

Valuation of Hotels and Motels for Ad Valorem Taxation

PURPOSE

Provide procedures to assist county assessors in the valuation of hotels and motels for ad valorem taxation,

Encourage inter-county communication and sharing of information on hotels and motels,

Promote statewide property tax equalization through the use of similar methodology.

TERMS AND DEFINITIONS

AVERAGE DAILY RATE: Total guestroom revenue for a given period divided by the total number of occupied rooms. It should be noted that the overall average daily rate per occupied room does not include any occupancy derived from complimentary rooms.

PERCENTAGE OF OCCUPANCY: The percentage of available rooms occupied for a given period. This is computed by dividing the number of rooms occupied for a period by the number of rooms available for the same period.

FRANCHISING: An agreement between a hotel/motel company (usually between a national or regional chain) and an independent hostelry owner whereby, for a fee, the owner is allowed to use the name, trademarks and various services offered by the chain.

HOTEL CHAIN: Any group of three or more hotels, motels, or resorts operated under a common name or by a single owner or operator.

MANAGEMENT CONTRACT: An agreement between a management company and a property owner whereby the management company assumes complete responsibility for managing the hostelry. For this service the operator is paid a fee based on a prescribed formula.

ROOM NIGHT: One room occupied for one night.

MOTEL: A building or group of buildings located on or near a highway and designed to serve the needs of travelers by offering lodging and parking and may also provide other services and amenities, e.g., telephones, food and beverages, meeting and banquet rooms, recreational areas, swimming pools, shops.

HOTEL: A facility that offers lodging accommodations and a wide range of other services, e.g., restaurants, convention facilities, meeting rooms, recreational facilities, and commercial shops.

RESORT HOTEL: A hotel, typically situated in a scenic area, that either provides or is near activities that attract leisure travelers, e.g., swimming, tennis, golf, boating, skiing, ice skating, riding, hiking, or sightseeing. Resort hotels generally offer restaurants, lounge, and entertainment outlets; a fitness center; concierge and valet services; and a limited amount of meeting and banquet space. Seasonality often affects the level of occupancy.

BUDGET HOTEL: A motel that can offer substantially lower rates due to high volume, lower initial investment costs, (land acquisition and construction costs) and efficient operations.

TRANSIENT HOTEL: A hotel catering primarily to business and convention guests, usually located in a metropolitan area.

ALL-SUITE HOTEL: A hotel in which space that could be allocated to meeting, banquet, restaurant and lounge facilities is instead allocated to guest suites that include separate living and sleeping areas. Most all-suite hotels offer free breakfast and an evening cocktail hour. With only limited food and beverage facilities, all-suite hotels are usually easier to operate and typically have higher profit margins.

EXTENDED STAY HOTEL: A hotel designed for travelers who must stay in an area for a prolonged period, typically five or more days; differs from a standard hotel in that rooms and amenities have a more residential atmosphere. Guestrooms have large living areas and full, eat-in kitchens; some have two separate sleeping areas, individual dining rooms, and separate baths. The exterior of an extended-stay hotel is similar to that of an apartment complex with recreational facilities and even barbecue grills. Since extended-stay travelers stay over the weekend, these hotels do not suffer normal weekend declines in occupancy. Because they offer limited food and beverage service, extended-stay hotels are usually easy to operate and have higher profit margins.

HOTEL/MOTEL UNIT: The smallest accommodations that can be sold to a patron; must contain a full bath, sleeping accommodations, and an entrance door with a key.

HOSTEL: A facility that provides lodging, generally for the budget conscious travelers. The rooms may have a private bathroom or a shared bathroom.

RACK RATE: An undiscounted room rate generally given to anyone who does not qualify or ask for a special discount rate. The term is derived from the brochure rack at the front desk, which contains information about each room's rate, including the highest rate that can be charged for that particular accommodation. When a hotel is expected to be full during a certain period or a guest arrives without a reservation, the rack rate is generally the only rate available. The average room rate, for a given period, is always less than the rack rate for the same period.

PUBLISHED RATE: The rate listed in directories and other publications. This rate is usually quoted as a range (i.e., single: \$70-\$100) and represents the various rack rates for specific types of accommodations.

