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Three Approaches to Appraising Hotels (8-minute read)

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Definition Of Market Value - Hotel Purchase & Sale Transactions

For hotel real estate, the Appraisal Institute's definition of market value will suffice.

*"The most **probable price** a property would sell for in a competitive and open market, assuming both buyer and seller are motivated and well-informed."*

Probable hotel price, according to the Appraisal Institute, implies that appraised values are not exact, but indeed are estimates of value.

All appraisals produce implied price estimates of value. Appraisers cannot determine an exact price for any hotel until after a successful sale transaction has closed. The market determines the final realized value (price).

Appraisal Software Improves Hotel Price Valuations

Excellent market-based price valuations can be made by the use of computerized hotel valuation software.

Read Library Article: “Hotel Market Analysis & Price Valuation Software”

NOTE: James Cornell is a Certified Hotel Valuation Software Consultant (CHVSC). The valuation software is used to produce reliable Hotel Market Analysis, Financial Projections & Price Valuations.

Three Valuation Approaches

Hotel appraisers will consider utilizing three valuation approaches to calculate the probable hotel value (price). This article examines the strengths and weaknesses of each valuation approach.^{1, 2}

- Cost Approach
- Sales Comparison Approach (sales comps)
- Income Approach

NOTE: Brokers and MAI Appraisers use the Income Approach to establish a realistic, market-based price when preparing a hotel for sale. Appraisers perform MAI appraisals, which are costly and may require days or even weeks of investigation and analysis. By contrast, valuations performed by Brokers (Broker Price Opinion) are generally less costly and can produce excellent market-based hotel price valuations.

Confirmation of Price

The Cost Approach and the Sales Comparison Approach both confirm the price valuation calculated by the Income Approach. Using all three appraisal approaches together is intended to verify the hotel value calculated by each of the other approaches.¹

Banks and Tax Authorities generally require all three valuation approaches. However, reliance solely upon the Income Approach is what most sophisticated investors and hotel appraisers utilize to render hotel price valuations.

Cost Approach to Valuation

The Cost Approach calculates market value by first estimating the cost to replace or construct the subject hotel as new. The appraiser does not initially include land value in the replacement cost. The appraiser or broker then adjusts the cost of replacing the subject hotel by deducting for physical depreciation, functional obsolescence, and external obsolescence. Vacant land value is then added back into the calculations to arrive at an implied price valuation.

Definitions: Physical depreciation is based on the wear and tear on furniture, fixtures, and equipment. Functional obsolescence pertains to the building's design and site layout. External obsolescence pertains to the local market, societal issues, and location. External obsolescence pertains to factors external to the subject hotel that are not curable.¹

The Cost Approach is Best Utilized Under the Following Circumstances

- The Cost Approach is best used to determine the *feasibility* of a new project.
- Best used for newly built hotels or hotels that have undergone extensive modernization.
- The Cost Approach substantiates price valuations made by the other two valuation approaches.

Strengths of the Cost Approach

The strength of the Cost Approach is that construction costs and land values are generally available. Construction costs and renovation costs can be obtained from cost estimators, construction cost manuals, architects, engineers, and contractors.

The Cost Approach is often used in conjunction with the Income Approach and the Sales Comparison Approach. All three valuation approaches substantiate the price valuations of the other approaches. Reliance on all three approaches lends credence to the final calculated appraisal.

NOTE: Brokers use the Income Approach as a standalone method to set the price before a hotel sale. Excellent price valuations are calculated when the proper Cap Rate and Net Income are incorporated into the valuation computations.

Read Library Articles:

- “Hotel Valuations – Correct NOI Calculations”
- “Calculate Cap Rates Using Regression Analysis”

Weaknesses of the Cost Approach

- Appraisers struggle to apply the Cost Approach reliably because they find it difficult to quantify depreciation accurately. They often apply highly subjective judgments when estimating physical depreciation for furniture, fixtures, equipment (FF&E), and building wear and tear, which leads to adjustments that appraisers frequently understate or overstate.
- Functional obsolescence typically affects older hotels that require substantial renovation. As the hotel ages, appraisers find it increasingly difficult to support the subjective cost estimates this obsolescence demands.
- External obsolescence arises from local market, social, and economic forces that the property owner cannot control or easily cure. Appraisers must rely on largely subjective—and often poorly supported—judgments to quantify the dollar impact of external obsolescence.
- Appraisers achieve the best results when they use the Cost Approach together with the Income Approach and the Sales Comparison Approach. The Income Approach proves superior because it alone can generate credible hotel price valuations without depending on either the Cost Approach or the Sales Comparison Approach.

Sales Comparison Approach to Price Valuation (sales comps)

Appraisers must compare apples to apples, meaning they must select comparable sales that closely resemble the subject hotel to derive a reasonably accurate market-based price. Appraisers find this very difficult because hotels sold in the same local market are rarely homogeneous.¹

Strengths of the Sales Comparison Approach (sales comps)

- The best use of this valuation method is to establish a reasonable range of values within price brackets, based on actual sales transactions (sales comps) of comparable hotels. High and low sales comps bracket the price estimates calculated by the Cost Approach and the Income Approach. The price brackets are intended to confirm the validity of valuations derived from the Cost Approach and the Income Approach.¹
- The strength of the Sales Comparison Approach is that it provides verifiable value estimates for homogeneous properties such as vacant land and single-family homes. Sales comps of homogeneous properties enable an appraiser to arrive at a price estimate with little difficulty.
- The best-case scenario is when comparable properties match the given size, class, age, proximity, social factors, and amenities.¹

Weaknesses of the Sales Comparison Approach

The inherent weakness of the Sales Comparison Approach is that gathering data of recent sales comps in proximity to the subject hotel and with similar characteristics is often difficult. Data on recently sold hotels in smaller or remote markets is especially difficult to obtain.

