Hotel Valuations

A Guide to Looking Over the Pandemic Horizon

What's Ahead – An Introduction

There is a great degree of uncertainty and anxiety today among real estate investors, especially when it comes to lodging investments. Despite the current environment, seasoned investors are beginning to look beyond the crisis at hand to anticipate opportunities over the horizon. One of the questions we most frequently receive at The Plasencia Group is how to approach the valuation of hotel and resort investments, whether it is the real estate itself or the associated debt instruments.

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This guide examines a broad range of topics that we will continue to explore as the COVID-related dust settles and our cloudy crystal ball becomes a bit clearer. Questions addressed include:

- *How should buyers and sellers of hotel assets look through this dark cloud of industry uncertainty to identify opportunities and determine appropriate pricing?*
- *Which valuation methods are currently most relevant?*
- *How will this cycle be different from previous demand shocks and financial crises?*
- *Which fundamentals of a sound real estate investment strategy still hold true today?*

MARKET VALUE:

Does a fair price always depend on who's asking?

What a property is ultimately worth depends on the perspective of both buyer and seller. When we typically talk about market value, it is understood that:

- *A willing buyer and seller are motivated to complete the transaction.*
- *Neither party is under duress.*
- *There are no exceptional factors influencing the parties.*

Clearly the effects of the COVID-19 pandemic on the lodging industry are an exceptional factor in any effort to value a hotel or resort today. The concept of market value generally does not contemplate how sudden demand and revenue shocks caused by external forces can affect the asset's immediate cash flow and potentially intermediate- and long-term prospects.

Although there has been a limited number of hotel transactions since March, the current bid-ask spread has prevented most willing buyers and sellers from coming to agreement on price (value). In the current environment, sellers are generally still not fully willing to accept a loss of value while buyers are expecting opportunity windfalls by way of substantial discounts.

Part of the challenge in assessing market value today results from the lack of visibility regarding the depth and duration of the economic impact, both from COVID-19 itself as well as the government's actions to contain the virus by way of travel restrictions, safer-at-home orders, business closures, etc.

Many owners may believe they can still ride out the bottom of the cycle or do not yet feel sufficiently pressured by operating losses. Several have been granted short-term relief through forbearance agreements with their lenders. In short, many owners may find it implausible to accept that the value of their assets may have declined so precipitously in such a short period of time.

Conversely, some owners are eager to sell now to stem operating shortfalls. Others may have come to the conclusion that it may be wiser to cut their losses and simply give the keys back to lenders. Many lenders will increasingly become reluctant owners who will ultimately need to sell assets.

It is a matter of time before lodging properties will undergo forced sales. Based on our conversations with owners, lenders and servicers, we anticipate that the first wave of distressed assets will begin to hit the market in the late fall and early winter. The disconnect between value perceptions and timing will likely create meaningful opportunities for those with capital ready for investment.

APPROACHES TO VALUE: Which are most relevant today?

Generally, there are three commonly accepted approaches to value income-producing real estate, including hotels and resorts. A good investment advisor will use a combination of these methods to triangulate a given asset's value, providing a detailed analysis and ultimately pricing guidance depending on the specific asset type, location, etc.

This section articulates how investors are generally weighing the different methods when valuing lodging assets at this trough in the cycle.

Comparable Sales Method

The sales comparison approach assumes that an informed buyer will pay no more for a hotel or resort than the cost of acquiring an existing asset with similar utility. However, this approach will not be especially useful at this time, at least not until a reliable number of lodging transactions are realized to establish a meaningful sample and valuation patterns begin to emerge. The few hotel transactions that have taken place since March mostly involved unique circumstances that make them difficult to use for comparison. Late 2019 and early Q1 2020 sales may be a reference point worth considering, but should probably not be weighted heavily.

Discount to Replacement Cost Method

We are hearing more frequently that prospective investors are underwriting acquisitions using a discount to replacement cost method, evaluating hotels on a "price per pound" basis, whether that be per key or per square foot. The cost approach is based on the assumption that an informed buyer will pay no more for a hotel than the cost of building a brand new property with similar utility. The value is obtained by calculating the current cost of replacement and subtracting any depreciation factors. This valuation method may have some relevance in certain circumstances, but is complicated by the fact that many hotels will undoubtedly suffer accelerated functional and economic obsolescence due to their property type, chain scale, physical condition, location and changing customer expectations. In the current environment, these adjustments are difficult to estimate. These and other factors make this valuation method a poor indicator of value for most hotel properties.

