

Hospitality Valuation Yesterday, Today and Tomorrow

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Abstract: Hotels are operating businesses that include real estate, personal property and intangible business value asset components. This article discusses the changes that have occurred in the hotel business in recent decades, and updates hotel literature and court cases regarding the most popular hotel appraisal methodologies. This article also discusses published articles and sources regarding the possible allocation of asset component values among nursing homes and senior housing. Lastly, the article applies those methodologies and component asset returns to support reasonable hotel component asset ratios.

The hotel business has changed significantly over the last fifteen to twenty years, and this is before considering the future effects of COVID-19 on the industry. As businesses begin reopening, we are seeing weakened revenues and very significant declines in many hotel values. Hotels include real estate, personal property and some with significant intangible business value. It is important that appraisers and property owners have an up-to-date understanding and documentation of these values for future acquisitions, for financing and for property tax purposes.

Changes in the Hotel Industry

Changing consumer behaviors and new technology as expected are driving new trends. Among the changes in the hotel industry over the last decade include:

- **The growth of the select-service sector** – Select-service hotels provide occupants many services without having to pay the costs of the full-service hotels. Select-service hotels are a blend of full service and limited service. Select-service hotels are cheaper to construct and more efficient to operate. Some hotel rooms in older full-service hotels are twice as large, when compared to many newer Select-service hotels. Older full-service hotels are having a hard time trying to keep up with newly demanded amenities in the modern select-service hotels.

In 2018, Marriott had the largest pipeline of new hotels being constructed. In 2015, Marriott had 19 brands; by 2020, that number increased to 30. Their brands are classified as Classic (14 brands, with most of the new construction being Select service) and Distinctive (16 brands). Fairfield, Residence Inn and TownPlace Suites represents most of their newly constructed Classic Select service brands. New Distinctive Select service brands include Aloft, Moxy and AC Hotels.

Hilton increased their number of brands from 13 in 2015 to 19 in 2020. Some of the Select hotels under Hilton brands included Hilton Garden Inns, Homewood Suites by Hilton, Tru by Hilton and Hampton by Hilton. These increasing number of hotel brands are attempts to capture more room nights through market segmentation.

- **The typical ownership structure has changed** – As reported in the *Boston Hospitality Review*¹, Marriott Corporation owned and operated their facilities two decades ago, while today many are owned and managed by third parties under franchise agreements. Marriott merged with Starwood to form a company with 30 different brands that can capture demand from a large variety of very different hotel users. Hyatt, Marriott and Hilton, larger operators of hotels, do not actually own much of the hotel real estate today. Many institutional investors and real estate investment trusts (REITs) have acquired hotel assets. As quoted in *seekingalpha.com*², “the operator runs the show, from the booking to the cleaning, while the REIT collects the income and pays a percentage back to the operator.”
- **The hotel room booking business has changed** – Approximately 60% of the hotel bookings are leisure driven, with 40% being business bookings. Fifteen to twenty years ago, many people would pick up the phone and directly call Marriott, Hilton, or other chains, to book their

¹ Oshins, Mike, Boston Hospitality Review, BU School of Hospitality Administration, Spring 2017, <https://www.bu.edu/bhr/2017/06/12/hospitality-change-paradigm-and-perspective/>

² Seekingalpha.com, *REIT Rankings Hotels*, September 28, 2016, <https://seekingalpha.com/article/4008921-reit-rankings-hotels>

