RATES OF RETURN ON HOTEL INVESTMENTS

Debt and equity return requirements must be determined to understand the overall return rate for hotel properties.

by Daniel H. Lesser, CRE and Karen E. Rubin, CRE

As real estate counselors who specialize in the lodging industry, we are continually asked: What are capitalization rates on hotels today? We have found this question increasingly difficult to answer over the past couple of years. This article is our attempt to explain why and to give the reader some insight into the development of rates of return for hotel properties. Because capitalization rates reflect investment return requirements, we begin with a brief overview of today's hotel industry and its perception by investors in the marketplace.

The U.S. Hotel Industry

Today's U.S. lodging industry is considered to be troubled for several sound reasons. Individual examples of financially troubled hotel properties exist in almost every market area. Pressures on the industry in the past couple of years have been exerted from all sides: the supply side, the demand side and what we call the balance sheet (i.e., the financial) side.

The Demand Side

Demand for hotel rooms is closely related to travel trends which have been relatively easy to track in this country and to understand during the past few decades. These trends reflect the emergence of air travel as an increasingly important form of domestic travel. There has been tremendous growth in passenger activity at most, if not all, major U.S. airports. Furthermore, there are more major airports, and those airports are bigger and busier than ever before. Nevertheless, they have not been able to handle the amount of air traffic that has been generated, and regional airports have had to play an increasingly important role in the nation's air travel system. The continuing troubles with the nation's airline industry, and the emergence of the airlines' "hub" system, also have helped to "spread" air traffic throughout the nation.

Although the increase in domestic air travel has, in general, increased demand for hotel room nights, air travel has made it easier to take shorter trips which reduces the need for an overnight hotel stay. A business trip from New York to Chicago once may have resulted in a one- to two-week hotel stay. The same trip may now last only one or two days,

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either completely eliminating the need for a hotel room or dramatically shortening the required length of stay in a hotel. Average lengths of stay for most commercial hotels are only one to three nights; so the typical commercial hotel's tenancy turns over faster. This trend in general, did not have a negative impact on the hotel industry in the 1970s and 1980s; however, because the overall increase in travel (and therefore the demand for hotel rooms) provided the ideal stop-gap.

During the late 1980s, the weakening of the U.S. dollar on the international currency markets also served to spur travel (and hotel room demand) in this country. The results of this particular influence were a double bonus: The weaker dollar made travel to the United States by international visitors extraordinarily economical, while the much-touted "globalization" of the nation's economy gave international visitors more and better reasons for traveling here (and international travelers came in droves). At the same time, travel by U.S. citizens to international destinations became increasingly expensive because of the weakened U.S. dollar; U.S. citizens therefore were encouraged to travel domestically.

The periodic outbreaks of international terrorism that characterized the mid- and late-1980s also stimulated domestic travel (and, demand for hotel rooms) by suppressing the desire for travel abroad. Combined with the nation's expanding employment base and generally favorable, Reagan-era economic conditions which increased both discretionary and non-discretionary travel, demand for hotel rooms was strong and growing in many of the nation's marketplaces during the second half of the 1980s.

Well, welcome to the 1990s. On a national level we are in or hovering around a recession that has cost many people their jobs. Employment is shrinking in many marketplaces. International tensions vis-a-vis the (former) Eastern Bloc nations have been relaxed substantially, causing the federal government to re-evaluate its financial commitment to the nation's defense industry. As a result, major defense industry plants and military bases are closing, and the local economies that had relied upon these major employers are suffering. Although our currency remains weak, the economies of many of the nations who supplied us with so many willing visitors during the 1980s also have weakened, and we had a war in 1991.

A single glance at the passenger activity statistics for our airports during late 1990 and early 1991 is sufficient to demonstrate the wholesale abandonment of much of this country's travel activities during the period. While the airfare wars of the summer of 1992 have stimulated travel (and demand for hotel rooms), the domestic airline industry still appears to be contracting, raising the prospect of less competitiveness in air fares. In short, things have changed, and, however temporary some of these factors may be, the hotel industry in many markets has been hurt.

