1/- Hotel valuations earning multipliers – terminal value: Malta's scenario
Journal of Property Investment & Finance, Volume: 33 Issue: 3, 2015
http://www.emeraldinsight.com/toc/jpif/33/3

Purpose
– The purpose of this paper is to establish whether a terminal value is a substantial amount of the final figure in a hotel's valuation. Malta's scenario has been delved into, due to its high population density and its restrictive land area. Land values attract a high premium as compared with larger developed countries.

Design/methodology/approach
– An extensive literature review is undertaken to analyse the earnings multiplier adopted by various authors over the past 30-year period. The hotel cap rate (initial yield) has been compared with similar yields adopted in the institutional and property markets and then compares to market-based data.

Findings
– A table outlines the earnings' multipliers in perpetuity or for the limited expected design life for various cap rates. This data will act as a guide in guiding practitioners to establish an earnings' multiplier to be applied in their valuation methodology.

Research limitations/implications
– This analysis is based on 5 valuations as undertaken on hotels in Malta with classification grades varying from III to V. This notes that the terminal value varies within a range of 9-45 per cent of the total value. This analysis has to be undertaken for other countries for a global range of land terminal values percentages to be established.

The paper focuses on Malta but makes international commentary and comparison. It offers insight into the calculation of the appropriate capitalisation yields, with the paper contributing to the body of knowledge on hotel valuation.

Originality/value
– Updated insight is given by delving into the workings of the earnings' multiplier and establishes that in today's market the terminal value of the hotel basis has to be accounted for.

The above findings are based on a link between theory and practice. The approach used is to present literature and secondary data alongside the research calculations and analysis, providing insight in this specialist field.

Hotel valuations earning multipliers – terminal value: Malta's scenario

Denis Camilleri
DHI Periti, Floriana, Malta

Abstract
Purpose – The purpose of this paper is to establish whether a terminal value is a substantial amount of the final figure in a hotel's valuation. Malta's scenario has been delved into. This due to the fact that owing to Malta's high population density and its restrictive land area, land values attract a high

premium as compared with larger developed countries. Other matters such as earnings' multipliers derived from a cap rate (initial yield), CAPEX has also been delved into.

Design/methodology/approach – The methodologies adopted in hotel valuation practice has been delved into. An extensive literature review is undertaken to analyse the earnings multiplier adopted by various authors over the past 30-year period. The hotel cap rate (initial yield) has been compared with similar yields adopted in the institutional and property markets and then compares to market-based data. A discussion is undertaken on the validity of adopting discounted cash flow, as against the short cut market appraisal approach. Capitalization rates, cap rates have also been referred to as obtained from the academic and practitioners field and compared. Depreciation and the anticipated annual accommodation charges have been analysed. A database of hotel rooms value over the past 20-year period has been referred.

Findings – A table outlines the earnings' multipliers in perpetuity or for the limited expected design life for various cap rates. This data will act as a guide in guiding practitioners to establish an earnings' multiplier to be applied in their valuation methodology. An example in the Appendix clarifies the manner in which this data table is to be utilized. The finding of this example notes that for this hotel in Malta, as constructed on private land, the terminal value for this development hovers around the 30 per cent of the market value.

Research limitations/implications – This analysis is based on five valuations as undertaken on five hotels in Malta with classification grades varying from III to V. This notes that the terminal value varies within a range of 9-45 per cent of the total value. This analysis has to be undertaken for other countries for a global range of land terminal values percentages to be established.
Practical implications – Establishing the terminal value of a hotel business, will offer greater security for secured lending facilities required. It will further act as an important tool to establish the feasibility of a hotel development.

Originality/value – Updated insight is given to existing hotel valuation methodologies by delving into the workings of the earnings' multiplier and establishes that in today's market the terminal value of the hotel basis has to be accounted for. The above findings are based on a link between theory and practice.
Keywords CAPEX, Caps rate (initial yield), Depreciation, Discount rates, Earnings' multiplier, Terminal value
Paper type Research paper

Introduction

Most trading properties have a finite life. This includes also for hotels that are situated on freehold land. The exception to this would probably be boutique hotels situated in historic buildings/settings with upgrading defensive refurbishments as undertaken over specific periods for the running of the hotel business to sustain existing cash flow without the expectation of significant upside.

Thus, a trading property is valued in two tranches. The first is according to its trading profits capitalized over the estimated life of the business. The methods as undertaken to capitalize on the trading profits are discussed in the following section "The valuation of hotels". It is to be noted that this trading capitalized potential could also contain an element of goodwill that has to be identified. To capitalize on the trading profit an earning multiplier has to be identified.

The "Literature review" section addresses this, although it is noted that the earnings' multipliers quoted is only illustrative rather than indicative of the most recent market trends. Further with not too great insight given on how the earnings' multipliers are analysed, the question then revolves on whether this is undertaken solely by the comparative method.

