REMOVING PERSONAL PROPERTY AND INTANGIBLES FROM HOTEL VALUATIONS – THEORY AND PRACTICE

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Why Is The Title About "Theory and Practice"?

"Get the witness commit himself to the correct theory (valuation principle), then punish him if he violates the theory."

In developing this presentation, my method has been to try to get the theory right, and then see how to implement the theory.

As I see this dispute, one side has problem with the appraisal theory, and one side has problems implementing the theory.

Why Isn't There More on Case Law?

You can read cases better than I can.

The written materials do have a discussion of several representative decisions going both ways.

The cases go to great length to emphasize that the decisions do not set binding rules about hotel intangibles; they are simply evaluations of the strength of the evidence in each particular case.

Many of the decisions turn on factors peculiar to the jurisdiction, *e.g.,* who has the burden of proof and how substantial is it, assessment guidelines for that jurisdiction, etc.

Most importantly, at its core these are appraisal issues that have been foisted off on judiciary because the Appraisal Institute is timid. As judges, you will have to wade through these appraisal issues.

Two Main Schools of Thought on Hotel Intangibles

- RUSHMORE APPROACH
- Steven Rushmore. Mr. Rushmore has written five textbooks and two seminars for the Appraisal Institute on hotel valuations. He has also authored three reference books on hotel investing and has published more than 300 articles. He is the founder of HVS which has 30 offices throughout the world and specializes in the hotel industry.

- LENNHOFF APPROACH
- Mr. Lennhoff has taught nationally and internationally for the Appraisal Institute. He has been a development team member for most of the Institute's income capitalization courses and was editor of the Capitalization Theory and Techniques Study Guide (3rd ed.). He was lead developer for the course, Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets, and editor of the two accompanying business enterprise value anthologies, and he authored the Institute's Small Hotel/Motel Valuation seminar.

THREE MAIN AREAS OF DISAGREEMENT

- **Intangible Value attributable to the franchise relationship.** Rushmore says that operation of the hotel business does create intangible value; but it all goes to the hotel management company. Lennhoff says the property owner also received intangible value and it must be removed from the owner's income stream.
- **Tangible Personal Property (FF&E).** Both schools say that the return of and return on the FF&E must be removed from the income stream; but they disagree on how to remove it.
- **Business start up costs and financial assets.** Rushmore says that unless you are talking about a new hotel, nothing needs to be removed. Lennhoff says these costs continue to add value and that value must be removed.

Let's Think About Hotel Basics

Then we'll think about nuances like segregating intangible values

HOTELS DERIVE REVENUES FROM MULTIPLE SOURCES IN ADDITION TO ROOM RENTALS

- Sale of food
- Sale of beverages
- Sale of telephone services [internet]
- Sale of items in gift shops
- Commissions from vending machines
- Fees for laundry and cleaning
- Charges for in-room movies
- Charges for parking
- Rental of recreational facilities
- Rental of meeting rooms
- Rental of audio-visual equipment
- Rental of space for office or retail
- Charges for banquet & Catering

HOTELS NEED A LOT OF TANGIBLE PERSONAL PROPERTY (FF&E)

- Another unique factor in the operation of hotels and motels is that significant amounts of personal property including furniture and fixtures is required.
- Due to heavy use, the personal property has a short useful life, depreciates faster than the real property and has virtually no resale value.

COST APPROACH

- "Knowledgeable buyers of [hotels] generally base their purchase decisions on economic factors such as forecasted net income and return on investment."
- "Because the cost approach does not reflect any of these income-related considerations but does require a number of highly subjective and unsupportable depreciation estimates, this approach is usually given minimal weight in the hotel valuation process."
- "It is even less applicable than the norm when only a hotel's real estate component is being valued."
    - But it "<u>may provide a reliable estimate of value for newly constructed properties</u>."

Lesser & Ruben

Understanding the Unique Aspects of Hotel Property Tax Valuation, THE APPRAISAL JOURNAL (1993),

SALES COMPARISON APPROACH

- "As is the case for a hotel's personal property elements, virtually no actual market data exist that could be used as a basis from which to derive an appropriate adjustment." Lesser and Rubin.
- "For property types where real property rarely sells independently from the personal property, comparable sales prices often cannot be reliably allocated to the various asset classes." AORE 15th Ed. 669.
- "Reliance on this method beyond the establishment of broad parameters is rarely justified by the quality of the sales data. The market-derived capitalization rates sometimes used by appraisers are susceptible to the same shortcomings inherent in the sales comparison approach."
  - **Hotel Investments Issues & Perspectives, 2nd Edition** (With Jan DeRoos)
  - https://www.hvs.com/content/Bookstore/HotelValuationTechniques.pdf

THE INCOME APPROACH

- "This approach is often selected as the preferred valuation method for income producing properties because it most closely reflects the investment thinking of knowledgeable buyers."
- "A stabilized statement of income and expenses allows for market supported deductions for income attributed to personal property as well as income attributed to the going concern."
  - Lesser and Rubin
- Lennhoff agrees.

RevPAR Is Used to Compare the Income of Hotels

- **RevPAR (Revenue per available room):**
- Start with **Average Daily Room Rate ("ADR")**
    - Which produces better income $170 ADR or $200 ADR?
- Then multiply by **Occupancy Rate**
  - **RevPAR = ADR * Occupancy Rate**
    - Considers both the amount you get per room and the number of rooms you rent.
    - Roughly equivalent to gross operating revenue
- A hotel operating at a 60% occupancy rate with an average room rate of $200 has a RevPAR of $120 (60% × $200).
- A competitive hotel operating at an occupancy rate of 75% but with an average room rate of $170 has a higher RevPAR of $127 (75% × $170).

Don’t Confuse Hotel Leases With Typical Leases

Understanding how hotels are leased is **vital** to understanding the debate over intangible values.

The Traditional Hotel Lease

- "A total property lease is an agreement between a hotel company and a hotel property owner in which the hotel company leases the hotel (land, improvements, and [usually] the FF&E) from the property owner."
- "**The hotel company thus becomes the tenant and assumes all operating responsibilities as well as the financial obligations of funding working capital, operating expenses, and rent.** The landlord owner is passive with respect to all operating decisions and is not responsible for working capital or operating expenses."
- "The hotel company receives the residual net income after all expenses are paid including rent … **the financial burden is placed on the hotel company which enjoys the benefits of the property is successful but suffers losses when the operating performance is not adequate**."
    - Rushmore, HOTEL MARKET ANALYSIS, Appraisal Institute 2012 (*Rushmore, Text*) (Emphasis added.)

Business Risk and Rewards – Traditional Lease

Lease Provides for Rent of $880,000 per year

	Base Case
	Revenues
Total Rooms Revenue	8,000,000
	Expenses
Rent	(880,000)
Op. Exp.	(6,000,000)
NOI	1,120,000
	Pay Outs
Hotel Co Gets	1,120,000
Prop. Owner Gets	880,000

Business Risk and Rewards – Traditional Lease – Times Change

	Base Scenario	Good times
	Revenues	**Revenues**
Total Rooms Revenue	8,000,000	9,600,000
	Expenses	**Expenses**
Rent	(880,000)	(880,000)
Op. Exp.	(6,000,000)	(6,000,000)
NOI	1,120,000	2,720,000
	Pay Outs	**Pay Outs**
Hotel Co Gets	1,120,000	2,720,000
Prop. Owner Gets	880,000	880,000

Business Risk and Rewards – Traditional Lease More Changes

	Base Scenario	Good times	Bad Times
	Revenues	Revenues	Revenues
Total Rooms Revenue	8,000,000	9,600,000	6,400,000
	Expenses	Expenses	Expenses
Rent	(880,000)	(880,000)	(880,000)
Op. Exp.	(6,000,000)	(6,000,000)	(6,000,000)
NOI	1,120,000	2,720,000	(480,000)
	Pay Outs	Pay Outs	Pay Outs
Hotel Co Gets	1,120,000	2,720,000	(480,000)
Prop. Owner Gets	880,000	880,000	880,000

There Has Been a Shift Away From Leasing and to Franchising

- In the 1950's the Hotel chains started to expand internationally but were unwilling to expose themselves to the operational and financial risks of operating overseas. Hotel franchising was born with the foreign governments assuming the financial risk in order to develop tourism.
- "Once hotel companies discovered that they could make almost as much money with a management contract as with a property lease without assuming any of the financial risks, they started to change their modes of operation" and adopted the franchise/management model.

  Rushmore, Text 152.
- (Hotel company runs the business in return for a % of total revenues.)

The Shift Away From Leasing and to Franchising (Owner's Perspective)

- Owner gets chance of higher returns than traditional lease, because she receives net business income, plus
  - Instant identity, recognition and image
  - Reservation or referral service (Produces 15 to 30% of occupancy)
  - Chain advertising and sales
  - Procedural manual (Here's how to do it profitably)
  - Management Assistance
  - Group purchasing
  - Loyalty program
  - Financing advantage – Many lenders are more willing to lend on franchised hotels

    Rushmore, Text 155 / 165

The Legal Mind And The Appraisal Problem – What is the Issue?

- **After the owner of the real estate has paid all its expenses, is there a portion of the net operating income (NOI) that is attributable to tangible or intangible personal property?**
- **If so, what asset(s) is it attributable to, and how much of the NOI is attributable to that asset?**

Business Risk and Rewards Franchising – The New Normal

	Base Case
	Revenues
Total Rooms Revenue	8,000,000
	Expenses
Franchise & Mgt Fee	(880,000)
Op. Exp.	(6,000,000)
NOI	1,120,000
	Pay Outs
Fran/Mgt. Co Gets	880,000
Prop. Owner Gets	1,120,000

Fee = 11% of Total Rooms Revenue

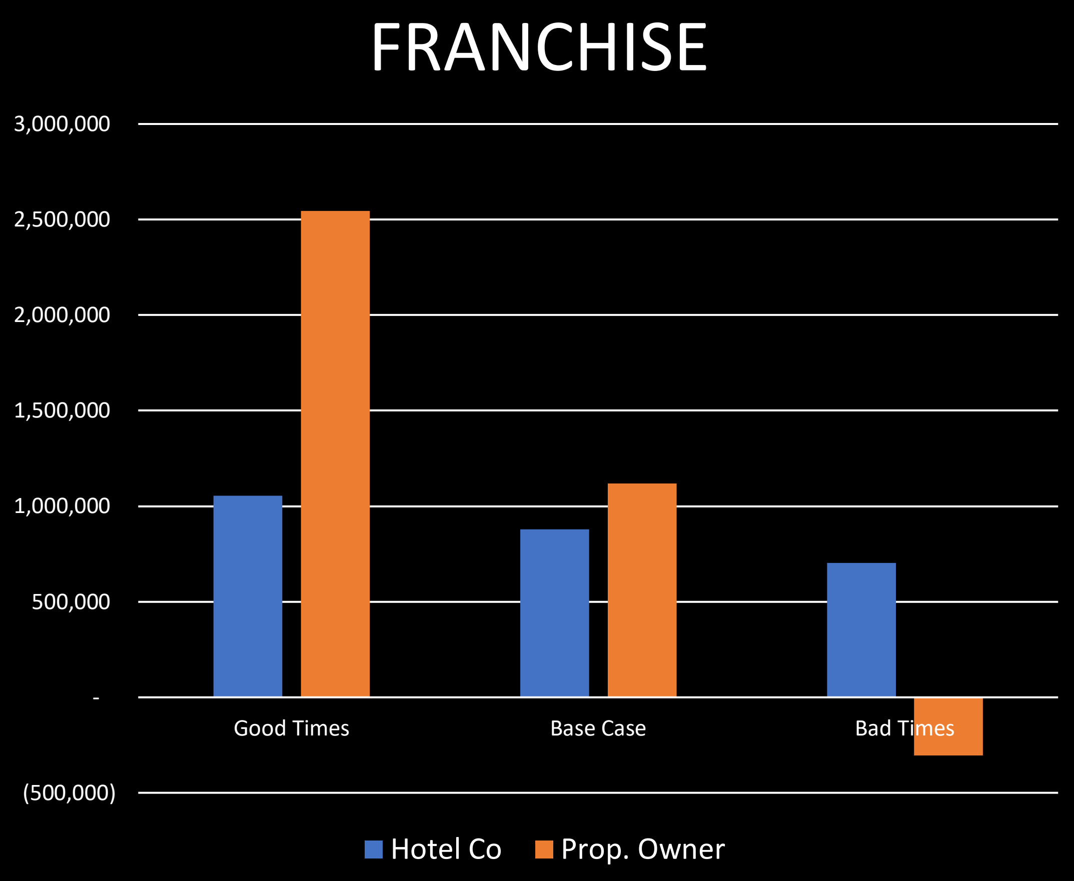
Business Risk and Rewards Franchising – Times Change

