AN INHOSPITABLE

WHY CAN’T WE AGREE
There is no consensus as to how to value hotels, and with many transactions being subject to atypical market forces, reported sales must be carefully examined and adjusted as needed before being used as comparables.
for lending, tax, and accounting purposes remains a battlefield. Partisans for the various warring factions and competing valuation methodologies are no closer today to reaching common ground and consensus on how to value a hotel than they have been in the last couple of decades.

This article explores ten of the leading concerns that have contributed to the confusion and lack of consensus in the valuation of hotels:

1. How is the market driving the confusion?
2. Does the “rule of thumb” method help produce credible indications of value?
3. Can the entire allocation mess be avoided by addressing values pre-closing?
4. Are real estate investment trusts (REITs) skewing non-realty allocations and thereby inflating hotel sales?
5. Are foreign buyers skewing sales comparables by overpaying?
6. Has California solved the Lennhoff/Rushmore debate?
7. Has the Appraisal Institute’s Course 833 helped or hurt?
8. Is there a state “legislative fix”?
9. The significance of recent and pending judicial decisions.

It is not a secret that there has been a nasty little war raging within the appraisal industry over how best to value “going concern” properties such as hotels. The current appraisal literature is replete with argument and counter-arguments from one faction/theory or another.

The Appraisal Institute’s Course 833 was supposed to begin the healing process and provide guidance, at least as to how to identify the intangibles that need to be considered for adjustment. However, based on personal experience attending this course, it seems to have merely stiffened the resolve of some to “fight to the death” before compromising or hearing another point of view. It certainly has succeeded in removing a lot of civility and professionalism from the discussion. That is tragic and a real missed opportunity to find the common ground that is required to produce certainty. Without certainty, opinions of value are meaningless, and only certainty provides a currency that all can use in valuing such properties for whatever purpose.

How is the Market Driving the Confusion?
It is a busy and interesting time to own or operate a hotel in the U.S. The last ten years have been a period of economic feast or famine. U.S. sale prices for hotels have been yo-yoing up and down, driven by rapidly changing financial, investment, regulatory, and lending environments.

These sales, in turn, have made valuing hotels under the sales acquisitions comparison approach almost impossible, either as a result of a lack of market sales or because of deals that are so atypical as to require many adjustments, which render any resulting value indications potentially unreliable. In many cases, sales make no economic sense based on actual net operating income (NOI). Some acquisitions appear to be underwritten on widely speculative and overly enthusiastic assumptions as to revenue per available room (RevPAR), NOI, and lower capitalization rates (cap rates). One wonders what the nature of any such transaction “premium” being paid.
might be. Is it a payment to reward something other than the real estate itself, as it existed on the date of the appraisal or assessment?

Most hotel insiders seem to regard and deal with “intangibles” associated with their hotels in the same way as Justice Potter Stewart did with pornography when he famously stated the following:

… I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description [“hard-core pornography”]; and perhaps I could never succeed intelligibly doing so. But I know it when I see it, and the motion picture involved in this case is not that. [Emphasis added.]¹

This article deals with the status today, including the obstacles presented, of applying a uniform approach to identifying, segregating, and valuing such intangibles, which most appraisers and assessors know exist when they look at an operating and stabilized hotel.

Management and Amenities as Important Distinguishers

Purchasers of hotels and underwriters of such transactions often share a common expectation of increasing value post-acquisition through remodeling, upgrading, and refurbishing the acquired property. Management tools to increase value include rebranding (new flag) and upgrading guest rooms and common areas with new fixtures, furniture, and equipment (FF&E) and increased amenities. But should this increased asset value get attributed solely to the real estate alone, or must it be distributed on some basis among the other components of value present at the hotel, including tangible personal property (TPP) and intangibles, including, but not limited to, goodwill? If the increased value is a direct result of new and better management, is it appropriate to allocate any of that new added value to the real estate that houses it (other than to the extent that the physical building and improvements were responsible)?

Financial Crisis and Rebound

Gone, and apparently already forgotten, are the dark days after 9/11 when hotel values in the U.S. plunged overnight and remained depressed for several years. After rebunding and reaching a fever pitch in 2007, values crashed again with the financial crisis launched by the failure of Lehman Brothers in late 2008 and the collapse of the house of cards built with mortgage-backed securities that no one seemed to understand. Transparency relating to underlying hard assets was lacking, with lenders focused primarily on the lucrative and multiple fees that they could earn upfront by trading in these instruments. Unfortunately, like in so many prior financial manipulations, when the curtain was pulled back there was no “there, there.”

After hotel values plunged again, financing for acquisition and construction dried up or got very expensive. Hotel fundamentals deteriorated, and RevPAR dived, as corporate and vacation travel was cut in the recession. This, in turn, led to loan defaults for the overleveraged and foreclosures, and in general created a pretty miserable time to own or operate a hotel.

Of course, those investors and institutions with money jumped in at the bottom of the market and slowly bought assets cheap through the jobless recovery of the last eight years. Thus, the hotel business slowly recovered, fueled in part by cutting of expenses and room rates. Corporations adopted a strategy of doing more with less to increase profits, earnings before interest, taxes, and amortization (EBITDA), and, therefore, stock prices, even while top-line revenues were declining or only growing sluggishly. Companies with big travel budgets invested in video conferencing and slashed travel and entertainment, thereby further hampering the recovery of the hospitality industry.

Low Interest Rates Lead the Recovery.

How did hotels dig themselves out of this mess and become, yet again, the hot acquisition commodity they are today? There were many factors, but probably none more important than the historically low interest rates that the Federal Reserve pushed through as a cure to the recession of 2009–2012. Interest rates dropped so low that they were effectively at or below the rate of real inflation. This sounded like free money to many investors who had been sitting on the sidelines. Who could turn down free money?