The Supply Side

The hotel industry's widespread supply side problems are largely a legacy of the "two accelerators, no brake" development mentality of the 1980s. Prior to 1986's tax reform, hotel property did not have to be "economic" to yield desirable returns in the form of tax savings to investors. Remember when the hotel building itself was depreciable in less than 19 years and the furniture, fixtures and equipment were depreciable in five years? These features made hotels desirable, given the ability (now, of course, long-gone) to pass-through passive after-tax losses to offset active income. And remember, too, that there was (arguably) at least some pent-up demand for new properties after the recession and double-digit interest rates of the early 1980s.

Even after tax reform, however, new hotel development continued at an historically strong pace well into the late 1980s. The entrance of the Pacific Rim investor into the U.S. real estate market proved to be an incentive to new hotel development, particularly in markets of particular interest to this investor type (e.g., Southern California and Manhattan). In the late 1980s Pacific Rim investors were interested in hotel properties in particular, especially the high-end resort products. Enough sales of existing U.S. properties were made to this investor segment, at prices well above those their U.S. counterparts were willing or able to pay, to cause the hotel investment market to consider potentially new highs in values and new lows in capitalization rates, irrespective, at times, of whether the particular property was Pacific Rim-investor material.

In addition to the perceived economic benefits of hotel investment in the 1980s, we noted another, less quantifiable factor in the investment decisions being made at the time: For lack of a better term, we call this "the ego factor." We had first-hand exposure to "the ego factor" time and time again in the late 1980s, and we found it in places one ordinarily would not expect to look. We remember clearly the public company that wished to acquire a waterfront hotel property in the suburban Northeast with an offering price that was a good 25% to 30% above what we considered to be the property's market value. We could not understand why this transaction was being considered at this price, until we found out that the company's CEO had just purchased a rather large yacht and required a marina slip, one of the lesser amenities offered at this particular hotel property.

Then there was the case of the luxury-oriented hotel under construction in Southern California. The project had taken years to develop and was within six months of opening when the CEO of its public company owner/developer was ousted. The new CEO did not care for certain design elements that had been incorporated into the property from the original architecturals. Because the property was adjacent to the company's international headquarters, it was argued that the company's image could be damaged irretrievably unless the hotel had the proper ambiance. The result was an additional

year of construction and uncounted cost overruns for project redesign.

With all the talk of ten-year discounted cash flows, debt coverage ratios, terminal capitalization rates and the like, it was clear by the late 1980s that many individual people—powerful, successful people, in particular—just *liked* hotels, darn it. Perhaps influenced by the subconscious memories of those childhood Monopoly games, these people wanted to own one or two of them. If the economics of the particular deal did not make sense, wasn't it all for the long-term good of the company?

The Financial Side

Irrespective of the relationship between hotel room demand and hotel room supply in any particular market, even nominally successful hotels may be troubled properties today because of the ongoing scarcity of third-party financing. We are all aware of the crisis in our banking industry and the limited availability of institutional financing for most types of real estate. This has proven to be particularly problematic for hotels, however, because so many were constructed in the last 10 years and were financed with mortgages intended to be in place only for five or 10 years.

One response to the fluctuating interest rates and inflationary pressures in the 1970s was the balloon or bullet mortgage, a term that sounds somewhat antiquated today. Call them what you will, their maturity dates are here! There are far fewer lending institutions in this country than there were five and 10 years ago, and a fairly significant percentage of them have been "burned" on hotel deals as a result of hotel room supply and demand factors. Let us not forget to acknowledge the historical overleveraging of hotel properties during the development fever of the 1980s. A 75% loan-to-value ratio and a debt coverage ratio of 1.25 seemed conservative enough in 1985. Problems occurred only when supply and demand factors forced declines in value of 40% to 50%, leaving the first mortgagee either in the midst of a hostile foreclosure action or in possession of an asset whose value did not come close to the mortgage value on the books.

The lending community in this country therefore is largely uninterested in financing hotels. Although there have been several exceptions, they are hard to find. Domestic lenders active in the hotel market are, in general, the sellers of properties obtained through foreclosure actions. Interestingly enough, we still hear about a fair amount of interest in hotel properties from equity investors and their ilk. The problem is that, of all the equity investors who express their interest in a hotel deal, few can come to the table with financing in place.