	Base Case	Good Times
	Revenues	**Revenues**
Total Rooms Revenue	8,000,000	9,600,000
	Expenses	**Expenses**
Franchise & Mgt Fee @11%	(880,000)	(1,056,000)
Op. Exp.	(6,000,000)	(6,000,000)
NOI	1,120,000	2,544,000
	Pay Outs	**Pay Outs**
Fran/Mgt. Co Gets	880,000	1,056,000
Prop. Owner Gets	1,120,000	2,544,000

Business Risk and Rewards Franchising – More Changes

	Base Case	Good Times	Bad Times
	Revenues	**Revenues**	**Revenues**
Total Rooms Revenue	8,000,000	9,600,000	6,400,000
	Expenses	**Expenses**	**Expenses**
Franchise & Mgt Fee @11%	(880,000)	(1,056,000)	(704,000)
Op. Exp.	(6,000,000)	(6,000,000)	(6,000,000)
NOI	1,120,000	2,544,000	(304,000)
	Pay Outs	**Pay Outs**	**Pay Outs**
Fran/Mgt. Co Gets	880,000	1,056,000	704,000
Prop. Owner Gets	1,120,000	2,544,000	(304,000)

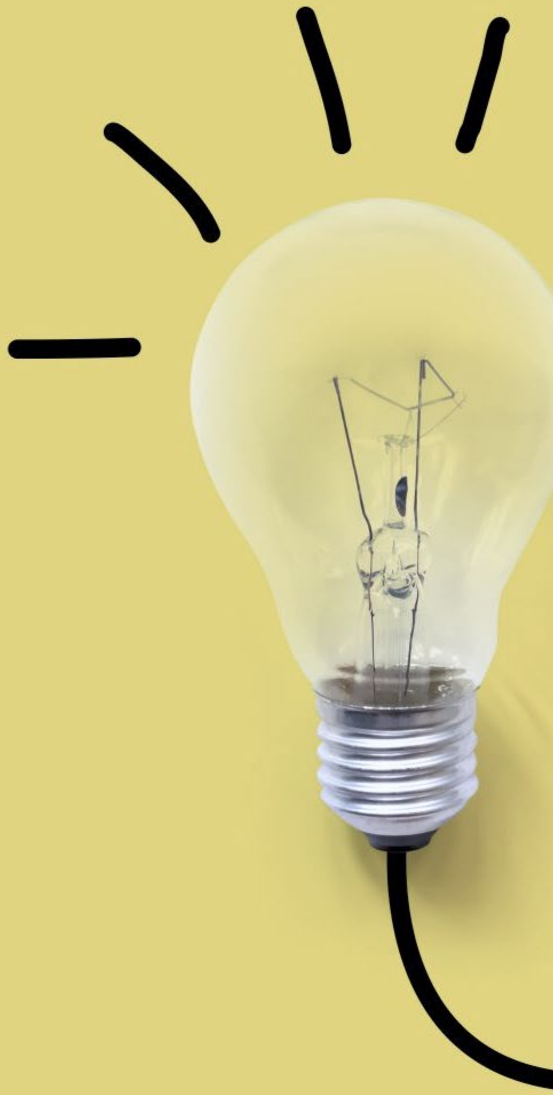
Contrasting Risks and Rewards



The Bottom Line
On
The Bottom Line

In a hotel franchise arrangement, the franchisor and franchisee are joint venturers in the hotel business.

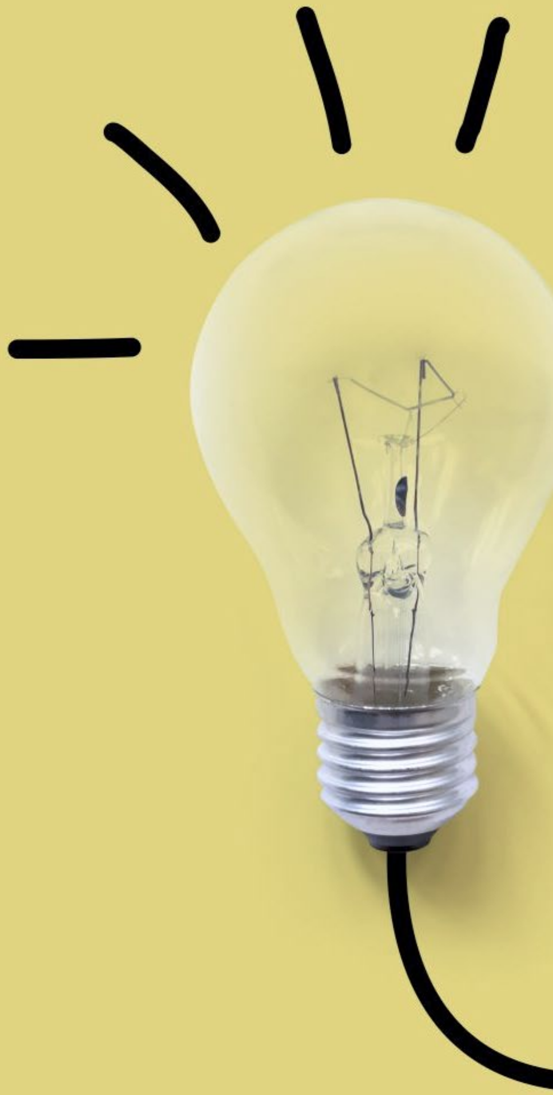
The property owner receives net business income rather than traditional rent.



Mr. Rushmore, Does the Owner Get NOI or Rent?

"The basis for valuing a hotel's real property component is the income approach which takes a property's stabilized net income and capitalizes it into an estimate of value.

[S]uch stabilized net income contains all of the revenue generated and expenses incurred by a hotel in carrying out its ongoing day-to-day functions of taking reservations; selling rooms; hiring, training, and directing staff; performing maintenance; purchasing equipment; and the myriad other activities needed to keep a hotel operating."

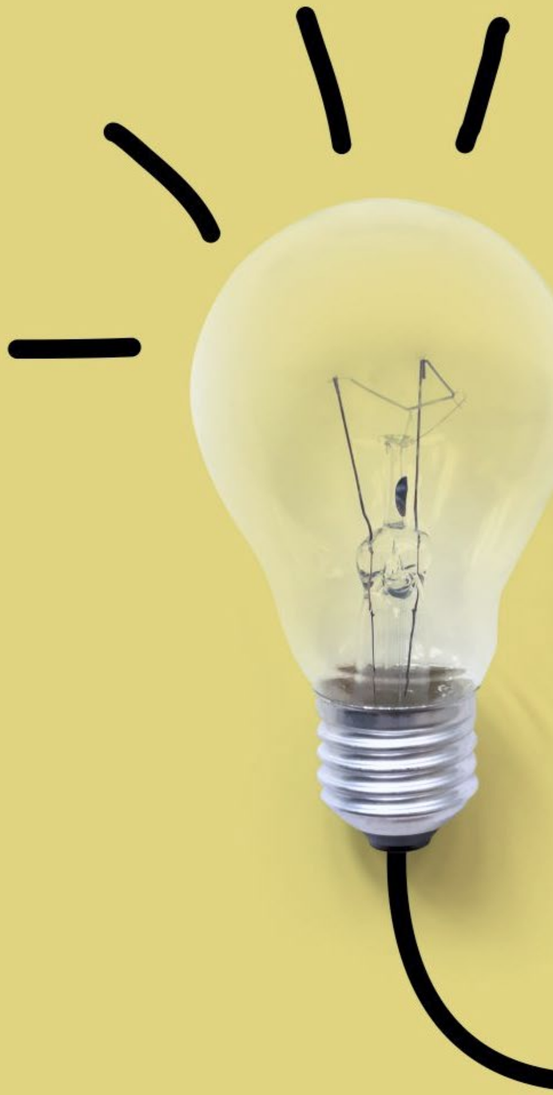


S. Rushmore, "Why the 'Rushmore Approach' is a Better Method for Valuing the Real Property Component of a Hotel," Journal of Property Tax Assessment and Administration, Vol. 1, Issue 4. (*Rushmore*)

Mr. Rushmore, Are You Sure?

[Under a franchise the owner "assumes … responsibility for all working capital, operating expenses, and debt service. The management company is paid a fee for its services and **the owner receives the residual net income after all expenses.** Unlike a property lease, the financial burden under a management contract is placed entirely on the owner, who enjoys the upside benefits of a successful property but suffers the downside losses if the operation is not profitable."