The section “Market-based earnings’ multiplier” looks into analysing the earning multiplier from market-based data taken from international practices of hotel valuers. Table IV in this section is a calculation of the earnings’ multipliers, depending on the life expectancy of the hotel business and the cap rate (initial yield) to be adopted. A methodology on how an earnings’ multiplier can be calculated is then undertaken. The following section dwelling on the “Earnings’ multiplier as affected by the inverstment and corporate fields” endeavours to reconcile the earnings’ multiplier. This is obtained by considering the workings of the investment propertymarket or the corporate property market. Following the 2008 global financial meltdown, this effected the earnings’ multiplier. Further on, an insight on how the highs and lows, together with the economic bubbles of the financial market affect the earnings’ multipliers is gauged. The second tranche in the valuation process then occurs at the end of its business life, with the terminal value popping in, due to economic obsolescence, which generally will be the projected land value at the estimated end of the business life, as discounted back to its present value. This economic obsolescence is gauged from Rushmore’s (1997) observations that for a hotel development to be feasible its land value is not to exceed 15-20 per cent of its market value, with this percentage being even higher in countries with low labour costs. Rushmore (1997) then continues that the hotel business may have a life span as short as 20 years, or as long as 60 years, averaging out over 40 years. Further, a terminal value will not ensue for land held on a leasehold basis, with the leasehold expiring during the life span of the hotel.

These feasibility ratios are tested by hotel valuations as undertaken in the densely populated Islands of Malta, Gozo and Comino. This archipelago situated in the centre of the Mediterranean is a small island state of 316 km2. In the 2005 Malta census the population stood at 404,962. In the last census NSO (2011), although the population grew by 2.7 per cent to 416,055, a slowdown in population growth occurred due to an average annual increase of 1,849 compared to nearly 2,700 evidenced in the previous decennium. Malta remains by far the most densely populated European Union (EU) Member State, with an average of 1,320 persons per km2, compared to an overall average of 116.6 persons per km2 for the EU.

The section on “Land values in densely populated areas” outlines some global statistics on land values. This is then followed by the section “Landed property Malta’s database”, which includes for data as compiled by the practice of DHI Periti. This section notes that for the highly populated Islands of Malta, landed value annual increases over the past 30-year period is double the annual increases for the affordable residential property market.

The previous sections then lead onto the following section “Terminal hotel values – the Maltese scenario”. Table XIII in this section outlines the present market value and exsiting use value together with the terminal land value of 5 in number hotels as valued by the practice of DHI Periti over the past three-year period.

The above simplified two tranche method had been challenged by the British Association of Hotel Accountants (BAHA, 1993), arguing that the terminal (residual) value is not a very important component of the estimated market value. The Royal Institution of Chartered Surveyors (1994) had responded to this by stating that in some valuations the terminal (residual) value accounts for as much as 50 per cent of the estimated market value. The difficulty here arises that the terminal value accounts for a significant proportion of the estimated market value, but based on a distant ultimate uncertain year. Thus, techniques should be employed to reduce the risk of error in deriving this terminal value (Nilsson et al., 2001).

The “Recommendations” section identifies an earnings’ multiplier methodology, then analyses the benefits if any on applying the discounted cash flow (DCF) method for an ongoing hotel business. The final comments relate on the terminal value of the hotel development, and whether the above BAHA (1993) statement of the terminal value is still valid.

The Appendix includes for a mid-market hotel valuation example. This then discusses the methodology, based on a link between theory and practice as outlined in all of the above sections. The cyclical maintenance and capital expenditure CAPEX requirements as effecting the valuation are also delved into.

The valuation of hotels

This is undertaken according to the valuation of premises based on operational performance of business trading properties. The type of properties which are normally valued on the basis of fully operational business units include for hotels, bars, restaurants and other licenced premises, a wide range of private health care facilities and most types of leisure property from amusement arcades to squash courts. The valuation will therefore include trading potential and it must exclude personal goodwill. Goodwill is classified if the company is presumed to be carrying on its business as a going concern and that all the assets are being utilized on a continuing basis. Goodwill may be made up of tangible and intangible elements. Transferable goodwill as attached to the business is known as tangible as opposed to intangible personal goodwill. This calls for intangible goodwill to be excluded from the valuation figure, that is any turnover that accrues solely from the personal skill, expertise, reputation attached to the existing management. On the other hand the intangible element of goodwill can be included on the basis of worth, thus being defined as a "value in use". A hotel that is open and trading will attract a higher value than a closed one. Similarly a newly built hotel attracts a lower value than a hotel with a proven record. The difference between these two market values, that is of the open and trading hotel as opposed to the value of a closed hotel or a newly built one can be taken as the goodwill value. Finally the valuer must exclude any trade due to personal goodwill, but include for the potential realized by an average competent operator.

Royal Institution of Chartered Surveyors (RICS, 2011) notes a Reasonably Efficient Operator as: "A market-based concept whereby a potential purchaser, and thus the valuer, estimates the maintainable level of trade and future profitability that can be achieved by a competent operator of a business conducted on the premises acting in an efficient manner. The concept involves the trading potential rather than the actual level of trade under existing ownership so it excludes personal goodwill".

Hospitality properties are not frequently sold and when sold, difficult to be similar due to the variety in the services offered. The sales comparison approach relies heavily on a large number of recent sales to support a strong predictive value.