

Valuation of Hotels in France

Jean-Louis DARGERE, France

Key words: hotel trade, occupancy rate, income, risk premium, property market.

ABSTRACT

During the 20th century, there was a change in our way of life with an ever increasing number of business and tourist trips. In the words of President ROOSEVELT "the world is shrinking". These trips called for accommodation, hence the development of hotels. France was no exception to this phenomenon (considerable hotel and restaurant infrastructure which stretches over the whole of the country and consolidation of hotel chains). Valuation hotels has become a major branch of French appraisers' business.

THE VALUATION OF HOTELS

In order to ensure that their investment is profitable, property owners require appraisers to forecast the performance of the purchase made. For this reason, to meet these requirements, French appraisers is tending to prefer financial methods (cash flow) although traditional methods are still used as an appraiser always uses several methods in order to better discern the value to be determined.

The Discounted Cash Flow method will expose in this paper, with the determination of the risk premium to be included in the discount rate based on a strategic schedule which depends on the relative value of the hotel market and the relative value of the hotel (rating according to various criteria).

A hotel industry operation includes a certain risk for the investor. What level of risk premium should be integrated in the discount rate ? It would appear that this depends on the level caution use in the assumptions taken as the rate of inflation, the rate of growth of rents in relation to this rate of inflation, and the discount rate.

The valuation of the hotels can be seen to be a delicate business in that it calls for an in-depth knowledge of the hotel market, the analysis of the specific and external elements of the hotel and the use of a diversity of methods of analysis.

RESUME

Durant le 20^{ème} siècle, transformation de notre mode de vie avec des déplacements professionnels et des déplacements touristiques de plus en plus nombreux. Suivant l'expression du Président ROOSEVELT, " le monde se rétrécit ". Lors de ces déplacements, nécessité d'un hébergement, d'où le développement des hôtels. La France n'a pas échappé à ce phénomène (importante infrastructure hôtelière étendue massivement sur tout le territoire

et mutation avec des mouvements de restructuration de chaînes). L'estimation des hôtels est devenue une branche importante de l'activité de l'Expert Immobilier Français.

EVALUATION DES HOTELS EN FRANCE

Les investisseurs, soucieux de la rentabilité de leur capital investi, obligent les experts à une étude prospective du rendement de l'acquisition réalisée. C'est pourquoi, pour répondre à ces besoins, les méthodes dites financières deviennent de plus en plus utilisées par les Experts Français (cash flow) mais les méthodes traditionnelles restent d'actualité car l'expert utilise toujours plusieurs méthodes pour mieux recouper la valeur à déterminer, et elles sont également toujours en vigueur et utilisées par les Tribunaux Français.

Cette communication présentera l'évaluation des murs d'hôtel par la méthode de l'actualisation des Cash Flows. Une opération hôtelière comporte un certain risque pour l'investisseur et dans cette méthode, cette prise de risque difficile à estimer par l'expert doit être rajoutée à un taux d'actualisation minimum. Elle correspond à la volatilité des résultats financiers futurs de l'hôtel étudié, mais afin d'évaluer leur pérennité, il peut être intéressant de se baser sur une étude stratégique du marché local hôtelier et de l'hôtel étudié.

La réalisation d'une grille stratégique, fonction de la valeur relative du marché hôtelier et de la valeur relative de l'hôtel (attribution de notes sur divers critères), sera une tentative pour une meilleure appréciation du risque.

L'évaluation des hôtels s'avère délicate du fait qu'elle requiert la connaissance approfondie du marché hôtelier, l'analyse des éléments intrinsèques et extrinsèques de l'hôtel et l'utilisation de méthodes d'estimation diverses.

