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Going Concern Issues in Hospitality Valuation

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OVERVIEW

- Hotels are a mixture of real estate, personal property and business enterprise value (BEV). The combined total of these three components are often referred to as a going concern.
- The question is who owns what portion of value and how is each portion of value measured?
- The market is the best evidence of answering this question.

GENERAL THEORY OF HOW HOTELS ARE VIEWED IN THE MARKET

- Hotels generate income in a variety of ways and have a wide variety of expenses. The income is the result of activity that is commonly thought of as a “business”. However, the ***income that is generated needs to satisfy the return requirements of the real property, personal property and BEV components of value.*** The issue at hand is the accurate measurement of all three of these components.

WHO OWNS THE BUSINESS ENTERPRISE VALUE PORTION OF THE GOING CONCERN?

- Hotels are usually managed by experienced entities that are specialized in the operation of the "business" of the property type. This function can be an outside management company, or an experienced owner operator
- It is common for the ownership and management to be separate.
- These management companies have significant investment in their brand (training, reservations systems, legal process, administration, marketing, etc). They expect a return on and return of their investment.
- These management companies are paid a fee to compensate them for their return on and return of their investment in the activity that generates the BEV in a hotel property.
- It is the management function that creates the BEV portion of the going concern.

WHAT IS TRANSFERRED IN A HOTEL ASSET SALE TRANSACTION?

- A typical hotel buyer purchases a property based on net cash flow after all expenses are deducted, including the expense deduction accounting for management/franchise/branding.
- The expense for management/franchise/branding is actually revenue to the management/franchise/branding owner. Specifically, the net cash flow after the deduction for management/franchise/branding is the return to that entity, or in other words the return to the owner of the BEV portion of the hotel going concern.
- As a result, the transfer of the hotel is only that portion of the net cash flow that reflects the return to the real and personal property components of the going concern. The net cash flow to the BEV is already removed, and thus not considered.
- This is how a typical hotel market participant views this situation, and therefore mirrors market activities.

CASE STUDY (SIMPLIFED)

- 400 Room hotel in urban location
- Full service with typical amenities
- The market has majority of hotels with national, regional and local branding/mgt
- Ownership is a passive owner (no daily mgt)
- Property is professionally managed
- Market negotiated management/franchise fees paid

CASE STUDY (SIMPLIFED)

- Management/Franchise company has significant investment in corporate HQ, staff, marketing, accounting, legal, design, and more
- The owner does nothing more than hand over the keys of the hotel to the management company on day one
- The management/franchise company handle the decisions on how to deploy in the market

QUESTIONS

- Do the management/franchise company have an investment in their business?
- What is the return on and return of to the management/franchise company
- If the owner is passive, how do they have any contribution to the BEV portion of the asset?
- Does the specialized nature of hotel management and branding companies make this asset class unique (Yes a leading question!)