Rushmore, HOTEL MARKET ANALYSIS, ***152.***



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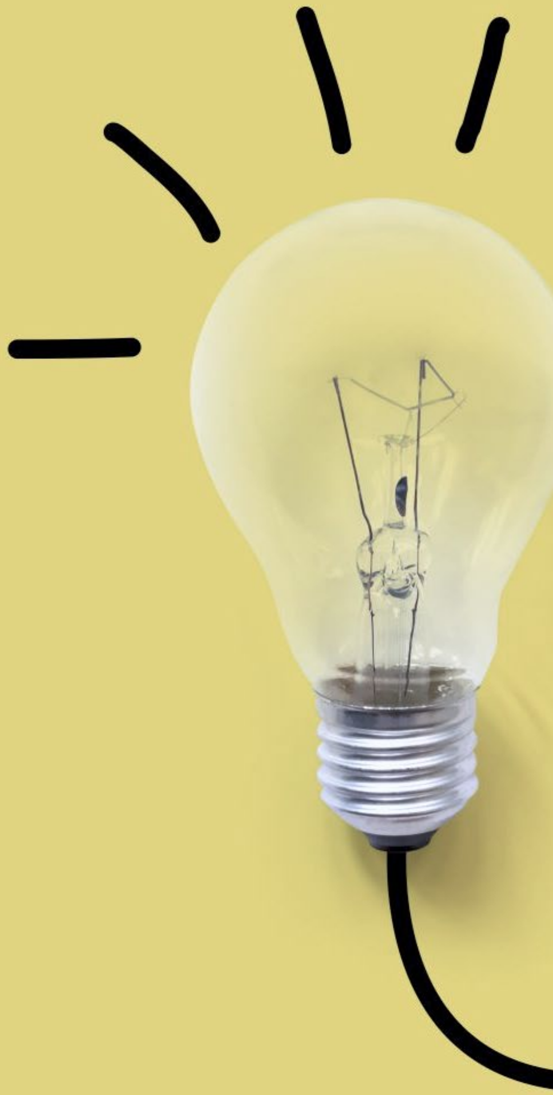
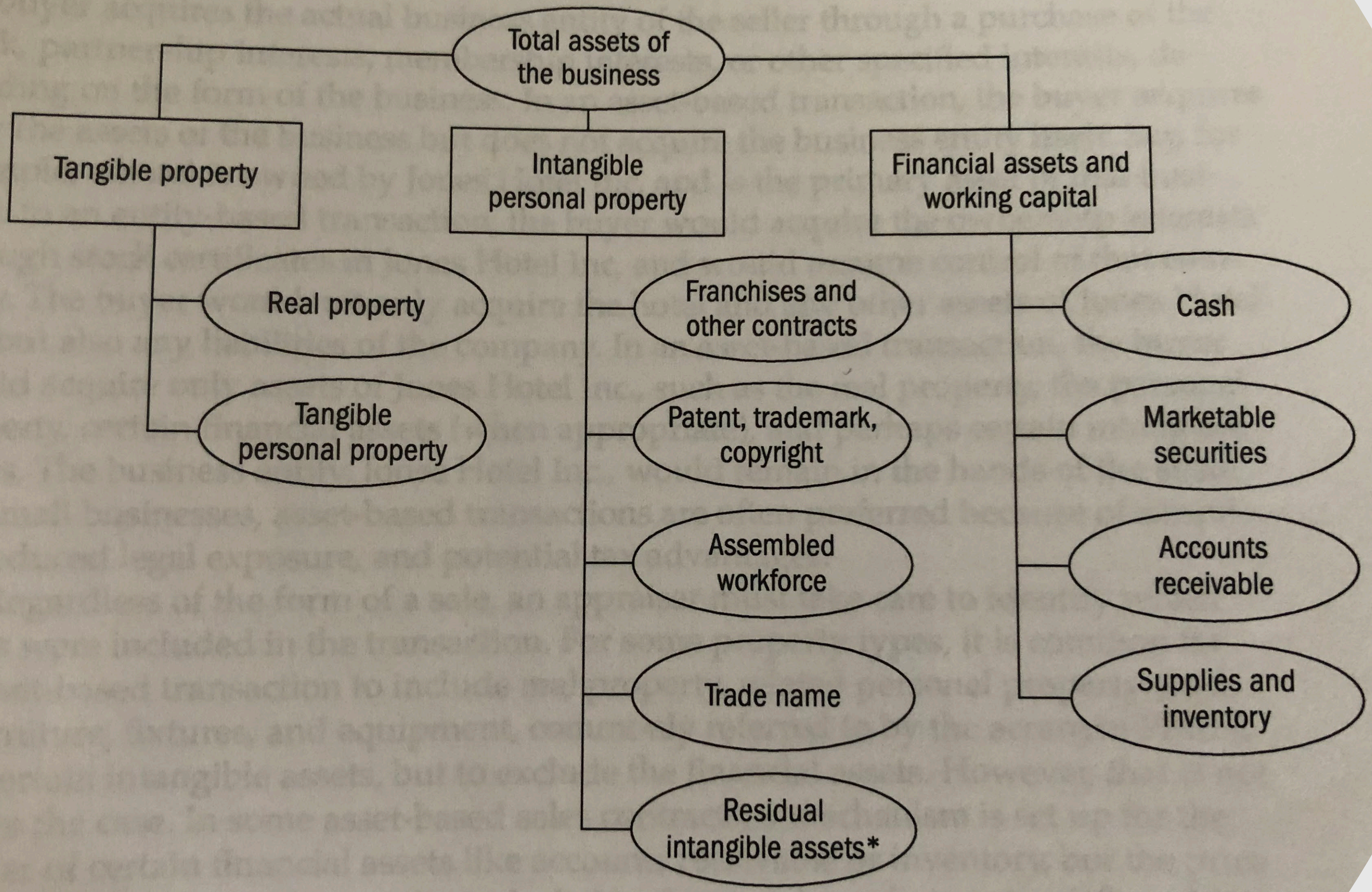


Intangibles

What Are They?

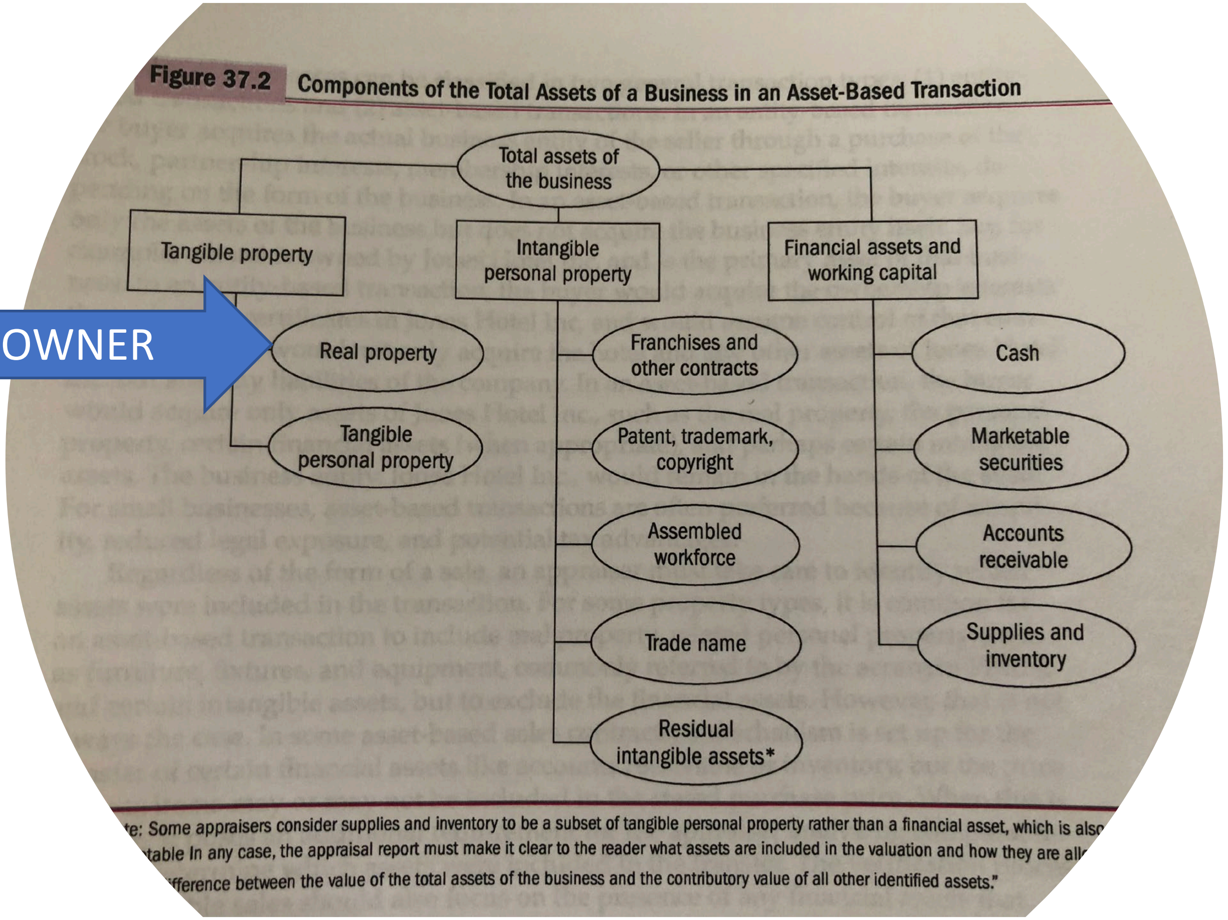
Figure 37.2 Components of the Total Assets of a Business in an Asset-Based Transaction



…e: Some appraisers consider supplies and inventory to be a subset of tangible personal property rather than a financial asset, which is als… …able In any case, the appraisal report must make it clear to the reader what assets are included in the valuation and how they are al… …ference between the value of the total assets of the business and the contributory value of all other identified assets."

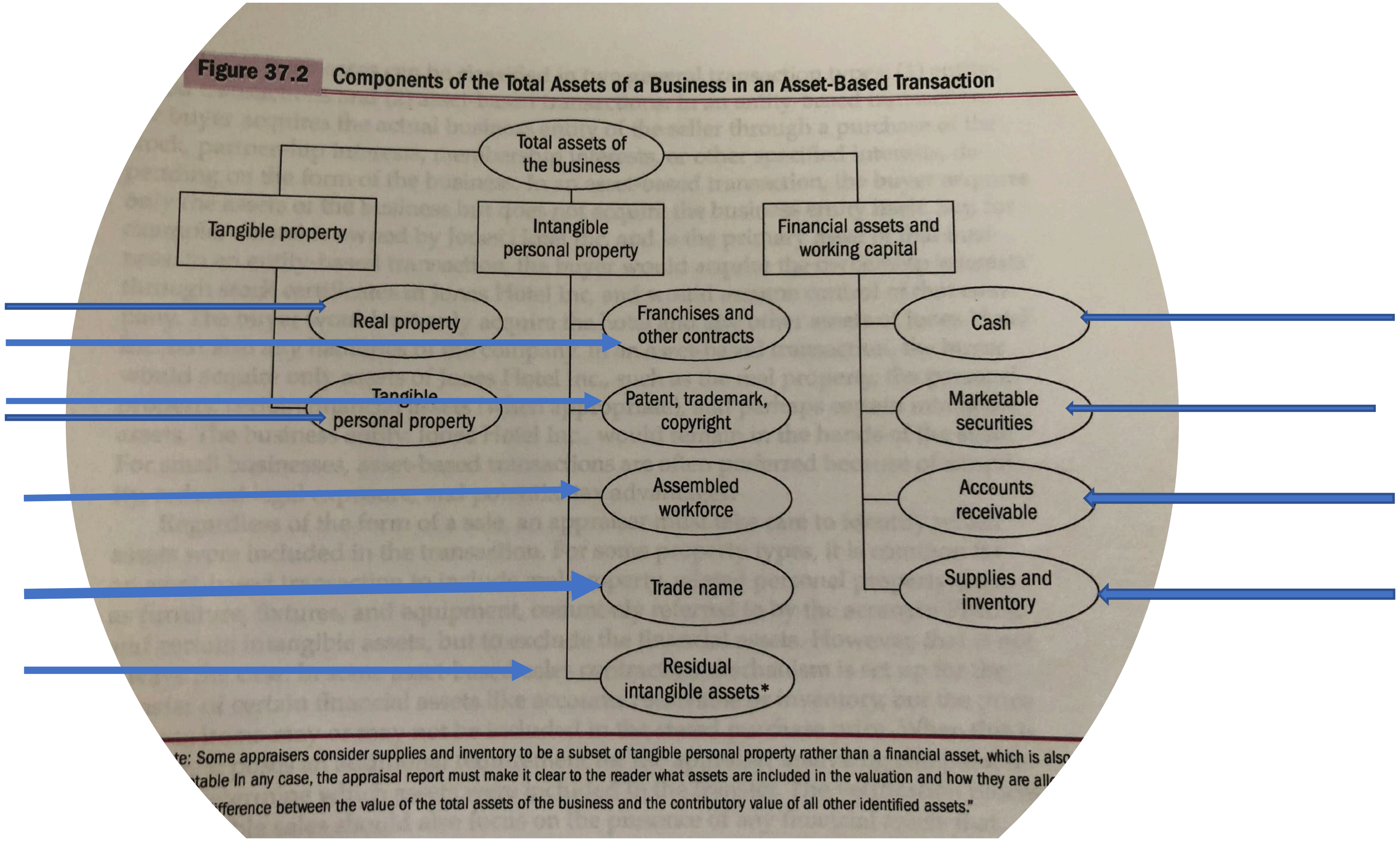
WHAT YOU WANT
(To Capitalize To Reach Real Property Value)