CONTACT

Jean-Louis Dargere, Commission 9
Land Surveyor of O.G.E
7, rue Jeannin, 71400 AUTUN
FRANCE
Tél. + 33 385.522.639
Fax + 33 385.521.575
E-mail : JEAN-LOUIS.DARGER@wanadoo.fr

Valuation of Hotels in France

Jean-Louis DARGERE, France

INTRODUCTION

During the 20th century, there was a change in our way of life with an ever increasing number of business and tourist trips. In the words of President ROOSEVELT "the world is shrinking". These trips called for accommodation, hence the development of hotels. France was no exception to this phenomenon. First world tourist destination thanks to a varied architectural, landscaped, cultural and entertaining patrimony, France is endowed with a considerable hotel infrastructure which stretches over the whole of the country. Since several decades, the hotel trade is in full alteration with consolidation of hotel chains. Valuation hotels has become a major branch of French appraisers' business.

This paper is divided into three sections:

- 1) Development of hotels in France and listing the hotels available.
- 2) Rental value of hotels.
- 3) Open market value of hotels.

1. CHANGE IN THE NATURE OF HOTELS AND CENSUS OF THE NUMBER OF HOTELS

1.1 Change in the Nature of Hotels

As against the independent hotels, considerable development of chains with big investors who make a rigorous study of establishments in depending of profitability. Importance of the rôle of the appraiser in these prospective studies.

A voluntary chain is a group of independent hoteliers to undertake a certain number of actions in common (Logis de France, Relais et Châteaux, etc.) while still retaining their legal and financial independence. As to the integrated chain, it is run by a big hotel group, and its member hotels operated by the group or its subsidiaries.

Share according to rooms	1986	1999
Indépendents	88 %	42 %
Voluntary Chains	8 %	23 %
Integrated Chains	4 %	35 %

It can be observed that independent hotels have a large share in the French scene. This structure, often family-based, suffers from its weaknesses at the commercial and financial level. In parallel, we are experiencing a growth in hotel chains since 1988, the number of hotels involved here has been multiplied by 9 for the integrated chains.

By making a network across a country, or indeed a continent, the operations of restructuring (agreements, purchases or mergers) must make it possible to reduce costs and lessen risks.

This growth in the power of hotel chains is based on strategies of collaboration to seek the effect of scale (from 30 hotels) and even of speed of penetration in new markets, as for instance in Asia. This phenomenon also exists in other fields like catering, an example being the MacDonaldis chain.

The development of integrated chains and voluntary chains is also based on a commercial logic supported by the offer of services and of new technologies : new systems of reservation and reception of customers, and the internet network.

At the worldwide level, the American groups confirm their supremacy with the exception of one big French group which holds 4th position.

Rank	Group	Country	Number of hotels
1	HFS	USA	5,500
2	Holiday Inn Worldwide	GB	2,260
3	Choice Hotels international	USA	3,646
4	Accor	FRA	2,465

1.2 Census of the Number of Hotels

The hotel population of France consists of about 20,000 establishments with a total capacity of 600,000 rooms. The ministerial order of February 14th 1986, which distinguishes 6 categories of tourist hotels, will enable us to record the hotel population in each category both in the Ile de France (PARIS and her suburbs) and in the provinces.

1.2.1 General

In 1999, France welcomed 71.4 million foreign visitors. In this it is well ahead of Spain (52 million) and the United States (47 million). To cope with this flow of people, France has a large hotel population.

1.2.2 The Hotel Population in Number of Establishments

As observed at 31.12.1999

	0 *	1*	2*	3*	4* et 4* Luxury	Total
Ile de France	142	224	966	686	141	2,159
Province	2,070	2,016	9,170	2,676	472	16,404
TOTAL France	2,212	2,240	10,136	3,362	613	18,563

Development of the population from 1994 to 1999

	1994	1999	Variation
1*	4,750	2,240	- 52.8 %
2*	10,602	10,136	- 4.4 %
3*	3,267	3,362	+ 2.9 %
4* et luxe	527	613	+16.3 %
TOTAL	19,147	18,563	- 3.1 %

1.2.3 The Hotel Population in Number of Rooms :

As observed at 31.12.1999

	0 *	1*	2*	3*	4* et 4* Luxury	Total
Ile de France	7,672	6,807	48,233	42,866	19,460	125,038
Province	47,447	35,601	236,912	112,739	25,841	458,540
TOTAL France	55,119	42,408	285,145	155,605	45,301	583,578