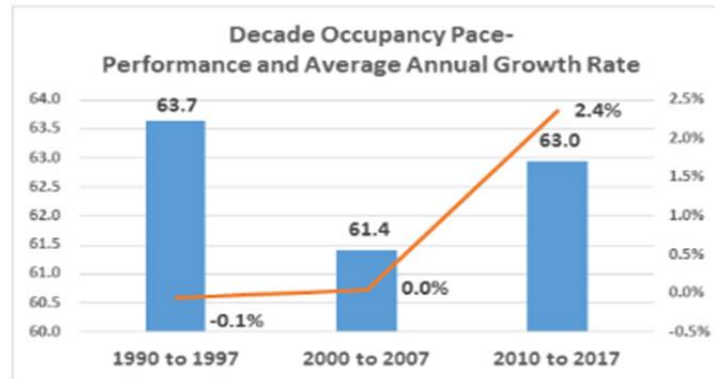
hotel rooms. Today online travel agents (OTAs), such as Expedia and TripAdvisor and Travelocity and Hotwire, offer competitive bookings to certain segments of the hotel business. In order to combat guest's booking there travel arrangements through OTAs, major hotel companies (Marriott, Hilton, IHG) developed very user-friendly phone applications. These apps save on third-party booking costs and drive the hotel companies' loyalty programs. Studies have shown that direct bookings can account for 25% or more of hotel revenues. Most guests have never stayed in the hotel they are booking, on a given night; however, they are very familiar with a brand which can drive their booking decision.

- **COVID-19 Pandemic**– This is potentially a Black Swan event that could have a more devastating impact on the leisure travel industry than any recession in recent decades. According to the *Commercial Property Executive*³, the week ending April 25, 2020, had over a 70% decline in revenue over the same year in 2019: “*Compared to the same period a year prior, hotel occupancy dropped 62.2%, to 26.0 percent nationally. The Average Daily Rate (ADR) – the average income from paid occupied rooms- was down 42.9 percent, to \$73.61, and revenue per available room (RevPAR) declined 78.4 percent.*” Given it will likely take two to three years or longer for the industry to recover to prior revenue levels, the negative impact to property values will be significant.

As reported in *todayshotelier.com*⁴, the following are occupancy and new hotel development trends in the US over the last thirty years:

³ Friedman, Robyn, *Open for Business: Hotels Post-COVID-19*, Commercial Property Executive, May 4, 2020, <https://www.cpexecutive.com/post/open-for-business-hotels-post-covid-19/>

⁴ Kalcevic, Laura, STR, *The Hotel Lodging Cycle*, Todayshotelier.com, <https://www.todayshotelier.com/2018/01/01/the-hotel-lodging-cycle/>



Between 1990 to 2007, the first two, seven-year periods, occupancies declined, while new construction grew. These periods were driven by the availability of financing. From 2010 to 2017, the new supply in hotel rooms began to grow as occupancies began to improve. Collectively since 1987, as reported from this same source, the total supply of hotel rooms in the US increased 72.3% while the demand increased 78.5%.

It is important to understand the lifecycle of hotels and resulting implications to value and component values. The first phase of a typical hotel cycle includes construction and the original brand. This period usually lasts for 15 to 20 years, and it is in line with the original franchise agreement and brand design for the property. Ownership may change during this first phase of the lifecycle. In the second phase, the owners may be seeking to re-segment or maximize the maturity value of the business. During this stage, the hotel brand may require design and finish upgrades to modernize the improvements. This stage may extend another seven to ten years. Hotels in this phase, that are in very good locations and submarkets, have even converted to independent, non-flag operations in order to maximize the cash flow to the property owners. The third phase of the typical cycle of a hotel is a post-maturity stage. In this stage, the hotel may change flags one or more times, or even become an independent hotel without a national flag. The location and local demand/supply factors and consumer preferences will then determine if the property can be retrofitted to continue as a known flag, redeveloped with another hotel, or be converted to an alternative use. Most external-entry motels still in use would identify with this phase three hotel lifecycle.

When the implications of COVID-19 are understood, the changes witnessed over the last fifteen years may pale at the changes over the next 15 years in this industry. Given that hotel REITs had high standard stock price deviations before COVID-19, they may move out of these volatile hotel assets. The ownership structures may again change in the next ten years. In hotel market downturns in the past, hotel operators like Marriott have re-acquired real estate assets to then resell them again in hotel markets that were less volatile. The operators will have to re-stabilize hotel businesses before an investment market can once again be established for hotel businesses.