COMMERCIAL RATE: A discounted room rate available to certain commercial travelers. Some commercial hotels will charge any commercial traveler a commercial rate upon request, while others offer it only to established accounts. Commercial rates are always below rack and published rates.

REAL ESTATE INVESTMENT TRUST (REIT): A corporation or trust that combines the capital of many investors to acquire or provide financing for all forms of real estate. Its shares are freely traded, often on a major stock exchange. To qualify for the favorable tax treatment currently accorded such trusts, 95% of the taxable income of a REIT must be distributed among its shareholders, who must number at least 100 investors; no fewer than five investors can own more than 50% of the value of the REIT. The Federal Securities and Exchange Commission stipulates that REITs with over 300 investors have to make their financial statements public.

LIMITED SERVICE: A hotel or motel that is primarily a "rooms only" operation, offering either no or limited food and beverage, conference rooms, recreation rooms or other amenities.

FULL SERVICE: A hotel that offers a full range of amenities such as, food and beverage operations, conference rooms retail space, recreational facilities business centers, room service, etc.

GENERAL INFORMATION

In performing hotel-motel valuations and feasibility studies, appraisers are primarily interested in the micro, rather than the macro, aspect of demand. Micro demand for transient accommodations refers to the competitive demand within a limited geographic area such as a town, city or county. Macro demand is much broader in scope and takes into account national and international travel patterns. Macro demand usually only receives limited attention in most appraisals, but it is an important consideration because it often foreshadows changes in travel trends for micro areas.

In preparing a hotel market study and appraisal, accurate quantification of micro demand are needed. The unit of measurement commonly employed is the room night.

A room night is defined as one room occupied by one or more persons for one night.

For example, a business traveler who stays at a motel for three nights accounts for three room nights. A family that uses one room for three nights also generates three room nights. If the family had occupied two rooms during their three-night stay, the demand generated would have been six room nights.

CLASSIFICATION OF LODGING FACILITIES

Hotels and motels are designed and located to attract one or more specific market segments. Because hotels differ in their design, physical facilities, amenities, and locations, all of which directly impact financial operating results, it is important to define and accurately classify the different characteristics of lodging facilities. This establishes tiers of comparability necessary to produce uniform values. Hotels and motels can be classified using three categories:

1. Types of facilities offered
2. Class or quality of facilities and services
3. Location

Types of Facilities Offered

The type of facility refers to the physical hotel property as well as the amenities and services offered to guests. The types of lodging facilities commonly found in the United States include:

Commercial Hotels

Caters primarily to travelers who are conducting business within the area around the hotel.

Usually located around offices, industrial properties, restaurants, and entertainment outlets.

Amenities usually included restaurant, lounge, recreational facilities (swimming pool, fitness center etc.) meeting, and conference rooms and shops.

Services offered may include room service, secretarial support, computer terminals, photocopy and fax services, valet service, airport pickup and car rentals.

Typically experience high occupancy rates Monday through Thursday night with a significant drop-off on Friday, Saturday, and Sunday.

Convention Hotels

Designed to accommodate large groups and functions.

Have large meeting and conference rooms, exhibit space for trade shows, and extensive restaurant and lounge capacity.

The key component is meeting space.

Convention hotels experience occupancy trends that are generally strong Monday through Thursday nights and drop off on weekends.

Resort Hotels

Oriented toward the leisure traveler and are located near activities such as swimming, tennis, golf, skiing, sightseeing and other recreational amusements.

Offer a limited amount of meeting or banquet space.

Often influenced by seasonality.

All Suite Hotels

Have guestrooms that include both a sleeping area and a separate living area in a single unit.

The living room usually contains a couch that converts to a bed, armchairs, coffee table, an eating table, and a television. Most offer a kitchen with at least a micro wave-oven and small refrigerator.

The economics of the all-suite concept are based on eliminating or reducing a significant portion of the hotel's public space (restaurant, lounge, lobby area) and transferring this space to the guestrooms.

All-suite hotels primarily cater to the commercial and leisure travelers who do not have a need for a large amount of public space.

The services and amenities of all-suite hotels are comparable to commercial hotels, although they may be downsized.