Development of the population from 1994 to 1999

	1994	1999	Variation
1*	80,124	42,408	- 47.1 %
2*	302,854	285,145	- 5.8 %
3*	148,334	155,605	+ 4.9 %
4* et luxe	36,090	45,301	+25.5 %
TOTAL	567,402	583,578	+ 2.9 %

Despite a decrease in the economic range (0*, 1* and 2*), it still represents 3/4 of the total capacity in 1999. As to the middle and upper ranges, they are still progressing because of restructuring movements (disappearance of independent structure to the benefit of the chains).

1.2.4 The Occupancy Rate (O.R.)

The occupancy rate is an important indicator for the valuer for analyzing the activity of the hotel as against its competitors ; it is the ratio of the number of rooms rented and the number of rooms offered taking into account the periods when the hotel is closed.

	0 *	1*	2*	3*	4* et 4* Luxury	Average O.R.
1994	54.6 %	59.4 %	57.7 %	57.2 %	60.3 %	57.8 %
1999	60.2 %	47.8 %	55.6 %	62.1 %	67.7 %	58.7 %

The occupancy rate depends principally on the geographical situation of the hotel in the country, where there appear lacks of balance between high and low seasons (summer-winter, sea-mountain, Paris-provinces) ; for example, Burgundy experienced an occupancy rate of only 53% in 2000.

1.2.5 Conclusion

Valuation of hotels is difficult when adopting the long-term approach. This is because the long-term strategy of the hotel enterprise is often determined by shareholders who are affected by the national and international financial context.

Events of the international economic situation influence in one direction or the other the size and destination of the flow of people, and their behaviour. The terrorist activities of the month of September 2001 will disturb the hotel business market (reduction in tourist movement already observed) and consequently an intensification of the marketing strategies of the hotel chains.

The introduction of the Euro will be an interesting financial tool for the coming years, since it should intensify European competition and consequently the movements of concentration into chains. The two main movements are therefore the concentration in the form of chains and internationalization.

2. RENTAL VALUE OF HOTELS

The rental value represents financial compensation (actual or potential) to the use of an asset as part of a lease.

2.1 Summary of Legislation

Hotel leases come under the legislation regarding commercial leases with the decree of September 30th 1953 and its successive modification, and the Law of July 1st 1964 specific to hotels which controls the particular problem of work carried out by the lessee. The main characteristic is the right to renewal of the lease for the benefit of the tenant, or failing that an indemnity known as the indemnity of eviction.

2.2 Rental Value by Direct Comparison

This method is the most frequently used by valuers since it involves valuing a recent asset with reference to transactions involving comparable assets (nature and location).

2.3 The Hotel Industry Method

The valuation of the rental of a hotel lease can also be determined in accordance with the customs of the profession and in the French hotel industry a method has been set up which is

called the "hotel industry method", which consists in determining the rental value from a percentage of the annual receipts.

The principle is as follows :

1° Estimation of the net theoretical annual receipts :

It is the maximum turnover which the hotelier can make by renting all the rooms offered for 365 days.

But the following elements must be taken into account:

Reduction of receipts for breakfasts when they are included in the price of the room

Adaptation of the prices offered according to the season (see sales brochure)

Application of a **occupancy rate** (real or potential) to these theoretical receipts.

Deduction of service charge by applying an allowance of the order of 15%.

And deduction of VAT applicable to the category of hotel involved.

2°) Application of a coefficient depending on the category of hotel. This percentage corresponds to the share of the rental which can be absorbed by the turnover achieved by a careful manager. The percentages rise as the category of hotel falls. This is because the structural and equipment costs (staff, equipment, renovation) are higher as the category of hotel rises.

The percentages observed are as follows : category 0* (19 to 22%), category 1* (16 to 17%), category 2* (14 to 16%), category 3* (13 to 14%), category 4* (11 to 12%) and category 4* luxury (9 to 11%).