The discount to replacement cost method is particularly popular among investors who typically invest in other real estate asset classes and are considering entering the hospitality sector for the first time.

Discounted Cash Flow and Income Capitalization Method

Traditionally, knowledgeable hotel investors utilize a discounted cash flow (DCF) and income capitalization approach to establish a hotel's value as this method best reflects the present value of the future financial benefits of owning the property.

The future benefits of an income-producing property such as a hotel are its net income, estimated by a projection of revenues and expenses, along with the anticipated proceeds from its future sale. These benefits can be converted into an indication of market value through a capitalization process and DCF analysis. A DCF analysis is ideal for hotels as it usually includes various sources of revenues and related expenses and is highly sensitive to both micro- and macro-economic factors. Most hotel investors typically use a 10-year DCF that assumes a 10-year holding period, with 10 years of operating cash flow and an assumed sale of the hotel at the end of that holding period.

The biggest challenge in the current pandemic-impacted economy – one that has driven the hotel and travel industry to unprecedented declines in revenue and profitability – is developing a reasonable set of financial projections that adequately reflect the depth and duration of the current downturn and the likelihood and strength of a recovery. With limited visibility as to how the pandemic and its impact on the economy, and the travel industry in particular, will resolve itself (by way of vaccines and effective treatments), many investors are assuming that a recovery will occur in the intermediate-term and that most hotels will likely be able to return to 2019 levels of revenue within two to three years, depending on the hotel, market, location and other factors.

A Note on Opinions of Value vs. Appraisals

During this period when hotel values are difficult to ascertain, it is important to emphasize the difference between opinions of value and appraisals. The distinctions fall into a few key areas:

PARTY Opinions of value are often presented by investment advisors (brokers) on behalf of their clients, while appraisals are conducted by licensed, third-party professionals who arguably have no interest in the asset's potential sale.

FEES Appraisers will always charge a flat fee in exchange for conducting their analysis and presenting a report. On the other hand, an opinion of value is typically provided by an investment advisor to a potential client along with a proposal for services related to marketing the asset for a contingency fee.

CERTIFICATIONS While investment advisors are highly sophisticated in their trade, they are not bound to the stringent requirements for data collection and analysis with which a commercial MAI-designated appraiser must comply.

NUMBER OF ASSETS Appraisers assess assets individually while investment advisors are able to provide opinions of value on portfolios of assets.

Due to the uncertainty inherent in making such projections, The Plasencia Group often advises investors to consider a range of potential outcomes and valuations that reflect a "base-case", "downside-case" and an "upside-case." An appropriate risk-adjusted discount rate can then be applied to provide an estimate of value for each scenario.

Since projections will reflect reduced cash flow during the recovery period, the valuation also should accordingly reflect the "discount" attributable to the impact of the pandemic. However, the valuation will not reflect any non-market factors and duress situations that may justify additional discounts. Another consideration relates to the concept of a stabilized value that is intended to reflect the anticipated financial results of the hotel over its remaining economic life and excludes temporary or unusual factors impacting the earnings of the hotel.

Using the current environment as an example, an investor could look through to the other side of an economic recovery, consider any market factors that may permanently affect the operation of the hotel, and then attempt to estimate the stabilized earning potential of the property at that point in time. In turbulent times such as these, The Plasencia Group often advises investors to use a stabilized value as a benchmark to assist in the process of assessing current asset pricing.

Open-Bid Auctions vs. Sealed-Bid Sales

We're often asked about what options the owner of a severely impaired asset might have when a sale becomes forced, whether due to property condition or market dynamics. In many cases, that challenged property is often liquidated through an auction process. Auctions are most suitable when an asset is particularly distressed and difficult to value, but will appeal to a broad array of investors. In other words, the value immediately becomes what a party is willing to pay, and does not necessarily reflect a realistic estimate of the price a property might generally achieve under normal conditions. A major benefit of an auction is that it is generally the most expedient option to determine a distressed-condition value and complete a disposition in an accelerated manner.

