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Comparative Capitalization Rate Study

A review of the differentials in capitalization rates based on location and property type over a ten year period

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If HVS maintained an “FAQ” list, “Where are cap rates today?” would be at the top of the list, followed closely by “What is the right cap rate for this hotel?” Not only is there no good answer to these questions, the correct response is actually a series of other questions, starting with “What net income are you capping?” and “How is that net income expected to change in the future?” and continuing on from there.

While there is no way to answer the cap rate question for a specific asset, there are some broad parameters that can provide insight, if not guidance, into how the investment market has answered this question over the past decade.

HVS maintains a database of over 11,500 hotel sales in North America, over 10,000 of which involved properties located in the United States. While some of the data dates back to the early 1970s, the majority of the transactions included in the database occurred in the 1990s (over 4,200) or in the years 2000 to 2009 (over 4,300). The data encompasses all property types and locations, and while it does not include every transaction that occurred during this period, we believe this database to be the largest in the U.S., and the sample broad enough to provide meaningful information concerning how the investment market has viewed different property types, locations and tiers.

What is a Capitalization Rate?

The term “cap rate” is commonly used when discussing property prices and values, but these conversations rarely include a definition of “cap rate,” or more importantly, a clarification of what cap rate is being referenced. *The Dictionary of Real Estate Appraisal* defines an overall capitalization rate as “An income rate for a total real property interest that reflects the relationship between a single year’s net operating income expectancy and the total property price or value; used to convert net operating income into an indication of overall property value.” In mathematical terms, the equation for deriving an overall capitalization rate is expressed as follows:

$$R = NI/Value$$

For any transaction or valuation, there are several different capitalization rates that can be derived or used. The principal variables are as follows:

- What net income is being used?
 - Net income for the period immediately preceding the sale or valuation?
 - Net Income forecast for the first year following the sale or valuation?
 - Net income forecast for the stabilized year, in current dollars?

- How is the Net Income defined? The most common variables are the management fees and reserve for replacement, which should (but may not always) be included in the calculation of the Net Income.
- How is the value defined? When considering a transaction, there are often factors in addition to the sales price that influence the total investment in the property. These factors can include:
 - Extraordinary closing costs borne by the buyer, such as termination fees paid to the manager or franchisor
 - Additional capital investment in the property, most commonly for renovations or expansion

Given these variables, any transaction could have multiple capitalization rates. For the purposes of this study, we have utilized the capitalization rate indicated by the net income for the most recent fiscal or calendar year. The net income includes both management fees and reserve for replacement costs. We elected to use the historical net income because this amount was a known number, and was available for all of the transactions. The forecast net income was not always available, and is also subject to variance based on the perspective of the successful buyer.

It is important to note that since the capitalization rates used in this study are based on the historical net income, they do not explicitly take into consideration any upside potential from economic or market cycles, nor from any changes to the property implemented by the new owner. Such potential upside is typically a significant factor considered by buyers, and can have a material influence on purchase and pricing decisions. Buyers typically model any anticipated upside into the forecasts on which their pricing is based; as the resulting transaction price is a component of the equation to determine the capitalization rate, this upside is inherently reflected by the capitalization rates.

It must also be noted that the capitalization rates reflected in this study cannot and should not be used in selecting a capitalization rate to be applied to an individual asset or valuation exercise. The results published herein are in aggregate form, and reflect historical data that occurred in market conditions that differ from the conditions that prevail today.

Methodology

In preparing this research, we focused on data for the period 2000 to 2009. This period is broad enough to provide a sufficient volume of data, and also has the benefit of encompassing multiple economic cycles. We then eliminated all properties for which we did not have a confirmed capitalization rate. A significant volume of the transactions involved

portfolio transactions; only data for those portfolio transactions for which property-specific price allocations were reported was retained. The resulting data encompasses 996 transactions. Of these, 557 are classified as “major transactions,” defined as a transaction of \$10,000,000 or above. The remaining 439 reflect sales prices of under \$10,000,000. While HVS’s research typically focuses on major transactions, for the purpose of this study we have included all 996 transactions, as the smaller-dollar-volume transactions constitute a significant number of certain property types and regions.

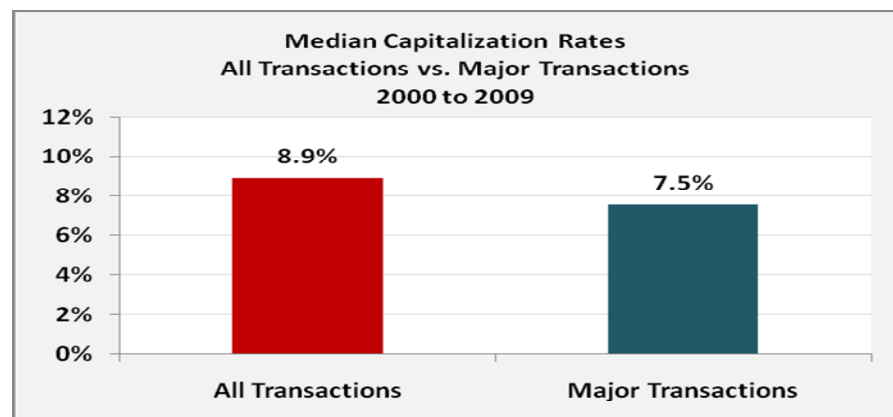
The data was then classified based on the following parameters:

- Region
- Major Metropolitan Market
- Property Location
- Operating Tier

Within each classification, the average, minimum, maximum and median capitalization rates were calculated. The average and median data are consistent in terms of the relationship between the various categories. However, a review of the specific data revealed that the average is in some cases skewed by outlying data, while the median data reflects the central tendency of the data and thus the investment market. We have therefore elected to present the median data in this study.