Acquisitions by REITs. Hotel investors started looking at replacement cost against acquisition prices and used the cheap money to start buying again, if they could get it. Many could not, but REITs found that they once again had become the darlings of Wall Street and could buy very cheap capital to acquire hotels. Accordingly, all of the hotel REITs went on a buying splurge that continues today. As is usually the case where availability of cheap money disproportionately drives investment decisions (rather than operating fundamentals), sales were seen that made no obvious sense based on existing NOI and cash flow.
Many of these sales were of trophy properties in U.S. markets where the barriers to entry or duplication were historically very high. The effect on hotel valuation was that these sales were then in turn used as comparables to help value other properties for loan or assessment purposes. Accordingly, there has been a compounding effect when non-REITs such as foreign investors looking for a safe haven started competing in this heated marketplace and paying these same “inflated” prices. Cap rates began to drop again, even though the fundamentals of hotel operations were still weak. In some cases, future NOI was used to value hotels, which could be very far from actual or historic NOI.

Lately, interest rates have begun to rise from their historic lows, and this has cooled the buying frenzy somewhat. Still, there are many unanswered questions:
- What are we to make of all these recent hotel sales?
- How can we use them at face value or unadjusted, in valuing other hotel properties for lending or assessment purposes?
- Are these reported sales prices only for the total assets of the business (TAB) and, therefore, serve to mask and inflate the true value of the underlying value of the real estate?
- Do these sales require so many adjustments to get to the underlying real estate value, so as to make them of little use as indicators of fair market value under the sales comparison approach to value, in valuing other similar hotel properties?
- Can it be assumed that the next buyer will also have access to low and plentiful financing? If not, will that push values down again by causing cap rates to rise to reflect that additional risk?
- Is a hotel value now dependent on the buyer’s access to cheap money or flight capital from outside of the country?
- If a REIT or a foreign investor will not buy a hotel, who do you sell to and will you get less for your property?

These are all difficult questions for lenders, appraisers, and assessors to answer. They are generated from the choppy data provided by recent sales.

**Market in Los Angeles.** For instance, consider Los Angeles, where the market for the second half of 2013 has been resilient and vibrant according to a recent Jones Lang LaSalle (JLL) national hotel investment survey.² In fact, Los Angeles exhibited the highest ratio of buyers to sellers among the markets surveyed by JLL, and investor expectations for hotel performance are among the highest in the Americas, with a positive net balance sentiment of 65.1% for the short term and 75% during the medium term for the city. The medium-term outlook suggests that investors feel that Los Angeles still has significant hotel performance upside.

JLL adds that there were quite a few hotel trades in 2011 and 2012, so the market was taking a breather in the first half of 2013. In addition, as supply and demand fundamentals improved, many investors decided to wait it out to see what would happen before deciding to take their assets to market. Also, many Beverly Hills luxury hotels that had been stable for years simply did not trade at all. And lastly, many owners wanted to take advantage of the favorable debt markets and hold onto properties longer in an environment in which there has been such a willingness on the part of conduit and balance-sheet lenders to lend again.

Expectations for leveraged internal rates of return (IRR) in Los Angeles have held steady at 17.2% over the past six months, a full percentage point below the Americas’ average, given investors’ positive view of the market. Surveyed cap rates for the market average 7.5%, which is slightly below previous survey periods for the city, and investors expect cap rates in the market to decrease during the next six months as hotel profits increase and more high-quality assets come to market. Also, the high number of buyers to sellers is poised to push up asset values and result in more transactions. Some 70% of respondents in the JLL survey who are active in the market are pursuing acquisition opportunities, with private equity investors, own-

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er/operators, and REITs at the forefront, in addition to offshore investors. Recent transactions in this market attest to the growing momentum of hotel trades. For example, Pebblebrook Hotel Trust recently purchased the luxury Redbury Hotel in Hollywood for $34 million and plans to capitalize on its upside potential. It forecasts that during the next 12 months, the hotel will generate EBITDA of $2.75 million to $3 million. The REIT netted a total of $97 million from a preferred equity offering of 400,000 series C shares, which followed public offering of 3.6 million series C shares in March 2013. It will use the proceeds for general corporate purposes, including possible acquisitions and investments.

**Distressed Properties.** According to CoStar, at their height in 2010, more than 40% of hotel property sales and volume were distress-related. Now as indicated in Exhibit 1 both metrics are below 25%, and the pipeline of distressed assets is shrinking too.

CoStar finds a changing investment climate:

For many investors, especially those interested in value-add purchases, this may be the time to start considering assets in secondary markets. With distress shrinking and investors focusing on relatively safe assets, in top core markets price points often rival mid-2000s highs. And the share of overall volume in these typically fundamentally superior metros remains above the long-term trend.

As of the first quarter of 2013, CoStar’s Commercial Repeat Sales Index (CCRSI) found that hotel pricing expanded by 12% over the past year, exceeding the improvement seen in any other property type. However, pricing outside of the six largest core markets has not increased as dramatically, and there is generally more occupancy upside still to come in many secondary markets. On the whole, these markets are expected to have two more percentage points of occupancy gains before losing steam, double the improvement of the core market group. But timing is becoming a factor, as some investors are already finding their way into the nation’s interior.

**Current Overall Market Outlook**

Nationally, hotel owners can breathe a little easier. Their investments are not likely to be much affected by new hotels coming on the scene to take a piece of the pie. Lodging Econometrics (LE) predicts new hotel openings of 739 projects with 82,587 rooms for 2015, representing a growth rate for new supply of 1.6%. LE calls the growth slow to moderate but steady and an improvement over 2011’s cyclical bottom of 346 projects with 37,193 rooms. Despite these increases, the industry is still far away from the peak for new openings of 1,341 projects with 154,258 rooms set in 2008.

**Where Are We in the Development Pipeline?** At mid-year 2013, the total construction pipeline stood at 2,822 projects with 350,151 rooms, a 4% increase for projects year over year (YoY). Projects under construction have
been on the rise for eight quarters. At 646 projects, they are up 23% YoY, while rooms at 81,531 are up 22% YoY. Projects expected to start in the next 12 months are up 36% at 1,116 projects. Rooms at 128,861 are up 38% and have been trending upwards for four quarters.

However, projects in early planning are down 23%. Early planning currently stands at 1,060 projects with 139,759 rooms. LE says this indicates that fewer luxury and upper upscale resort and city center projects are entering the pipeline. While growth in the pipeline is sluggish by historic standards, LE believes that there is no real catalyst for development on the horizon. Due to the severity of the “Great Recession,” compared to other lodging real estate cycles, this one appears destined to be prolonged for a minimum of two extra years. Overall, development is likely to continue “sailing against the wind” into the second half of the decade.9

Why Are Going-Concern Properties a Valuation Problem?