Nonetheless, hotel sales are occurring. The Hotel & Motel Brokers of America (HMBA) reported 170 hotel sales in 1991, a 72% increase over 1990's total of 99 property sales and the second-largest number in the organization's 33-year history. Strongly influencing the increase in hotel transactions was the opening, in mid-1990, of the Resolution Trust Corporation (RTC) pipeline of properties. According to the HMBA, the RTC had approximately 155 hotels in its portfolio in January 1991 and 109 hotels (46 of which were under agreement) as of January, 1992. Thus, most transfers of hotels are related to foreclosed properties with troubled financial histories. So we note that the 1991 sales reported by the HMBA featured an average per-room price of $18,400, roughly 15% below the average reported per-room selling price in 1990.

This environment has made it difficult to talk about capitalization rates and return requirements for hotels. How can we look to the market to get a handle on capitalization rates when the market of consummated sales consists largely of sellers who were under duress or of properties that were sold out of foreclosure or of transactions that *were* foreclosures and not arm's-length sales? How can we look to the market to provide information on capitalization rates when most hotel owners are only would-be sellers who, if they have any financial wherewithal, would hold onto their properties until they could consummate a deal in their best interest? Well, here is what we are doing.

Rates Of Return

We have noticed over the years that the real estate market in general and the hotel real estate market in particular is not efficient. When real estate is compared to, say, the stock exchange, we wonder: Where is the up-to-the-minute information on price/earnings ratios? Across whose computer terminal does the most recent sales price of a particular property flash? What daily newspaper prints lists of the latest prices for real property and the indicated capitalization rates? And, finally, what exactly *is* this animal that we all agree exists and that we call a capitalization rate?

This last problem is particularly significant because there are so many kinds of capitalization rates and no consensus within either the real estate industry or the hotel real estate industry on the kind of capitalization rate that should be used. Obviously, the intention of any capitalization rate is to reflect the relationship between a property's value (or price) and its income. However, there are many ways of expressing this relationship. So, when we are asked about capitalization rates for hotels, our first question is: What rate are you talking about?

An investor may formulate a capitalization rate that can be applied to a myriad of net income levels. For example, direct capitalization rates can be developed based on historical net income, forecasted first year net income or forecasted stabilized net income deflated to current dollars. To add to the confusion, some investors may capitalize different levels of net income, including: before or after a reserve for replacement for furnishings, fixtures and equipment; before or after an incentive management fee; or any combination of the reserve for replacement and incentive management fee.

The same confusion arises when discount rates are discussed. The term discount rate is equivalent

to yield or internal rate of return (IRR). Some investors segment their analysis of returns between debt and equity yields over an assumed holding period. Other investors focus on the total property yield or the unleveraged return. Again, a discounted cash flow investment analysis can be predicated on a multitude of net income levels.

At bottom we define a capitalization rate as a rate of return that an investment entity seeks when purchasing real estate. For example, if an income-producing piece of real estate is forcasted to generate $1,000,000 in cash flow and an investment entity wants to earn a 10% return, then the purchase price must be $10,000,000. To establish an appropriate rate of return, an investor must consider the risk inherent in the investment and the returns that may be achieved by alternative investments. Although risk is easily identifiable, it is relatively ambiguous and extremely difficult to quantify. Therefore, we believe that the preferred method for quantifying capitalization rates involves the realization that a capitalization rate is merely the weighted cost of the capital utilized to acquire an investment.

As previously alluded to, hotel real estate transactions, like most real estate transactions, typically involve a capital structure that includes debt and equity funds. Although there is a notable scarcity of available third-party debt funding insofar as hotels are concerned, we find that the great majority of transactions are being financed. And reliable sources tell us that mortgages are being put in place on hotel deals.

Debt Return Requirements

One source of reliable hotel mortgage data is the American Council of Life Insurance (ACLI). The ACLI's *Investment Bulletin* surveys commercial mortgage commitments quarterly and publishes the results by property type. For most of 1990, 1991 and 1992 the companies reporting to this survey accounted for roughly two-thirds of commercial mortgages held by U.S. life insurance companies; thus, this data to a very large extent comes directly from "the horse's mouth." Although many recent quarters have had insufficient data on hotel and motel loans specifically, published data for 1991 encompassed a total of 41 hotel/motel loans representing over $165 million in commitments. Table 1 shows the relevant information by quarter for 1991.