- Market-derived capitalization rates can be computed using sales comps; however, cap rates are vulnerable to mis-calculation because of the inherent weakness found in the Sales Comparison Approach.¹

Hotels Are Not Homogeneous

Hotels generally differ significantly from one another. Because of these differences, appraisers must apply numerous adjustments to make these hotels

in the same or similar market as reasonably identical to the subject hotel as is possible. Appraisers find these adjustments challenging because they involve complex factors, high subjectivity, and limited market data. Moreover, appraisers frequently err when quantifying adjustments, as these adjustments depend heavily on subjective judgment and limited market data.

The Sales Comparison Approach (Sales Comps) Can Produce Erroneous Results

Examples:

Class: Two recent sales in the same market of a luxury class 5 Star Hotel, when compared with an old ranch-style motel. Finding recent comparable hotel sales in the same market is frequently difficult, if not impossible.

Location: When appraisers compare two similar hotels located in different markets, they discover that comparable hotels in New York sell for significantly higher prices than comparable hotels in Arkansas.

Depreciation: When appraisers compare newer hotels with updated furniture, fixtures, and equipment (FF&E) to older hotels whose FF&E has suffered significant physical wear and tear.

Function Distinction: Erroneous valuation results can happen when hotels are compared in the same market but are functionally distinct.

Income Approach

The Income Approach considers both the value of the real estate and the business's financial performance. Appraisers value a hotel by calculating the

present value of all future cash flows the hotel will generate plus the present value of the real estate, including land and improvements.

Appraisers prefer the Income Approach when a hotel generates positive cash flows. They capitalize stabilized cash flows once the hotel's growth and earnings reach a sustainable level.

Brokers prefer the Income Approach as a standalone valuation method and rarely combine it with the Sales Comparison or Cost Approaches. Cornell Hotel Brokers applies the Income Approach because buyers, sellers, appraisers, and brokers worldwide favor it.

Capitalization Rate Calculation (Cap Rates)

Appraisers can derive market-based capitalization rates using several Income Approach methods.

For before-tax hotel valuation, appraisers calculate value using either the Loan-to-Value (LTV) ratio or the Debt Coverage Ratio (DCR). Modern valuation software performs these calculations quickly and accurately.

Read Library Article: “Hotel Market Analysis & Price Valuation Software”

Appraisers also use the Weighted Average Cost of Capital (WACC) method to develop an overall capitalization rate that reflects the required returns for both equity and debt investors. Appraisers find this method straightforward to calculate and particularly appropriate when local market supply and demand remain stable.¹

Commercial real estate buyers, sellers, appraisers, and brokers prefer the Income Approach to render accurate price valuations

- Market data primarily drives the Income Approach. Reliable data and statistics are readily available, which enables realistic market-based price valuations.
- Appraisers make fewer subjective decisions when they apply the Income Approach.
- Most knowledgeable investors use the Income Approach.
- Appraisers and brokers can more easily implement the Income Approach because hotels worldwide follow the Uniform System of Accounts for the Lodging Industry (USALI).

Computerized Price Valuations Reduce Error

- Hotel appraisal software produces market-based calculations that enable current and reliable valuations.
- Reduces calculation errors.
- Faster results.
- Less expensive than complete MAI Appraisals needed by banks and tax authorities.
- Accurate Cap Rates are necessary to calculate a credible market-based price for hotel valuations.
- Based on the Discount Cash Flow, which generates more precise price valuations for income-producing real estate.

Read Library Articles:

- “How to Choose the Right Broker”
- “Small Brokerage Firms versus Large - The Advantage Goes to Small Firms”
- “Our Offer to You”
- “About James Cornell”

Attributions & Endnotes

Stephen Rushmore, MAI, CHA, has built a globally recognized name and reputation in the hospitality industry. Through HVS, Rushmore has appraised thousands of hotels worldwide. He stands as a renowned educator and author, having published extensively in leading industry magazines and academic journals.

Rushmore developed the Rushmore Approach, which accurately derives capitalization rates by weighting the required returns of lenders and equity investors. He then incorporates the resulting weighted-average cost of capital into a regression analysis to produce the most current and defensible cap rate, which appraisers apply to generate verifiable, accurate hotel valuations.

Rushmore introduced much of modern hotel valuation theory to the industry. This article and others on this website draw heavily from his books, articles, newsletters, and lecture materials.

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

² This article was written by James Cornell and is largely based upon publications by Stephen Rushmore, MAI, CHA. Rushmore has developed a name and reputation which is well recognized in the hospitality industry. Rushmore (HVS) has appraised thousands of hotels around the world. He is a renowned teacher and author who has been published in numerous industry magazines and academic journals. Other authors cited are regarded as industry leaders in real estate valuations.