The more common open-outcry auction style creates competition among prospective purchasers as bids openly ascend until the highest bidder remains. The potential purchasers are not as concerned about taking on the risk of potentially overbidding as they have the benefit of gauging how their competitors are valuing the same asset.

On the other hand, we may see a greater use of sealed-bid sales for distressed hotel dispositions than ever before by lenders who are forced to take control of assets and need to sell them quickly. A sealed-bid sale gives potential buyers one chance to submit to the seller a single bid, usually in a sealed envelope, by a declared deadline. On the stated date, all of the bids are opened and the highest bidder is usually declared the "winning" purchaser. This method induces the buyer to submit a higher offer and also allows the seller to retain a tremendous amount of control over the process because the bids remain private. Bidders aren't comparing their bids against a figure already established by another party as is often the case in an open auction. Unlike an auction, a sealed-bid sale still allows for additional negotiations between the seller and the highest bidder, aimed at refining certain terms of the offer. Sealed-bid sales help the seller ensure that an asset isn't being sold at too low a price or at terms overly onerous to the seller.

It is important to note that in both types of processes there are scenarios in which the highest bidder may not be the one selected by the seller. If the highest offer doesn't meet all of the seller's requirements, the seller can move down the list to the next highest bidders, possibly with better overall terms.

ECONOMIC REALITIES:

Is this cycle really that different from previous downturns?

We've seen a lot of analysis about past economic declines with the hope that past recoveries might paint a picture of what's ahead in the coming months as a result of the current pandemic. The reality is that this black swan event is quite different from previous downturns in many ways. Take the effects of the 9/11 attacks as an example. The current situation differs in several ways:

- **Government intervention** and new regulations were swift and consequential. Many hotels faced mandates by local municipalities to reduce capacity or close entirely with virtually no notice.
- **New rules for hotel operations** will have lasting effects, including costs related to cleaning standards, maximum space capacities, occupancy limitations, physical distancing and other rules applicable to lodging properties. These new considerations will likely impact the performance and positioning of hotel properties for some time to come, especially when it comes to the group events, meetings and banquets that are so important to the success of many hotels.
- **Prolonged restriction of domestic and global travel** will continue to affect hotel performance and values for a longer period. Traveler concerns will persist until a vaccine is widely available, and likely for months thereafter.
- **The geopolitical landscape** has affected travelers for months by way of global cross-border restrictions and could continue for some time.
- **The forced acceleration of trends** has changed the way that some people behave and conduct business, for better and worse. These include changing customer preferences with regard to property type, room amenities, food and beverage offerings, and technology requirements, among many others. For example, some companies may opt for more frequent video conferencing instead of business travel or group conferences.
- **Debt positions were reasonable** going into the pandemic. Hotels were not over-leveraged, but no debt underwriter could have assumed such steep declines or even zero revenue or negative cash flow for such an extended period.

Some of the dynamics described on the previous page are relatively easily mitigated or shifted to an acceptable "new normal", but it is yet to be seen how hotel investors will react to the perceived risks that have been brought to light by this pandemic and its unprecedented impact on the travel industry.

The market-by-market nature of the hospitality business isn't different, but it has changed rapidly. Namely, the timelines to recovery will be different depending on the type of asset and its location. While it may take just a few years for a suburban select-service, recently constructed or renovated hotel to attract its leisure transient demand base, a property rendered obsolete may be more permanently impaired in the post-COVID environment.

Another difference between this downturn and previous down-cycles is that the dry powder that was already sitting on the sidelines remains plentiful and eager to enter the market, much of it from foreign capital sources. We expect more and more international capital to invest in U.S. hotels. The same factors that have attracted foreign investors for decades, namely rule of law and transparency, continue to render the U.S. the most attractive real estate investment venue in the world.

Domestically, family offices and high-net-worth investors are buying hotels that should provide unlevered returns at levels they are not able to achieve in other investment vehicles. Further, a number of hotel REITs are well-positioned to acquire larger hotels or portfolios of properties utilizing corporate rather than asset-level debt.