All Transactions vs. Major Transactions

The median capitalization rates for all the transactions and for those classified as major transactions are set forth in the following chart.



The transactions with a value of \$10,000,000 or above reflect a median capitalization rate of 7.5%. This is 1.4 percentage points lower than the median for all transactions. The make-up of the two samples provides some insight into this differential. The major transactions principally comprise larger, select- or full-service and/or more upscale hotels, while

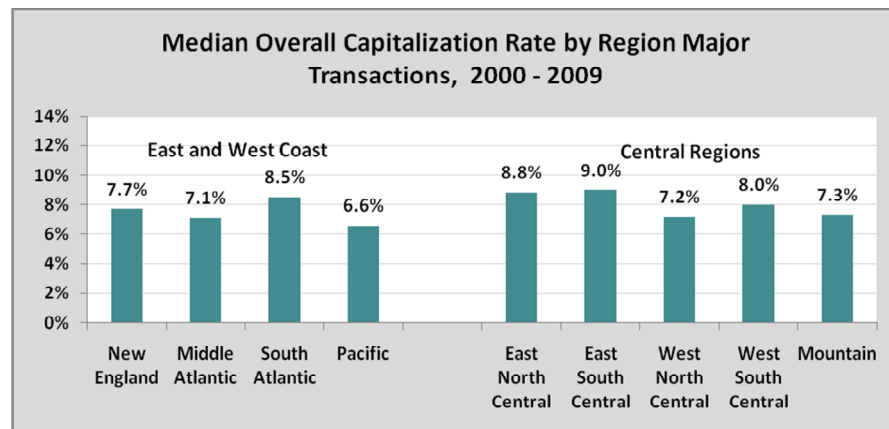
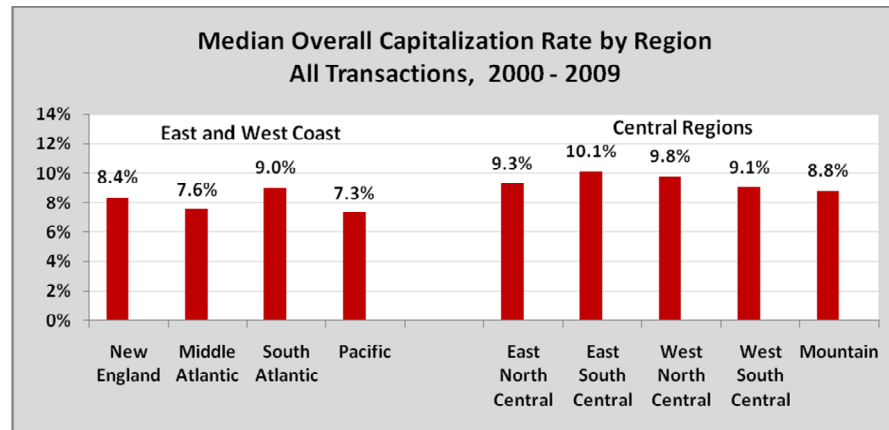
the full sample includes a greater proportion of smaller and/or limited-service hotels. Thus the hotels included in the major transactions are more homogenous, and the cap rates more comparable, than is the case for the full sample. Further insight into the factors that contribute to this premium can be found when the data is examined on the basis of location and property characteristics.

Capitalization Rates by Region

The data was divided into nine regions based on the location of the property sold. The states included in each region are set forth in the following chart. Note that these classifications agree with Smith Travel Research's definitions of each region with the exception of the Middle Atlantic and South Atlantic regions. We have elected to include Delaware, Maryland and the District of Columbia in the Middle Atlantic region, rather than the South Atlantic region, as a review of the data indicates that the properties and transactions in these states are more comparable to those in New York, New Jersey and Pennsylvania than those in the other South Atlantic states.

Region	States included in Region
New England	Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, Connecticut
Middle Atlantic	New York, New Jersey, Pennsylvania, Delaware, Maryland, District of Columbia
South Atlantic	Virginia, West Virginia, North Carolina, South Carolina, Georgia, Florida
Pacific	California, Oregon, Washington, Alaska, Hawaii
East North Central	Ohio, Indiana, Illinois, Michigan, Wisconsin
East South Central	Kentucky, Tennessee, Alabama, Mississippi
West North Central	Minnesota, North Dakota, South Dakota, Iowa, Nebraska, Missouri, Kansas
West South Central	Arkansas, Louisiana, Oklahoma, Texas
Mountain	Montana, Idaho, Wyoming, Colorado, Utah, Nevada, Arizona, New Mexico

The median capitalization rates reflected for each of the nine regions are set forth in the following graph.