As one would expect, the contract interest rates for hotel and motel mortgages substantially exceeded that reported for other property types. Full-year 1991 ACLI data indicates that the average hotel/motel contract interest rate for all types of mortgages (including fixed rate-fixed term, participation, joint venture and other special features) was 104 basis points above the average contract mortgage interest rate on industrial properties (for which a total of over $876 million had been reported as committed), 96 basis points above the average contract interest rate for office buildings (for which over $1.4 billion was reported committed) and 78 basis points above the average contract interest rate reported for apartments (for which over $6.2 billion was reported as committed). Obviously, the relatively low amount committed on hotels and motels, combined with the higher interest rates, tells the real story about the current desirability of financing these types of properties. Nonetheless, the ACLI provides hard data that clearly indicates return requirements for the debt component of the capitalization rate.

Another source of published data on hotel mortgages is the previously mentioned Hotel and Motel Brokers of America (HMBA). The HMBA recently

TABLE 1

Hotel/Motel Mortgage Interest Rates-1991 (by Quarter)

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total 1991
Fixed rate/fixed term					
No. of loans	1	N/A	5	30	39
Amount committed (+000)	$4,890	$25,980	$29,814	$91,995	$152,679
Contract interest rate	*	10.75%	10.03%	10.49%	10.51%
Other special features					
No. of loans	—	—	1	1	2
Amount committed (+000)	—	—	*	$9,400	$12,426
Contract interest rate	—	—	*	*	*
Total					
No. of loans	1	N/A	6	31	41
Amount committed (+000)	$4,890	$25,980	$32,840	$101,395	$165,105
Contract interest rate	*	10.75%	10.00%	10.40%	10.44%

**Data not shown for limited number of loans.*
Source: American Council of Life Insurance.

developed a new publication, called *Transactions by HMBA*, which lists many types of financial criteria relative to hotel sales. For 1991 the HMBA's average listed first mortgage loan-to-value ratio was 73.7% at an average interest rate of 9.8%, an average amortization period of 21.5 years and an average term of 12.5 years.

Another way we are able to quantify return requirements for hotel debt is by looking at individual deals as they occur as well as the terms offered by sellers who provide financing for hotels. We have listed some of what we have seen as follows:

- At a major auction held at the end of 1991, the Federal Deposit Insurance Corporation (FDIC) offered purchase money mortgages for first mortgages on hotels up to a 75% loan-to-value (or loan-to-price) ratio. Interest rates ranged from 150 to 200 basis points over seven-year Treasury notes (between 8.35% and 8.85%); amortization schedules were based on 30 years, and mortgage terms were seven years. This was non-recourse, non-assumable debt with a 1.25% origination fee. Other terms included a prepayment penalty of 3% during the first three years, 2% during years four and five and none for years six and seven.
- Third-party financing was placed on a midwestern airport hotel by an Asian lender at the end of the third quarter 1991. A first mortgage in the $10 to $15 million range reflected the full purchase price of the property (i.e., a loan-to-value ratio of 100%). The terms were interest-only at 250 basis points over prime (about 9% as of March, 1992). The mortgage probably was intended as some sort of bridge financing because its original term was only 1.5 years (not to mention interest-only). However, by January the term had been extended to six years with a 30-year amortization schedule. And lest this deal sounds too good to be true, be advised: A total of close to $8 million was either guaranteed or pledged by the borrower in the form of a security interest in other non-realty assets, and the borrowing entity included the property's management.
- Another third-party financing was provided by the same Asian lender in early 1992. The property was a standard-class (chain-affiliated) hotel in another midwestern market. This deal was for a non-recourse first mortgage in the $5 to $10 million range at a 75.5% loan-to-value ratio. The interest rate was 300 basis points over prime; the term of the loan was five years, interest only for the first two and a 25-year amortization schedule thereafter.
- In late 1991 a quasi-governmental arm of the RTC took back a purchase money mortgage on a standard-class (chain-affiliated) hotel in a relatively depressed area of the Northeast. The loan-to-value ratio was 70%, with interest at 200 basis points over prime. The mortgage was in the $5 to $10 million range. We were unable to ascertain the amortization schedule with exactitude but estimate that it was based on a 30-year schedule; the term of the loan was seven years.
- A major U.S. insurance company took back a purchase money mortgage on a first-class, chain-affiliated (franchised) hotel in the South at the end of 1990. The mortgage amount was in the $15 to $20 million range, and there was a commitment for a $5 to $7 million second mortgage from an Asian lender. The term of the first mortgage was for five years; fixed interest was set at increasing rates during the term, starting at 7.5% and escalating to 9.5%. We were unable to ascertain the amortization schedule.
- Another major U.S. insurance company took back a purchase money mortgage on a mixed-use (hotel and office) asset in Texas in the third quarter of 1991. Interestingly, the hotel was not a chain-affiliated property. The loan was in the $5 to $10 million range, but a letter of credit for over $1 million was provided as additional security. The loan-to-value ratio was a little over 71%, with a fixed interest rate of 10%, a seven-year term and a 25-year amortization schedule.
- In the fourth quarter of 1991 a European lender took a first mortgage on a small, independent Manhattan hotel property. This was a takeout of previous financing; so the property did not sell, but the stated loan-to-value ratio was 60% of appraised value. The loan was in the $30 to $50 million range, with interest at 150 basis points over LIBOR. We were unable to ascertain either the term or the amortization schedule on the loan.
- In the fourth quarter of 1991 an Asian lender provided third-party, first-mortgage financing on a package of seven domestic hotels (roughly 1,300 rooms). The mortgage amount was in the $30 to $50 million range at a stated loan-to-value ratio of 65%. The interest rate was LIBOR plus 190 basis points, with a seven-year term and a 28-year amortization schedule. This was a takeout of an original note held by another lender.
- A domestic savings and loan provided a first mortgage on a budget hotel in Texas during the first quarter of 1992. The loan was in the $1 to $5 million range, with interest at 100 basis points over prime. The loan-to-value ratio was estimated at 40% based on a first-half of 1991 sale price plus an estimated $1 million in renovation costs. The term of the loan was seven years, with a 30-year amortization schedule.

From the deals we have seen consummated and from published data, we believe that required returns for the debt portion of a hotel investment are identifiable at this point in time, despite the scarcity of third-party financing for hotels. Our conclusions are that loan-to-value ratios in the 40% to 75% range generally reflect the market, such as it is, with fixed interest rates in the 9.5% to 10.5% range. Although floating interest rates begin at levels that are materially lower, there is no way of knowing how they will end up. We see, in general, amortization schedules of 25 to 30 years and loan maturities of five to 10 years. While some third-party financing appears to be coming from Asian and European lenders, some domestic lenders are providing

financing in the form of purchase money mortgages. Although loan-to-value ratios are down from the 75% and above levels that were standard in the late 1980s, debt is still a significant portion of a capitalization rate and can be well supported. However, because equity return requirements are supposed to reflect investor expectations rather than documented interest rates, they are more difficult to quantify accurately.

Equity Return Requirements

The portion of the hotel investment that is not funded by debt in the form of a first mortgage typically comes from an equity investor. The rate of return that an equity investor expects over a ten-year holding period is known as equity yield. Unlike the equity dividend, which is a short-term rate of return, an equity yield specifically considers a long-term holding period (generally 10 years), annual inflation-adjusted cash flows, property appreciation, mortgage amortization and proceeds from a sale at the end of the holding period.

It is difficult to quantify the rate of return required by equity investors who seek to purchase hotel properties. To establish an appropriate equity yield rate, a hotel analyst may consult several sources of data. First, one may analyze recent sales transactions and extract rates based on historical and forecasted net income figures. Second, one may refer to numerous published sources of data. Finally, one may determine anticipated yield rates through investor interviews.