Previous Hotel Valuation Literature

Since the 1980's, there have been references to the existence of business value in hotels, and many have discussed ways to try and identify or quantify the business value. There was *Hotel Investment Analysis: In Search of Business Value* by Bernice Dowell in 1997, and *Hotel Valuation: Splitting the Hospitality Business From the Real Estate Assets* by Peter Gloodt in 1998. There was *Business Value Allocation in Lodging Valuation* by Eric Belfrage in 2001 and *Hotel Asset Allocation: Separating the Tangible Personalty* by Heather Reichardt and David Lennhoff in 2003. All of the above hotel valuation articles were republished in *A Business Enterprise Value Anthology*⁵ by David Lennhoff in 2000, with ten hotel-specific valuation articles, with each of those articles initially published from 1984 to 1998. In 2011, Mr. Lennhoff and the Appraisal Institute published a second addition of this anthology, with nine hotel-specific valuation articles dating from 2004 to 2009.

There was an article from *The Appraisal Journal*⁶ titled *New Option in Hotel Appraisals: Quantifying the Revenue Enhancement Value of Hotel Brands* by Scruggs Love, Bruce Walker and Douglas Sutton. According to that article, “*the portion of the income attributable to the brand is clearly proven here to not be either real estate or*

⁵ Lennhoff, David, *A Business Enterprise Value Anthology*, Appraisal Institute, 2001, ISBN 0-922154-63-5.

⁶ Love, Scruggs, Walker, Bruce, Sutton, Douglas, *New Option in Hotel Appraisals: Quantifying the Revenue Enhancement Value of Hotel Brands*, *The Appraisal Journal*, Appraisal Institute, Summer 2012, Pages 223-234.

tangible personal property; it is attributable to the intangible business component.” Hotel literature is very clear on the business-value issue.

As noted previously, a lot is changing in the hotel business over the last fifteen years. If you search the web for new hotel valuation articles, many of the links that pop up are public relations (PR) type articles from firms in the industry or automatic valuation models (ATMs). Clearly there is business value in hotels, though the argument is still open as to how to best quantify or separate the business value from the real estate value.

Methodologies and Previous Court Cases

The two primary methods of estimating real estate value in hotels is the Income Approach and the Cost Approach. Documentation of real estate value from a Sales Comparison Approach is difficult because many of the market participants often did not fully disclose the transactional details [Recently however, some buyers have begun engaging appraisers to clearly allocate asset values, to guard against paying too high real estate recording costs and for prospective property tax considerations]. The Income Approach is a residual method that begins with total going concern value and deducts personal property and intangible business value component values. An Income Approach is the most common, and sometimes sole, valuation method employed by some assessors and many appraisers.

The Cost Approach is always a direct and clean valuation method for the real estate of hotels, as it is for hospitals and senior housing and other property types with business value components. This is a direct method that starts with land and current depreciated replacement costs, without including components of personal property and business value. This approach assumes good documentation of land and replacement costs. *If there is a significant difference between real estate value conclusions using the Income and Cost approaches, then this is a sign that documentation for the Cost Approach is faulty or there is still business value in the residual Income Approach real estate conclusion.*

The two most often cited income approach methods in hotel valuations are the Management Fee Approach and the BEV (Business Enterprise Value) Approach. The Management Fee Approach, also regularly referred to as the

Rushmore Method, makes the assumption that if you deduct a value associated with the management fee, then you will be removing the business value. As described in the Appraisal Institute's class *Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets*⁷, this method begins with the total hotel business value and deducts an estimate of business value and an estimate of personal property value, with the remaining value assumed to be real estate value. The Rushmore or Management Fee Method and the BEV Method both begin with similar methodologies. Both make deductions for management and franchise fees as well as FF&E reserves.

The BEV Approach then makes some other deductions. For example, there is a deduction for a personal property (or FF&E) return. Other deductions may also include business start-up costs, working capital and benefits associated with the affiliated brand, workforce, etc., that the Rushmore or Management Fee Approach argues that have already been deducted. The resulting residual real estate value from the BEV Approach is often significantly below the Rushmore or Management Fee Method real estate conclusion.