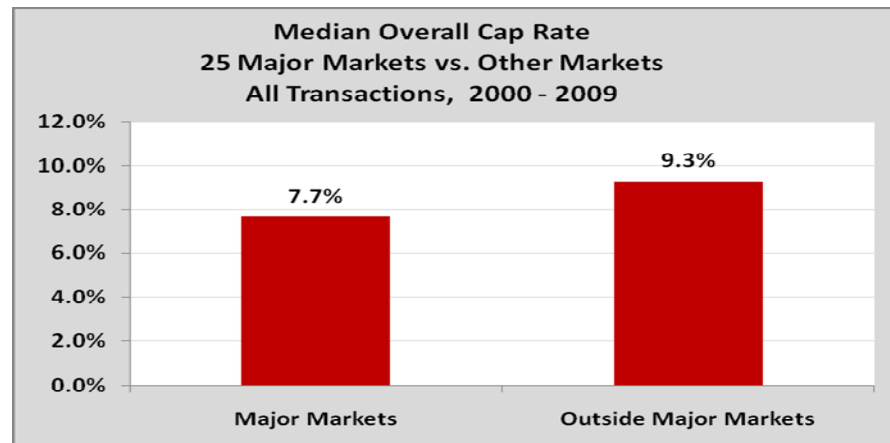


The Pacific region reported the lowest median capitalization rate, followed by the Middle Atlantic region. The highest rate, and the only one to top 10%, was for the full sample in the East South Central region. A review of the data indicates that the regions that encompass the east and west coasts of the U.S. are characterized by significantly lower capitalization rates than the regions that make up the central part of the country. The disparity is less notable, but still evident, when only the major transactions are considered.

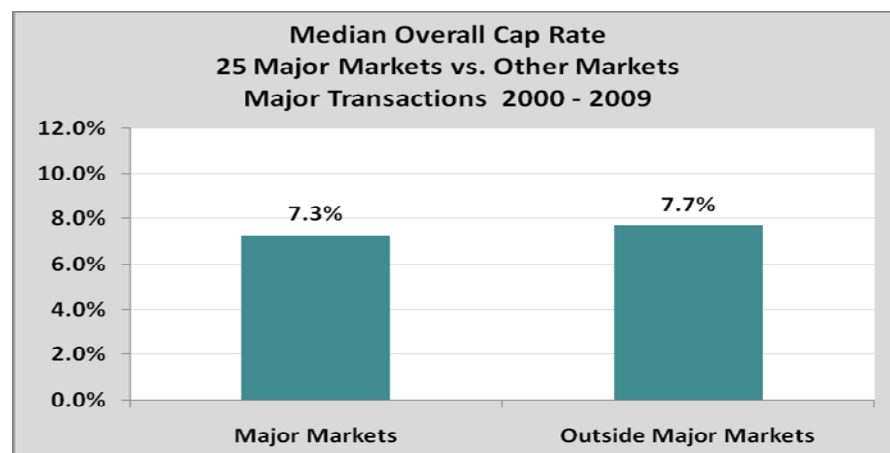
The profile of these regions is largely responsible for the noted differential between the coasts and the central region. As will be demonstrated subsequently, resort and urban locations are characterized by lower capitalization rates than suburban and highway locations. The vast majority of resort locations, and proportionately more urban areas, are located on the east and west coast. The central region encompasses a more balanced mix of urban, suburban and highway locations and thus is more influenced by the (relatively higher) capitalization rates that characterize these types of locations.

**Capitalization Rates
by Major Market**

Smith Travel Research tracks the top 25 major metropolitan markets in the U.S. The major markets are Anaheim, Atlanta, Boston, Chicago, Dallas, Denver, Detroit, Houston, Los Angeles, Miami, Minneapolis, Nashville, New Orleans, New York, Norfolk, Oahu, Orlando, Philadelphia, Phoenix, San Diego, San Francisco, Seattle, St. Louis, Tampa, and Washington DC. We have classified the sales transactions based on their inclusion in one of these 25 markets. This data is set forth in the following chart.



A review of all transactions reveals that the median capitalization rate for the major markets is 1.6 points lower than the rate reflected in the non-major-market transactions. When only the major transactions (\$10,000,000 or higher) are considered, the discrepancy drops significantly, to only 0.4 points.