On the rental value thus determined, allowances must be applied when the tenant lead has to bear exorbitant costs:

- real-estate tax and insurance : allowance of 5 to 8% or the actual amount
- major repairs : allowance of 10 to 15%, even 25% in the case of major work
- renovations under the law of 1/7/1964 : allowance of 35 to 50% in the case of a burdensome renovation and of 10 to 20% for equipment or sanitary work.

The following example will allow to understand better the method : hotel 1* with 83 rooms and an average price by 25-euro rooms.

$$1°) \text{ maximum turnover} = 25 \text{ Euros} \times 83 \text{ rooms} \times 365 \text{ days} = 757,375 \text{ Euros TTC}$$

Application of an occupancy rate :	$757,375 \times 0.65 =$	492,294 Euros TTC
Deduction of service :	$492,294 / 1.15 =$	428,082 Euros TTC
Deduction of VAT :	$428,082 / 1.055 =$	405,765 Euros HT

2°) **Rental value :** $405,765 \times 0.17 =$ **68,980 Euros HT**

Summary: It appears that the rental is not linked to the operating profit of the hotel. It is for the valuer to adapt the criteria of this method in order to obtain results in accordance with economic reality.

3. OPEN MARKET VALUE OF HOTELS

3.1 General

In order to ensure that their investment are profitable, property owners require appraisers to forecast the performance of the purchase made. For this reason, to meet these requirements, French appraisers is tending to prefer financial methods (cash flow) although traditional methods are still used as an appraiser always uses several methods in order to better discern the value to be determined, and they are also still in force and used by French courts.

To determine the open market value of hotels it is necessary to examine a certain number of elements which a valuer is in the habit of studying, and this will not be gone into in the present communication : elements directly related to the property to be valued (location, the size and make-up of the building, occupancy rate, etc.) and elements external to the property to be valued (twon planning, legal environment, competition, interest rate, etc.).

The fixing of the open market value of hotels is carried out by various methods which were generally familiar to the valuer : direct comparison, rental yield, and projection (discounted cash flow). The valuer will use various methods to determine the open market value of either the hotel bricks and mortar, or the goodwill, or the whole property.

3.2 The Discounted Cash Flow Method

This method is based on:

- forecasting income and expenses related to exploitation of the asset,
- estimating a “ residual value” at a chosen analysis horizon,
- discounting the forecast future cash flows resulting from the information gathered above, the total constituting the value of the asset.

This method, then, takes an essential factor into account: the time.

The value of the asset depends on the net advantages expected of it, which correspond to the net cash flow elements generated in the future in a given period (economic life of the property or investment period selected for this property). These advantages take into account the rates of profitability required of the property period by period.

Generally, the discounting period selected can correspond to the longevity of the operation or exploitation (10 to 15 years) but the choice of the length of the period studies may depend on the property owner or investor and his characteristics (for example, a projection over 5 years will be planned when the investor is a mutual fund).

Calculating the residual value : the residual value is the estimated value attributed to the building at the end of the analysis horizon. The method involves the capitalisation to infinity of the “standardised” net income generated from the asset, the building will stay in a usable condition with renovations and that it can therefore generate revenue. It is difficult to foresee the characteristics of the real-estate market at the end of the analysis period, which is why it is possible to select the current capitalization rate of the hotel trade market. The residual value of the building at the end of the period has a relatively low weight in the method .

To determine the discount rate which consists in arbitrating as between a real-estate investment and a financial investment depending on the discount period, the valuer can use two methods to calculate the discount rate :

Case n° 1 : discount rate calculated from the yield of private-sector bonds of the 2nd category (rate of low-risk money).

Case n° 2 : discount rate based on the average weighted cost of capital. This method consists in regarding the discount rate as a combined rate which must serve to repay the sources of the funds (the investor's contribution and loan). The financing conditions of the hotel project must be taken into account.

Example: for a given investment divided up as 80% in loan at 5.5% and 20% in own resources at 20% (higher risk, greater chance of losing the money quickly), the discount rate will be 8.4%.