Extended Stay Hotels

This facility is a cross between an apartment complex and an all-suite hotel.

The guestrooms are typically larger than the rooms in a standard all-suite hotel and contain more living space.

The guest units are designed to accommodate stays of more than five days, therefore they are equipped with larger kitchens containing full sized refrigerators, stoves with ovens, microwaves, and dishwashers. They also include cooking equipment, dishes and eating utensils.

The exterior of the property generally resembles an apartment complex.

Budget Motels

These were introduced in the late 1980s. Budget hotels are a low-end hotel based on the idea that much of the floor area in a typical hotel room is unnecessary and can be eliminated.

A budget hotel room usually includes a queen size bed, dresser, nightstand, desk and full bath with combination tub and shower.

Microtel hotels typically offer limited amenities.

Conference Center Hotels

These are unique hotel products designed specifically to accommodate small groups and meetings.

Attempt to create an ideal environment for productive, successful meetings.

They offer high tech meeting space with the latest audiovisual and computer equipment.

Casino Hotels

Casino hotels combine a transient hotel with a full casino facility.

The guestrooms are an amenity to the casino and the rooms, restaurants, and lounges are designed to keep or attract the guest to the casino.

Casino hotels seek to attract leisure travelers who enjoy gambling.

Health Spa

Health spa resorts cater almost exclusively to one market segment - the health conscious leisure traveler.

These facilities generally offer an all-inclusive program that includes accommodations, meals, a medical check-up, individually designed related activities, usually an exercise program, and various types of counseling.

Guest normally stay for three days to two weeks.

These facilities typically include fitness equipment, exercise rooms, and other health related amenities.

Health spas require highly specialized marketing and operating expertise, particularly in the area of exercise, fitness, and health management.

Class or Quality of Facilities and Service

The class of a lodging facility is a way of describing the quality of the property and the level of service provided by the staff. Generally class is reflected in a hotel's ability to achieve a particular room rate.

The class of a hotel relates to its particular market area. The facilities and level of service that might be considered first-class in Leadville, may not get such a rating in Aspen.

The lodging industry in the United States does not recognize a uniform system of hotel classes.

Hotel chains try to market their properties to a particular class of traveler. Budget hotels cater to the very rate-sensitive traveler while the Westin attracts an upper-end, luxury-oriented clientele. Most chains attempt to create and maintain a specific image with respect to their class of facilities and service.

Location

The third way to classify lodging facilities is based on location. A property's location affects many factors including the market segments served, the types of facilities and services required, and occupancy cycles.

Hotel locations may be classified as airport, highway, center city, suburban, convention center, and resort.

Airport Hotels

Situated near a commercial airport and serve out of town visitors.

Attract those who use the airport, including airline passengers and crews.

Designed to accommodate small and medium sized meetings.

Usually provide passenger pick-up and delivery in a hotel car, van, or shuttle service.

Generally experience fairly stable year-round occupancy patterns.

Highway Hotels

Located near a major travel route with high visibility and easy access.

Generally attract individual commercial and leisure travelers.

Usually have small meeting rooms.

Either have their own restaurant or are located near a food service facility that serves three meals a day.

The success of a highway hotel depends on auto travel. This is part of the risk inherent in highway hotels as auto travel can easily be influenced by shortage of fuel or changes in highway traffic patterns brought about by new roads, highways, and interchanges.

Center City Hotel

Located in an urban downtown area.

Attracts commercial and leisure travelers, as well as meeting and convention markets.

Center city hotels usually have hi-rise construction and are more expensive to operate than their suburban counterparts.

Characteristics are adequate parking, strong security, quiet rooms away from the street noise, and room service.

Suburban Hotel

Located in commercial areas with a concentration of offices, retail, and industrial businesses.

These properties cater to individual travelers, meeting and convention demand, and some leisure business.

Many are constructed as mid-rise buildings and provide a full range of amenities, including restaurants, lounges, meeting and banquet rooms, swimming pools, health and fitness clubs, and tennis courts.

Parking is generally free and readily available.

Convention Center Hotel

These hotels generally capture a large portion of the room nights generated by a convention center.

The hotel may actually be attached to the convention center.

Resort Hotels

Often offer one or more special recreation attraction such as skiing, boating, scenic beauty, or a historic experience.