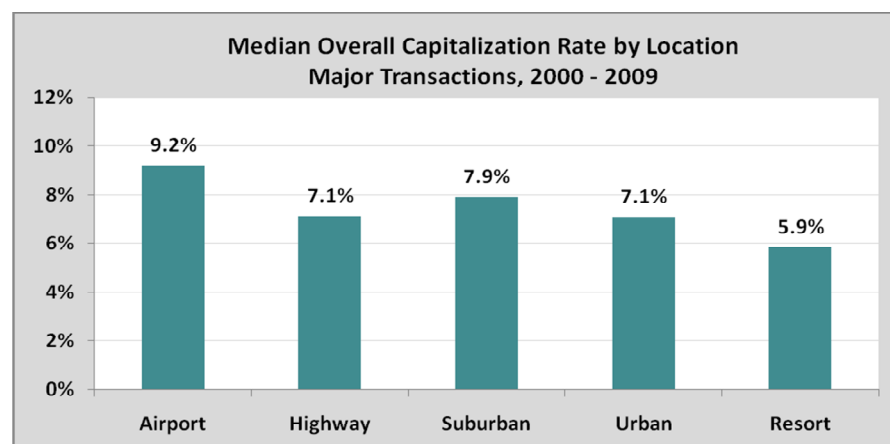
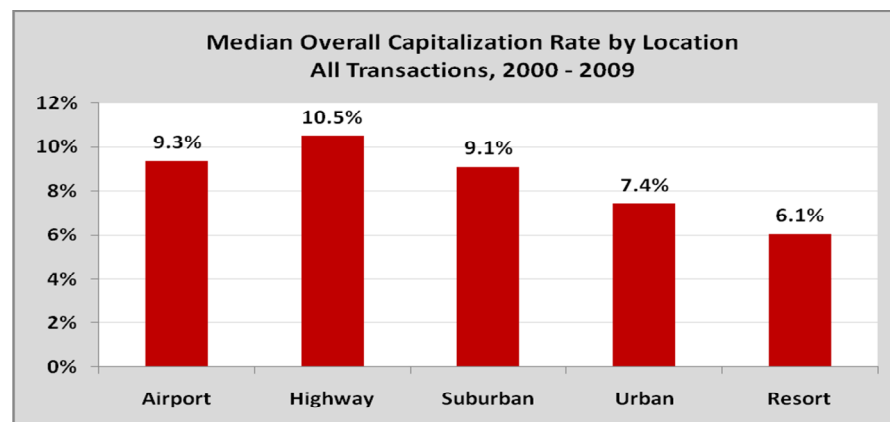


Again, the mix of properties included in the two categories appears to be the source of the differential. Over 75% of the transactions in the 25 major markets are classified as major transactions. Only 42% of the transactions outside the major markets reflected prices in excess of

\$10,000,000; when only these transactions are considered, the median capitalization rate drops from 9.3% to 7.7%. A review of the properties represented in the transactions valued at under \$10,000,000 indicates that these are predominantly smaller, limited-service hotels. This category also includes some older, full-service properties, as well as a disproportionately high number of independent hotels, as compared to the sample as a whole.

Capitalization Rates by Location

Each of the transactions has been classified based on the characteristics of the location and neighborhood. The categories utilized are Airport, Highway, Suburban, Urban and Resort. The median capitalization rates for each location are set forth in the following charts; the first chart incorporates all 996 transactions, and the second reflects only the major (>\$10,000,000) transactions.



Transactions involving resorts reflect the lowest median capitalization rate in both data sets, with a minimal differential between all transactions and the major transactions. This correlation is logical as the vast majority of the resort transactions reflect prices of over \$10,000,000. Similarly, there is little differential in the capitalization rates reported in

the urban category. Data for both the highway and the suburban categories indicates that the capitalization rate for the major transactions is significantly lower than that reported for the sample as a whole. Again, a review of the individual sales reveals that most of the transactions valued at under \$10,000,000 involved smaller, predominantly limited-service properties, as well as some older hotels.

The lower capitalization rates reflected for the resort and urban locations can be attributed, in large part, to the barriers to entry that typically characterize these areas. In most instances, sites for new hotel development in both urban and resort areas are rare and, when available, extremely expensive. Moreover, in many cases a hotel is not the highest and best use of the site, so that new hotel development is dependent on mixed-use projects. Such projects usually require an extended development period, often five or more years, depending on the approval process and construction conditions. These circumstances create a significant barrier to entry, which enhances the value of existing hotels by limiting the potential for new competition. In some instances, the underlying value of the land and the potential for redevelopment also contributes to the lower cap rates that characterize these assets.

