

The Valuation of Holiday Hotels. A Case Study of Negril, Jamaica

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SUMMARY

Climate change has resulted in several devastating effects globally. One effect which has transformed Jamaica's Hotel Industry is the alarming rates at which the island's shorelines are receding.

This paper presents a case study on receding shorelines in Jamaica's third largest tourist centre and proposes a Discounted Cash Flow (DCF) framework for the valuation of holiday hotels in the Negril, Jamaica. The research presents critical arguments against the use of the Profits, Sales Comparable and Contractors Methods of Valuation when valuing hotels. The author concludes that DCF analysis is the best means of providing the market value for holiday hotels, although professionals and academics have argued that at best, it provides the value of the worth attached to the investment.

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1. INTRODUCTION

In July 2009, the Jamaican Government expressed to the United Nations, the urgent need to control the rate of beach erosion in Negril, as climate change and rising sea levels, have resulted in the destruction of coastal ecosystems in the tourism town centre and alarming rates of shoreline recession.

On August 23, 2011 it was reported in the *Holiday Place* (a newspaper in the United Kingdom) that an estimated \$25 million will be needed to save Negril's coastline from erosion which has been destroying its beaches. It was also reported that Negril's shorelines have been receding within the last two years at a rate of one (1) – two (2) metres annually. Simpson (2013) confirmed this statistic by stating "erosion was rapid with loss estimated at one metre yearly. As a result, local authorities must act immediately (Climate change taking a toll on Negril beaches, *Daily Gleaner*, 04 November, 2013).

1.1 Negril Within the Local Context

Map 1 show that Negril is located on Jamaica's west coast and straddles sections of two parishes – southern Westmoreland and northern Hanover. The location has an estimated population of 3,000 residents and is the island's third largest resort area with 49 resorts and 74 beach profiles. The town has been known as the seven (7) mile long beach by tourists, although it is only just over four (4) miles in length.



Map 1. A map of Jamaica with a focus on Negril. Extracted from Risk and Vulnerability Assessment Methodology Development Project (RIVAMP) Report, p.23

suggests that the study area has been experiencing irreversible shoreline retreat within the last 40 years, with average beach erosion rates ranging from 0.5 – 1 metre per annum over the period 1968-2006. The RIVAMP also reported that many of Negril's shorelines have limited defense strategies to combat the rate of shoreline retreat. It has also been expressed that since 1990, the rate of beach recovery after the occurrence of natural disasters has dwindled significantly.

1.2 How Should Holiday Hotels be Valued?

In light of alarming rates of shoreline recession in Negril, one may argue that it isn't unrealistic to believe that in the future, Negril's beaches may no longer exist. By extension, it also leads one to the conclusion that without beaches, the level of demand for hotels will decline and so too will their values. This brings into questioning the suitability of the Profits Method of Valuation, as an approach for conducting hotel valuations.

One purports that the Profits Method does not account fully for all features of hotels that are experiencing shoreline retreat. This is being argued as Jamaican Hoteliers may still be attaining high profits, although their beachfront properties are eroding at rapid rates. Thus, the value outcome calculated from the Profits Method is dependent on the amount of profit made by trade related or commercial activities taking place on a property.

Dialogue with local valuers, have also revealed that Jamaican Hoteliers have been paying large sums of monies to replace sand that is being lost as a result of wave actions on their property(ies). It has also been implied that in many instances, lost sand coverage on hotel properties is being replaced with sand dredged from the sea. Although, there have not been any formal reports of such activities by Hoteliers, there has been a reported incidence of beach theft where one of Jamaica's largest hotel chains has been accused of the act. This case involves the theft of two hundred and fifty (250) truck loads of sand over the period May – June 2008. In reference to this legal matter, Journalist Paul Henry (2011) wrote:

“Felicitas is alleging that Bedrock and/or other persons removed the sand from the Coral Springs property and that they acted as Fiesta's and Riu's agents. The developer is also alleging that the stolen sand was used in the development and construction of the beaches at Fiesta's and Riu's hotels and that Fiesta and Riu knew or ought to have known that the sand had been illegally obtained” (The Observer, 5 July 2011).