Going-concern properties are usually defined as real property that serves as a platform for a particular business, the value of which is the aggregate of four components:

- Land.
- Improvements to land.
- Tangible personal property.
- Intangibles.

Accordingly, using the value of the going concern (aka business enterprise value) or to use the newly approved Appraisal Institute (AI) terminology, the total assets of the business (TAB) to represent the real estate-only value of the property is always going to be the wrong answer for both lending and assessment purposes.

Often, these properties are designed and improved for a very particular business purposes. In doing so, the property loses much of its generic real estate value and takes on a more subjective and perhaps increased value, but to a much smaller potential pool of users, buyers, and tenants. That, in turn, can affect its market value and generate different types of values, including investment value, market value for assessment purposes, and fair market value under the Uniform Standards of Professional Appraisal Practice (USPAP).6

As Steven Rushmore put it so aptly back in 1984:

… Appraisers soon learn that lodging facilities are more than land, bricks, and mortar; they are retail-oriented, labor-intensive businesses necessitating a high level of managerial expertise. In addition hostelleries require a significant investment in personal property (furniture, fixtures, and equipment) that has a relatively short useful life and is subject to rapid depreciation and obsolescence. All these unusual characteristics must be handled in a proper manner during the hotel valuation process in order to derive a supportable estimate of market value.7

Status of the Valuation Methodology Debate

An objective analysis of the difference between the so called Rushmore and Lennhoff approaches always leads to the conclusion that they agree more than they disagree on the basic valuation methodology. Both of these camps rely primarily on an income approach to value hotels. They both apply a residual technique to arrive at an annual, stabilized NOI of the TAB, which they then adjust until they get to an estimate of annual NOI of the real estate only that is then capitalized into a value estimate of the real estate using a “loaded” capitalization rate (i.e., base cap rate plus applicable local tax rate because property taxes are usually not expensed prior to arriving at the NOI of the real estate).
The Rushmore and Lennhoff schools both start with the assumption that 100% of the NOI of the TAB cannot be allocated to just the real estate, or else the significant investment in tangible personal property (TPP) and intangibles that are present in all operating hotels is not rewarded. They also seem to agree that the TAB NOI needs to be adjusted to get down to the NOI of the real estate and then capitalize that into a value indication of the real estate alone, using a real estate-specific cap rate. However, they disagree on what below-the-line adjustments should be made (e.g., whether to deduct the depreciated value of the TPP after having already taken a return on and of it or if startup costs should be considered and adjusted for).

Exhibit 2 illustrates the main differences between the Rushmore and Lennhoff camps:  

Lennhoff himself often makes the point that there is more that he and Rushmore agree on than they disagree on. But they do disagree. Furthermore, it appears that the engine of their dispute is the purpose of the intended valuation. Rushmore and his camp historically favor and want to protect lenders. That is the basic profile of their clients, and their work product is typically appraisals for lending. Accordingly, they are very sensitive to any methodology that would dilute the value of the underlying real estate “hard assets” (even in USPAP appraisals) because that could affect the amount and size of the loan that could be made by the lender to the hotel or its buyer. Lennhoff, on the other hand, has been associated more with hotel operators and their need to reduce operating expenses, particularly property taxes. The key differences are Lennhoff’s promotion of a business start-up cost deduction, and his deduction for a return on FF&E. They both adjust for residual intangibles. Any way you look at it, both methods are complicated and require numerous potentially subjective adjustments, which if done improperly, would skew the resulting real estate value indication significantly.

With all these complicated valuation formulas, the question becomes whether, as the French proverb goes, we are … “noyez le poisson,” or are we drowning the fish?” Is there a simpler and more universally acceptable method to value hotels? Do we need 70 pages of USPAP complying analysis and valuation to tell us how much to pay for, lend, or assess the real estate that houses a hotel?

Does Rushmore’s Rule of Thumb Method Produce Credible Value Indications? Rushmore has asserted as far back as 2003 that the hotel industry may have a rule of thumb that provides a rough approximation of a hotel’s value based on its room rate. This rule of thumb suggests that the value of a hotel can be estimated by multiplying the hotel’s average room rate (ADR) by 1,000. The result is presumably the TAB value of the hotel on a per room basis. If a 100-key hotel has an average room rate of $300, its value per key is $300,000 (300 x $1,000); thus, the
EXHIBIT 3
Assessor vs. Rule of Thumb Assessments Comparison

<table>
<thead>
<tr>
<th>Hotel Type</th>
<th>Proposed Assessed Value</th>
<th>Average Daily Rate</th>
<th>Rooms</th>
<th>Multiplier</th>
<th>Rule of Thumb Value</th>
<th>PAV as % of RoT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Washington, D.C.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Upper Midscale</td>
<td>$12,677,960</td>
<td>$130</td>
<td>100</td>
<td>1,000</td>
<td>$13,000,000</td>
<td>103%</td>
</tr>
<tr>
<td>Luxury</td>
<td>$69,239,610</td>
<td>$425</td>
<td>144</td>
<td>1,000</td>
<td>$61,200,000</td>
<td>88%</td>
</tr>
<tr>
<td>Upscale</td>
<td>$67,557,300</td>
<td>$180</td>
<td>265</td>
<td>1,000</td>
<td>$47,700,000</td>
<td>71%</td>
</tr>
<tr>
<td>Boutique Hotel Nat Flag</td>
<td>$20,402,500</td>
<td>$180</td>
<td>140</td>
<td>1,000</td>
<td>$25,200,000</td>
<td>124%</td>
</tr>
<tr>
<td>Non Flag Limited Service</td>
<td>$30,312,640</td>
<td>$150</td>
<td>230</td>
<td>1,000</td>
<td>$34,500,000</td>
<td>114%</td>
</tr>
<tr>
<td>Non Flag Limited Service</td>
<td>$66,279,550</td>
<td>$160</td>
<td>340</td>
<td>1,000</td>
<td>$54,400,000</td>
<td>82%</td>
</tr>
<tr>
<td>Upper Upscale</td>
<td>$224,267,210</td>
<td>$210</td>
<td>807</td>
<td>1,000</td>
<td>$169,470,000</td>
<td>76%</td>
</tr>
<tr>
<td>North Virginia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>National Flag Upscale</td>
<td>$74,748,500</td>
<td>$175</td>
<td>319</td>
<td>1,000</td>
<td>$55,825,000</td>
<td>75%</td>
</tr>
<tr>
<td>Upper Upscale</td>
<td>$52,882,600</td>
<td>$185</td>
<td>241</td>
<td>1,000</td>
<td>$44,585,000</td>
<td>84%</td>
</tr>
<tr>
<td>Upper Upscale</td>
<td>$9,063,500</td>
<td>$190</td>
<td>45</td>
<td>1,000</td>
<td>$8,550,000</td>
<td>94%</td>
</tr>
<tr>
<td>Upper Upscale</td>
<td>$51,424,760</td>
<td>$165</td>
<td>396</td>
<td>1,000</td>
<td>$65,340,000</td>
<td>127%</td>
</tr>
<tr>
<td>Baltimore</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Upper Upscale</td>
<td>$102,809,000</td>
<td>$195</td>
<td>622</td>
<td>1,000</td>
<td>$121,290,000</td>
<td>118%</td>
</tr>
<tr>
<td>Value Totals</td>
<td>$781,665,130</td>
<td></td>
<td></td>
<td></td>
<td>$701,060,000</td>
<td>90%</td>
</tr>
</tbody>
</table>