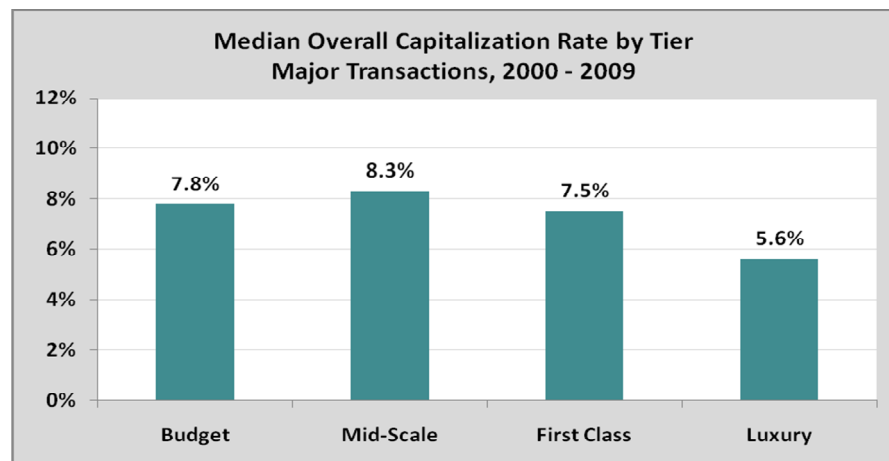
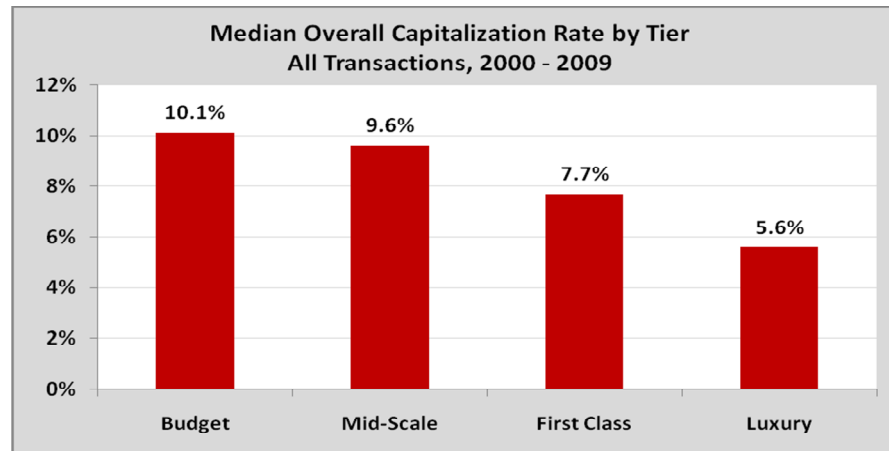
Another consideration is the longevity that characterizes most urban and resort locations. In other words, a site in a central business district would not typically become less desirable over time, as the nature and density of the surrounding improvements should ensure continued (and perhaps increased) demand for that site. Similarly, the beachfront location that makes a particular resort site desirable is a permanent characteristic of that site, and thus should ensure the continued desirability of the property over the long term. The longevity of the location benefits a hotel in that location, by effectively extending the economic life of the asset. While the building would need to be maintained and modernized, an owner can anticipate a much greater window in which to achieve a return on investment than is the case for properties in less desirable locations. These circumstances typically translate to a lower capitalization rate.

By contrast, suburban and highway locations are much more interchangeable. Sites available for development or redevelopment are far more common in these locations, and the typical lead time for development is quite short, usually 18 to 36 months. Moreover, the development patterns that affect these locations are characterized by ongoing expansion, with new submarkets emerging as development progresses out from the established core. Thus the likelihood of new competition within a given submarket is significantly higher, and the site of an existing hotel could potentially become less desirable over time. As a result, a return on the investment in a hotel in these locations has to be

achieved in a shorter time period, and the return requirement – and capitalization rate – must therefore be higher.

Capitalization Rates by Tier

Each of the transactions has been classified based on the tier of the property. The tiers utilized are Budget, Mid-Scale, First Class and Luxury. The median capitalization rates for each tier are set forth in the following charts; the first chart incorporates all 996 transactions, and the second reflects only the major (>\$10,000,000) transactions.



Not surprisingly, the luxury category reflects the lowest median capitalization rate in both charts, and the properties categorized as first class reflect the second lowest median capitalization rate, with little differential between the major transactions and the full sample. Barriers to entry play a significant role in the lower capitalization rates reported for these two sectors. Most of the properties in the luxury category are in either resort or urban locations, which as previously demonstrated are characterized by lower capitalization rates. Although the first-class tier includes properties in all locations, a significant proportion are in urban areas.

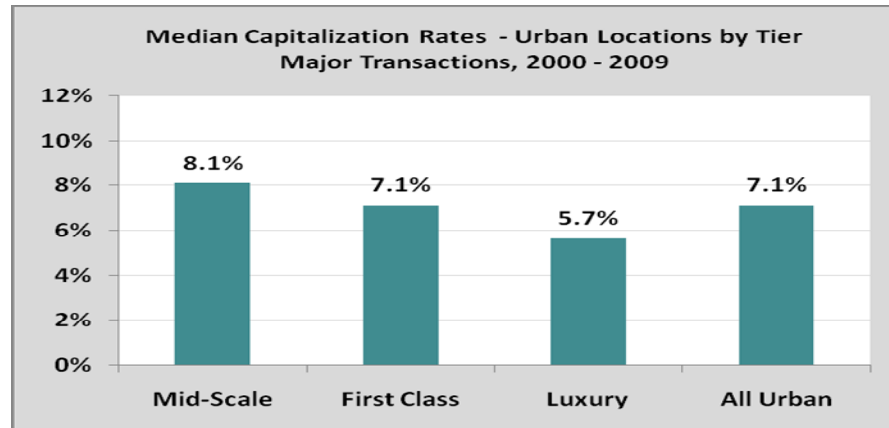
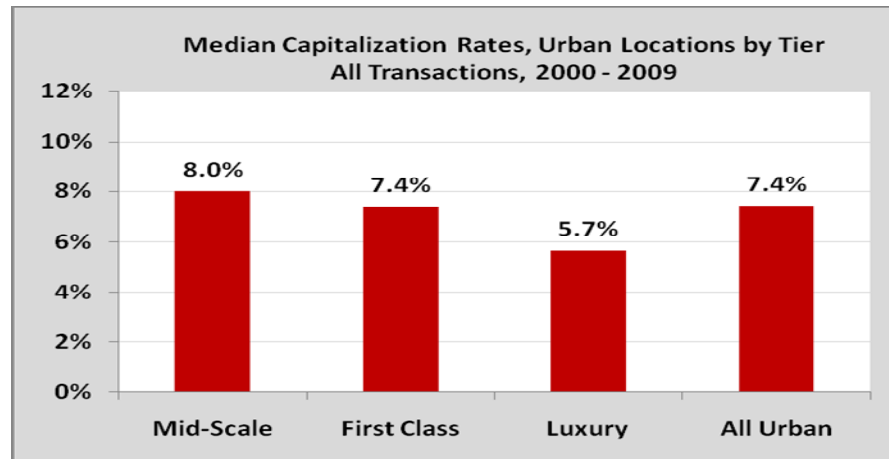
In addition to the influences of location on the two upper tiers, these properties also benefit from the profile of the hotels within these segments. Virtually all luxury properties and most first-class assets are full-service hotels. This attribute contributes to the barrier to entry factor, as full-service hotels are expensive to construct due to the amount and array of food and beverage, meeting space and other ancillary facilities required by the full-service profile. The feasibility hurdle is therefore higher, requiring a relatively high occupancy and average rate level before new development is economically justified. The development process for full-service hotels can also be extended, due to the more complex nature of the buildings. These factors tend to delay the entry of new competition into the market, providing existing hotels with a greater window to achieve improved revenue and profit levels and thus generate a return on investment.