If Hoteliers are dredging the sea and other beaches to replace lost sand on their properties, then it leads one to argue that the Profits Method of Valuation does not comprehensively account for the risk associated with holiday hotel property investments. This argument can be further strengthened as current methodology does not calculate or determine the investment's yield or performance in relation to the physical and economic obsolescence affecting such properties, but focuses primarily on the profits earned by the asset. One argues that a hotel may have high expenditure costs but an even higher income. In other words, the Hotelier's property investment may suffer from physical and economic obsolescence but like other commercial assets, with a high demand and limited security of tenure, the outcome is a high indication of market value. Thus, if these issues which affect the asset can be masked by an investor's profits, the need arises for explicit approaches which calculate the value of holiday

hotels based on all factors which are crucial to the performance of the asset. In the case of Jamaica's holiday hotels there are two critical factors: 1) the state/condition of beaches and 2) the amount of profits earned by the asset.

2. TOWARDS A VALUATION FRAMEWORK FOR HOLIDAY HOTELS

Literature has suggested that internationally, three types of approaches has been used to value hotels. These are the Sales Comparable Approach, the Contractor's Method and an Income Capitalization Approach which includes the Profits Method (Harris, P. Kett, R. & Nilsson, M., 2001). However, academic debate has ruled out the use of the first two approaches primarily for the following reasons:

1. The incomparability of hotels, the level of adjustments required and its impact on the accuracy of the value outcome. Harris et. al (2001) has argued that it is rarely the case that two hotels will be comparable. Schmidgall (1993) also purports that only in seldom circumstances the Sales Comparable Approach will produce reliable estimates of value, as the numerous adjustments made by the valuer, often erodes the valuation. He also contends that reliable hotel sales data is hard to obtain.
2. Sikich (1993) has argued that the Contractor's Method depends too heavily on highly subjective depreciation estimates and only concentrates on reproductive cost. This position is also supported by Lesser (1992) and McDonald (1998).

Academic and professional debates in relation to an income capitalization approach, has recommended the use of discounted cash flows in the hotel valuation process although others have argued that the method tends to ignore current property market conditions as it only concentrates on future income generation (RICS, 1994 as cited in Harris, P. et. al, 2001).

Despite these arguments being put forth by the Royal Institution of Chartered Surveyors (RICS), the British Association of Hotel Accountants (BAHA) argues for the use of DCF analysis when valuing hotels. The RICS has presented a counter argument to this position. In response the RICS (1994) wrote: "...the method does not consider market condition within the hotel sector..." (RICS, 1994 as cited in Harris, et.al, 2001, p.9). The author agrees with this argument, but also believes that if amended the DCF methodology can produce a value outcome which reflects the condition of the hotel sector. It is also one's belief that the values of Jamaican holiday hotels are not directly tied to the security of tenure of Hoteliers and by extension their security of income. Thus, if Hoteliers incomes were to be capitalized in a DCF by a yield rate which is determined based on the risk associated with the property and market, then the market conditions for holiday hotels would have been considered in the value estimate.

3. NO BEACH NO VALUE

Data on the rate of shoreline retreat in Negril implies that hotels in the locations are being affected by physical and economic obsolescence. These two types of depreciation are being experienced as the loss of beach coverage is indicative of the physical deterioration of hotel properties and secondly, shoreline recession can result in a change of the highest and best use

(HABU) of Negril’s hotels. Without beaches or limited beach frontage, the demand for these properties will decline by both Hoteliers and customers wishing to vacate at hotels. With little or no demand, then the HABU economic feasibility test would not be passed and as such resorts would no longer be the HABU for these properties. Salway (1986) purports “Economic depreciation was considered to be the result of a change in the highest and best use for land. Such a change could be related to a specific site or more generally to a surrounding area” (cited in Mansfield, J & Pinder, J., 2008, p.194).

In light of the aforesaid, one argues that when valuing holiday hotels, the equated yield (EY) of the investment must be calculated from the property’s specific risk (PSR), the market sector risk (MSR) and the yield rate of an investment which is comparable to the asset being valued. On further proposes that the variables used to calculate the EY should be calculated as follows:

- $PSR = \frac{\text{rate of shoreline retreat for the property}}{\text{total sand coverage of the property}} \times 100$

- $MSR = \frac{\text{average rate of shoreline retreat for hotels in the location}}{\text{Total sand coverage of all hotels in the location}} \times 100$

Then $EY = (PSR+MSR) - \text{the yield of comparable investment}$

The EY should then be used to discount the projected future income of the hotel, in order to arrive at the asset’s present value.