According to Rushmore, this rule of thumb is also helpful in evaluating the initial feasibility of a proposed hotel. Instead of comparing the results to market value, the rule of thumb can be used to determine whether the total project costs are in line and also how much can be paid to acquire the land.

It is worth noting that some of the assessing jurisdictions in New York City have adopted a version of this method to value their hotels for property tax assessment purposes. Although, they typically take off 20% +/- and only use a multiplier of 800+/- rather than the default 1,000, presumably to adjust for TPP and intangibles present in the TAB value that this method produces.

**Testing the Method.** In an effort to see how this method works in the real world, it was applied to the assessments issued in 2013 for selected hotels in the Mid-Atlantic region. Hotels were selected in Washington, D.C., Northern Virginia, and Baltimore, and then classified by their type (as defined by the Penn State Index of U.S. Hotel values). 11

The metro Washington, D.C. area is one of the top hotel markets in the country, and hotels there have sold for

high prices per key in recent years. Exhibits 3 and 4 show pro forma assessments based on the rule of thumb approach as compared to the actual assessor-proposed assessments issued in 2013. Exhibit 3 uses a formula of 1,000 x ADR x number of keys to get to the equivalent assessed value. This was then compared to the proposed assessed value, and the difference shown as a percentage.

Significantly, although the rule of thumb approach on average produces an overall set of values equal to 90% of those produced by the local assessors using the income approach, the individual variances swung dramatically from 71% to 127%. When compared to the appealed target value, the overall difference is 74%, and the range widens from 45% to 119% as illustrated in Exhibit 4. This is an important indi-

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9 http://www.linternaute.com/expression/langu


decisions because that reflects how values once they have the most recent comparison of these rule of thumb values as compared to the post-appeal setting.

Perhaps of even more relevance is a comparison of these rule of thumb values as compared to the post-appeal decisions because that reflects how assessors have changed their original values once they have the most recent hotel operating data. Based on decisions received to date, the overall percentage of the rule of thumb value to the post appeal values rose to 84%, with a range of 75% to 128%.

If a multiplier of 800 were used instead of 1,000 to reflect a 20% non-realty component in the TAB values of these hotels, the results are as follows:

<table>
<thead>
<tr>
<th>Hotel Name</th>
<th>Rule of Thumb (RoT) Value</th>
<th>Target Value</th>
<th>TV as % of RoT</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Washington, D.C.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Upper Midscale</td>
<td>$13,104,000</td>
<td>$9,960,000</td>
<td>76%</td>
</tr>
<tr>
<td>Luxury</td>
<td>$61,920,000</td>
<td>$47,040,000</td>
<td>76%</td>
</tr>
<tr>
<td>Upscale</td>
<td>$49,025,000</td>
<td>$51,500,100</td>
<td>105%</td>
</tr>
<tr>
<td>Boutique Hotel Nat Flag</td>
<td>$25,060,000</td>
<td>$16,030,000</td>
<td>64%</td>
</tr>
<tr>
<td>Non Flag Limited Service</td>
<td>$35,190,000</td>
<td>$22,004,200</td>
<td>63%</td>
</tr>
<tr>
<td>Non Flag Limited Service</td>
<td>$53,380,000</td>
<td>$55,400,000</td>
<td>104%</td>
</tr>
<tr>
<td>Upper Upscale</td>
<td>$169,470,000</td>
<td>$88,048,000</td>
<td>52%</td>
</tr>
<tr>
<td><strong>North Virginia</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>National Flag Upscale</td>
<td>$56,118,480</td>
<td>$48,985,000</td>
<td>87%</td>
</tr>
<tr>
<td>Upper Upscale</td>
<td>$44,585,000</td>
<td>$52,882,600</td>
<td>119%</td>
</tr>
<tr>
<td>Upper Upscale</td>
<td>$8,550,000</td>
<td>$3,819,000</td>
<td>45%</td>
</tr>
<tr>
<td>Upper Upscale</td>
<td>$64,944,000</td>
<td>$45,924,000</td>
<td>71%</td>
</tr>
<tr>
<td><strong>Baltimore</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Upper Upscale</td>
<td>$121,290,000</td>
<td>$79,072,500</td>
<td>65%</td>
</tr>
<tr>
<td><strong>Value Totals</strong></td>
<td>$702,636,480</td>
<td>$520,665,400</td>
<td>74%</td>
</tr>
</tbody>
</table>

EXHIBIT 4
Rule of Thumb Values Compared to Owner’s Values

is the swing in ranges remains large:

Overall Rule of Thumb Value to Original PAV: 93% to 172%
Target Values: 56% to 148%
First-Level Decisions: 93% to 160%

Based on this limited and selective data and analysis, any support for the rule of thumb method to determine the real estate-only value of a hotel is weak, so it is not likely to be the panacea that many thought it might. Therefore, once again, we are left with two competing, complex valuation methodologies that each produces similar TAB values for hotels and vastly different real estate-only value indications.