Full-service hotels also tend to be higher-quality buildings, in terms of design and construction. This attribute typically supports a longer economic life, including the probability that the building's economic life can be further extended through on-going maintenance and capital investment. A longer economic life increases the period over which an investor can expect to earn a return on investment and usually supports a higher anticipated reversion at the end of the holding period. These factors generally justify a lower capitalization rate.

Looking at the budget and mid-scale sectors, properties in these tiers have limited public space and generally feature low-rise construction using less costly materials and techniques, and can be developed at a relatively low cost. New hotels with the same profile are relatively easy to construct, and therefore the probability that a new competitive hotel will enter the market can be high. Moreover, buildings in these categories may have a shorter economic life as a result of both physical and functional obsolescence (such as exterior corridors). These factors can limit the period of time over which the property can be expected to perform at optimal economic levels, particularly if newer hotels enter the market. A higher rate of return is therefore necessary to offset the shorter period during which that return can be earned.

**Capitalization Rates
in Urban Locations,
by Tier**

To further demonstrate the impact of tier on capitalization rate, we have calculated the median capitalization rate for urban locations by tier. The budget tier has been eliminated from this calculation, as the number of transactions in this subcategory does not provide a sufficient sample.



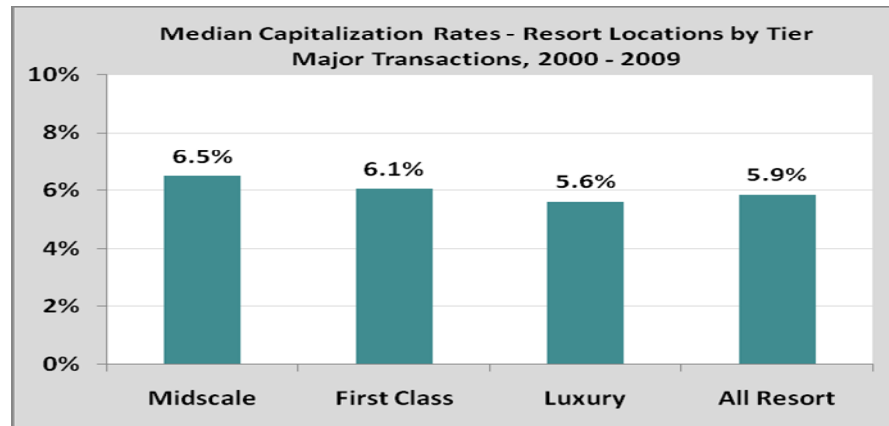
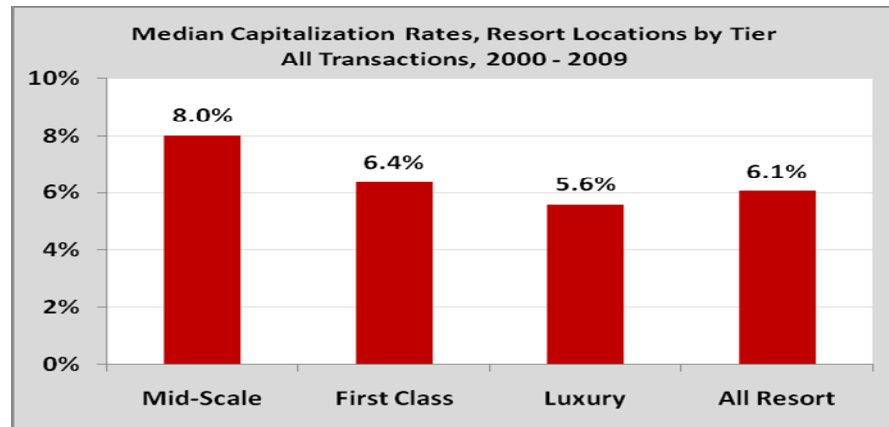
In both sets of data, the median capitalization rate for the urban luxury tier is well below the average, and the urban mid-scale tier is above the average. The differential between the major transactions and the full set of data is minimal. Also notable is the narrower spread between the mid-scale and first-class categories. Data by tier for the full sample illustrated earlier reflected a 1.9 point spread between the mid-scale (9.6%) and first-class (7.7%) segments. When only the urban transactions are considered, the spread between the two categories decreases to 0.6 points; most of this compression is due to the lower capitalization rate indicated for the mid-scale tier, which dropped to 8.0% in the urban category.

