancy? What are the costs of the current employee benefit packages? What processes are outsourced and why – payroll preparation, elevator maintenance restaurant management – may be provided by third parties. To what extent are these business partners adding value? Are there alternatives? How secure is the contract with the outsourcer and what is the cost to exit the relationship? Who are the hotel's suppliers and is best use being made of local or brand buying co-operatives? Is there a risk that costs will escalate post acquisition because some of these relationships may be put at risk? What Third Party Intermediaries are used by the hotel and why? Can value be added by adding new or different ones? Can the network of fellow franchisees of the brand be better leveraged to add value to this hotel? Again, these may not be easy questions to ask, nor to obtain full disclosure from the vendor, but attention to putting value on these assets will ensure that the projected future cash flows used for the valuation demonstrate a more robust view of the future business.

### Financial assets

Next in the assets to be valued are the financial assets of the business – the scope of assets to be considered will depend on the deal being considered. Is it a sale of a company, sale of an asset, sale of a lease, or a sale of a management contract? In most cases, it will involve considering the working capital employed by the business and evaluating whether the business's seasonality will give rise to a need for flexible facilities that allow for different levels of working capital at different times of the year.

Indeed part of this evaluation may conclude that the business uses negative working capital – this is often the case in hotels as cash receipts from credit card partners is received in advance of the payment to suppliers for food and beverage, prepaid membership may fund the operating supplies for the spa; even employees can be considered a source of finance through the retrospective payment of monthly salaries and benefits. So it is perfectly possible that the financial assets employed at the hotel are a source of finance, rather than an asset requiring finance. Knowledge of this clearly has an important impact on determining fair value of the business.

### Organisation

Finally in this consideration of the assets being valued, we need to think about the organisation that is being bought or sold. Does the business bring some unique irreplaceable asset such as knowledge or skill that can add value to tomorrow's business; or indeed does it lack some aspect of structure, knowledge, skill that makes it likely that it will not be able to cope with future business?

The current owner may have centralised services for a group of hotels with the result that individual hotels are under resourced on a standalone basis – if so the value of the hotel needs to be adjusted to reflect the cost of supplementing this resource, and the cost of making the change. Does the hotel have a sub brand that could be developed and for which value can be attributed? For example, the restaurant or the bar concept, or the spa? You need to ask if a tax-driven structuring of the business will add additional administrative cost whilst driving down the effective rate of tax? Will reporting to the new lender give rise to a cost that today does not exist? If so these costs need to be reflected in the value attributed to the business.

So far what I hope I have demonstrated is that a hotel or a hotel business valuation needs to consider five different types of assets. The valuer needs to understand where current management is adding value and where current management is failing to extract maximum value. To only consider one or two of these asset categories in a valuation risks an incomplete value being attributed.

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## Methods of valuation

So moving on from here let me now look at some of the methods adopted in this industry for valuation. The simplest is the rule of thumb – taught to me in university almost 40 years ago yet still remarkably good as an indication – is to multiply the average room rate by 1000 and this gives you a value per room. Thus, a 100 room hotel with an average room rate of €100 has an indicative value of €10m. Valuers such as HVS or JLL tend to use a value per room as a guide to price – hence in this example, the hotel is being valued at €100,000 per room.

These are simple guidelines but in their simplicity they can be very misleading and a great deal of caution needs to be adopted by the user of such information. A more useful, but still only indicative, measure is the multiple of earnings – either a multiple of historic or projected earnings. This has the merit of being based on the cash flow of the business – and thus reflects the value of income streams from most of the five asset categories, but is simplistic.

So one ends up concluding that the most reliable method is the tried and tested, but complex, methodology which requires a consideration of the future cash flows from the business. Only this method takes full account of all of the elements of all of the five categories of assets. By considering free cash flow, the DCF method reflects the new owners ability to meet the expectations of both providers of debt and providers of equity. When is interest to paid, and what is the payment profile for debt? What is the running yield demanded by equity providers and what is their expectation on exit yields? And only this methodology enables a proper evaluation of the risk associated with the various elements of cash flow, the timings of various elements of cash flow and the degree of uncertainty attributable to each element of cash flow. And these risk elements can be considered separately for each of the five different asset categories

So I believe that DCF analysis, properly conducted by a well qualified team, can enable a professional quantification of the value of each of the physical asset, the customer asset, the partner asset, the financial asset and the organisation asset.

But, care does need to be taken and in particular I believe care needs to be taken in respect of:

- a) testing the assumptions in respect of market size, market growth and market share that underpin the revenue projections
- b) obtaining professional and independent advice on the needs of the physical asset for replacement and repair, and the opportunity to deploy expansionary capex to extend the scope of the current business
- c) understanding the true costs of the acquisition or disposal – professional fees, taxes, change management, contract liquidated damages etc – so as not to underestimate this necessary element of a projected transaction
- d) factoring in the specific costs attributable to tax planning. Some of the costs that will be triggered by a sale will be taxes – capital gains taxes or value added taxes, and the business if profitable will incur income tax obligations. The structure may require administration and these costs need to be anticipated
- e) recognising the cost of management - management fees payable to the management company or the management team to be retained. This cost will be a long term liability that needs to be recognised in any valuation
- f) choosing a discount rate that reflects the unique costs of debt and equity applicable to this project in this location at this time in this currency.
- g) the degree of risk to equity of the level of gearing to be adopted; a high level of gearing, say above 70%, bringing additional risk to equity which should be recognised.
- h) ensuring that the residual value or exit multiple used in the valuation places the right emphasis between short term and long term risk and reward. Too often I have seen valuations that place an undue emphasis on residual value.

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### Intelligent thinking

So I hope that I have encouraged you to adopt intelligent thinking when it comes to valuing hotels – to recognising the contribution made to value by each of the five categories of asset, to recognise the limitations of some of the simpler forms of valuation and to challenge some of the components of a comprehensive discounted cash flow model to ensure it has been prepared robustly.

Finally, I want to remind you that a valuation is frequently used as a negotiation tool; and that this being the case, it is worth taking Einstein's advice to think outside of the box to ensure that your valuation incorporates all elements of value that it should.

Adopting these approaches will, I believe, ensure you don't value a hotel too high for a seller or too low for a buyer.

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