The Case of the Overvalued Hotel

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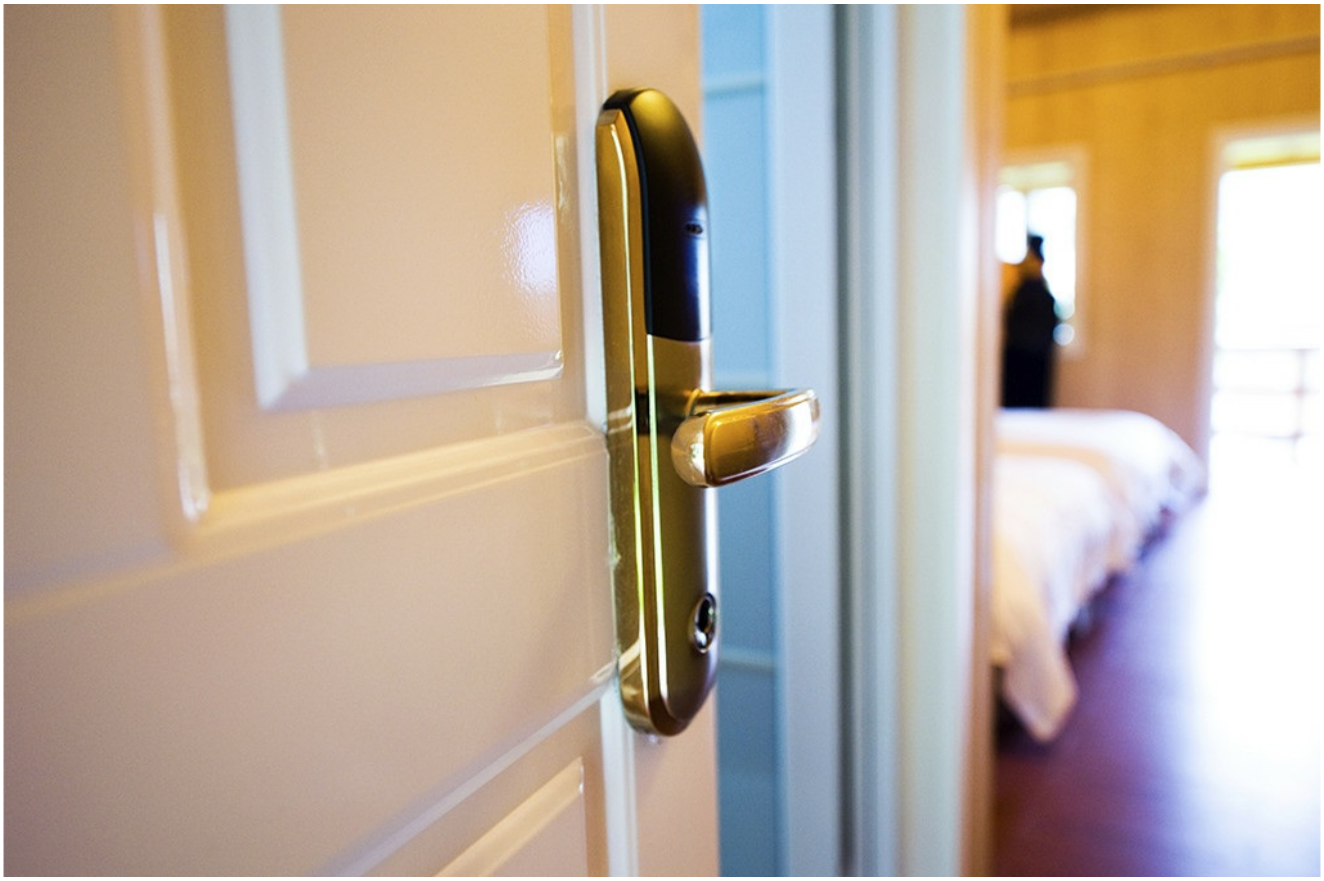

Or why the appraisal was 24 percent higher than the purchase price …

How can this be?!

Consider this: A purchaser is interested in buying a suburban full-service hotel property and enters into a purchase agreement for $16.1 million. The seller eagerly accepts this offer, and the deal is set to close. Of course, the purchaser needs to finance the transaction and seeks out a CMBS transaction.

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An appraiser is engaged. Happily, the appraiser arrives at a market value of $20 million. Immediately, worried phone calls ensue regarding the difference between the appraised value and the purchase price.

What could've caused such a difference? How could a seller possibly agree to a transaction where the property is undervalued by almost $4 million?! The appraiser must be way off …

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Let's start at the beginning

Now consider the background of this property: The current seller was once a buyer and purchased the property in late 2009, during the depth of the great recession, as part of a bulk sale that involved $300 million of office properties and this lone hotel asset. The current seller is repositioning the portfolio and has the opportunity to purchase a $16 million office building, which will fit nicely into the management, maintenance, location and tenant mix of his other assets. The buyer, on the other hand, is a professional hotel owner that has $260 million of full and limited-service hotel assets in the eastern part of the United States, primarily positioned in large growing suburbs of major metropolitan areas.

To the buyer, the property represents a new asset that can be mined for its upside potential, given its lackluster management over the past five years. To the seller, the property is a white elephant that doesn't fit into its current mix of assets. Relative to the full portfolio, the hotel and associated opportunity cost represent a significant disadvantage when positioned in a hotel property.

Will the typical buyer please step forward?

The appraiser is analyzing this hotel property (or any other property) based on the definition of market value. Inherent in this definition is the understanding of who the "typical" buyer for this property actually is. In this case, the typical buyer for properties such as the subject would be an investor — or investment group — who owned other hotels and was involved in managing them professionally for the greatest return.

Therefore, the market is comprised of participants who look at hotels in bulk based on the maximization of profits. The appraiser will analyze the property based on the typical purchaser or "market." In the case of the underpriced hotel, the appraised value was further supported by the following:

- **Limited new supply:** A market in which new supply has been added at a rate of around 1.5% annually for the last five years.
- **Limited new supply under construction:** The total proposed and in-the-pipeline new inventory represents less than 2% of the total market.
- **Growing demand for room-nights:** Demand, on the other hand, even if measured only by airport enplanements and office growth, has been increasing at a rate of around 4% annually.
- **The subject was historically a strong competitor:** The subject property had a penetration rate (room night sales compared to the competitors, assuming a "fair share" of the market) of around 90% in the four years while under the office REIT

ownership, when historically (before purchased by the office REIT) it had been a competitor able to garner 105% of market share.

Wrapping it up

In conclusion, gaining an understanding of the background and history of a property is an integral part of the appraiser's value analysis and is critical to explaining the appraiser's conclusions in relationship to the subject's recent market transactions. No parcel of real estate exists in a vacuum, separated from its history, the history of the previous owners and the potential it has in the eyes of a willing purchaser.

An understanding of who the likely buyer is in addition to the motivations of the seller is critical to an appraiser's conclusions.

Based in Detroit, David Abraham, MAI, is a Director of Valuation Services for Colliers International and also leader of the Hospitality Valuation Services practice group, which provides appraisals and market studies for hospitality properties throughout the United States. When he's not appraising or writing about hotel valuation and litigation support on his Commercial Valuation Advisor blog, David can be found traveling to far flung places, glacier climbing or just hanging out with his five kids. You can contact David by email or through LinkedIn.