Can the Allocation Mess be Avoided by Addressing Pre-Closing Values?

Inherent in all definitions of fair market value, market value, and fair value is the concept that they must each represent the value of what typical buyers and sellers of the subject property would pay for it on a given day and in an arm’s-length transaction, without undue influence and after reasonable exposure to the market.

So, what happens when the buyer and seller not only segregate the individual components of value in their closing documents but memorialize their allocation of those values in their purchase and sale agreement (PSA), on the HUD1 closing documents, and in the recordation, and on deeds and bills of sale used to officially transfer the title to all of the components of the subject property? What appraiser or assessor is not going to give that weight?

Obviously, such allocations, if signed off by the buyer and seller, will carry great weight if formally memorialized in the closing documents because that typically creates a presumption that said allocations represent market value as of that date. Would these agreements and their memorialization not trump intellectual disagreements about which intangibles to segregate and what their respective values are? Certainly for assessment purposes, which always establishes values post-closing, this would be helpful and usually dispositive for re-assessment purposes, if reasonable and supported by a third-party valuation. For lending purposes, the allocations would have to be in the PSA or its addenda to be considered and probably has less relevance in that connection. Post-closing reconstructed allocations are of course possible, but they typically are given less weight than those that are incorporated contemporaneously into the closing process or in the PSA and are negotiated pre-closing.

The most notable advantages of preclosing buyer-seller allocations would be:

- Reducing transfer and recording taxes due at closing.
- Reducing other ad valorem taxes/fees due only on real estate and payable at closing.
- Avoiding the reporting of inflated real estate values to the government.
- Influencing local real property assessors as to the value of real estate property acquired.
- Mitigating future real property taxation if based on “chasing” sales prices.
- Resetting tangible personal property asset values to fair market.

HOTEL VALUATIONS

November/December 2013

VALUATION STRATEGIES

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• Permitting more accurate personal property tax rendition reporting and taxation.
• Permitting the appeal of “current” real and personal property assessments issued pre-closing.
• Permitting the recovery of certain overpaid taxes post-closing.

Accordingly, if the buyer and seller agree as part of their purchase sales agreement to these allocations, it is a good indication of the market value of these assets, at least for tax purposes and perhaps for lending purposes as well.

Assets Sale vs. Sale of Stock or Controlling Interest. It should be noted that some jurisdictions such as California deem the sale of a majority or controlling stake in the stock of a corporation (or other owning entity) to be a constructive sale of the underlying real property owned by that entity. Therefore, even if no new deeds are recorded, assessors will try to deconstruct the transaction to get to individual real estate values to set new base year values or for the next re-assessment cycle. In bulk sales transactions like this, or of the assets themselves, allocation of individual TAB values of each of their components of value are very useful, particularly if done pre-closing and memorialized at closing.

Cost Segregation and Identifying Depreciable Intangibles. Once the TAB has been allocated, there are further benefits to look at on how each of the individual buckets of assets can be further valued and classified. Cost segregation is an analysis and valuation primarily for income tax purposes of the improvement value of the TAB (i.e., buildings, fixtures, and site improvements combined). It is primarily undertaken to help establish the correct classification and depreciation schedule for the building, etc., so not all are classified as 39 year assets, if portions should be depreciated quicker than that.

Intangibles usually can be qualified into those that are depreciable and those that are not depreciable at all such as goodwill. The exact process for doing this is outside the scope of this article, but there are five categories of intangibles that the Financial Accounting Standards Board (FASB) recognizes as depreciable at about half the useful life of real estate.12

Reporting. Post-closing, new buyers should be careful to report, on government questionnaires and any required income and expense surveys, the same allocations of the TAB as reported and used at closing for transfer tax purposes. The same is true for the reset value of TPP as reflected on the bill of sale used and recorded at closing. The new values should be reported on the next TPP rendition filed for those assets.

Are REITs Inflating Hotel Sales?
Since their establishment in 1960, REITs have not had to pay corporate taxes on income as long as at least 90% of their taxable income is paid as dividends. The tax savings from this exemption has been a main selling point. Industry officials and analysts note that the first REITs were established to give individuals an easy way to invest in income-producing real estate, and it is unlikely that they will lose their tax exemption any time soon. They point out that REIT dividends are taxed at a higher rate than other corporate dividends, 39.6% vs. 20%.

One of the key drivers of the increase in hotel prices is the active and aggressive participation by REITs. In fact, a growing number of commercial real estate owners are actually converting to the REIT format in order to get the dual advantages of beneficial tax treatment and greater availability to capital markets. From a valuation point of view, REITs are a source of distortion in the market place. First, they can overpay for assets because they have access to cheaper capital than “typical” investors. This has periodically led to a compression of cap rates used to underwrite REIT transactions. They in effect do not need as great a return on investment because their initial cost of capital is so much lower. This means that REIT sales often need adjustment before being used as sales comparables for other properties, and in particular, adjustments to their reported transaction cap rates which need to be carefully examined and adjusted upward to reflect more market typical costs of capital and returns on such investments.
rate compression was one of the main reasons commercial real estate got so overheated in the last boom and why the market fell so low when it corrected after 2008.

REIT sales are also routinely considered to be suspect because they are subject to draconian rules as to how much non-realty value they can assign to a going concern property. No more than 15% of revenues can be allocated to non-real estate assets or 25% of the overall asset values, although these are portfolio-wide restrictions. As a practical matter, CFOs of publicly traded REITs have been very conservative in assigning much value to TPP or intangibles, especially in hotels. Because they could lose their REIT status if they violate these rules, they tend to err heavily on the side of caution. This, in turn, can lead to reported REIT hotel sale data that is misleading because too much of the TAB has been assigned to the real estate and not enough to the non-realty assets.

Thus, with many hotel sales in recent years having been done by REITs, sales comparables based on those transactions are usually distorted for all of the reasons stated above and, therefore, need to be carefully verified with the participants, investigated, and adjusted as needed before being used, including cap rates derived therefrom. These under-adjusted hotel sales also have a damaging effect on the accuracy of ad valorem real property assessments. If the reported real estate component is overstated, assessors who rely primarily on that unadjusted data for mass appraisal purposes (as many do) will produce inflated assessed values, and that always results in over-taxation.

