



James Cornell

- CERTIFIED HOTEL APPRAISER, CHA
- LICENSED BROKER

Website: www.CornellHotelzz.com

P.O. Box 4077, Cordova, TN 38088

FAX: (866) 222-3097

Email: JamesCornell@CornellHotelzz.com

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Hotel Valuations – Correct NOI Calculations

(4-minute read)

Author: James Cornell

We calculate Net Operating Income (NOI) as the remaining amount of money after deducting all expenses, including the replacement reserve. NOI equals EBITDA minus the replacement reserve. For this article, NOI will include the replacement reserve.¹

Discounting or Capitalizing Net Operating Income (NOI)

The value of a hotel encompasses both the business and the real estate. NOI is used to calculate profitability and to estimate hotel price valuation. Generally, appraisers use two methods to calculate market value (price). Valuation experts calculated market value by either capitalizing or discounting NOI.^{1, 2}

Appraisers and brokers will project revenue and expenses for a year when the subject hotel has stabilized occupancy, average daily rate, and NOI, adjusted for inflation. Stabilized net income is either capitalized or discounted back to the year of appraisal to determine the estimated market value of the subject hotel.¹

Return on Investment

Expected return on investment is frequently measured by NOI divided by sales price, which equals the cap rate. Cap rate is a measure of a hotel asset's value.³

NOI Equation: $\text{NOI} = (\text{Gross Operating Income} - \text{Operating Expenses}) - \text{Replacement Reserves}$

Correct Cap Rate calculation based on NOI is essential for accurately appraising real estate value. Using an incorrect Cap Rate in hotel price analysis can halt a sale altogether and leave a good hotel property on the market until the price is adjusted to meet market expectations. No one will pay an excessive price for even a superb hotel.

Read Library Article: “Calculate Cap Rates Using Regression Analysis”

Correct NOI Calculation

Incorrect NOI calculations can significantly affect market-derived hotel price valuation. Substantial differences can occur between what an owner (seller-client) can expect to gain from a hotel sale and what the market is willing to pay. A hotel listed at an exorbitant price will languish on the market and remain unsold.

Low-ball hotel buyers who wait on the sidelines find an overpriced hotel attractive bait as the seller eventually lowers the hotel price to meet market valuation expectations. Low-ball hotel buyers are generally difficult to deal with, as they unreasonably continue to negotiate price and contract terms.

Correct Price Valuations Depend Upon Correct NOI

As the NOI calculation shows (see below), the correct calculation of NOI excludes debt service, depreciation, and income taxes as expenses. Investors do not deduct these expenses from NOI because they vary from investor to

investor. When appraisers evaluate hotels, they must use NOI as a measure of what the typical market, composed of serious and capable buyers, would pay.³

Operating Expenses

Businesses directly associate operating costs with hotel operations and incur these expenses to generate revenue. Companies do not directly connect non-operational expenses to generating revenue from property operations. For example, analysts do not deduct debt service from NOI because it does not directly affect day-to-day property operations.

We, as hotel professionals, calculate Net Operating Income after replacement reserves but before interest, taxes, depreciation, and amortization. Property owners set aside replacement reserves as funds for the periodic replacement of capital items in a property, typically estimating them at 3% to 5% of total revenues. We subtract replacement reserves as a day-to-day operational expense.³ Replacement and reserves typically include major repairs, renovations, or improvements to the property.

NOI is calculated as annual profit BEFORE deducting:

- Taxes
- Interest
- Depreciation
- Debt service
- Income taxes
- Gains and Losses on Asset Sales
- Corporate overhead
- Management incentives & bonus compensations
- Other expenses not pertaining to hotel operations

Expenses deducted from NOI include the following:

- Management fees
- Property taxes
- Property insurance
- Replacement reserves
- Utilities
- Maintenance

Experience and Proper Education Make a Difference

Cornell provides Broker Price Opinions (BPO) for hotel owners who want to determine the value of their property. There is a perfect buyer for your property. We focus on connecting your property with that buyer.

Cornell has compiled a comprehensive list of hotel contacts from various regions. Mastering the art of locating and presenting your property is a skill honed through years of experience, formal education, and numerous successful sales—our exclusive list of serious, qualified hotel buyers numbers in the hundreds.

For buyers looking to purchase hotels, we have an exclusive list of sellers offering their hotels for sale off-market, unlisted.

Read these articles in our Library/Blog:

- “How to Choose the Right Broker”
- “Small Brokerage Firms versus Large - Advantage Goes to Small Firms ”
- “Calculate Cap Rates Using Regression Analysis”
- “Hotel Market Analysis & Valuation Software”
- “Three Approaches to Appraising Hotels”

Attributions

¹ Stephen Rushmore, How to Value a Hotel, A Complete Guide to the Hotel Valuation Methodology by Steve Rushmore, MAI, CHA.

² Jan deRoos, Ph.D., and Stephen Rushmore, CHA, MAI, "Hotel Valuation Techniques," <https://hvs.com/content/Bookstore/HotelValuationTechniques.pdf>

³ John W. O'Neill, MAI, ISHC, Ph.D., Director of the School of Hospitality Management at The Pennsylvania State University. "Correctly Calculating NOI First Key To Cap Rates."