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DETERMINING THE VALUE OF A HOTEL: THE DEBATE CONTINUES; IS IT THE VALUE OF THE DIRT OR THE BUSINESS ENTERPRISE VALUE?

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PRESENTERS

David C. Lennhoff, Principal

- Designated appraiser
- International Educator
- Widely published Author
- A development team member for most of the Institute's income capitalization courses and was editor of their Capitalization Theory and Techniques Study Guide (3rd ed.). He also was lead developer for the new asset allocation 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.
- A member of RECGA, a national organization of analysts and academicians founded by the late William N. Kinnard, Jr. Ph.D. He is a frequent contributor to the Appraisal Journal.

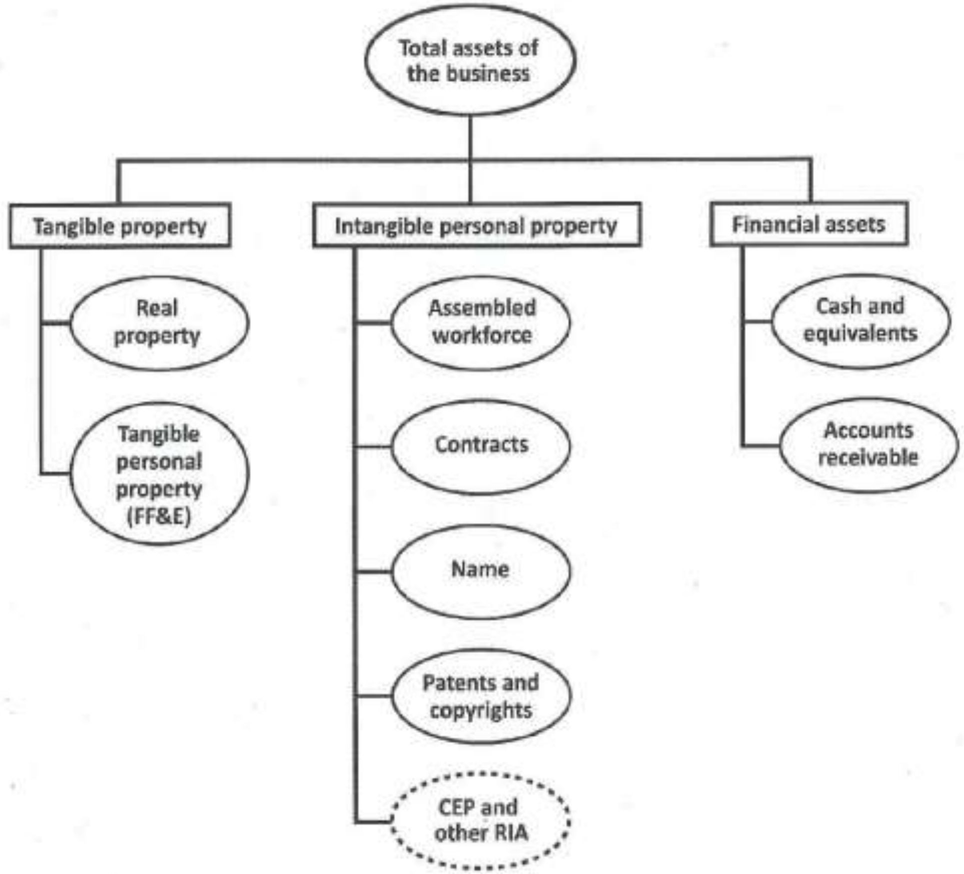
PRESENTERS

- Tom is Managing Director of HVS Property Tax Services in the Boston office
- He has been with HVS Global Hospitality Services since November of 2000.
- Prior to joining HVS, Tom spent over ten years in restaurant and hotel operations.

INTRODUCTION

- Main topic - extracting the non real property elements from hotel going concerns.
- Key to understanding - recognition of principles that underpin value.
- Remember: *Investors purchase assets in anticipation they will receive a return on these assets.*
- Tangible Personal Property: room furnishings, equipment (kitchen/dining, laundry, maintenance, recreation), computers, inventory, etc.
- Intangible Personal Property: franchise, assembled workforce, business name, innovations, etc.

III. Components of a Going Concern or Business



METHODS OF VALUATION

- Three methods of valuation
  1. Cost Approach
  2. Sales Comparison
  3. Income Capitalization

COST APPROACH

- Most straightforward—eliminates the need to address tangible and intangible personalty.
- Major drawbacks—recognition of difference between market value vs. value in use, and reliable measure of accrued depreciation.
- Three recognized methods of depreciation
    1. Age/life
    2. Market extraction (Cost Approach in reverse)
    3. Break down and feasibility rent (Income Approach in reverse)

SALES COMPARISON

- Sales of hotels abundant, but what usually sells is the total assets of the business rather than just the real estate.
- This method can only be used if appraiser has a way of reliably removing the contributions to the price of tangible and intangible assets.
- Sales, however, can serve as illustration of how much subject real property *cannot possibly* be worth.