Are Foreign Buyers Skewing Comparables?

Foreign investors, like REITs, are also disrupting the organized and rational operation of the hotel real estate market in the U.S. because of their special investment criteria. With many European countries suffering from stagnant economies, high interest rates, and ongoing fiscal crises, sophisticated foreign investors and their advisors have been looking to diversify their investment portfolios. They are attracted to the U.S. Because foreign investors can afford to overpay for real property because they are gambling on their home currency falling further by the time they cash out their investment in a stronger, dollar-based real estate investment. This, coupled with historic low interest rates at or near the rate of real inflation, means that even if a hotel’s current NOI remains constant over the hold period, the foreign investor can still realize a healthy return. This leads to currency premiums being paid that distort the market and, like REITs, requires careful analysis of sales and adjustment before any unit of comparison can be arrived at.

In today’s market, foreign capital and high-net worth investors are competing directly with the opportunity/hedge funds, pension fund advisors, and big institutions for a finite pool of assets. Hotels have been high up on their shopping lists. But are they buying just real estate or a currency play or long-term preservation of their capital? Are these “premiums” all intangibles that need to be backed out of the sales price for valuation and assessment purposes?

Cash Equivalency Adjustments

One technique that should be considered in adjusting hotel sales made by both REITs and foreign investors, before they are used or relied on in valuing hotels in the general market, is the cash equivalency analysis. While the details of how this is done are outside the scope of this article, basically adjustments are made to the underwriting assumptions, borrowing terms, and overall financing available to REITs and foreign buyers to equalize them with corresponding financing and capital costs available to “typical” U.S. buyers. For example for foreign investors, the difference is the currency and financing advan-

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12 http://www.fasb.org/facts/.
13 The Association of Foreign Investors in Real Estate came out with its “emerging market” survey in January 2013, which found that of the top five global cities for investment preferred by their members, four are in the U.S. This is the first time this has occurred since the question was first asked in 2001.
tage, and that premium is then backed out to get to an adjusted sales price and/or cap rate that can be used to help value typical U.S. transactions. However, absent insider information about such individual transactions, it is hard to do such adjustments with a high degree of confidence that they are appropriate. The need to be able to do so is growing however, as the volume of foreign investments accelerates.

Has California Solved the Lennhoff/Rushmore Debate?

As previously discussed, the Rushmore methodology stipulates removal of both the management and franchise fees in the valuation of a hotel in order to address and back out all of the non-realty components of the TAB, but that probably fails to completely remove them. As Eliot Johnson, Senior Manager of Property Tax for Marriott International Inc., has pointed out:

… Compensation to the hotel manager is intended to satisfy a debt for operating the business enterprise and should not be recognized as a means of extracting all of the associated returns entitled to the investor as it pertains to commencing a business operation. An additional function must be performed to appropriately remove this intangible asset from the Total Assets of the Business Enterprise and derive the income attributable to the real property solely.141

He goes on to assert that when deriving opinions of value for hotels in California, there is substantial regulatory and statutory guidance as to which of the Rushmore or Lennhoff adjustments should be made. In particular, he points to Section 502, “Advanced Appraisal,” of the California Assessors’ Handbook as a guide.15 In fact, the Assessors’ Handbook, while not stating it explicitly, appears to agree that Mr. Rushmore’s methodology does not fully address the removal of the business enterprise from the going-concern income stream. This publication is given great weight in many other jurisdictions, particularly in the Western states. The Handbook states inter alia the following:

Income derived from rental of properties is preferred to income derived from their operation since income derived from operation is the more likely to be influenced by managerial skills and may arise in part from nontaxable property or other sources. When income from operating a property is used, sufficient income shall be excluded to provide a return on working capital and other non-taxable operating assets and to compensate unpaid or underpaid management.

In California, the property tax treatment of intangible assets and rights is governed by two fundamental principles. The first of these is that intangible assets and rights are not subject to taxation.

The value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance or be reflected in the value of the taxable property.

If the principle of unit valuation is used to value properties that are operated as a unit and the unit includes intangible assets and rights, then the fair market value of the taxable property contained within the unit shall be determined by removing from the value of the unit the fair market value of the intangible assets and rights contained within the unit.

Goodwill, going concern, right to do business, franchises, customer lists, trademarks, trade names, work force in-place, vendor relationships, brand recognition, customer loyalty, the cumulative effect of prior year’s advertising and marketing, patents, copyrights, and licenses.

…the appraiser must determine whether additional income is attributable to real property, personal property or intangible assets …. An appraiser has to ensure that the final value indica-
Investors demand both a return of their investment (a recapture of the investment) and a return on their investment (a yield on the investment).

The value of intangible assets and rights cannot be removed by merely deducting the related expenses from the income stream to be capitalized. Allowing a deduction for the associated expense does not allow for a return on the capital expenditure. For example, allowing the deduction of wages to a skilled work force does not remove the value of the work force in place from the income indicator, because the wages paid does not necessarily represent a return of and on the work force in place, and further bears no relationship to the costs associated with locating, interviewing, training, and otherwise acquiring the work force.

When estimating the income to be capitalized, income and expenses are estimated on a market, or economic, basis. Market income, which is generally income from property rental, is based on market rent, which is the rent that a property would command, assuming prudent management, if placed for rent on the market as of the appraisal date. It is the rental rate prevailing in the market for comparable properties, in contrast to contract rent, which is the actual rental income of a property as specified by terms of a lease. Market expenses reflect the level of operating expenses that a prudent buyer would expect to pay assuming prudent management.

Given all of the above guidelines, it is difficult to understand why certain taxing jurisdictions in California, or at least their local equalization boards charged with adjudicating flawed assessments, have not wholeheartedly embraced the Lennhoff approach to valuing hotels. In fact, they have not. Their reluctance is probably driven by the potential negative fiscal affect of fully implementing these guidelines and the tax refunds that they would generate.