INCOME TO PROPERTY OWNER



WHAT YOU HAVE
(If You Capitalize All Hotel Income)

$



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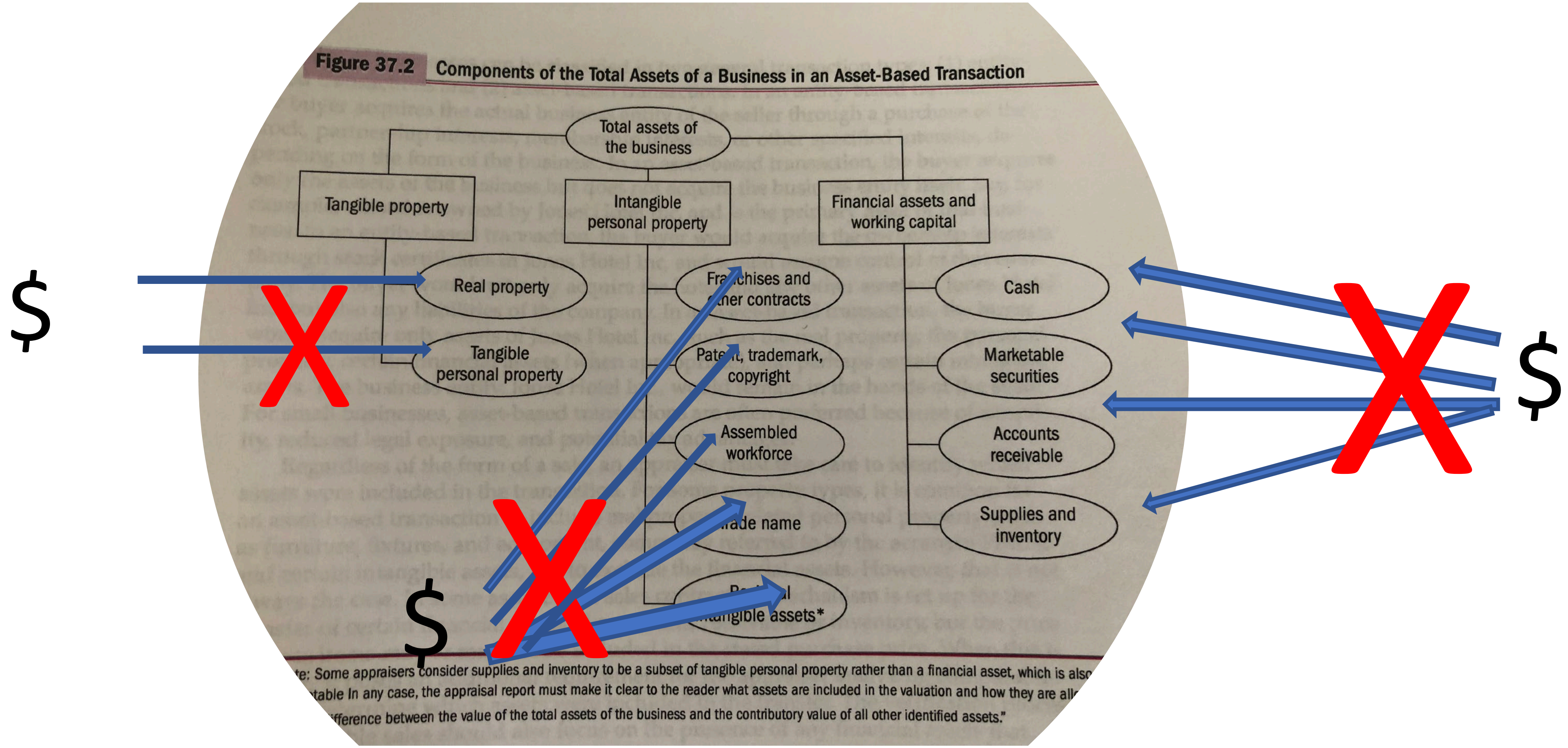
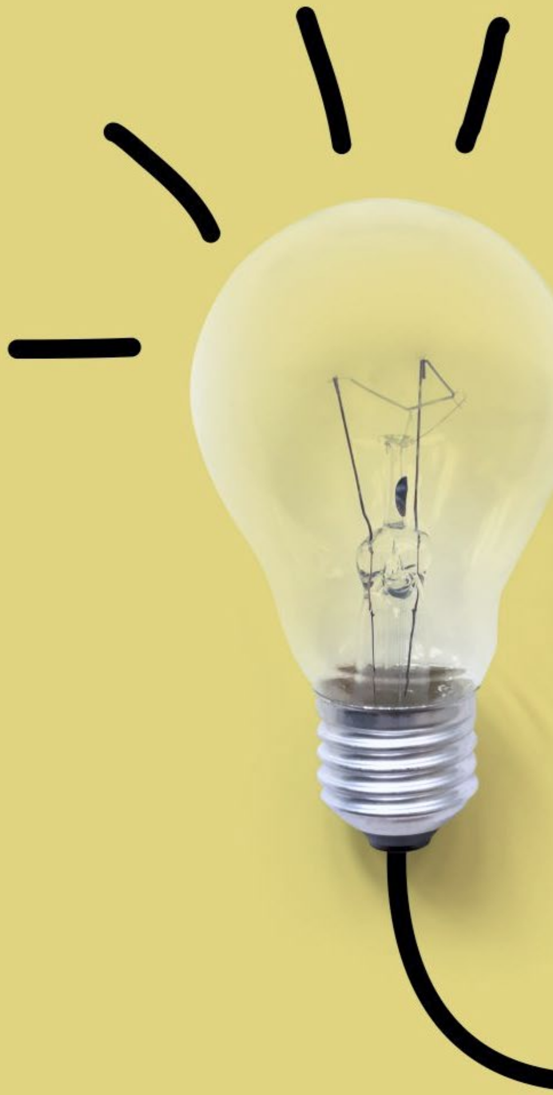
WHAT YOU NEED TO DO



	Base Case
	Revenues
Total Rooms Revenue	8,000,000
	Expenses
Franchise & Mgt Fee	(880,000)
Op. Exp.	(6,000,000)
NOI	1,120,000
	Pay Outs
Fran/Mgt. Co Gets	880,000
Prop. Owner Gets	1,120,000

Is any of this attributable to tangible or intangible personal property?

AS FAR AS I KNOW, THIS FACT HAS NEVER BEEN MENTIONED IN A JUDICIAL OPINION, BUT IT IS CRUCIAL TO UNDERSTANDING THE INTANGIBLES ISSUE



Hotel owners have swarmed to embrace franchising.

- **In 1970, <u>35%</u> of all hotels were affiliated with a chain.**
- **By 2010 the ratio was in the range of <u>80%</u>. *Rushmore, Text, 153.***
- **By 2015 HVS reported the ratio was <u>85%</u>.**

- WHY DO YOU THINK OWNERS EMBRACED FRANCHISING?

- DO YOU THINK IT HAD SOMETHING TO DO WITH THEIR BOTTOM LINE? IF NOT, WHY?

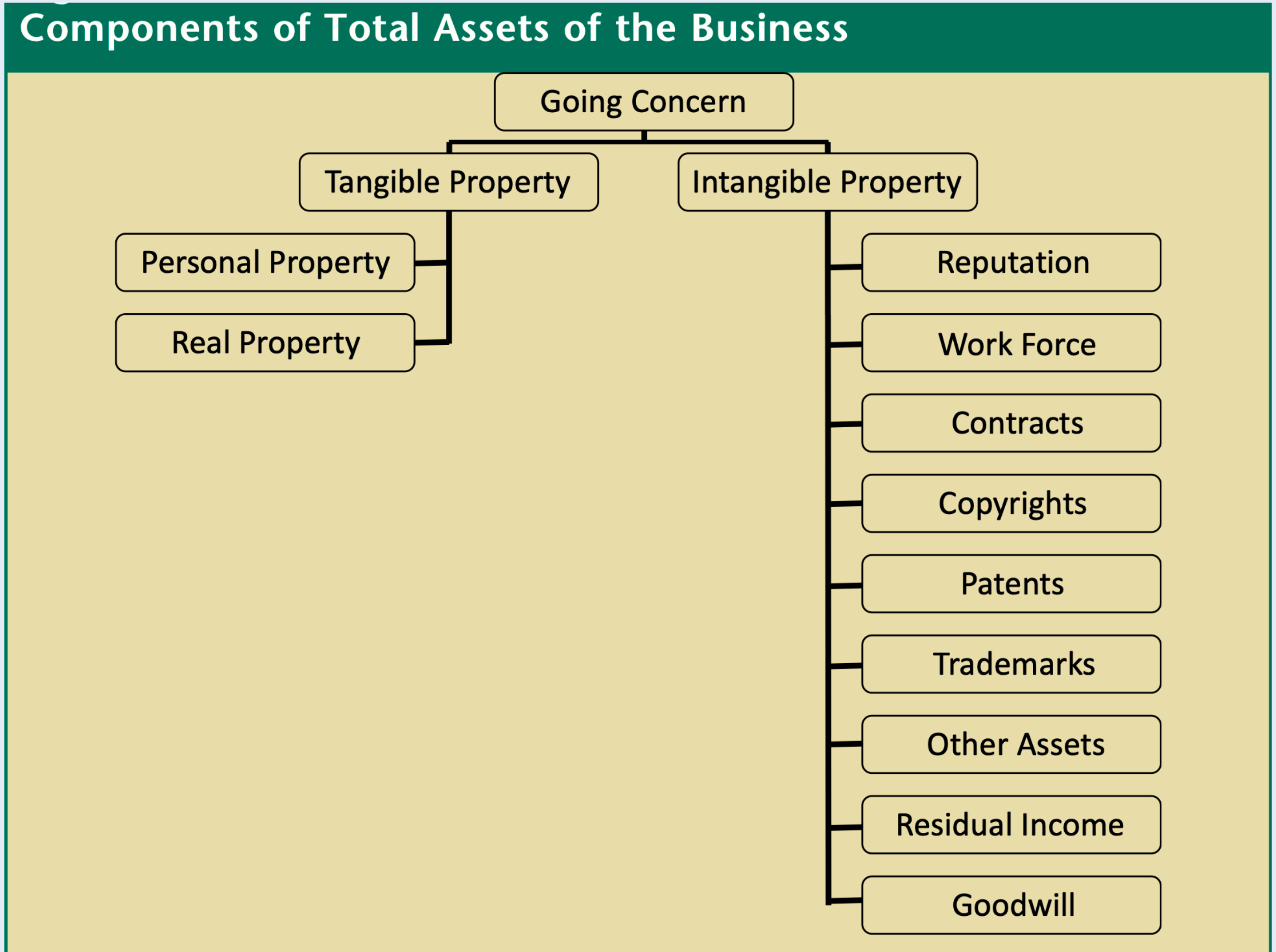
AND NOW, THE MAIN EVENT!

THE BATTLE OVER INTANGIBLES

Round 1: Does the Owner Receive Intangible Value From the Franchise Arrangement?