All other things being equal, the relative cap rates suggest that mid-scale assets in urban locations have a higher perceived value than those in suburban or highway locations. A review of the specific transactions included in this subset reveals that this category includes a significant number of limited- or select-service hotels that are affiliated with strong brands. These assets are typically characterized by better quality construction than their suburban equivalents, and are most commonly

high-rise buildings that are either newly-built or adaptive re-uses of older buildings that have undergone a comprehensive renovation. Thus these properties benefit from the barrier to entry factors discussed previously, and can also anticipate a longer economic life. The lower capitalization rates reflected in the data indicate that investors view these characteristics favorably.

Capitalization Rates in Resort Locations, by Tier

The same calculations were performed for the resort category; the results are set forth in the following charts. The budget category has again been eliminated, due to insufficient data.



Not surprisingly, the luxury resort segment reported the lowest median capitalization rate in both samples. As with the data by tier for the Urban category, these charts reflect a reduction in the differential in capitalization rates between the mid-scale and first-class tiers, particularly for the major transactions. The benefits of higher barriers to entry and an extended economic life that characterize a majority of the properties in resort locations are obviously sufficiently compelling to induce investors to accept a lower capitalization rate when buying hotels in this sector.

The “Better” Owner Factor

Another consideration not articulated by the data, but quite clear from our experience, is the “better” owner factor. Virtually every hotel buyer is certain that he/she/they will be able to maximize the net income and value of the asset they are buying in a way that the seller has not achieved. The “better” owner factor encompasses a number of self-perceived advantages, including better management or asset management; better stewardship of the property including the infusion of needed capital; critical mass resulting in enhanced buying and/or negotiating power; and a host of other factors. As the capitalization rates used in this study are based on the net income in the year preceding the sale, they do not take into consideration the (often significant) upside potential that buyers build into their cash flow forecasts, and thus does not reflect the investor’s anticipated rate of return, which would be enhanced by the anticipated improvements in the property’s operations and cash flow. Although buyers are reluctant to pay for value that they expect to create through their own efforts, it is clear that they will pay for the opportunity to create that value.

While the “better” owner factor can apply to all property types and locations, the upside potential is greatest for more complex properties and those that operate in higher-priced markets and locations. Thus, in our experience, this factor has a greater degree of influence on upper tier properties in major markets, and in urban and resort locations. Moreover, the greater window to achieve improvements provided by the higher barriers to entry that characterize these sectors extends the opportunity to achieve significant improvements and thus an enhanced return on investment.

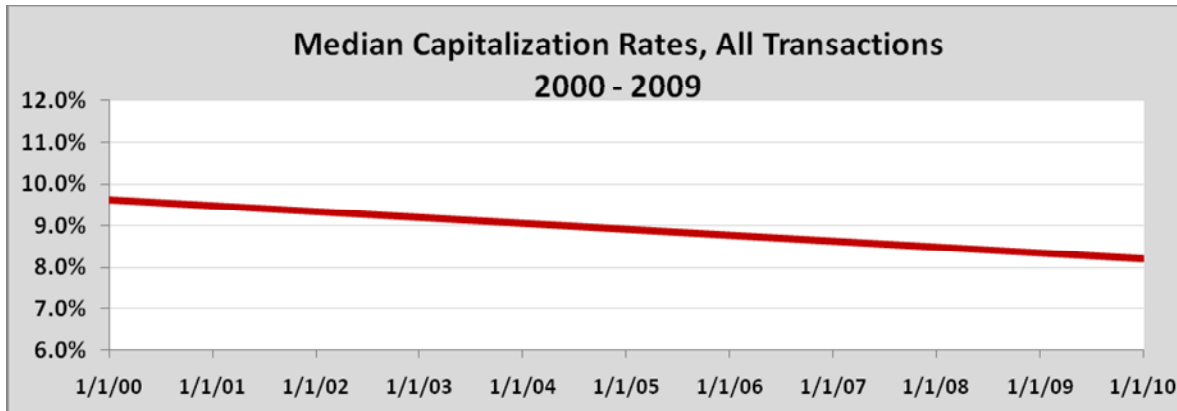
So What is the “Right” Cap Rate?

While the factors that influence the capitalization rate for any one hotel are specific to that property, some conclusions can be drawn from the data. The lowest capitalization rates were reported for the properties that, based on location, property type and tier, would be expected to attain the highest average rates, and typically have the highest replacement cost. Categories dominated by full-service hotels generally reported lower capitalization rates. And the lowest median capitalization rates were reported for the resort and urban categories, which are dominated by transactions of over \$10,000,000.