**Glendale Litigation.** This fear in turn may be why the Los Angeles County Board of Equalization (BOE) has taken the unprecedented step of hearing hotel assessment appeals only if petitioners first certify that they will not raise the issue of “intangibles” in their appeal presentations. If the petitioners insist on doing so, and most will, then the case is placed in a semi-permanent limbo to await the ultimate conclusion of the case of EHP Glendale Hilton, LLC v. County of Los Angeles.16 The central issue in the case, which is on appeal, was that the taxpayer filed an assessment appeal and argued “that the assessment impermissibly captured the value of nontangible intangible assets.”

**Has Course 833 Helped or Hurt?**

The Appraisal Institute’s recently launched Course 833 was taught nationally in the last year. It does not purport to tell how to allocate different values present in a going concern property, but it does lay out a road map as to how to identify which items might need adjustment.

The course’s official name is “Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets.” Its purpose is to provide the theoretical and analytical framework for separating the tangible and intangible assets of real estate-centric businesses. It is intended to provide an overview of business valuation procedures and clarification of real estate and business valuation terminology, so participants can become familiar with the terminology relevant to separating asset values. Furthermore, the purpose of the class is to include the “… review [of] the legal foundations for property rights, be introduced to the methodologies, and become aware of the controversial and unresolved issues in this field.”17 [Emphasis added.]

Amazingly, there is even a specific disclaimer on the Appraisal Institute website that states:

Note. Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets contains diverse opinions regarding appraisal theory and applications. Neither this course nor the Appraisal Institute advocates a particular theory or method. Rather, each appraiser must come to his or her own conclusion based on the property type, local market customs, and scope of work.18

So much for taking a leadership role in resolving this dispute, and finding common ground and setting an industry standard for valuing going concern properties. Course 833 does have a lot of useful new terminology and provides a useful framework to identify intangibles, but it does not go the last mile and actually tell how to value them.

On completion of Course 833, students should be able to:

- Recognize operating properties as distinct from pure space properties.
- Recognize when the scope of work requires the separation of various kinds of assets to produce a credible appraisal.
- Understand the concepts, terminologies, and economic principles that underlie the asset claims to the revenue stream.
- Understand the terminology relevant to separating asset values and the roots of that terminology in accounting, business valuation, and valuation for financial reporting.
- Understand the complexity of valuing a property as it relates to appraisal problems, separating asset values, and valuation for financial reporting.
- Identify when there is a need to work with a professional in another field, such as when conducting business or tangible personal property valuations.
- Recognize the methodology.

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Hotel Valuations

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- Objectively articulate the various issues that are considered controversial and unresolved.
- Understand the parallels between the business valuation methodologies and real property valuations.

Much more is needed to get everyone reading and singing from the same page of sheet music.

Small Business Administration. One of the interesting and unexpected by-products of Course 833 is that those who have successfully completed it and its exam are placed on a list of approved Small Business Administration (SBA) appraisers, who alone can do these types of intangible allocations for the SBA.

The Legislative Fix

One way to mitigate the problem of allocating values to non-realty components of a going concern property is to legislate when and how it must be done. This was attempted a few years ago in Georgia, to address the situation of assessors not making any attempt to adjust for non-realty items in their hotel assessments. Furthermore, assessors in the state took the position that they did not have to make such adjustments.

Starting in 2011, real property tax assessors in Georgia are now for the first time required to adjust for intangible value embedded within going concern properties such as hotels. A revision to the Georgia Code was enacted which provides as follows:

(B.2) In determining the fair market value of real property, the tax assessor shall not include the value of any intangible assets used by a business, wherever located, including patents, trademarks, trade names, customer agreements, and merchandising agreements.19

Unfortunately, this provision as adopted was watered down from the one originally proposed, which had a much longer laundry list of mandatory items that had to be considered and adjusted for if found to be present. The effort to establish mandatory adjust-
rejected it so vehemently when he first promulgated it back in the 1970s and 1980s.

In addition to the ongoing appeal of the Glendale case in California mentioned earlier, there is another landmark judicial case pending in Washington, D.C.20 Because Washington is a hotel town with a significant amount of its overall budgetary revenues generated directly or indirectly from taxes levied on hotels, vendors, employees, or guests, any potential change in how hotels are assessed for property tax purposes is significant.

In this case, Ashford Hospitality filed a judicial assessment appeal in Washington, D.C. Superior Court in September 2009 for the 2009 tax year, alleging that its assessment was inflated because of numerous errors committed by the assigned assessor. After mediation and prolonged discovery, a trial was held on this case in the summer of 2011. It is noteworthy that only one or two trials on assessment issues are held in Washington, D.C. annually, and that decisions thereon can take many years to be rendered. Some say that this delay is intentional to encourage taxpayers to settle disputes at the two prior levels of mandatory mediation that must be completed before trial.

This case is the first hotel trial in Washington, D.C. in more than 20 years. The plaintiff engaged David Lennhoff as the appraiser and expert witness. He prepared and delivered a full-blown valuation of the hotel based on all of his theories and beliefs. The Washington, D.C. Office of Tax and Revenue (OTR) responded by saying that it uses the Rushmore approach, and that its proposed assessment complied fully with that approach.

Interestingly, the OTR did not commission an independent appraisal or engage a licensed state-certified general appraiser knowledgeable in hotel valuations to support its position and represent them at trial. Although the OTR assessor designated to be the expert witness was the author of its valuation report, he was unlicensed, had only recently moved to Washington, D.C. from California, and had no appraisal designations or special hotel training. Nonetheless, the judge allowed him to testify and opine as an “expert witness” on behalf of OTR, and he bravely did battle with Lennhoff.

To most courtroom observers, the outcome should be obvious, and the judge should rule in favor of the plaintiff despite the assessor enjoying a presumption of correctness and the high burden that this places on the plaintiff. Whether the judge elects to find for the plaintiff on narrow grounds, or just decides the case without opining broadly on the Lennhoff/Rushmore controversy, remains to be seen. A ruling for plaintiff will probably result in an application to the D.C. Court of Appeals to hear the case on further appeal and a request to clarify these issues once and for all. The Court of Appeals may of course decline to do so even if asked. This is a case to watch and one of the few pending in a major jurisdiction that could advance and perhaps clarify the Lennhoff/Rushmore debate.