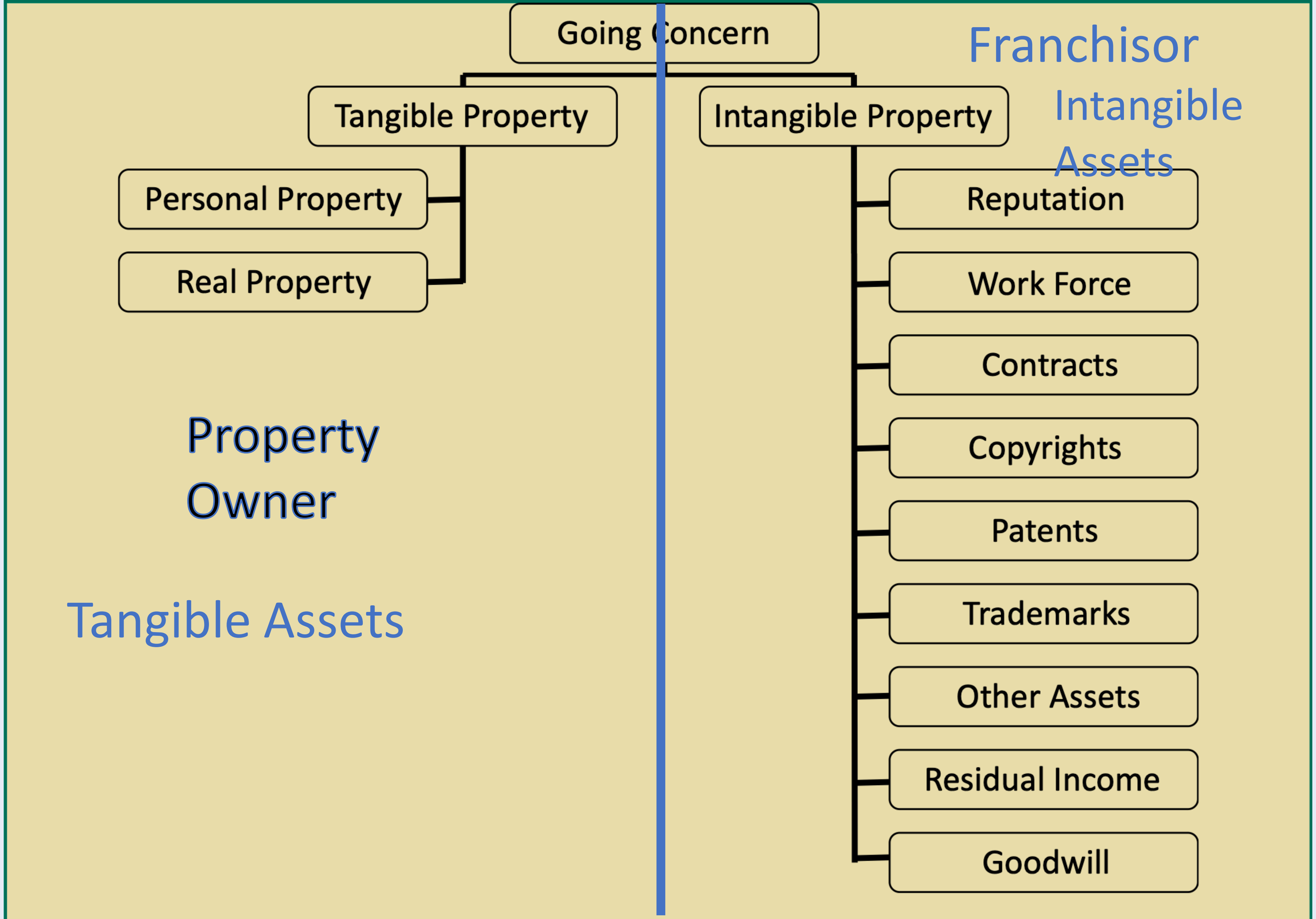
Let’s Start With Rushmore

Rushmore: Think About Who Owns What



Source: *The Appraisal of Real Estate*, 13th ed. (Chicago: Appraisal Institute, 2008), p. 30.

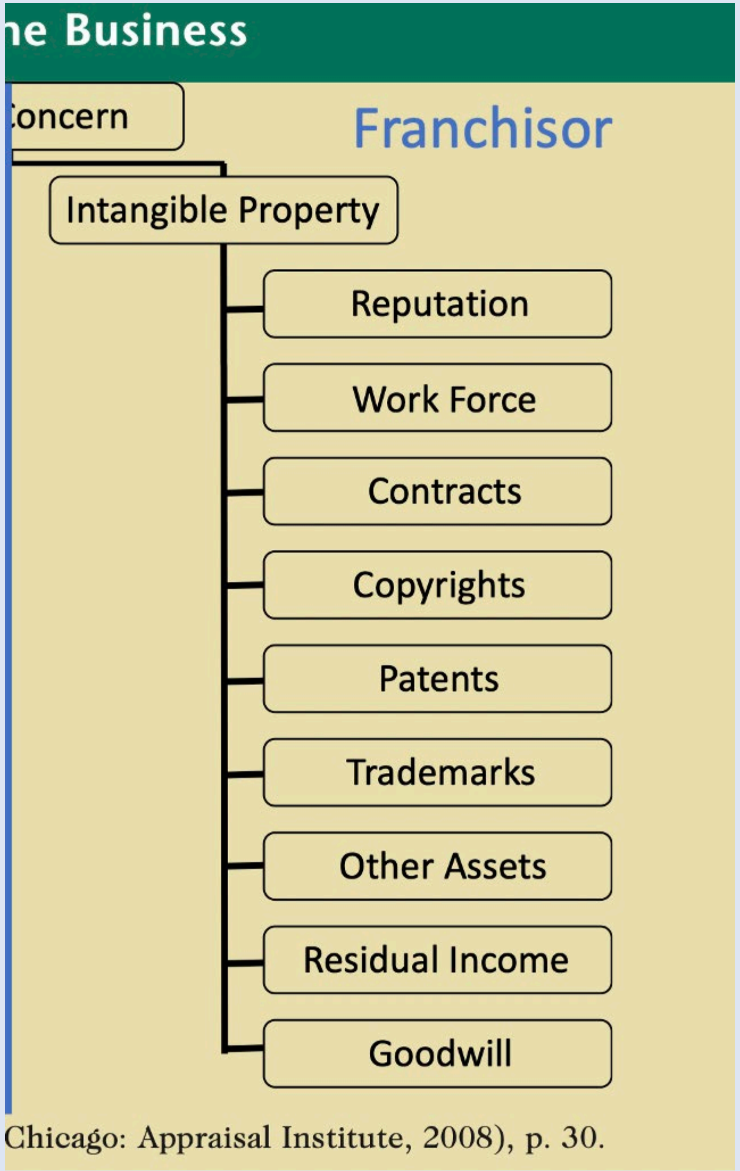
Components of Total Assets of the Business



Source: *The Appraisal of Real Estate*, 13th ed. (Chicago: Appraisal Institute, 2008), p. 30.

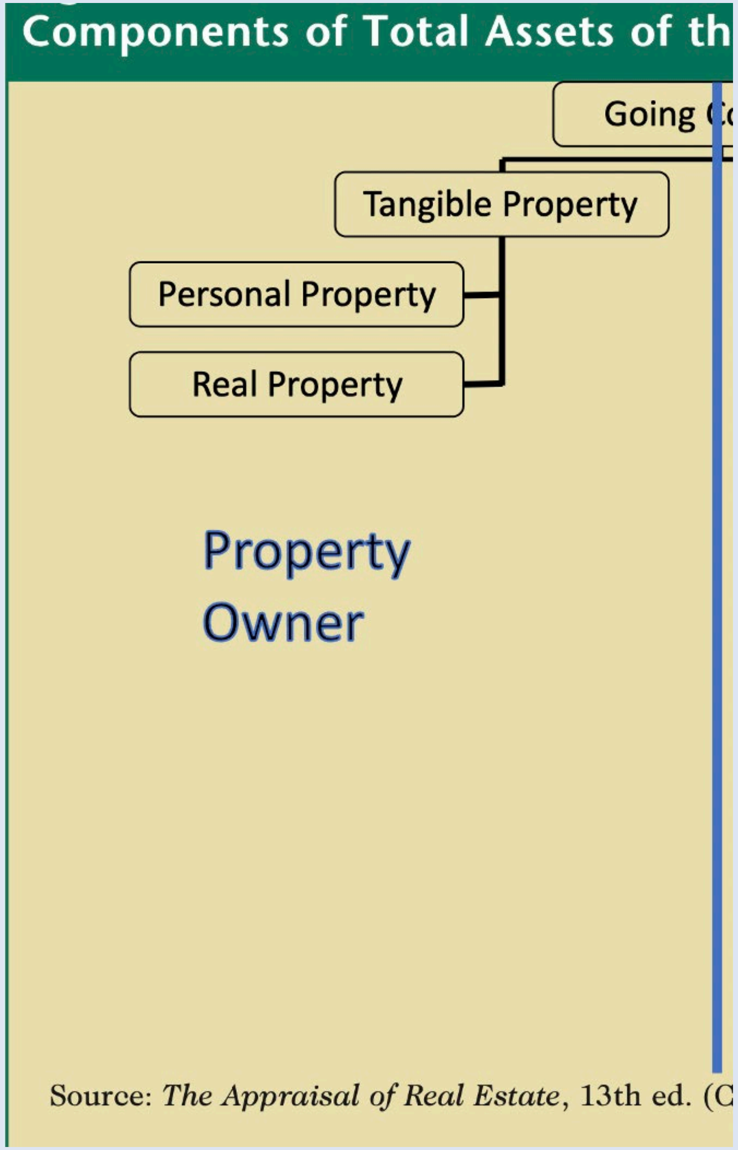
Rushmore's Rationale

1. All these business assets belong to the franchisor; not the owner.
2. The Franchisor's receives fees to manage the business.
3. Therefore, the fees account for all the business income.



Rushmore's Rationale

- 4. These are the only assets that belong to the property owner.
- 5. The assets are tangible property.
- 6. Since all the business income has been removed (see previous slide), the remaining income is attributable to the real and tangible personal property; not intangible assets.



THE CENTRAL TENET OF THE RUSHMORE APPROACH

- "The process of isolating the value of a hotel's business is based on the premise that by employing a professional management agent to handle the day-to-day operation of the property, an owner maintains only a passive interest, while <u>the income attributable to the business has been taken by the managing agent in the form of the management fee.</u>" Lesser & Rubin, (Emphasis Added.)
- *E.G.*, When you remove the management and franchise fee, you remove the intangible value.
- (The value of tangible personal property is a separate issue.)

Courts That Have Endorsed the Rushmore Method Have Adopted Rushmore's Reasoning

- "The appraisal theory is that by hypothesizing that the property owner employs a professional management agent to take over the day-to-day operations of the business enterprise, **the property owner is in the position of a passive investor in real property who makes no profit from the business operation at the property."**

Marina Dist. Dev. V Atlantic City, 27 N.J. Tax 469 (2013)

Rushmore: The Owner Gets NOI

- “[Under a franchising agreement] the owner, unless stipulated otherwise, assumes a passive position with respect to the operating decisions while assuming responsibility for all working capital, operating expenses, and debt service. The management company is paid a fee for its services and **<u>the owner receives the residual net income after all expenses.</u>** Unlike a property lease, the financial burden under a management contract is placed entirely on the owner, who enjoys the upside benefits of a successful property but suffers the downside losses if the operation is not profitable.”

Rushmore, HOTEL MARKET ANALYSIS, ***152.***

Any Exceptions to the Rule?

- "[I]f there were evidence of super competent management [producing significantly lower expenses and or significantly higher revenues than typical] with the premium not being attributable to location, condition, facility offering, etc." Suzanne Mellon, MAI, a Rushmore protégé and Senior Managing Director and Practice Leader at HVS, "*Property Taxes Post COVID-19*" HOSPITALITYNET.
  - *Extremely hard to prove.*
- "Examples of other potential intangible factors can include income ascribed to leases in excess of market rent … as well as branded/themed or services that can command extraordinary profit premiums." *Id*.
  - *Extremely rare – perhaps Disney?*

Before We Turn to Lennhoff's Views – Let's Consider Another Famous Appraiser

Oscar Wilde

- "A cynic is a man who knows the price of everything and the value of nothing."