Analysis Of Recent Sales Transactions

During each year our firm appraises more than 400 hotels, including properties located in most major national markets. Most of these appraisals utilize a mortgage-equity approach in which income is projected and then discounted to a current value at rates reflecting the cost of debt and equity capital. In the case of hotels that were sold subsequent to our valuations we are able to determine an appropriate equity yield rate by excluding incentive management fees from the projection of income and expense,

TABLE 2

Sample of Hotels Sold

Hotel Type	Location	Year of Sale	Sale Price per Room	Overall Rate *	Total Property Yield	Equity Yield
Midscale	Binghamton, NY	1985	$ 52,200	10.4%	14.6%	20.3%
Luxury	Beverly Hills, CA	1987	265,957	14.9	19.7	32.0
Luxury	Carlsbad, CA	1987	518,672	7.9	8.7	5.6
Midscale	Boston, MA	1988	52,065	10.8	15.3	21.8
Luxury	Boston, MA	1988	141,058	10.1	13.2	17.7
First Class	Chicago, IL	1988	124,734	9.0	12.3	16.5
First Class	Denver, CO	1988	51,440	11.9	14.3	19.4
Midscale	Kingston, NY	1988	61,782	10.7	14.8	22.9
Midscale	Milford, CT	1988	60,185	10.8	14.3	20.0
Midscale	Philadelphia, PA	1988	48,971	9.8	14.5	21.5
Midscale	San Francisco, CA	1988	43,702	8.7	10.5	12.8
Midscale	San Francisco, CA	1988	56,034	12.2	17.3	28.9
First Class	Wilmington, DE	1988	88,601	14.1	19.9	34.5
First Class	Annapolis, MD	1989	121,212	15.5	17.6	31.4
First Class	Boston, MA	1989	102,374	12.0	16.0	25.2
Midscale	Concord, CA	1989	60,060	16.5	20.2	35.5
Midscale	Corning, NY	1989	34,483	14.5	20.9	37.1
Luxury	Los Angeles, CA	1989	226,667	14.7	19.5	36.2
First Class	Mission Valley, CA	1989	133,974	11.4	16.0	24.6
First Class	New Orleans, LA	1989	97,065	11.9	17.1	28.9
Luxury	San Francisco, CA	1989	228,856	10.3	15.7	19.7
Midscale	Walnut Creek, CA	1989	49,240	12.1	15.0	20.3
First Class	Buckhead, GA	1990	74,124	10.2	3.8	19.6
Economy	Easton, MD	1990	27,500	14.5	21.2	38.4
Midscale	Foster City, CA	1990	75,210	8.5	9.8	8.4
First Class	Newport Beach, CA	1990	88,757	12.0	17.0	28.0
Luxury	Palm Springs, CA	1990	191,163	14.0	19.6	33.7
First Class	San Francisco, CA	1990	105,263	10.1	14.7	22.5
Economy	Bridgeton, MO	1991	14,212	15.7	16.1	20.4
Midscale	Bretton Woods, NH	1991	20,064	31.7%	22.7%	27.6%

**Direct capitalization rate based on stabilized year deflated to current dollars.*
Source: Hospitality Valuation Services.

inserting the projection into a valuation model and adjusting the appraised value to reflect the actual sale price by modifying the return assumptions. Table 2 presents a representative sample of hotels that were sold shortly after we appraised them, along with the imputed total property and equity returns based on our valuation approach.

It should be noted that the rates of return cited in Table 2 assume a specific type of financial structure and may not represent the actual expectations of these buyers. The table illustrates, however, the levels of returns a typical investor may expect when acquiring one of these hotels.

Published Sources

Numerous real estate firms and organizations publish newsletters and summaries of investor surveys and hotel real estate sales. A review of some of the more recent newsletters from these firms illustrates that anticipated total property yield rates (Yo) employed by hotel investors in their analysis range from 12.0% to 18.5%. Anticipated equity yield rates (Ye) range from 15.0% to 28.0%. Going-in capitalization rates range from 10.0% to 14.0%, and terminal capitalization rates range from 9.0% to 14%. The typical holding periods reported by these surveys range from 5 to 15 years.