**Future Capital Expenditures**

Most people would not buy a house with a leaking swimming pool. Typically, they would either insist that the seller fix it before the closing or get a credit against the purchase price for the full cost to cure the problem. In valuing hotels, essentially the same problem can be presented. Sometimes, there are large items of deferred maintenance or other obsolescence that the normal repair and maintenance reserves of the hotel cannot fund or address. Older hotels may today have outdated plumbing; energy inefficient windows; or inadequate air conditioning, heating, or elevators. Furthermore, some properties built pre-1979 have asbestos issues that may be currently encapsulated and handled, but any future repair or remodeling would require complete and expensive remediation. Similarly, a roof, once its warranty has expired and depending on its condition and construction, can be a never-ending battle, particularly if multiple roof surfaces have been applied as temporary solutions.

These are all big-ticket items, and the next buyer of the property is not going to pay full price for a hotel with these un-remediated problems because to do so would jeopardize the buyer’s future stabilized ROI. After all, commercial real estate investors are buying future cash flow from all revenue sources, especially in hotels. Anything that would dilute that income stream would also diminish the present value that the next buyer will pay for the hotel as a going concern property. Leaky roofs or no hot water do not sustain or enhance future RevPAR assumptions very well.

In arriving at a value indication that as of a certain date mirrors what the

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19 3 Georgia Code Ann. § 48-5-23(3)(B).
20 CHH Capital Hotel Partners LP (Ashford Hospitality), D.C. Sup. Ct. 2009 CVT 00945, filed 9/24/2009. Because the Washington, D.C. court system consists of only the Superior Court and Court of Appeals, Superior Court decisions there may have significantly more weight than decisions from first-level triers of fact in other jurisdictions.
next typical, prudent, and knowledgeable next buyer would pay for the subject property in an arm’s-length transaction after exposure to the market, any unresolved large future capital expenditure(s) (CapX) should be taken into account and adjusted for in the valuation process.

Sometimes, adjustments for such items are addressed as increases to the selected base cap rate in order to reflect additional risk, particularly if the amount or extent of the future hit cannot be quantified. The selection of the additional risk component to the cap rate can be very subjective, and it is usually hard to load a cap rate for such future risk and make it credible and market-supported, especially in markets where all comparable hotels to the subject property have similar issues, and there is no verified data that suggests that this was a consideration or adjustment in recent similar sales.

Accordingly, hotel valuators may look at the owner/seller’s CapX budget to quantify the likely costs to cure needed to preserve assumptions of future cash flow. The problem is that in most organizations, there are several CapX requests and estimates floating around. The easiest to obtain is of course the one that has been scrutinized, accepted, and funded for budgetary purposes. These amounts are funded over a finite period of time and will be spent because these items are crucial, although not always spent in the current calendar or fiscal year.

Unfortunately, these amounts are usually just a fraction of the originally requested CapX funds made by the local manager/engineer. Management will typically trim these requests, even if fully documented and justified, to the amount that can be effectively funded out of cash flow. Apart from emergency repairs, the total required investment to cure adverse conditions and obsolescence is only ever partially accepted and then only funded over the longest period of time possible.

So, is the raw or unbudgeted CapX a better number to use as a below-the-line adjustment for valuation purposes? Certainly, if coupled with a timeline to likely expenditure so that it can be discounted back to a present value, this amount would represent a better reflection of the likely cost to fix the entire “swimming pool” and more fully mitigate future risk and loss of anticipated NOI to the buyer. Overall, it is probably a best practice to request both the finally accepted budgeted CapX, as well as the raw CapX request. If they vary dramatically, that is a sign that additional work is needed to get to the fair market value of the subject property.

Conclusion

The following observations can be made:

• There is still no consensus as to how to value the real estate component of a stabilized and operating hotel in the U.S. Which approach to take seems to depend on whether the valuation is primarily for lending purposes or to assist in the mitigation of property taxes.

• Many recent hotel sales are based on very speculative assumptions as to future demand and performance in terms of ADR and RevPAR. REITs and foreign investors appear to be overpaying for hotel assets by virtue of their superior buying or financing power. Accordingly, their reported transactions do not necessarily meet the definition of fair market value or fair value. That distinction may be acceptable for lending purposes, as long as USPA is complied with in terms of the scope and limitation of the appraisal, but it may not meet the applicable legal standards for assessment purposes. Therefore, great care must be taken in extracting indications of value or cap rates from such sales without first making all indicated adjustments.

• The hotel market appears to be fragmenting into a multi-tiered market driven by different underwriting assumptions and anticipated return rates and holding periods. Again, any hotel sales produced from such a choppy market must be carefully examined, verified, and adjusted as needed, before used as a comparable or to extract a cap rate, to establish the value of another hotel in the same market.

• In the case of REITs and foreign investors who are using “cheap” investment funds or are motivated by potential currency arbitrage or a need to move assets to a “safe harbor,” thereby reducing their ROI expectations and increasing the prices they will pay for “trophy assets,” a cash equivalency adjustment may be needed to adjust those prices to typical market comparable sales.

• If an oversupply of certain types of hotels in a particular market develops, but this is not reflected in local sales prices, adjustments may also be warranted. If this is coupled with accelerated replacement of FF&E or remodeling to try and differentiate a hotel in that market, or to justify increased RevPAR, future NOI assumptions need to be closely considered, together with any deferred “raw” CapX. Increased prices require increased investment yields. This can be accomplished by a combination of increased revenue and decreased expenditures. The next buyer is going to discount the future sales price by the cost to cure such deferred raw CapX.

• Overall, hotel sales prices are back to 2005/2006 levels and therefore those established at the height of the last market spike pre Lehman Brothers crash. That in turn represented the height of the value cycle for the last couple of decades. So it is hard to say where values go from here, particularly since it is likely that interest rates for new financing, coupled with property-specific income and expense data, will determine hotel values, rather than their being based on any homogenized value.

• The appropriate valuation methodology and assumptions to be used for hotels and their underlying real estate is still very confused and subjective. Unfortunately, no real prospect exists for any unity or uniformity on this subject anytime soon.

• For the foreseeable future, U.S. hotel values are likely to be determined by the answer to the question, “What do you need the valuation for?” It is too bad that we cannot find a common ground, so we can all just get along.