This methodology is being proposed as one believes that it offers a more robust alternative to the current DCF framework. Currently, market and property specific risks are subjective and based on the valuer’s interpretation of the market. In the proposed framework, market risk and property specific risks are perceived to be more objective as they are calculated from variables which are measureable and relate specifically to the property itself that is being valued and the general geographical area in which the subject is located. However, it must be noted that the proposed framework was developed on the premise that without beaches Jamaica’s holiday hotels have no value. This presumption also implies that sand is a mineral for resort properties, as it can directly affect a freeholder’s and lessee’s security of income and security of tenure.

By inverting formulae provided for calculating the PSR and MSR, one can calculate the remaining useful life of a property as a resort, and the remaining useful life of the hotel industry in a given location. This is presented below:

- $\text{Remaining useful life of resort property} = \frac{\text{total sand coverage of property}}{\text{rate of shoreline retreat for the property}}$

- $\text{Remain. useful life of the Hotel Indus.in a location} = \frac{\text{total sand coverage of location}}{\text{rate of shoreline retreat in location}}$

Thus, with sand being classified as a mineral for resort properties, the valuer is not only able to arrive at a more objective estimate of value, but he can also approximate the freeholder's or lessee's tenure in the property, thereby providing better quality advice to his client. This will improve the decision making process for investors and provides them with an indication of the level of risk associated with the investment and by extension, it better enables them to be knowledgeable on probable rates that should be charged for services offered at the hotel.

4. CONCLUSION

Rushmore (1998) commented "the hotel industry is highly cyclical and hotel profits and values rise and fall rapidly as occupancies and room rates move up and down" (as cited in Harris, P., Kent, R. & Nilsson, M., P.9).

By utilizing an approach which discounts the asset's projected income by a yield rate which encompasses obsolescence affecting the property, the tenure of interest holders and the perceived risks associated with the investment, then these variables will be embedded in the property's estimated value. Thus, occupancy rates will be a dependent variable of the property's estimated value, rather than value being the dependent variable of profits and by extension occupancy rates, as implied by Rushmore (1998).

The case of holiday hotels in Negril is a unique one, as it implies that resort properties in the location are being severely affected by physical obsolescence and economic depreciation, but are still highly valued assets. Thus, one argues that the Profits Method conceals the unique nature of these properties and has failed to incorporate these factors in the valuation of resort properties.

In 1994, the RICS argued that DCF analysis is not a suitable approach for valuing hotels as it estimates the worth of the investment to the investor and not the property's market value. However, one argues against this position for the following reasons:

- The case study of Negril has shown that without beaches, hotels have no value. Likewise, the demand for these properties will be dependent on the existence and condition of beaches at holiday hotels.
- These properties comprise of two classes of investors – those who invest in the property by way of a lease or ownership and operate a holiday hotel (sellers) and those who obtain a license to vacate on the property for a period of time (buyers). Thus, occupancy rates charged by hotels are a reflection of a price at which a willing buyer and seller is willing to trade at. Occupancy rates also reflects the worth both buyers and sellers attach to the asset. One takes this argument further and posits that both classes of investors would be unwilling to invest in these properties if they had no beaches. Hence the worth of the asset for both buyer and seller is tied to the presence and condition of beaches on the property.

Thus, a DCF analysis which has been developed around a condition/situation which is linked to a willing buyer and seller's perceived worth of the investment, and where the worth attached to the investment is similar for both parties, provided that the transaction is an arms-length one, where the property had been adequately exposed to the market and both parties acted knowledgeably, then the use of DCF analysis can be justified as the criteria for market value has been met.

The proposed framework requires the valuer to have intimate knowledge of the hotel

industry but also the subject property and its adjoining locations. This together with the robustness of DCF analysis provides a compelling basis for developing a valuation framework.

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BIOGRAPHICAL NOTES

Ms. Tina Beale currently serves as the Programme Director for the B.Sc. in Land Economy and Valuation Surveying which is offered in the Faculty of the Built Environment at the University of Technology (UTech), Jamaica. She has been employed as a Lecturer in the Land Economy and Valuation Surveying Division for the past five (5) years and specializes in the areas of Applied Appraisal Techniques, Principles of Property Valuations and Investment Appraisals. She is also a member of the Association of Land Economy and Valuation Surveying (ALEVS).

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