Rooms Revenue Multiplier (RRM) vs. the Sophisticated Investor

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In the last down hotel cycle, we saw investors relying mostly on a simple approach of taking a single year's gross revenues and applying a multiplier to it to determine acquisition prices. Yet during the current "up" cycle, sophisticated investors are using a direct capitalization as well as a discounted cash flow (DCF) analysis to arrive at an appropriate purchase price.

However, after working on hundreds of distressed hotel properties involving underwriting, IPO, and workouts, we are concerned that far too many investors will continue to use a simplistic application of the Rooms Revenue Multiplier (RRM).

US Real Estate Advisors has recently completed an analysis of hotel transactions in the North East and has concluded that many of these properties were inappropriately priced using RRM analysis. Our experience in Underwriting and Working out distressed hotels, nationwide, over the past several years has compelled us to write this article highlighting the inadequacies with this approach.

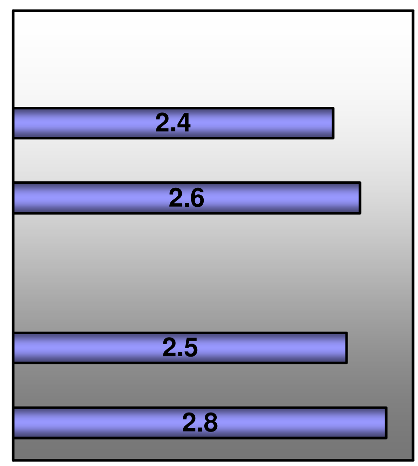
The Rooms Revenue Multiplier (RRM) is used to compare the income-producing characteristics of hotel properties in order to convert income streams into an indicated purchase price. The appropriate method used to select a multiplier is by surveying relevant market data. Multipliers can be derived from recent sales data by calculating the ratio of the sale price to the annual rooms revenue at the time of sale for the comparable property.

The direct capitalization approach takes into consideration both the Gross Income and Expenses on a hotel and converts the resulting net operating income (NOI) into a value. The discounted cash flow approach takes into consideration the real upside potential in pricing the coming hotel recovery because it captures the income producing potential over a 10-year holding period.

In contrast, if you ask any Broker or Special Servicer how to value a marginal hotel property, they will tell you to use a 2.0 multiplier for the trailing twelve months of room revenues. In some cases it seems as if the tail (RRM) is wagging the dog as far as value is concerned. Conversations with several buyers and brokers indicate that transactions are being executed without regard to the property's expenses (aside from taxes and utilities), due to the buyer's perceived ability to operate the property at a known expense ratio. However, there are many flaws to using this approach when making investment decisions.

A survey of current multipliers is provided below to demonstrate the generalizations implicit in the RRM approach:

2003	
Full Service	2.4
Limited Service	2.6
2004	
Full Service	2.5
Limited Service	2.8



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Top Ten Problems with the RRM Approach

1. Backward looking, not forward looking
   Unlike a DCF analysis, RRM analysis is usually backward-looking. Typically, a multiplier is applied to the revenue results of an historic period, usually the trailing twelve months.

2. Single year analysis vs. multiple year analysis
   The beauty of hotels is that they can be marked-to-market every day. RRM analysis does not reflect this income-characteristic of hotel properties. The DCF approach, which uses a multi-year projection analysis, allows for adjustments over time to reflect the upside

potential of hotel properties and to determine a stabilized-indication of the investment quality of the property.

3. Physical characteristics
There are no adjustments for differences in capital requirements, age, and size. Typical hotels range in size from 80-150 rooms. Larger hotels trade at higher multiples during strong markets and at lower multiples during weak markets. Capital requirements can be considerable given that many hotels have had their flags downgraded over the past few years. The age of a hotel can significantly affect its value. With so many hotels built in 1999 and 2000, an older property will suffer and not trade at as high a value as newer hotels. Larger hotels usually trade at higher multiples than smaller hotels. When surveying market data, avoid including a multiple derived from a sale of one hotel that has 300 keys while the other hotels have 100 keys.

4. Operating characteristics
Hotels of the same type, whether Budget, Mid-Priced, Luxury, or "Boutique", have similar expense ratios. However, these ratios can vary at individual hotels depending on the unique characteristics of the hotel. Since RRM assumes the same operating characteristics for all hotels of the same type, slight differences in expense ratios can significantly impact the purchase price.

5. Business cycles
The RRM method doesn't account for the cyclical nature of hotel performance. Since it is still early in the current up-cycle, applying a multiplier to the trailing 12-month's rooms revenue might not fully capture the upside potential of a hotel property. Low interest rates with strong demand for quality assets are driving up hotel values. Investors will not maximize the benefits of a multi-year recovery if they only look at a single years RRM.

6. Supply and Demand
Competitive forces could make one hotel viable and the other at risk of foreclosure. Consumer preferences are not static, but change over time. Over the past few years, exterior-corridor hotels have become less desirable to consumers because of concerns with security. For safety reasons some businesses have implemented travel policies that do not allow employees to stay at an exterior-corridor hotels.

7. Quality of Construction
RRM analysis doesn't adjust for differences in the quality of the construction. For example, the cost of a new hotel could be, say, $65,000 per room, while the multipliers could be from hotels that cost $50,000 or $70,000 per room, but the analysis doesn't recognize any difference.

8. Occupancy
Occupancy should exclude from consideration any abnormal relationship between supply and demand, as well as any nonrecurring conditions that may result in unusually high or low occupancies. RRM analysis does not adjust for these non-recurring conditions.

9. Consistency
There is a lack of consistency in applying multipliers. Some buyers use the rooms revenue for the trailing 12-month, while other buyers use the rooms revenue projected for the next 12-months to arrive at purchase. Additionally, some buyers apply the multiplier to the rooms revenue, only, while other buyers apply it to the entire gross income.

10. Multiplier selection
Since the range of multipliers can vary from 1x to 4x, using regional or national average multipliers can lead to very imprecise indication of value. Multipliers should be derived from recent sales data for comparable properties; however, determining which properties are truly comparable can be a difficult task. Any error in the selection of the appropriate multiplier can cause significant differences in the pricing of the hotel.

For example, a hotel whose rooms revenue last year was $1,000,000, would be valued at $25MM if a 2.5 multiplier is applied, but would only be worth $20MM if a 2.0 multiplier is applied - a difference of $5MM. An incorrect value causes an obvious problem in calculating the loan to value (LTV) ratio, which can create delays and frustration in trying to determine whether a deal makes sense and whether it meets your underwriting or disposition criteria.

Conclusion

The usefulness of RRM depends on the situation and the preferences of the user. No single pricing approach is superior in all situations but for marginal properties in a down-market the RRM will generally support a lower price and can be most effective to use as a negotiating tool. More accuracy can be arrived at using a direct capitalization rate to determine an acquisition price. And even more accuracy can be had utilizing a DCF approach in an up-market. This may be especially true when the market recovery strengthens. While we usually attempt to mirror the market, the dilemma we face is the lack of refinement in making investment decisions using a "back of the envelope" analysis like RRM.

The sophisticated investor should use multiple types of analysis to truly understand the potential value of a hotel property. This knowledge can create a competitive advantage to a buyer or a seller of a hotel property when other market participants only use RRM.

U.S. Real Estate Advisors, Inc. is a Boutique advisory firm specializing in portfolio analysis, negotiating workouts for asset managers and lenders, loan underwriting, valuation and due diligence for single assets, portfolios and securitization.

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