Why Oscar?

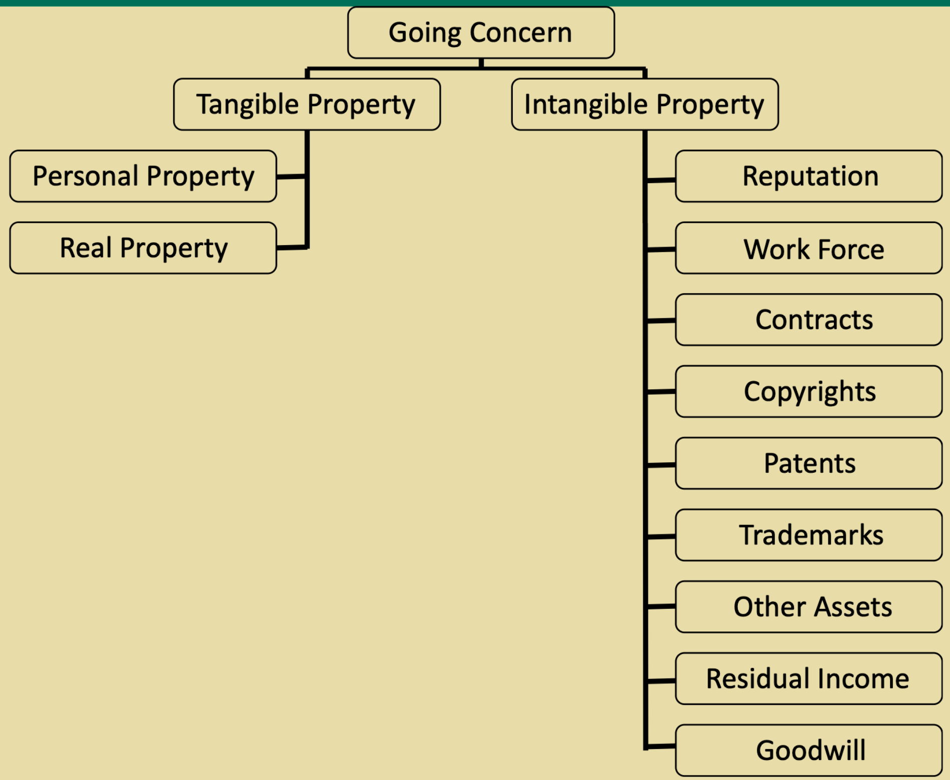
- While Rushmore equates the fees paid with the business value; it may be that Rushmore has confused price with value.

- It seems more correct to say that the fees paid by the owner are the ***price*** paid for the intangible business assets; not the ***value*** of the intangible intangible business assets.

What Does Lennhoff Have to Say About Intangibles Attributable to the Franchise Relationship?

Lennhoff Takes A Different View of the Total Assets of the Business

Components of Total Assets of the Business

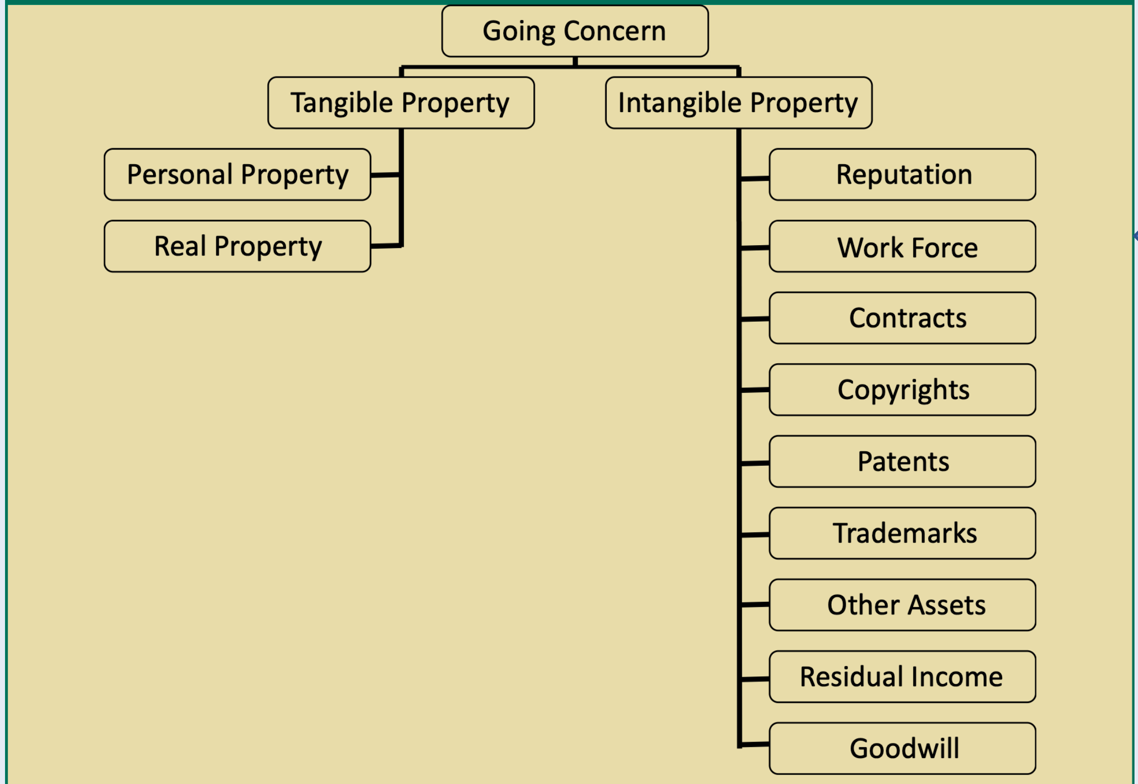


Source: *The Appraisal of Real Estate*, 13th ed. (Chicago: Appraisal Institute, 2008), p. 30.

If travelers stay in hotel because of Marriott's good reputation, it benefits both the Marriott brand <u>and</u> the individual hotel

Lennhoff Takes A Different View of the Total Assets of the Business

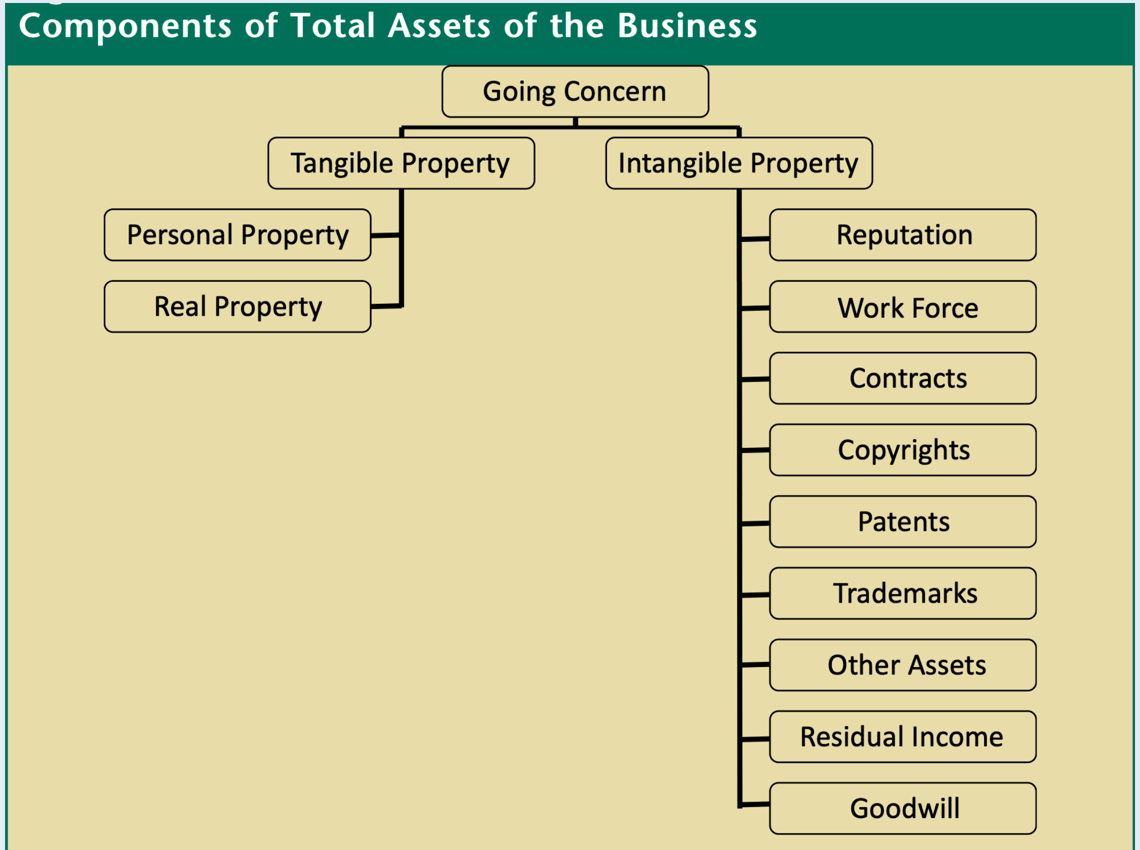
Components of Total Assets of the Business



Source: *The Appraisal of Real Estate*, 13th ed. (Chicago: Appraisal Institute, 2008), p. 30.

The Hotel Co. may manage the workforce, but the wages come from the owner. The presence of the workforce benefits both.

Lennhoff Takes A Different View of the Total Assets of the Business



Source: *The Appraisal of Real Estate*, 13th ed. (Chicago: Appraisal Institute, 2008), p. 30.

Since the property owner receives the net business income, this residual income flows to the property owner.

Lennhoff and the Return Of and On Capital

A Quick Review

- Definitions according to the *Dictionary of Real Estate Appraisal, 6th Edition.*
  - **Return of capital**. The recovery of invested capital through income or reversion or both.
  - **Return on capital**. The additional amount received as compensation (profit or reward) for use of an investor's capital until it is recaptured. The rate of return on capital is the yield rate or the interest rate earned or expected.
- A mortgage provides a good example of the return of and on capital. When a bank loans a borrower capital (money) the loan is paid off in monthly installments, perhaps $1,000 per month. That $1,000 includes both the *return of capital (the principal payment*) and the *return on capital (the interest payment*).

Lennhoff's Central Criticism

- "The problem [with Rushmore's view that the Hotel Co gets all the business value] is it ignores the very reason one buys a franchise: the expectation of receiving back what has been paid for it plus an acceptable return on that amount."
  - D. Lennhoff, "*Separating the Real Property From the Tangible and Intangible Personalty in Appraisals*," THE PRACTICAL REAL ESTATE LAWYER. (*Lennhoff I at p. 10*)
- In Lennhoff's view, franchise agreements are prevalent in the hotel industry, not because they are one-sided deals with all the business income going to the franchisor; but because they are win-win situations.
- That is, the franchisor wins by being paid to manage the business plus a low-cost way expand its network, and <u>the hotel owner wins because its bottom-line improves because of the franchise.</u>

HVS ON THE NECESSITY OF RETURN <u>ON</u> INVESTMENT

- "As illustrated above, budget/economy hotels had a median development cost of $95,000 per room in 2019. … However, as has been the case in previous years, this was the category with the least development activity in our survey, as the **land and construction costs necessary to develop this product are not typically justified by the revenue potential; thus, new construction of economy hotels is often not feasible."**
- **This is another way of saying that developers demand a return of and return on their investment, and if they don't anticipate income sufficient to provide it, they won't invest.**

Á La Oscar, Lennhoff Sees Price and Value as Distinct

- Lennhoff finds the idea that removing a cost removes value to be flawed. (Cost does not necessarily equal value.)
- Lennhoff might ask, if we remove the cost of utilities from the income stream, do we have the value of a hotel without water and electricity?