A new source of hotel investment return data is the previously mentioned publication entitled *Transactions by HMBA*. Although this publication does not consider yield data, it does contain interesting direct capitalization rate data. During 1991 the HMBA reports to have sold 170 hotels, which account for approximately 25% of all reported nonjudicial U.S. hotel and motel sales. The size of these lodging facilities is typically up to 400 rooms. Statistical data relating to conventional sales and lender-owned (REO) sales summarized in the premiere edition of *Transactions 1992* include: operating performance at the time of sale, including average daily room rate and rooms revenue per room; hotel sales transactions statistics, including selling price per room, rooms revenue multiplier, net operating income multiplier and capitalization rate; and financing attained at the time of sale, including first mortgage loan-to-value ratio, amortization period, loan term and debt coverage ratio. Of the 170 HMBA hotel sales tracked during 1991, 94 were conventional sales, and 76 were REO sales. The average capitalization rate reported for the 94 conventional sales was 11.9%. The average capitalization rate for 70 sales of properties with fewer than 75 rooms was 12.5%. The average capitalization rate for 24 sales of properties with greater than 75 rooms was 9.8%.

Investor Interviews

As hotel real estate counselors we are in constant contact with numerous institutional and individual hotel investors. These investors have return requirements that may be expressed as an equity yield rate based on a 10-year projection of net income before incentive management fees but after debt service. Table 3 illustrates the equity yield requirements of a cross-section of hotel investors.

TABLE 3

Equity Yield Requirements

Source of Equity	Equity Yield Requirement
Individual syndicator	**20% to 24%**
Institution	**18% to 22%**

Source: Hospitality Valuation Services

Yields And Capitalization Rates Of Three Current Deals

As a final foray into the world of hotel capitalization rates, we analyzed three recent hotel transactions to illustrate current return rates. The three properties vary significantly in size, location and level of quality.

Sale number 1 was of a high-rise, luxury-class, under 500-room, chain-affiliated hotel located in the South Central United States. The property was purchased with cash for slightly more than $120,000 per room during the past year. The property had a successful operating history. Occupancies generally were in the high 70% range, and average room rates were slightly over $100 (with an upward trend) in 1990 and 1991. The overseas buyer was expected to ultimately finance part of the purchase with offshore funds and back the mortgage by a corporate guarantee. Because the anticipated debt did not reflect a pure real estate mortgage, we factored into our analysis several assumed structures for hotel debt financing from third parties or sellers. Table 4 illustrates the various yields and capitalization rates derived from the analysis.

Sale number 2 was of a mid-rate, first-class, chain-affiliated hotel located in the South Central United States. The property was sold by a U.S. lending institution and purchased during the past year by an overseas hotel operator with cash for approximately $41,000 per room. We were unable to ascertain if the buyer was interested in or able to finance a portion of the investment. The purchaser was reportedly planning to renovate and rename the property at an approximate cost of $14,000 per room. We analyzed the transaction on an all-cash basis and with several assumed debt structures. Table 5 illustrates the various yields and capitalization rates derived from the analysis.

The third sale involved an older (originally constructed in the late 1960s) mid-priced, standard-class, chain-affiliated lodging facility in the northern midwest. The facility had operated with 100 to 200 rooms. The property's historical occupancies were in the 50% to 60% range, but room rates had been declining from the ±$65 level since 1989. The purchaser intended to reposition the property to the upper end of the budget segment, eliminate the hotel's restaurant and lounge facilities but retain a limited amount of function space, and change the property's chain affiliation to one more suited to a budget-type operation. The property had been foreclosed and was sold out of foreclosure in mid-1992 for

TABLE 4

Yield and Capitalization Rate Analysis

Hotel Type	Luxury high-rise hotel
Location	South Central United States
Sales price per room	$121,000

Direct Capitalization Rates

Level of Income	Historical	First Year Projected	Stabilized Year Deflated to Current $
NOI after reserve for replacement	8.5%	9.5%	9.6%
NOI before reserve for replacement	10.3%	11.7%	11.8%