INCOME CAPITALIZATION

- Most popular method of valuation for hotels.
- Appraiser has more detailed information about Subject property, making it more manageable than Sales Comparison.
- First step - start with income to total assets then remove income attributable to tangible and intangible personalty.

REMOVING TANGIBLE PERSONAL PROPERTY

- Removing return “of” and return “on” tangible personalty.
- Income representing return “of” and “on” - same method you could use to quantify annual debt service for loan.
- Biggest controversy - confusing a replacement allowance with removal of the asset.

REMOVING INTANGIBLES

- Deductions from income stream are necessary to account for return "on" and "of" intangible assets.
- Argument: Real estate cannot be the residual, as only intangibles are residual
- Smith and Parr – "If only tangible assets are subject to property taxation, then the value of the monetary and intangible assets must be extracted as a first step."

ITEM 7: ESTIMATED INITIAL INVESTMENT

YOUR ESTIMATED INITIAL INVESTMENT FOR A NEW BUILD HOTEL*

The following represents the range of initial investment for a 250 room new build Brand Hotel.

Type of Expenditure	Estimated Amount (Note 1)	Method of Payment	When Due	To Whom Payment is to be Made
Application fee	$100,000 (Note 2) for a 250 room hotel	Lump sum	$85,000 plus $15,000 ($300 per guest room in excess of 200 rooms) on making license application*	Licensor
Market Study	$12,000 - $25,000	As agreed	As agreed	Outside suppliers
Real estate (Note 3)	Highly Variable (note 4)	As agreed	As agreed	Outside suppliers
Carrying charges	Highly Variable (note 4)	As agreed	As agreed	Outside suppliers
Site work and building (Note 5)	$37.5 million – $60 million (Note 5)	As agreed	As agreed	Outside suppliers
Signage	$50,000 - $200,000	As agreed	As agreed	Outside suppliers
Furniture, fixtures, equipment (FF&E), Operating Supplies & Equipment (OS&E), and full laundry (to include sufficient inventory needed for opening)	$5.5 million – $10 million (Note 6)	As agreed	As agreed	Outside suppliers
Architecture and design (Note 7)	$600,000 – $1.6 million	As agreed	As agreed	Outside suppliers
Operations Assistant Program (See Item 11)	$23,000 – $26,000	Lump sum	After opening	Providing hotels
General and administrative (Note 8)	$435,000 - $550,000	As agreed	As agreed	Outside suppliers
Telephone and computer system equipment	$250,000 - $450,000	As agreed	As agreed	Outside suppliers
Reservation and System equipment (See Item 11)	$95,000 - $200,000	As agreed	As agreed	Galaxy
Additional Funds (Note 9)	$507,000 - $1,003,000	As agreed	As incurred	Outside suppliers
Total:	**$45,072,000 - $74,154,000 (Note 10) (Excluding Real Estate, Inestimable items & Carrying Charges)**			

* Unless designated by an asterisk in the "When Due" column, none of the costs described in this chart is refundable by Licensor. If designated by an asterisk, some or all of the costs may be refundable based on the terms of your Agreement.

FRANCHISE FEE METHOD

- Suggests the cost of the franchise (annual royalty rate) somehow removes the value of the asset from the income stream.
- Reason for buying a franchise—expectation of receiving a return on investment.
- Smith and Parr – "Franchise value = Present value of cash flows for franchised firm after payment of running royalties and a lump sum initial franchise fee *minus* Present value of cash flows for non-franchised firm."
- California Assessor Handbook, *Advanced Appraisal,* "deduction of management fee from the income stream of a hotel does not recognize or remove the value attributable to the business enterprise that operates the hotel."

EXCESS PROFITS METHOD

- Excellent tool and used extensively by business valuers
- Problem - business valuers use this to identify income attributable to intangibles as residual to removal of income to tangible real and personal property.
- Based on fundamental relationship: Income = Value x Rate
- When rearranged to solve for "excess" to real property, functions very much like residual technique.

PROXY RENT

- Requires supporting a cap rate for each component.
- Also based on fundamental relationship: Income = Value x Rate
- Correct cap rate needed as well as appraiser being able to support a value for the intangible component.

CONCLUSIONS

- All three methods of valuation are acceptable as long as both the return “on” and “of” the value of various non realty assets can be identified, quantified and eliminated.
- Income Capitalization is preferred method
- Smith and Parr – “If only tangible assets are subject to property taxation, then the value of monetary and intangible assets must be extracted as a first step.”