HVS Monday Musings: Income Capitalization Approach – The Gold Standard for Valuing Hotels

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According to a recent **GlobalData report**, 573 deals (including mergers & acquisitions, private equity, and venture financing) were announced in the global travel and tourism (T&T) industry in the first half of 2022, reflecting a 3.1% increase over the same period last year. However, before these deals are concluded, the asset needs to be valued. So, how do we determine a hotel's market value and what exactly is valued under the category of hotels? The main valuation techniques are briefly covered in this article.

The hotel's market value takes into account the value of all of its different components, including the land, building, furniture and equipment, inventories, working capital, and any other business value. By any other business value, we mean the premium or discount that will be calculated based on the operational performance of the hotel.

There are three commonly used methods for valuing hotels: the Sales Comparison Method, the Cost Approach Method, and the Income Capitalization Method.

1. The Sales Comparison Method: In this approach, market value is estimated by comparing the sales price of recent transactions involving similar properties to the subject hotel. The differences (dissimilarities) are netted off with appropriate adjustments to these prices. These differences may pertain to transaction characteristics such as leasehold/freehold rights, financing terms, conditions following the sale, and prevailing market conditions, as well as property characteristics such as branded/unbranded, performance, location, physical condition, and facilities.

The Sales Comparison Method often provides highly credible value estimates for assets such as vacant land and residential apartments because the adjustments are minimal and relatively simple to compute. However, this method is far more complex for hotels because of the numerous adjustments required and the difficulty in estimating them.

2. The Cost Approach Method: In the Cost Approach method (also known as Replacement Cost Method), market value is estimated by calculating the current cost of replacing the hotel building, less depreciation.

Summary

This article discusses the main hotel valuation techniques briefly.

Comments

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Typically, the replacement cost is estimated on either a per room or square-foot basis*. The value of the land is then added to the depreciated replacement cost estimate to arrive at the total estimated value.

The cost approach is seldom used to value existing hotels because these hotel assets are vulnerable to physical deterioration, brand/unbranded chain, and external factors and the losses in value are difficult to quantify due to the lack of recognized cost reporting body/association.

3. The Income Capitalization Approach: This method of valuation assesses the business as a going concern rather than just the value of the buildings and land because hotels are income-producing assets that are bought to realize future profits. The Income Capitalization Method closely simulates knowledgeable buyers' investment rationale and strategies, making it the preferred method for appraising income-producing assets and is widely regarded as the Gold Standard Method for valuing hotels.

The Income Capitalization Method estimates the present value from the projected future income from the hotel assets. Future income includes the annual net income plus the net revenue from selling the hotel asset in the future. Through the capitalization and **discounted cash flow** analysis, we translate this future income into a representation of the market value at the time of the analysis. The distinctive feature of the discounted cash flow analysis is that it takes into account the expected market rate of return, country-specific tax benefits, and the expected rates of return demanded by equity investors and lenders.

**There is currently no recognized cost reporting body or association recognized as a standard across India.*