The common denominators for all the data sets with lower median capitalization rates are barriers to entry and extended economic life. These factors combine to create a relatively longer period over which an investor can expect to achieve a return on his or her investment. This greater window of opportunity enables investors to utilize a lower return requirement when making their purchase and pricing decisions. Conversely, when an asset does not benefit from these characteristics a higher rate of return is required, so that the investment can be amortized over the shorter period of optimal economic performance.

One Final Note

The purpose of this study was to examine relative capitalization rates over a ten-year period, without regard to trends over time. However, with the data already compiled, we look at how cap rates have trended over this period. The following chart displays the trend line in cap rates over the period, for all 996 transactions used in this research.



As the chart indicates, the median capitalization rate for all transactions decreased from approximately 9.75% as of January 1, 2000, to just over 8.0% as of January 1, 2010. Declining capital costs and the broader acceptance of hotels as investment real estate that characterized the middle years of this period undoubtedly had a significant influence on this trend. More recently, depressed cash flows and buyer optimism about the future of the industry are likely to have been the dominant influence. We are currently seeing transactions that reflect capitalization rates that are in many instances even lower than those reported in the 2006 and 2007 timeframe, when the capital markets were at their peak. The more recent decrease is principally a reflection of the depressed cash flows that characterized 2009 performance, which were for most hotels at historical lows. Investors acquiring hotels in the present market are doing so with the expectation of significant improvements in revenues and net income for the industry as a whole over the next several years, even without any upside for the specific property. It will be interesting to see how this trend line shifts over the next ten years.

One Final Caution

Identifying the correct capitalization rate or capitalization parameters is often the most challenging part of any pricing or valuation exercise, and it can be tempting to rely on “published studies” as a primary source. It is rarely appropriate to do so, as most studies (including this one) present data in aggregate form, and the aggregation process includes not only a number of assets and transactions, but also typically a span of time that encompasses changing market conditions.

The purpose of this study was to examine the relative median capitalization rates, by asset class, over an extended period of time, to

gain insight into how the investment market views different property attributes and characteristics. The data presented in this study is in aggregate form, and while it provides useful and interesting information concerning the relative capitalization rates for different asset classes, it does not provide – and should not be used – as the basis for a capitalization rate to be applied to an individual asset. The correct capitalization rate or parameters for any pricing or valuation is specific to that asset, and must explicitly consider the attributes of the property, the characteristics of the net income to be capitalized and prevailing market conditions – including particularly the cost and availability of capital - as of the date of the valuation.

About the Author



Anne R. Lloyd-Jones, CRE, is Managing Director of the New York office of HVS, the premier global hospitality consulting firm. Since joining HVS in 1982, Anne has provided consulting and appraisal services to over 5,000 hotels. Anne's particular areas of expertise include market studies, feasibility analyses, and appraisals. She is also an expert in the valuation of management and franchise companies, and brands. Her experience includes a wide range of property types, including spas and conference centers. She has appeared as an expert witness on numerous occasions, providing testimony and litigation support on matters involving bankruptcy proceedings, civil litigation, and arbitration.

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About HVS

HVS is the world's leading consulting and services organization focused on the hotel, restaurant, shared ownership, gaming, and leisure industries. Established in 1980 by President and CEO Steve Rushmore, MAI, FRICS, CHA, the company offers a comprehensive scope of services and specialized industry expertise to help you enhance the economic returns and value of your hospitality assets.

Steve began his career in the 1970s as a consultant in the hospitality division of a prominent New York City real estate firm. Through that experience, Rushmore noted the limited body of knowledge available to assess the value of hotels and motels, taking into consideration both the business and real estate components. Rushmore's first book, *The Valuation of Hotels and Motels*, quickly became the definitive work on the subject, and soon after, HVS was born. The HVS method of providing an economic study and appraisal for hotels and motels immediately became, and continues to be, the industry standard.

Over the past three decades, HVS has expanded both its range of services and its geographical boundaries. The company's global reach, through a network of 30 offices staffed by 400 seasoned industry professionals, gives you access to an unparalleled range of complementary services for the hospitality industry:

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Investment Banking
Asset Management & Advisory
Hotel Management
Hotel Parking Consulting
Executive Search
Food & Beverage Services
Gaming Services

Convention, Sports & Entertainment Facilities
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Sales & Marketing Services
Shared Ownership Services
Golf Services
Eco Services
Risk Management

Our clients include prominent hotel owners, lending institutions, international hotel companies, management entities, governmental agencies, and law and accounting firms from North America, Europe, Asia, Latin America, and the Caribbean. Our principals literally 'wrote the book' on hospitality consulting, authoring numerous authoritative texts and hundreds of articles. HVS principals are regarded as the leading professionals in their respective regions of the globe. We are



client driven, entrepreneurial, and dedicated to providing the best advice and services in a timely and cost-efficient manner. HVS employees continue to be industry leaders, consistently generating a wide variety of articles, studies, and publications on all aspects of the hospitality industry.

HVS is the industry's primary source of hotel ownership data. Our 2,000+ assignments each year keep us at the forefront of trends and knowledge regarding information on financial operating results, management contracts, franchise agreements, compensation programs, financing structures, and transactions. With access to our industry intelligence and data, you will have the most timely information and the best tools available to make critical decisions about your hospitality assets.

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