A hotel industry operation includes a certain risk for the investor. What level of risk premium should be integrated in the discount rate ? It would appear that this depends on the level caution use in the assumptions taken as the rate of inflation, the rate of growth of rents in relation to this rate of inflation, and the discount rate (see cases n° 1 and n° 2 above).

Making out a strategic schedule, based on the relative value of the hotel market and the relative value of the hotel (scoring on a variety of criteria) will represent an attempt at a better appreciation of the risk.

The risk premium is often difficult for a valuer to appreciate, it corresponds to the volatility of the future financial results of the hotel under study, but to value these in the long term it may be interesting to base one's thinking on a strategic study of the local hotel market and of the hotel in question.

The valuation of the various criteria consists in attributing to them depending on their performance a score between 0 and 4 according to the following principle : 0 (excellent

performance), 1 (good performance), 2 (moderate performance), 3 (inadequate performance) and 4 (non-existent performance).

The strategic schedule must be adapted by the valuer to each valuation, and could be as follows :

STRATEGIC SCHEDULE		
Relative value of the hotel	Risk class	Total V1
Geographical situation in the town		
Specific commercial situation in the street		
Condition of upkeep		
Analysis of services offered		
Analysis of rate of occupancy over last 3 years		
Pricing policy		
Sales policy of the hotel or the chain		
Lifetime of the building		
Relative value of local hotel market	Risk class	Total V2
Analysis of present offer		
Analysis of future offer		
Analysis of existing demand		
Analysis of future demand		
Analysis of the socio-economic environment		
Sensitivity of the hotel or chain with respect to hotels		
Analysis of economic market		

The risk premium depends on the two relative values and its calculation must take into account the weight of each relative value, which leads us to develop the following formula :

Let “p” be the percentage of risk premium

The amplitude of the risk can reasonably be between 0.5% and 10.5% (case of a hotel which is in a state of collapse and has little economic future).

$$p = [53 \times (V1/32) + 47 \times (V2/28)]/10 + 0.5$$

On the occasion of this communication, the method of so-called "discounted cash flow" will be presented with a precise example concerning the valuation of open market of the hotel bricks and mortar, the cash flow will be as follows : Gross Income (rentals received or rental value determined by the hotel industry method) – owner's costs (major work on the building, major equipment, rental fees, taxes, duties, etc...).

This valuation is the case most often met with by the valuer, but this value is linked with the goodwill especially if it is in decline (little chance of re-conversion for such buildings). Thus, the valuer often finds that the hotel to be valued also has a restaurant which must also be valued by various methods (market comparisons, applying a price per square meter to the total surface area, or by choosing a rate of yield and applying it to actual and future rental income).

Finally the Current Net Value is calculated as follows :

$$\sum_{i=1}^n \frac{RN_i}{(1+ta)^i} + \frac{\text{Residual Value}}{(1+ta)^n}$$

4. GENERAL CONCLUSION

It can be observed that hoteliers are organizing themselves to use the Internet network in the context of reservation of rooms in order to optimize the booking of each hotel. In addition, independent hoteliers are forming groups to make themselves know through guides and publicity in all forms. The existence of a restaurant in a hotel generates supplementary costs and they compromise the result of the hotelkeeper and consequently, are often the independent hotelkeepers who abandon the activity of restaurant.

The valuer also has occasion to carry out valuations of tourist residences : smaller yield than the hotel industry (3 to 6% only). If the properties are sold as "spatio-temporal" properties, the valuer must carry out a precise study of the occupancy rate, the maintenance costs, and resale. This type of property has caused disappointments for some owners because management fees for the building improved quickly, so that the Valuer has to exercise a certain amount of care.

The valuation of the hotels can be seen to be a delicate business in that it calls for an in-depth knowledge of the hotel market, the analysis of the specific and external elements of the hotel and the use of a diversity of methods of analysis.

In their respective countries, the valuers of Commission 9 of the F.I.G. are certainly confronted with the same problems with regard to valuation of the hotels.