Hotel News Now

Academic Research

What drives hotels' holding periods?

12 JUNE 2020 7:26 AM

The factors that drive a hotel's holding period include asset and owner characteristics and can impact hotel valuation when it's time to sell.

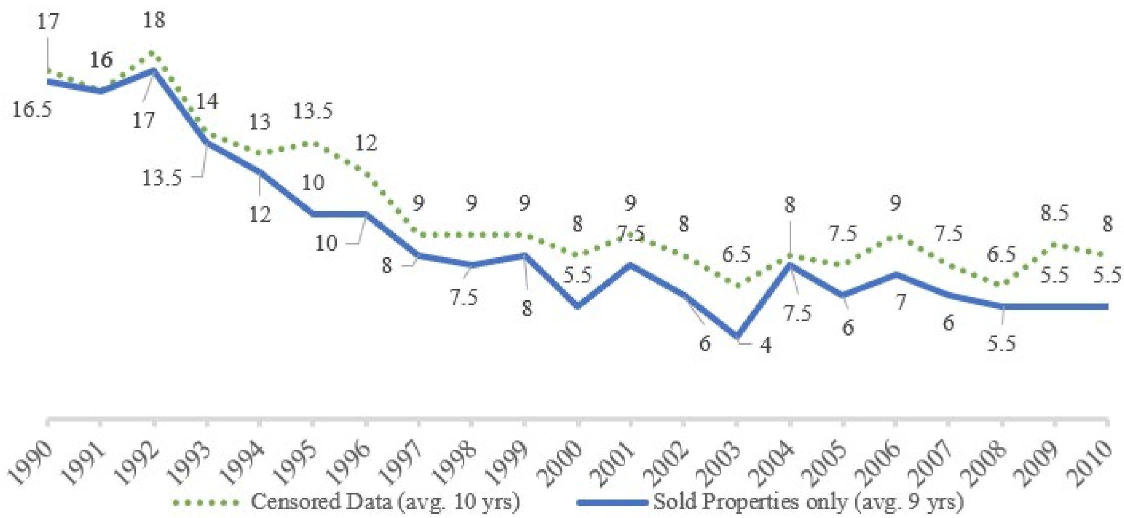
By Cédric Poretti and Prashant Das

LAUSANNE, Switzerland—The sale of an existing hotel determines its holding period, which is the duration of how long an owner keeps an asset after acquisition.

In 2019, nearly $40 billion worth of hotels were sold in the U.S. alone. Holding period determines the effectiveness of owners' capital improvement budgets as well as tax planning, lenders' call protection measures, and above all, transaction consultants' business opportunities. Our conservative estimates suggest that in 2019 fees charged by lenders and consultants related to hotel transactions alone would have been approximately $200 million to $1.2 billion. Interestingly, our knowledge of what determines the holding period (or sale decision) of a hotel is very limited. Figure 1 shows that holding periods exhibit substantial variation over time. We attempted to explain the variation in our forthcoming research paper . In this article we provide a few excerpts from it.

Copyright © 2008-2020 CoStar Realty Information, Inc.

Figure 1. Observed Holding Period of Sold and Unsold Hotels by their Year of Acquisition



Notes: The Y-axis signifies observed holding period. The X-axis denotes the year of acquisition. The dotted line (censored data) includes hotels that were not sold until their most recent observation in the sample. The solid line summarizes the holding period of sold properties only. The analysis is based on 3,239 hotels owned by 290 real estate investment trusts and real estate operating companies.

