

## 7 tips to adjust a hotel's benchmark cap rate

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What if the most accurate benchmark is not available? What if the benchmark is from an earlier time period, or from a different location or asset class? Here are seven tips to help you adjust.

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A hotel's cash-flow generation potential determines its fair market value. According to the income capitalization method, a hotel's projected cash flow from the following year is divided by cap rate to determine its current value.

Therefore, keeping other things constant, there is an inverse relationship between cap rate and asset value. Analysts determine the cap rate for a specific asset by adjusting a benchmark cap rate. The current market cap rate in a local market for the subject asset sub-class serves as the ideal benchmark. But what if the most accurate benchmark is not available? What if the benchmark is from an earlier time period, or from a different location or asset class?

Here are some tips (extracted from a recent study) on how to adjust the benchmark cap rate.

### 1. Location matters

The study finds that certain markets have significantly higher cap rates than others. Cap rates might even differ across downtown and suburban areas of the same city. Faster growing and less risky markets (in terms of, say, inflation or gross domestic product) will experience comparably inflated asset value and hence suppressed cap rates.

Beyond other idiosyncrasies, locations could be compared across some measurable and intangible attributes. Metropolitan areas with higher GDP tend to lower the cap rate. Regulatory environments have significant impact on the cap rates as well. Markets with stricter regulations on real estate developments lower the growth in supply of hotels, thus increasing their value (and lowering the cap rate). On the other hand, markets where people and land developers enjoy higher freedom tend to have higher\* cap rates.

### 2. Cap rate spread across asset classes is relatively stable

Keeping other things constant, immediate cross-sectional (across assets), or time-series variations in cap rates are restricted to a few percent points.

During the last decade (2006-2015), for example, the contemporaneous spread between hotels and apartment cap rates varied around 250 to 300 basis points. With hotel sub-classes, the variations are usually within the range of 100 to 200 basis points. For example, cap rates in luxury and full-service hotels are respectively 200 and 150 basis points lower than in select-service hotels.

### 3. Cap rates are persistent in the short run, but self-disciplining in the long run

Cap rates are sticky. They do not change overnight. Today's cap rate will not be far off the cap rate a quarter ago.

During the last decade, the quarterly changes in hotel cap rates in the United States averaged at 5 basis points (-6 to +30 basis points). Yet, although positive shock to the cap rate in this quarter will spur a similar movement during the next quarter, such a persistence will tend to self-discipline itself through an opposite change within a year.

Also note that the mean itself might change over time due to macroeconomic trends. Therefore, an analyst must not go too far in the past to project future cap rates unless a sound econometric model is available.

### 4. Increased risk inflates the cap rate

Investors want to pay less at the outset to eventually reap a higher return to compensate for increased risk. The increase in risk (which inflates the cap rate) could come from differences across location characteristics (e.g. downtown versus suburban), sub-classes (e.g. select-service versus full-service hotels) or broad asset classes (e.g. apartments versus hotels).

The change in risk perception also could be incorporated into cap rate variation of the same asset over time. If a hotel is acquired during exceptionally healthy market conditions at its going-in cap rate; most likely the going-out cap rate will go up a few years later if the market conditions then are not projected to be as good and vice versa.

### 5. Theoretical derivation is supported, but one must work around information shortage

Theoretically, the cap rate should be derived by adding risk premia to the capital structure weighted average of benchmark cost of equity and debt, in excess of the expected growth rate.

Returns in the stock and bond markets offer proxies for the benchmark costs of equity and debt. Inflation rate is a good proxy for growth

in cash flows. The realized cap rate, indeed, shares positive association with corresponding equity market return and risky bond return, and negative association with inflation rate. Besides, debt capital being cheaper, increase in the loan-to-value ratio substantially suppresses the cap rate. However, several other local and macro-level attributes are significant determinants which, arguably, offer proxies for measuring various risk premia.

## 6. Risk-free rate is not a good benchmark

Intuitively, being a function of the cost of capital (which equals risk-free rate plus risk premia), cap rates should be correlated with treasury rates. After all, both the cost of equity and debt equal the risk-free rate plus the respective risk premia.

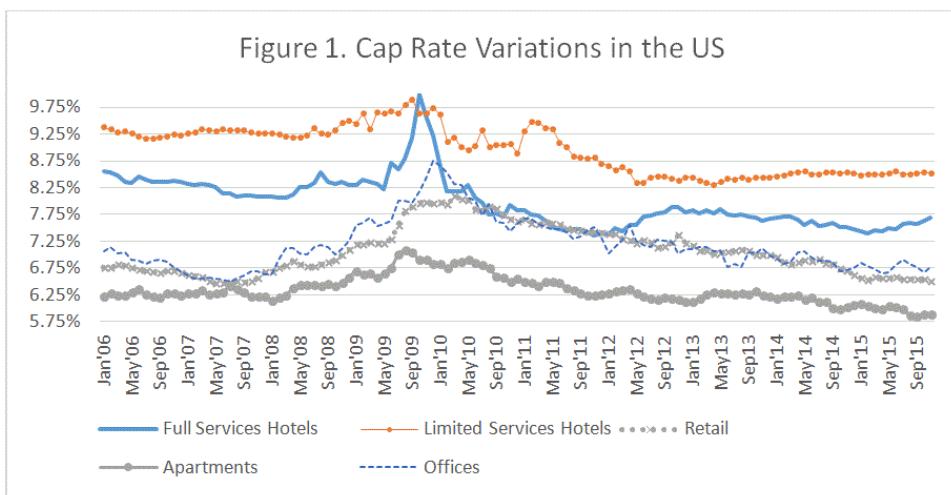
However, this perception could sometimes be misleading. One must be aware that the treasury rates are sometimes artificially manipulated for realizing the monetary policy goals, thus leading to relatively volatile risk premia. Non-government securities such as risky corporate bonds (Moody's BAA-rated bond index) are better benchmarks for the cost of debt.

## 7. Cap rates are associated with REIT fundamentals, but it's complex

Cap rate shares a complex association with the corresponding stock markets. Increased total real return in the broader real-estate-investment-trust sector feeds into the cost of equity, thus inflating the cap rate. However, realized cap rates in hotel asset markets are roughly analogous to the dividend yield offered in the corresponding REIT markets. Improved dividend yield in the hotels sector improves investor sentiments, thus deflating the cap rate.

A subjective metric could be developed to build an opinion on the overall direction of cap rate changes, either across assets or markets, or over time based on the clues provided above.

Accordingly, the benchmark could be adjusted. Further adjustments could be made for a specific asset by benchmarking it against the average assets in a market.



Data Source: Real Capital Analytics

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### About the author

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Correction, 15 February 2016: An earlier version of this story read "suppressed" cap rate.