Courts have had their say so on hotel valuation methodologies relating to property taxes. The Rushmore Approach (or Management Fee Method) and the Business Enterprise Value (BEV) are two major methodologies that have received a lot of attention in hotel tax appeal court cases. In 1999, the New Jersey Tax Court ruled in favor of the Rushmore or Management Fee Method, and against the BEV Method prepared by David Lennhoff⁸. The ruling in this case stated *"it should not be understood as a definitive pronouncement on appraisal practices designed to extract real estate value from the assets of a business..."* The Rushmore or Management Fee Method won the day, but the court did not pass judgement on why one method is better than another. Both of these approaches are residual real estate approaches, in that they begin with the total business value and start deducting items to exclude before reaching a real estate value estimate. In the Saddle Brook Marriott case, the BEV method estimated the

⁷ Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets, Appraisal Institute, Part 10-165.

⁸ *Chesapeake Hotel, LP, Plaintiff, v. Saddle Brook Township, Defendant, Saddle Brook Township, Plaintiff, v. Chesapeake Hotel LP, Defendant*. Decided October 26, 2005, <http://caselaw.findlaw.com/nj-tax-court/1051630.html>.

residual real estate value at 36% of the value of the total business going concern. This may have been a contributing reason that the court sided with the Rushmore or Management Fee Method in this case. However, the judicial case ruling failed to mention that the hotel improvements were 30 years old with significant renovations needed. The hotel had a good business value but old and depreciated bricks and sticks. Perhaps the judge believed the residual real estate value may have been lower than reasonable percent of total value.

The Rushmore or Management Fee Method has become a commonly-used tool for counties estimating assessment value in hotels, in large part because lower courts or appeal boards assume the taxpayer has the burden of proving assessments are not correct. Then there were cases where jurisdictions ruled against the Rushmore or Management Fee Method. The Half Moon Bay Ritz Carleton and County of San Mateo court case in 2014⁹ (court of appeals), ruled and documented that the Rushmore or Management Fee Method did not remove all of the income associated with the business enterprise. San Mateo County stated in that case *“the intangible value was removed by deducting the management and franchise fee, although an expert for the County’s expert conceded the Assessor’s approach did not remove all intangible assets and rights.”* In the Ritz Carlton case, the California appeals court in 2014 ruled that the Rushmore or Management Fee Method was not correct, and that there was intangible business value not properly removed to get to real estate value.

In another case in California, the state Superior Court ruled [in EHP Glendale, LLC, V. County of Los Angeles¹⁰, that the *“appraisal technique [used by the Assessor and adopted by the Board, or the Rushmore or Management Fee Method] was “clearly impermissible under California law.”*

In a very recent case, the District Court of Appeals (DCA) of the State of Florida, Fifth District¹¹, ruled in June 2020 that The Rushmore or Management

⁹ *SHC Half Moon Bay, Plaintiff and Appellant v. County of San Mateo, Defendant and Respondent*, Filed May 22, 2014, <https://cases.justia.com/california/court-of-appeal/2014-a137218.pdf?ts=1400792516>

¹⁰ *EHP Glendale dt al., Plaintiffs and Appellants, v. County of Los Angeles, Defendant and Appellant*, Filed February 7, 2011, <https://cases.justia.com/california/court-of-appeal-2nd-appellate-district/B217036.PDF?ts=1462303508>

¹¹ Rick Singh, As Property Appraiser, Appellant/Cross-Appellants, Walt Disney Parks and Resorts US, Inc., Scott Randolph, As Tax Collector, Reedy Creek Improvement District, A Political Subdivision of the State of Florida, and Leon Biegalski, ET AL, Appellees/Cross-Appellants,

Fee Method is an illegal method under Florida law because it fails to remove all intangible business income before estimating real estate value. The appeals court did not rule in favor of Walt Disney Parks and Resorts US, Inc., in that case dating back to 2015, but it sent the case back to local property appraiser to reassess the value of the real estate again. The Rushmore or Management Fee Method has been used by assessors on hundreds of Florida cases, as well as throughout the country for many years. The implication from this initial ruling was that this method will have to be changed or not used in the future in Florida. On August 7, 2020, a revised *Rush* court opinion ¹² was issued by the 5th DCA stating that the local jurisdiction “incorrectly applied the hotel appraisal method”, but did not make the method itself illegal for use in Florida as the earlier ruling had implied.