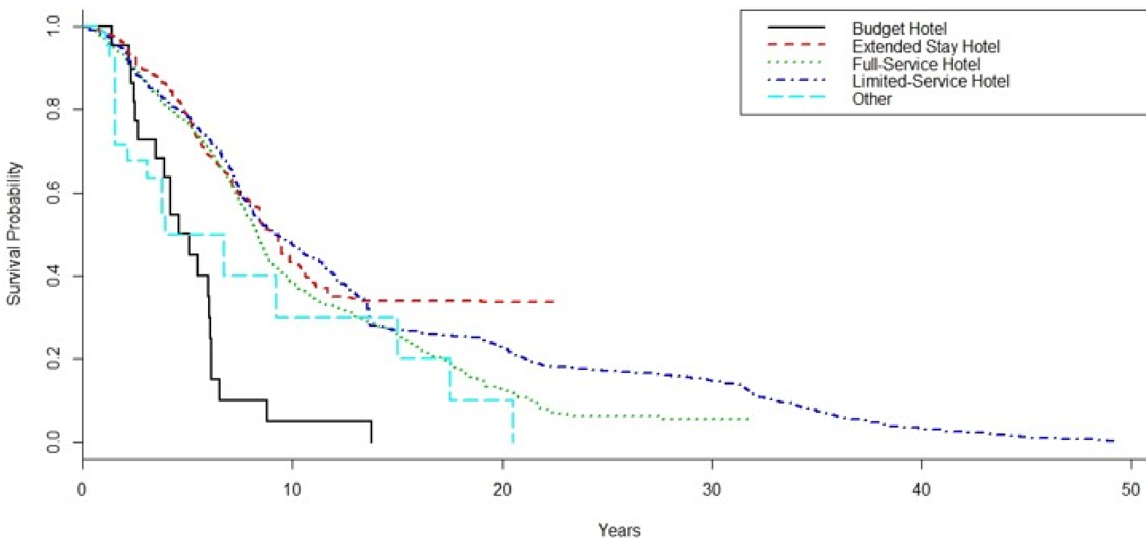
What determines the variation in holding periods?

Asset characteristics

We find that limited-service hotels have the longest average holding period (more than 10 years), while budget hotels have the shortest (4.9 years) . In Figure 2, we show the holding period variation in terms of survival curves. See the bold curve of budget hotels, for example. At the 10th year of the holding period (X-axis), less than 10% (Y-axis) “survive” with the current owners. In other words, 90% of budget hotels are sold within the first ten years of acquisition.

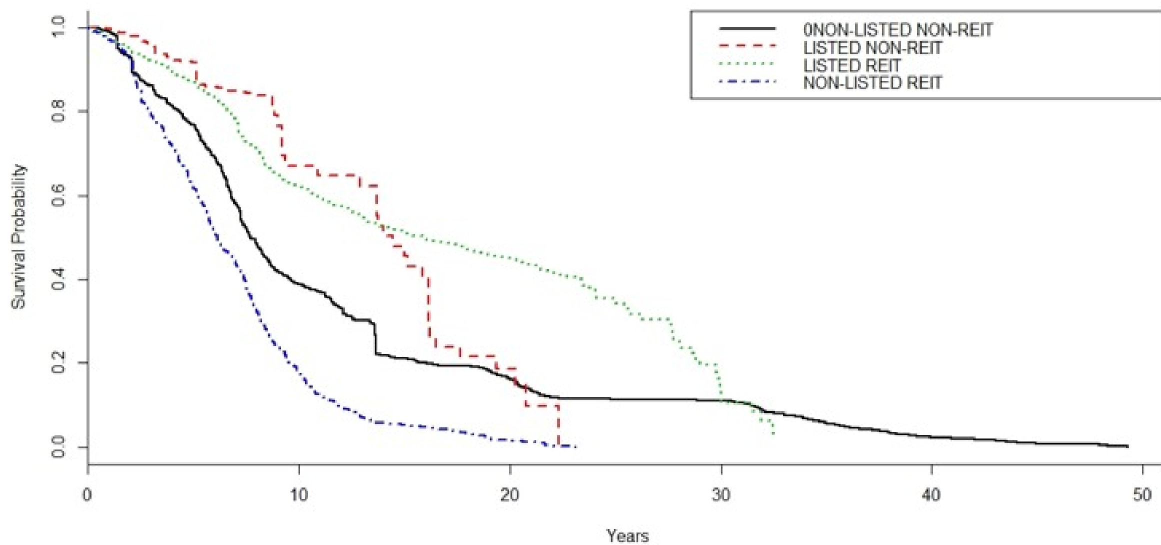
One might argue that other factors related to the property itself could drive the decision to sell. We found that the timing of renovation (e.g., capital expenditures) matters in explaining holding periods. More precisely, when the buyer is not involved in the renovation, the acquisition may not be made with the intent to operate the hotel in the long run and the hotel is sold more rapidly. We explain these results by the fact that the best positioning of the property is likely to be different from the acquirers’ portfolio. For the same reason, assets owned through portfolio acquisitions are sold quicker, and properties built on leased land have a longer holding period due to their lack of attractiveness to prospective buyers. Finally, older hotels are sold sooner and larger hotels are held longer.