Ten Year DCF Yield Rates

	Leveraged @ 65%		Leveraged @ 50%		All Cash	
Yield Rate	Total Property (Yo)	Equity Yield (Ye)	Total Property (Yo)	Equity Yield (Ye)	Total Property (Yo)	Equity Yield (Ye)
NOI after reserve for replacement	13.5%	18.0%	13.5%	16.1%	13.5%	13.5%
NOI before reserve for replacement	17.1%	25.7%	17.1%	22.2%	17.1%	17.1%

approximately $13,000 per room; however, the buyer committed to spend another $7,000 per room (approximately) in renovations. The total investment therefore was $20,000 per room. Third-party financing was obtained at a stated 60% loan-to-value ratio; based on the purchase price alone (without considering the renovation costs), the actual loan-to-purchase-price ratio was closer to 70%. However, based on the purchase price plus the renovation cost, the loan-to-value ratio calculated out at slightly under 45%. The interest rate on the mortgage floated with the prime rate; however, this interest rate was reported to be artificially low due to the strong guarantees put in place by an entity that was known to the lender. The loan had a three-year balloon and was amortized on a 15-year schedule. Because the anticipated debt did not reflect a pure real estate mortgage, we factored into our analysis several assumed structures for hotel debt financing from third parties or the seller. Table 6 illustrates the various yields and capitalization rates derived from the analysis.

TABLE 5

Yield and Capitalization Rate Analysis

Hotel Type	First-class mid-rise hotel
Location	South Central United States
Sales price per room	$41,000
Renovation cost per room	$14,000
Total acquisition cost	$55,000

Direct Capitalization Rates

Level of Income	Historical	First Year Projected	Stabilized Year Deflated to Current $
NOI after reserve for replacement	2.8%	6.7%	12.1%
NOI before reserve for replacement	5.2%	8.5%	14.1%

Ten Year DCF Yield Rates

	Leveraged @ 60%		Leveraged @ 50%		All Cash	
Yield Rate	Total Property (Yo)	Equity Yield (Ye)	Total Property (Yo)	Equity Yield (Ye)	Total Property (Yo)	Equity Yield (Ye)
NOI after reserve for replacement	15.1%	20.0%	15.1%	18.8%	15.1%	15.1%
NOI before reserve for replacement	18.1%	25.5%	18.1%	23.2%	18.1%	18.1%

TABLE 6

Yield and Capitalization Rate Analysis

Hotel Type	Older, mid-rate hotel (to be converted to budget)
Location	North Midwestern United States
Sales price per room	$13,000
Renovation cost per room	$ 7,000
Total acquisition cost per room	$20,000

Direct Capitalization Rates

Level of Income	Historical	First Year Projected	Stabilized Year Deflated to Current $
NOI after reserve for replacement	6.0%	7.0%	15.7%
NOI before reserve for replacement	8.5%	9.6%	18.0%

Ten Year DCF Yield Rates

	Leveraged @ 60%		Leveraged @ 45%		All Cash	
Yield Rate	Total Property (Yo)	Equity Yield (Ye)	Total Property (Yo)	Equity Yield (Ye)	Total Property (Yo)	Equity Yield (Ye)
NOI after reserve for replacement	18.8%	27.0%	18.8%	23.7%	18.8%	18.8%
NOI before reserve for replacement	21.6%	32.4%	21.6%	28.0%	21.6%	21.6%

Conclusion

While third-party financing on hotel properties is scarce, hotel deals are being made, and the sales are being financed. That hotels are being bought and sold with equity and debt funding supports the consideration of mortgage and equity return requirements in developing today's capitalization rates. Despite the large number of seller-financed deals, purchase money mortgages and loans backed by corporate credit, debt terms for hotels are ascertainable, although the range of current loan-to-value ratios is broader than it was in the past. On the equity side, the market is clearly fragmented, with no apparent consensus on the required equity returns. Clearly the quality, age and class of the particular property, the strength (or weakness) of its operating and financial history, its position, both historical and potential, in the marketplace and the magnitude of any required renovation or repositioning influence strongly the type of equity investor who will be attracted to the property and the equity portion of the required return on investment. In developing capitalization rates for any particular hotel property, it is important to recognize these factors, interpret them in light of the kind of equity investor who would be attracted to the property, and understand their effect on the required rates of return to the equity component.