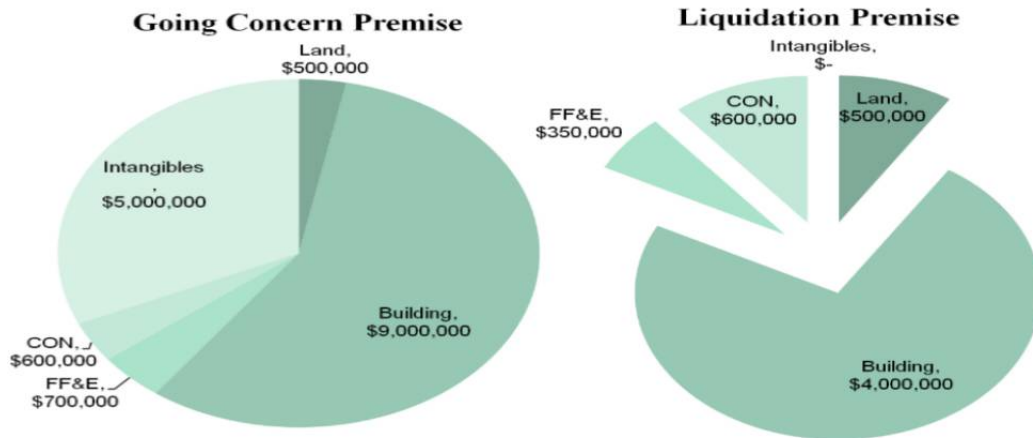
There are other modified valuation approaches that have found common grounds with the Rushmore/Management Fee and BEV hotel valuation methods, and that are more favorable among other jurisdictions to remove business value for property tax cases. For prime market hotels with high food and beverage businesses, a modified BEV and proxy rent method can be straight-forward and acceptable to both parties to clearly remove business cash flow associated with the food and beverage, which is unrelated to the real estate bricks and sticks. Whatever the valuation method, it is clear that certain state laws and jurisdictions will continue to favor the use of certain methods over other methods.

https://www.5dca.org/content/download/638103/7254554/file/182927_DC13_06192020_08263_0_i.pdf

¹² <https://www.orlandosentinel.com/news/os-ne-disney-hotel-property-tax-ruling-20200807-2lnc7b2rajbq5kiuvdmcadmiwa-story.html>

Possible Allocations of Component Assets for Hotels

Hotels are like nursing homes and hospitals, in that they all have intangible value, with regular need to quantify non-real estate assets. The following is an example of a nursing home allocation taken from an Appraisal Institute forum given at the annual Appraisal Institute Conference in 2011¹³:



Source of Graphs and Numbers: *Appraisal Institute Going Concern Forum: Valuation Issues in Appraising Realty and Non-Realty Components, Las Vegas, 2011, Page 70.*

Going Concern Premise			Liquidation Premise		
	Asset Values	% of Total		Asset Values	% of Total
Land Value	\$500,000	3.2%	Land Value	\$500,000	9.2%
Buildings Value	\$9,000,000	57.0%	Buildings Value	\$4,000,000	73.4%
FF&E Value	\$700,000	4.4%	FF&E Value	\$350,000	6.4%
CON Value	\$600,000	3.8%	CON Value (a)	\$600,000	11.0%
Intangibles	\$5,000,000	31.6%	Intangibles	\$0	0.0%
Total Transaction Assets	\$15,800,000	100.0%	Total Transaction Assets	\$5,450,000	100.0%

(a) Apparently assumes CON could be moved to another location.

According to *this* example from the Appraisal Institute forum, the value of the real estate for a profitable nursing home going concern is approximately 60% of the total value, with a personal property and intangible value of approximately

¹³ *Going Concern Presentation 8-17-2011, Valuation Issues in Appraising Realty and Non-Realty Components, Appraisal Institute, Page 77.*

40%. Also, in this example, the value of the intangibles would be zero in a liquidation scenario.