Figure 2. Baseline Survival Function by Property Type Sub-Samples



Copyright © 2008-2020 CoStar Realty Information, Inc.

Figure 3. Baseline Survival Function by Owner Type



Notes: Both charts depict the Kaplan-Meier Survival Function based on a sample of 6,138 hotels (divided across subsamples) located in the U.S. that were acquired by REITs and REOCs between 1969 and 2018. Fifty-seven percent of the hotels were sold during the sample period. Sale of an asset denotes a "hazard" and the event of staying unsold is depicted as "survival." The X-axis denotes survival duration. The Y-axis denotes the cumulative probability of survival until a given duration if the asset has remained unsold by that duration.

Owner characteristics

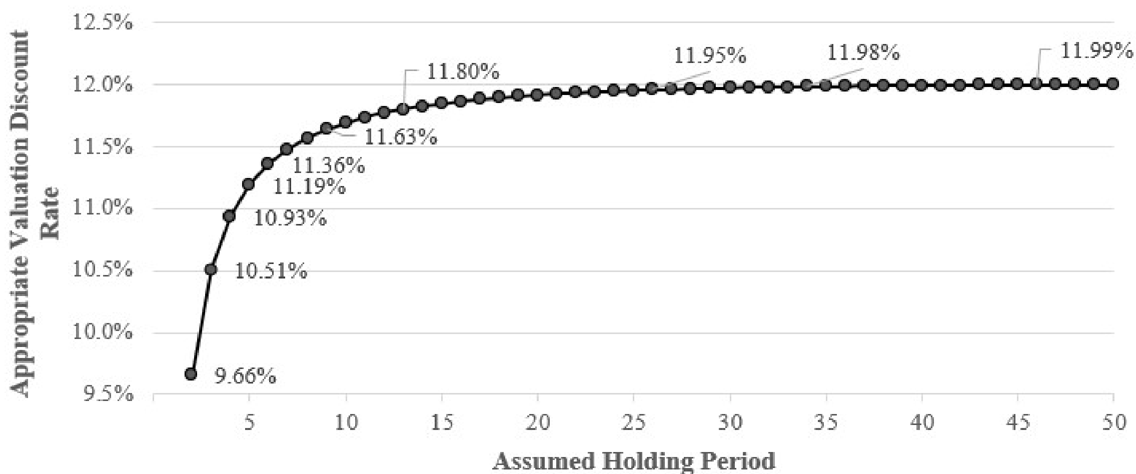
We also analyzed whether "owner type" influences the decision to sell. The results show that REOCs hold their assets for a shorter period of time than REITs. Indeed, after a certain period of time, hotel properties do not provide enough tax benefits anymore, which pushes REOCs to sell. In contrast, REITs are less concerned with this issue given their tax-exempt status.

Next, we compared listed and non-listed firms, and it appears that non-listed firms (REITs or REOCs) have shorter holding periods. Why? Listed firms tend to have easier access to financing via the capital markets. For these corporations, new acquisitions can be made without having to sell some of their current holdings. Holding period variation by owner type is shown in Figure 3.