ECONOMIC REALITIES:
What hasn't changed?

It is important to keep in mind that the basic fundamentals of sound real estate investment strategy continue to hold true today. Most pre-COVID market variables such as supply and demand dynamics, access and visibility, labor costs, property taxes and the like will persist in a post-COVID world.

Capital structures will vary on a case-by-case basis as assets begin to trade and loans are worked out. Opportunistic investors, whether "vulture" capital or "white knight" capital, will seize opportunities for arbitrage in lending and acquisitions, not to mention in asset and note purchases, much like in past downturns.

The debt side of a capital stack puts hoteliers in a unique position as well. As in previous downturns, capital from traditional lenders dried up quickly and almost completely, beginning at the onset of the pandemic and continuing through today. The lack of debt creates a bit of a "chicken and egg" scenario, where sponsors are seeking debt for transactions while lenders are in wait-and-see mode to assess transactions and rebuild confidence in the industry as a whole. For this reason, all-cash buyers will be expecting greater pricing discounts.

LOOKING OVER THE HORIZON: What can we expect in the months ahead?

What will the landscape look like a year or two from now? Even if things get worse before they get better, we at The Plasencia Group are betting that things will resume to some sense of normalcy within two years. Looking over the horizon to the sunny side, the truth is that some lodging assets will have fared better than others, but they should all be on a path to recovery once a vaccine is widely available around the world.

There will likely be a lag in full recovery for some hotels and resorts, such as those reliant on corporate and group business. Employers will want to have the confidence that their teams will be safe when they return to business travel. Event planners will want to make large meetings and conferences safer by allowing enough time for participants to have been inoculated.

Distressed assets will have traded in the next 12 to 18 months, and by 2022 we expect to see healthy and continued transaction activity, likely with fewer distressed sellers than in late 2020 and early 2021. Investors who are able to take advantage of discounted pricing at the bottom, especially given a dearth of debt, will be enjoying high returns on their low investment basis, and potentially even considering taking them to market to reap those gains.

Additionally, we would not be surprised to see a government-backed asset aggregation and liquidation program emerge similar to the Resolution Trust Corporation (RTC) that aided in resolving the savings and loan crisis of the 1980s. We don't know exactly what form of government intervention and assistance may or may not come for hotel lenders and borrowers, but given the unprecedented volume of troubled loans being processed by servicers, it seems likely that some sort of industry-wide resolution will be required for the most distressed assets. Such a system would rapidly facilitate a great volume and velocity of transactions. In such a scenario, investors could expect deep discounts and perhaps even federally-backed financing.

In Summary

Despite the ostensible uncertainty that the industry is currently facing, the members of our firm remain encouraged by continued interest from capable and trustworthy capital sources investing in the space. Maintaining a long-term view helps every party in the industry to remember that this too shall pass, just like after devastating disruptions such as the Great Depression, WWII, 9/11, Hurricane Katrina and the Great Recession. We will return to normalcy, or perhaps a "new normalcy;" it is simply a matter of timing that no one can predict with certainty. Again, the fundamentals of sound investment strategies still hold true, and there will very likely be once-in-a-career opportunities that present themselves to investors positioned to seize them.

When lodging transaction activity picks back up—and it eventually will—we expect it to be at a dizzying pace, with trickles of activity rapidly evolving into a tidal wave of investment opportunities. Pricing for the first substantial transactions to close will be in the spotlight as investors and potential sellers alike look to benchmark how different types of hotel assets in various markets recover relative to the industry as a whole. The valuation methods and considerations articulated in this guide will be at the forefront of our team's analyses as we prepare opinions of value and proceed to market assets on behalf of sellers. Similarly, we will guide investors to submit offers that are attractive among what will undoubtedly be very competitive processes.

We at The Plasencia Group look forward to working with sellers and buyers alike, offering our insights and steadfast leadership through this challenging cycle. We hope to be of assistance to you soon.

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Contact us today if our experienced advisory team can assist you in valuing assets in your portfolio and crafting a strategic plan for them.

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