Also attract leisure-oriented meeting and convention demand, but most are not frequented by commercial travelers. Immediate site access and visibility are often unimportant and can actually be detrimental to a resort location.

Other factors that can affect the desirability of resort locations are: climate (especially adverse periods such as hurricane season in the Caribbean), perceived safety and guest comfort, political stability, and distance and travel time from the point of origination to the resort destination.

HOTEL CHAINS Vs INDEPENDENTS

A chain is defined as any group of three or more hotels, motels or resorts operated under a common name or by a single owner or operator.

Generally a hotel chain is equated with a recognizable name such as Marriott, Holiday Inn, or Howard Johnson rather than an independent hotel with no brand name affiliation.

Over the past 20 years, the chain affiliation has become increasingly prevalent in the hotel industry. In 1970 approximately 35% of all United States hotels had chain affiliations, by 1990 the market share had increased to 68%.

Trade names are used by individual lodging facilities in one of three ways.

First, a hotel may actually be owned by the hotel chain. For example, all Red Roof Inns and Motel 6 hotels are owned by the chain; they do not franchise or operate under management contracts.

Second, a hotel may be owned by an independent owner who uses the trade name under a franchise arrangement with the hotel chain.

Third, a hotel may be owned by an independent owner and managed by the hotel chain, which provides management service and the trade name identification.

Most hotels in the United States are operated under a franchise arrangement. Some may use a chain's management service, but very few hotels are actually owned by the lodging chain. Since chain affiliations can have a direct impact on a hotel's value, appraisers should be familiar with hotel franchising and management contracts.

FRANCHISING

A franchise is an agreement between a hotel-motel company, usually a national or regional chain, and an independent hostelry owner in which the owner pays a fee to use the name, trademark, and various services offered by the chain. One of the more important services received is the national reservation service, which typically accounts for 20% - 30% of a hotel's reservations.

Hotel motel chains dominate the supply of transient accommodations. The number of nonaffiliated hotels and motels has been declining.

The major problem facing most independent hostelries is the lack of identity. Travelers usually prefer a known product. When valuing an independent hotel or motel, the appraiser should be aware of the risk factors involved. The market may reflect either a lower stabilized net income or a higher capitalization rate for an independent hotel property.

A franchise creates certain benefits and costs for both the owner and the chain.

Benefits to the Owner of a Franchise

Instant identity, recognition, and image

Every chain has its own image, which indicates its price level and market.

Reservation or referral service

Most franchises have some type of central reservation system that enables guests to reserve a room by calling a toll-free number. A good reservation system generates approximately 15% to 30% of a property's occupancy.

Chain advertising and sales

All major franchises publish a directory in which each property is briefly described and location and rate information are provided. The extent of media advertising and actual sales solicitation varies from chain to chain.

Procedures manual

Chains urge all their properties to follow standardized systems and procedures. Operating manuals are provided and each affiliated facility is inspected periodically to ensure that policies are being observed. Some chains have training schools to instruct management on basic operational techniques.

Management assistance

Most chains can provide franchises with specialized assistance in the various aspects of hotel-motel development and management such as planning, operations, and marketing. These services are not always covered in the normal franchising fees and are contracted for separately.

Costs to Owners of a Franchise

Required facilities

Most chains require that an affiliated property have a minimum number of rooms and a food outlet on the premise or next door. Approximately three-quarters of the nation's chains also require a swimming pool.

Membership fees

Franchise chains require an initial fee, which is generally determined by the size of the property. A continuing royalty fee, based on a percentage of room sales, is then paid each year. There are additional charges for chain advertising and reservation services. Depending on the individual franchise fee structure and the number of rooms booked through the reservation system, the actual cost of a franchise varies from about 2% to 8% of gross room sales.

Required standards

Franchises must adhere to certain construction, design, operational and maintenance standards. Standards are set for building materials, heating and air conditioning requirements, the size of guest rooms, the type of decor, the hours of operation, minimum staffing, pricing, advertising, and cleaning and maintenance. Failure to follow the required standards can jeopardize the franchise.