The problem with assuming a five- or 10-year holding period

Beyond its influence on fees, holding period also has a major impact on the valuation of hotels. Indeed, theoretically the Gordon Growth model suggests that once cash flows have stabilized, holding period should not have an impact on the value of an asset. However, the prevalent real estate valuation method has its nuances, particularly due to the going-out cap rate assumption. Being dictated by the market, the going-out cap rate often deviates from its theoretical value and is (erroneously) specified at the outset without a holding period consideration. Besides, the choice of holding period is rather arbitrary (usually five or 10 years). As shown above, the holding period is not only a dynamic property of an asset, but also a critical input in the discounted cash flow (DCF) method. A lack of clarity leads to serious valuation errors.

Figure 4. Equivalent Discount Rate across Holding Periods



Notes: This hypothetical example shows variations in equivalent discount rates in a DCF valuation exercise which keeps the valuation at Year-0 unaltered for a given property across differently assumed holding periods. The stabilized asset acquired at $100 million generates $10 million in cash flows in its first year of operation which grows 2% annually, which means the going-in capitalization rate is 10%. The going-out capitalization rate is fixed at 10.5% across all

Copyright © 2008-2020 CoStar Realty Information, Inc.

assumed holding periods.

Valuation implications

The nature of the going-out cap rate is uncertain. Consider valuation amid the COVID-19 crisis when uncertainty about the future has been at extreme levels. Things will get clearer in the coming years, likely rendering the going-out cap rate lower than today, depending on the holding period. This goes against prevalent valuation practices. Similarly, the discount rate will vary with the assumed holding period. However, the going-in cap rate relates to a point in time. Besides, the stabilized cash flow growth rate (whenever it is achieved) is not sensitive to the holding period. Therefore, the best initial estimate of the discount rate should equal the sum of the going-in cap rate and the growth rate. However, given the fixed (i.e. holding period independent) specification of the going-out cap rate, one needs to adjust the discount rate based on the assumed holding period. The calculation of discount rate adjustment can be computationally derived so that valuation is not sensitive to the assumed holding period. A specific valuation scenario is presented in Figure 4. We can further generalize this scenario using regression analysis and derive a general formula for discount rate adjustment .

Conclusion

Holding periods (i.e. how long buyers hang on to their hotel) are strategically important for multiple stakeholders in the hotel business, including investors, lenders and consultants. We show that the holding period depends on multiple factors and can be predicted using econometric modeling. More importantly, the prevalent valuation process makes hotel valuation sensitive to the assumed holding period. Therefore, we prescribe an adjustment to the discount rate so that the valuation is consistent across differently assumed holding periods.

Cédric Poretti, Ph.D. CFA is an Assistant Professor of Accounting at the Ecole hôtelière de Lausanne, Switzerland. He developed and teaches courses in financial accounting/managerial accounting/financial statement analysis, and also serves on the academic board. Earlier, Dr. Poretti worked in the financial industry (FX trading and private banking) as a portfolio manager and an economist. His research mainly focuses on audit, corporate governance, financial reporting, and valuation. Dr. Poretti has published various papers in scientific journals, and regularly participates in international conferences. Since 2017, he also serves on the board of AAIG, an association focusing on corporate governance research.

Prashant Das, Ph.D. is an Associate Professor of Real Estate Finance and the acting Director of the REFE Institute at the Ecole hôtelière de Lausanne (EHL), Switzerland. At EHL, he developed and teaches courses in real estate finance, valuation and investment and also serves on the Academic Board. Besides, he serves on the editorial board of the Journal of Property Research and the Journal of Sustainable Real Estate. Prashant has published over 20 research papers in scholarly journals and co-authored two books on real estate. He is a recipient of nine internationally competitive research awards and a teaching excellence award.

This article is based on academic research, submitted in partnership with STR's SHARE Center, which provides support and data resources to professors and students in hotel and hospitality fields of study at colleges and universities worldwide. The assertions expressed in this article do not necessarily reflect the opinions of Hotel News Now or its parent company, STR, and its affiliated companies. Please feel free to comment or contact an editor with any questions or concerns.

Copyright © 2008-2020 CoStar Realty Information, Inc.