IAAO Task Force: Rushmore is Right https://www.iaao.org/library/2017_Intangibles_web.pdf

- The IAAO Task Force offers this in defense of Rushmore.
  - “[S]ince the management fee is based on a percentage of revenue, the intangible value that results from the management fee approach rises and falls with the revenue achieved. If a management company succeeds at increasing revenues, the resulting intangible value increases accordingly.”
- There is some truth in that. Because fees are a % of total revenue, when revenue increases, fees and, concomitantly, intangible values, do increase.
- Let’s think about that a little more closely.

Hotel Hypothetical:
Hilton to Hyatt

	Before		After
Total Rooms Revenue	$1,000,000	Total Rooms Revenue	$1,100,000
Franchise and Mgt Fee	10%	Franchise and Mgt Fee	10%
Business Val (Rushmore)	$100,000	Business Val (Rushmore)	$110,000
Other Expenses (80%)	$800,000	Other Expenses (80%)	$800,000
NOI (to owner)	$100,000	NOI (to owner)	$190,000

Rushmore's focus to establish intangible value

Lennhoff's focus to establish intangible value

Hotel Hypothetical:
"Luxury Service at an Economy Price"

Before	
Total Rooms Revenue	$1,000,000
Franchise and Mgt Fee	10%
Business Val (Rushmore)	$100,000
Other Expenses (80%)	$800,000
NOI	$100,000

By providing the hotel services typically found in luxury hotels, we will draw more customers and dramatically improve room revenues for this midscale hotel!

Rushmore: This is the determinant of business (intangible value) to the recipient of the NOI (Owner).

Hotel Hypothetical:
"Luxury Service At An Economy Price"

Before		After	
Total Rooms Revenue	$1,000,000	Total Rooms Revenue	$1,100,000
Franchise and Mgt Fee	10%	Franchise and Mgt Fee	10%
Business Val (Rushmore)	$100,000	Business Val (Rushmore)	$110,000
Other Expenses (80%)	$800,000	Other Expenses (90%)	$990,000
NOI	$100,000	NOI	$0

The PRICE of Management has increased.
The VALUE of Management has decreased.

Does The Price of the Intangibles = the Value of the Intangibles?

- As the IAAO suggests, there is a correlation between fees and revenue. Whether that correlation equates fees to a measurement of intangible value to the person who **pays** the fees is far from clear.
- But now you get to focus on that question from a personal perspective!

GOOD NEWS!
YOU JUST INHERITED A HOTEL!

Your Inheritance

- Your aunt and uncle passed away and left you a 100-room economy hotel. They did a great job managing and maintaining the hotel, but it is not affiliated with any chain.
- The Travelodge hotel chain contacts you about a franchise: they will manage the hotel and operate it under the Travelodge name. You investigate and conclude if you affiliate with them, the hotel’s total income over the next ten years will increase by $1.9 Million.
- You are intrigued – but cautious.

More News

- You inquire about the fees to affiliate with Travelodge. All the fees combined over the next ten years equal $1.9 million. (About right, *see, Rushmore Text*, p. 159)

So, the franchise increases 10-year revenues by $1.9 million.

But the franchise costs are also ($1.9 million)

Net to you $0

- No return on your investment.

Your Telephone Starts to Ring …

- Stockbroker calls. If you invest $190 K/year in S&P 500 rather than hotel, You'll probably have $2.6 million in ten years. (7% per annum return on.)
- Spouse calls. For $190K/year we can get a fabulous vacation home.
- Your lawyer calls. There is no guaranty that you will get that $1.9 million. There is the potential to lose money. (Business risk.)
- So, if the $1.9 million in fees to Travelodge doesn't leave you money ahead, will you incur that expense given
    - Opportunity Costs
    - Return on Investment
    - Risk?

A Better Deal

- Now you get a call from another Hotel Co. They will manage the hotel and operate it under their brand name for $1.9 million. You investigate and conclude if you affiliate with them, the hotel's total income over the next ten years will increase by $2.9 Million.
- In this scenario you are probably going to franchise because you get a $1 million return on your investment. Now the 10-year price of the franchise is $1.9 million, but the 10-year value of the franchise is $2.9 million. You are now one of the hotel owners who have flocked to franchising.
- The franchise's intangible value increased your bottom line more than the the amount of the fees.
- Contrary to the central tenet of the Rushmore view, not all the income attributable to the business has been taken by the managing agent in the form of the management fee.
    - When the real estate does not appreciably change; but the NOI does, the increase is due to intangibles.

If Lennhoff is Right About the Theory, Then How Does One Measure Intangible Values?

- Compare the subject hotel with a comparison group of physically and locationally similar hotels.
- If the Subject has appreciably better net income, the most likely explanation is attributable to the intangible business values.
- Remove the intangible income from the income stream and capitalize it based on an appropriate rate.
- Each of these points requires a subjective judgment. Each invites intense (and extensive) cross exam.
    - But isn’t this true about any number of appraisal judgments? *E.g.*, cap rates, comparability, depreciation, etc.

Round 2: How Do You Remove A Return of and On FF&E?

Hint: This Round is Really About Replacement Reserves

Both Sides Agree That for FF&E You Must Remove a Return Of and a Return On

Rushmore: "Two calculations are needed to remove the personal property value from the income flow—a return of personal property and a return on personal property." S. Rushmore, "Why the 'Rushmore Approach' is a Better Method for Valuing the Real Property Component of a Hotel," Journal of Property Tax Assessment and Administration, Vol. 1, Issue 4. ("*Rushmore*")

Lennhoff: "Removing the tangible personal property [] requires removing both the return 'of' and return 'on' the tangible personalty." D. Lennhoff, "Separating the Real Property From the Tangible and Intangible Personalty in Appraisals," The Practical Real Estate Lawyer. (*Lennhoff I*)

If the removal of <u>tangible</u> personal property requires the removal of both a return of and a return on the tangible property, shouldn't the removal of <u>intangible</u> property also require the removal of both the return of and the return on?

- If not, why not?

Replacement Reserves

- Definition: “Replacement allowance. An allowance that provides for the periodic replacement of building components that wear out more rapidly than the building itself and must be replaced during the building’s economic life; sometimes referred to as *reserves* or *reserves for replacement*.” *Dictionary of Real Estate Appraisal.*
  - *(Same concept for FF&E which wears out much more rapidly than the building itself.)*

- With respect to hotels, the creation of the reserve for replacement is not just an accounting entry, it is a mandatory expense under the franchise agreement. *Rushmore Text*, 169 (Minimum reserve is typically 3% of rooms revenue, but some franchise agreements set the amount at up to 5%.). The Hotel loan documents may also require a reserve for replacement.

AORE on Replacement Reserves for Real Property

Replacement reserves are often used to provide for the periodic replacement of building components that wear out more rapidly than the building itself. AORE 485. *E.g.*, parking lots, roofs, etc.

"Depending on the local practice, the replacement allowance may be reflected explicitly as an expense, or implicitly in the capitalization or discount rate." *Id.*

So at least when we are talking about real property, the orthodoxy is that you remove the replacement allowance from the income stream because it is an expense, or alternatively increase your cap rate.

Why would a reserve for replacement of personal property be treated differently?

Rushmore: Here's How to Remove the Return OF

Rushmore: on the return OF: "Hotel companies and appraisers account for the frequent replacement of FF&E by establishing an expense deduction known as a reserve for replacement. This fund, which reduces the hotel's cash flow in annual installments, is set at the amount necessary to replace all existing FF&E with new FF&E over an assumed useful life**…The Rushmore approach considers the reserve for replacement to be the 'return of FF&E.' "** ***Rushmore*****, p20, (Emphasis added.)**

Rushmore: Here’s How to Remove the Return ON

- **Rushmore: on the return ON FF&E**: Estimate the depreciated value of the FF&E and then multiply it by the overall capitalization rate for the hotel enterprise. This produces the income attributable to the FF&E and when subtracted from the total income, produces the income attributable to real property.
    - Lennhoff differs only in the choice of cap rate, he contends that the cap rate for the hotel enterprise is incorrect, the cap rate for FF&E needs to be increased to account for the higher risks of FF&E.

Rushmore’s Example of Return ON

Assumptions	
Total Net Income	$1,000,000
Capitalization Rate (for Hotel Enterprise)	12.5%
Total Property Value	$8,000,000
Value of FF&E in place	$750,000
Calculate Income attributable to FF&E	
Value of FF&E	$750,000
Capitalization Rate (for Hotel Enterprise)	12.5%
Income attributable to FF&E (The Return on the FF&E)	$93,750
Remove FF&E Income to get Real Property Value	
Net Income for Hotel	$1,000,000
Less Income attributable to FF&E	-$93,750
Net Income without FF&E	$906,250
Capitalization Rate	12.5%
Income Value without FF&E	$7,250,000

Rushmore's Example of Return ON (Alternate)

Assumptions	
Total Net Income	$1,000,000
Capitalization Rate (for Hotel Enterprise)	12.5%
Total Property Value	$8,000,000
Value of FF&E in place	$750,000
Calculate Income attributable to FF&E	
Value of FF&E	$750,000
Capitalization Rate (for Hotel Enterprise)	12.5%
Income attributable to FF&E (The Return on the FF&E)	$93,750
Remove FF&E Income to get Real Property Value	
Net Income for Hotel	$1,000,000
Less Income attributable to FF&E	-$93,750
Net Income without FF&E	$906,250
Capitalization Rate	12.5%
Income Value without FF&E	$7,250,000

Rushmore points out an alternate method that produces the same result. Just deduct the value of the FF&E:

$$\begin{array}{r} 8,000,000 \\ -\ \underline{750,000} \\ 7,250,000 \end{array}$$

This only works if cap rate for FF&E is the same as cap rate for hotel enterprise.

Rushmore's Cap Rate

- Rushmore uses a band of investment to derive his cap rate for the enterprise: a weighted average of the mortgage loan rate for hotel real estate and the equity rate for investment in a hotel enterprise. *Rushmore, Text* 343-353.
- A fundamental rule of capitalization is that the degree of perceived risk is one of the primary determinates of the capitalization rate. Higher risk equals higher rate (and lower value.) But the risk of investing in FF&E with a typical useful life of five to seven years (and virtually no residual value) is substantially different than the risk of investing in an operating hotel with a typical useful life of forty years.

Lennhoff: Here's How to Remove the Return OF and ON

- To provide for a return of and on the FF&E, you must:
  - (1) deduct the value of the FF&E in place by estimating the depreciated value of the FF&E. This provides a return OF the FF&E.
  - *(2)* Then multiply the value of the FF&E by the appropriate cap rate to get a return ON the FF&E.

Lennhoff's Cap Rate

- Directional Guidance is available:
  - Chattel Mortgage rates -- if available -- may be useful
  - Hotel FF&E rates would be higher than hotel mortgage rates;
    - but how much higher?
- "The percentage rate of return on personal property should reflect the cost of capital commonly used to purchase F F & E. Chattel mortgages, which normally bear interest rates ranging from two to five points over real estate mortgages, demonstrate the perceived risk in personal property investments. Unfortunately, chattel financing is somewhat rare and interest rates for these loans are difficult to document. The current interest rates on hotel mortgages probably understate the required F F & E rate of return, but this readily available data establishes a firm benchmark that is difficult to dispute."