The following is an asset allocation table for various types of senior housing properties, as reported in the published article in 2011 by the *National Investment Center (NIC)*:¹⁴

Table 5

Allocation of Going Concern to Real Estate			
	ILFs	ALFs	Nursing Homes
1999 Mullen's Article	73.50%	53.10%	36.70%
2011 Cost Approach Method	57.36%	53.88%	25.13%
Age	15	16	32
Range based on Age of Facility	35% - 70%	30% - 65%	20% - 55%
Age Range for all Facilities	5 to 35 Years		

Hotels are clearly different from hospitals or senior housing, but in all of these properties there are clearly revenues associated with services provided that are unrelated to the real estate values.

The ratio of real estate to total value in a hotel can be impacted by a number of factors. A new hotel will have a lower business value, particularly if it is a limited service hotel. A mature hotel with higher food and beverage business will have a higher business value component, which is logical because the improvements have been depreciating. As shown in the following table, appraisers should be able to look to market component returns to support hotel component asset allocations:

¹⁴ Beazley, Trey, Sparks, Steven, Bates, Michael, *Valuation of Real Estate Within Senior Housing Facilities*, Senior Housing & Care Journal, National Investment Center, 2011, Pages 23-33.

Hotel Ratio Analysis 1 - 60% Real Estate Value						
	Footnote Source	Overall Component Returns	Times	% of Asset to Total	Equals	Weighted Component Returns
Land Value	1	5.0%	X	5.0%	=	0.250%
Improvement Value	2	7.5%	X	55.0%	=	4.125%
Combined Real Estate Value				60.0%		
Personal Property Value	3	10.0%	X	5.0%	=	0.500%
Intangible / Business Value	4	14.0%	X	35.0%	=	4.900%
Weighted Average Hotel Returns				100.0%	=	9.8%
Indicated MVTAB OAR Range for Hotel with Higher Business Component						9.5% to 10.5%
¹ Returns on ground rent comparables ² Sinking Fund Factor replacing Building @ 6% over 40 years. ³ Sinking Fund Factor replacing Personal Property @ 10% over 10 Years ⁴ Cost of Equity						
Hotel Ratio Analysis 2- 80% Real Estate Value						
	Footnote Source	Overall Component Returns	Times	% of Asset to Total	Equals	Weighted Component Returns
Land Value	1	5.0%	X	5.0%	=	0.250%
Improvement Value	2	7.5%	X	75.0%	=	5.625%
Combined Real Estate Value				80.0%		
Personal Property Value	3	10.0%	X	10.0%	=	1.000%
Intangible / Business Value		14.0%	X	10.0%	=	1.400%
Weighted Average Hotel Returns				100.0%	=	8.3%
Indicated MVTAB OAR Range for Newer Operating Developments						7.5% to 8.5%

In general, the recent acquisition market supports hotel cap rates as low as 6% for newer facilities in good locations to 10% or higher for older hotels. [Note: the authors anticipate market cap rates to rise due to COVID-19 and higher current risks]. **Based on this analysis, hotel real estate value should comprise from 50% to 85% of the total going concern purchase prices.** There are some hotels with food and beverage and other business revenues that exceed room revenues; in these cases, the ratio of business to total value could be over 50%, meaning the tangible land, improvements and personal property combined could be lower than 50% of the total price.

Summary Conclusions

The majority of current and previous hotel valuation literature agrees to the presence of real estate, personal property and intangible business value component in hotels.

A few appraisers still *falsely* conclude no intangible business value in their conclusions [Note: It is common practice for some hotel appraisers to value the going concern, using all business revenues and hotel business sale cap rates, and to *not* provide separate concluded real estate value (aside from providing an insurable value for insurance purposes)]. This has likely occurred due to lending or former REIT accounting considerations. More hotel buyers are beginning to allocate a business value component internally, or externally in formal recordings, for future property tax purposes.

The hotel and senior housing literature detailed in this article reflects business value in all hotels. If the highest and best use is to continue as an operating hotel business, then there is a component of business value. It is up to the appraiser to provide documentation to support those component valuations. Slightly differing methods should come to a similar range of real estate value conclusions, if the documentation is clear and well explained. **The hotel appraisal industry should apply similar valuation methodologies whether the appraisal is for acquisition, for financing or for property tax purposes.**

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