Side by Side Comparison

FF&E REMOVAL PROCEDURES	
Rushmore	Lennhoff
	Deduct reserve for replacement. (Because it is a recurring, mandatory expense – this doesn't remove anything)
Deduct reserve for replacement. (Return OF). "The Rushmore approach considers the reserve for replacement to be the 'return of FF&E.' " ***Rushmore*****, p20,**	Deduct value of FF&E in place. (Return OF)
Capitalize estimated value of FF&E at the overall rate for hotel enterprise; alternatively, just deduct value of FF&E in place (Return ON)	Capitalize estimated value of FF&E at a rate appropriate to the risks of that asset class. (Return ON)

Double Counting?

Double Speak?

Rushmore suggests that Lennoff is double counting when he deducts both the replacement reserve and a return on FF&E.

Lennhoff suggests that Rushmore is less than forthright when he says that the deduction of replacement reserve is done to remove the return of FF&E in an <u>real estate</u> appraisal. Because Rushmore also calls for the deduction of replacement reserves when he is appraising the <u>total assets</u> of the hotel business. *Rushmore Text*, 283-295.

Cui Bono?

- The Replacement Reserve is -- as Lennhoff contends -- a mandatory expense, so those dollars will not go the owner's bottom line.
- Lennhoff is also correct when he says that Rushmore regards the replacement reserve as a necessary deduction to remove the return of FF&E when valuing only real estate, yet he also removes the Reserve when he is valuing the total assets of the hotel.
- But who benefits from the replacement reserve? The owner. The reserve goes to (partially?) pay the owner's obligation to pay for FF&E. In that sense, the replacement reserve can be seen as a (partial?) return of FF&E.
  - But how precise is the reserve? Does 3-5% of total rooms revenue actually measure the return of FF&E, or is it just a rule of thumb?

Round 3: Should Franchise Development Costs (Start Up Costs) Be Deducted?

Lennhoff -- Yes; Rushmore -- No

What Type of Development Costs?

Selected Nonrealty Franchise Development Costs

Required Hotel Franchise Item	Approximate Cost	Provider
Initial franchise fee	$200/rm or $60,000, whichever is greater	Franchisor
Property management and reservations systems & in-person training	$163,000-$168,000	Franchisor/equipment suppliers
Other systems/training	$215,500 - $233,500	Franchisor/equipment suppliers
Pre-opening training & services	$82,500 - $102,000	Franchisor
Feasibility study	Up to $50,000	3rd party supplier
Kitchen/laundry equipment	Up to $4,700/room	3rd party supplier
Start-up costs (wages, prepaid expenses, licenses, deposits, etc.)	Up to $4,200/room	Suppliers, franchisee
Pre-opening local advertising	Up to $170,000	Suppliers
3 months operating funds (i.e., working capital)	Up to $4,200/room	Suppliers, franchisee
Furniture & fixtures	Up to $22,000/room	3rd party supplier
Professional interior design services	Up to $9,300/rm	3rd party supplier

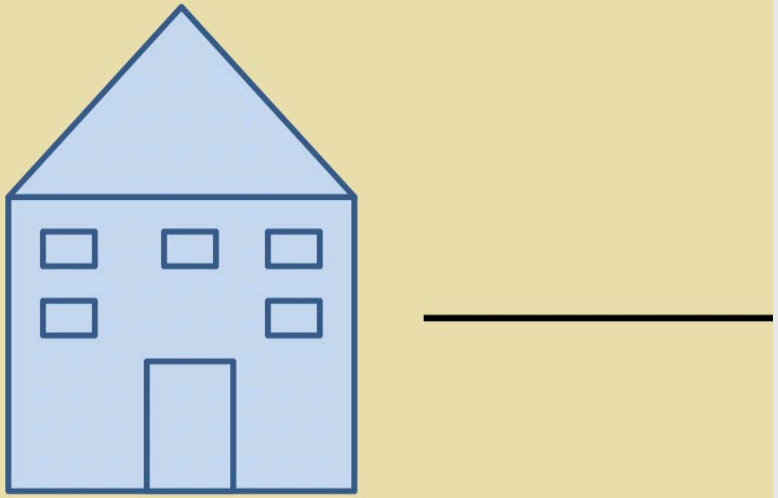
Source: 2010 Renaissance Hotels Franchise Disclosure Document, pp. 46–47.

Lennhoff and Reichardt, *Hotel Valuation Myths and Misconceptions Revisited*

http://www.willamette.com/insights_journal/11/winter_2011_13.pdf

Are These Items Present In a New Hotel?

Day 1 – New Hotel Opens



Hotel includes:
- Land
- Building
- FF&E
- Contracts
- Trained Workforce
- Other Business Components

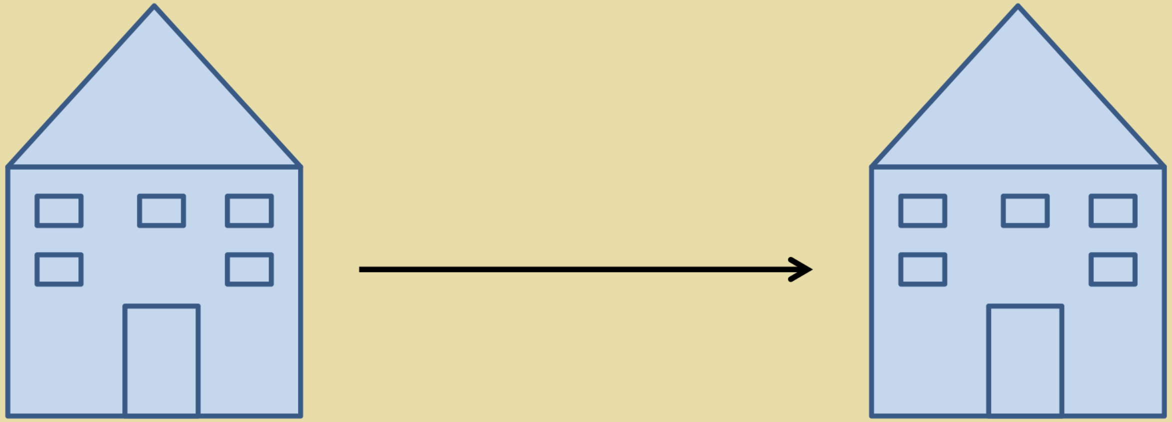
All paid for by developer/ owner prior to opening day

Why Deduct Start-Up Costs From an Older Hotel?

Figure 2
Going Concern Intangible Asset Value
Start-up Costs Component

Day 1 – New Hotel Opens

5 Yrs Later – Same Hotel Sells



Hotel includes:
- Land
- Building
- FF&E
- Contracts
- Trained Workforce
- Other Business Components

All paid for by developer/ owner prior to opening day

Hotel includes:
- Land
- Building
- FF&E
- Contracts
- Trained Workforce
- Other Business Components

All paid for by buyer in the purchase price

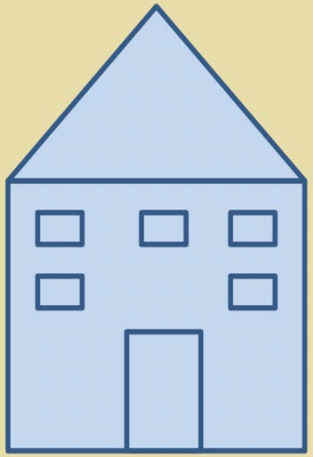
http://www.willamette.com/insights_journal/11/winter_2011_13.pdf

Rushmore on Start-Up Costs

- It may be appropriate to deduct start-up costs for some businesses like shopping malls (!) and offices. This is because those enterprises have long term leases and the benefit of securing a new tenant continues for many years. *Rushmore, 17*.
- Hotels are different: the rooms (tenant occupancy) turn over every few days. Therefore, no enduring benefit from start-up expenses.
- "A hotel's sales, marketing and leasing efforts must be perpetual. Because start-up activities are such an integral part of a hotel's business activities, these expenses are included in the income statement. Recognizing this fact, the Rushmore approach does not make a separate deduction for initial start-up costs." *Id.*

Rushmore: These Expenses are Ongoing Because the Benefits Don't Endure

5 Yrs Later – Same Hotel Sells



Hotel includes:

- Land
- Building
- FF&E
- Contracts
- Trained Workforce
- Other Business Components

All pai... by bu... the p...ase p...ice

Ongoing expenses paid by owner

Ongoing Expenses: Focus on FF&E

- New Hotel – Day 1
- All agree FF&E must be removed from valuation of R.E.
- FF&E has a typical life of 5 -7 years

- 10-Year-Old Hotel
- All the original FF&E is gone.
- Replaced with FF&E purchased over the 10 Years.
- Should this new FF&E be removed from valuation of R.E.? Rushmore says yes.
- Lennhoff says the same principle applies to the other non-realty start up costs.

Punch and Counter-Punch

Lennhoff

- You buy a 5-year-old hotel
- Would you rather have a hotel with a trained workforce in place, or would you rather remain closed for six weeks to hire and train your own?

IAAO Special Committee

- Typically, the management company of a hotel, not the owner, hires the managers and workers. Therefore any value of the assembled workforce belongs to the management company.
  - But the wages come out of the owner's pocket.
  - If the manager dictates the FF&E, does that mean that the value of the FF&E belongs to the manager?

What About Assuming the Presence of Intangible Assets?

- “Intangible assets and rights are not subject to taxation.” *California Assessor’s Manual, 151*
- “Tangible property should nonetheless be assessed and valued by assuming the presence of those intangible assets and rights that are necessary to put the tangible property to beneficial or productive use.” *Id.*

If There are Additional Intangibles to Remove, How Does One Remove Them?

- An example might be workforce in place.
- Step One: Estimate the costs to locate, interview and train employees.
- Step Two: Capitalize those costs at a rate commensurate with the risks of that asset class.
- This highlights one of the difficulties of Lennhoff’s method: where do you find market-based support for the cap rate?
- One response is to refuse to accept the adjustment because of lack of enough credible evidence.
- On the other hand, isn’t some evidence of the proper adjustment better than no evidence of the proper adjustment?

But That's Not How The Market Values Hotels

1. The Rushmore school points out that buyers of hotels don't value hotels the way Lennhoff does, buyers don't allocate values to intangible assets. Instead, buyers capitalize the NOI from the hotel business, much the way Rushmore recommends.
2. This appears to be correct; buyers tend to base their decisions on DCF models, capitalizing the the NOI from the business.
3. But Rushmore agrees that in order to appraise real property, you must remove a return of and on the personal property. As pointed out in 2, that is not what buyers do. Since buyers are capitalizing business income, replicating the methods used by buyers will produce an incorrect answer for the value of real property.
4. Buyers ask, what is the value of a hotel business conducted on this site. That is not the question that assessors are asked to answer.

Why Don’t We Just Ask the Buyers What They Paid for the Intangibles?

1. This is an appealing argument for the Rushmore School.
2. If you asked the buyer of a hotel how much they paid for the work force, or the intangibles, or the FF&E, they would probably say, “huh?”
3. Buyers tend to run a bunch of DCF models using different forecasts and determine what they will pay for the hotel business at the subject location.
4. Buyers want to know what price they can pay for the hotel business; they are not concerned what they pay for the real estate alone.
    1. How much did you pay when you bought your house?
    2. How much did you pay for the land?
    3. How much for the improvements?

OK, Buyers Don't Care What They Paid for the RE, But What About the Lenders?

1. First Rule of Banking: Get as Much Security as You Can!
2. Banks Don't Just Lend on the Real Estate. *Dowell.*
3. *f Banks do view*

- "The use of recognized brand name generally increases a hotel's revenue generating ability and thus adds to the hotel's bottom line, enhancing its value. Yet this portion of the property's value is clearly attributable to the brand name rather than to the property's real estate component, as will be discussed later in this article."

Lesser & Ruben