In granting a franchise, a chain offers no guarantee or financial commitment to the success of the property. Should the property fail, the chain can immediately withdraw its franchise and demand that all forms of identity be removed. The owner assumes all financial liabilities.

Benefit to Chain (Franchiser)

Inexpensive, low risk expansion

Franchising allows hostelry chains to expand their operations with minimal capital and personnel investment.

Increased representation improves the chain's recognition, which tends to increase the volume of sales.

Allied expansion

Some chains develop allied businesses to support their franchises and other company-owned operations. These businesses include interior designers, building contractors, furniture, equipment, and travel agencies.

Cost to chain (Franchiser)

Franchise services

Chains must provide the services described in the franchise agreement. Maintaining the reservation system and advertising the chain comprise the bulk of their responsibility.

Quality control

Inspection, supervision, and enforcement of franchise procedures and standards are necessary.

One neglected property can tarnish an entire chain. Some chains have abandoned their franchising programs because they found it impossible to enforce operational standards.

A franchise is neither a requirement nor a guarantee of success. It is important to remember that franchises are not permanent, and are terminated when sold. Most franchises are for terms of 10-25 years. New owners must apply for and be granted a new franchise.

MANAGEMENT CONTRACTS

A management contract is an agreement between a management company (operator) and a property owner (investor) whereby the operator assumes complete responsibility for managing the hostelry. For this service the operator is paid a fee based on a prescribed formula. The owner has little say in the operational policies, procedures, and day to day management.

Benefits to Investors

Professional management

Management contracts allow an inexperienced investor to participate in the benefit of hostelry ownership without becoming involved in the day-to-day management.

Management companies offer professional talent, proven methods of operations, and relief from most of the operational burden.

Profitable affiliation

Some chains do not franchise, so the only way an owner can obtain the benefits of a potentially profitable affiliation with such a chain is through a management contract.

Borrowing power and possible operator investment

Many lenders are more willing to make loans on hostelries that are managed by reputable management companies rather than by individual operators.

Costs to Investors

Management fees

The individual investor and operator typically negotiate management fees. The fee for management contracts is generally structured in one of several ways:

A percentage of a defined gross revenue (usually 2%-6%)

A percentage of a defined gross as a basic fee, plus a percentage of a defined operating income as an incentive fee (usually 1%-4% of the gross and 5%-10% of the net)

A percentage of a defined net operating income (usually 10%-25%).

Base management fee is often a percentage of gross income.

An incentive management fee is often a percent of net income.

Required facilities and standards

Management companies require that the properties they operate meet certain physical specifications pertaining to size, layout, design and decor. The investor must provide sufficient funds to properly maintain the property and regularly replace short-lived items.

Benefits to Operators

Good profit potential

Management contracts offer good potential for profit, especially with high volume operations. Because the owner is responsible for all expenses, the financial risk to the operator is minimal.

Inexpensive expansion with quality control

Hotel chains can expand with a low capital investment and still keep quality under control with in-house management.

Costs to Operators

Management services

In addition to providing the standard services of a reservation system and chain advertising, the operator employs a staff of regional managers, supervisors, and specialists in food and beverage service, accounting, marketing, and engineering.

VALUATION

Lodging facilities are unique forms of real estate; in addition to land and improvements, they are labor intensive, retail businesses that are dependent on the management skills of a hotel operator. Unlike other forms of real estate such as office buildings, which are typically encumbered by long term leases, lodging facilities require the leasing of guest rooms on what is often a daily basis.

With no long-term leases to protect ownership and with tenancy turning over on a daily basis, hotels are often the first form of real estate to show the effects of local market trends on their income statement. This means that of all the commercial real estate types, hotel values can fluctuate most rapidly.

Another difference between hotels and other forms of real estate investments is that, unlike other commercial properties, lodging facilities generally derive income from multiple revenue streams. In addition to the sale of guestrooms, a typical full service lodging facility derives revenue from the sale of food and beverage items, the resale of telephone service, and the sale of retail items in gift shops. Other revenue sources may include commissions from vending machines located on the premises, fees for laundry and dry cleaning, and charges for in-room movies.

Another unique factor in the operation of hotels and motels is the significant amount of personal property, including furniture and equipment, that is required.

In determining market value for hotels, the appraiser usually considers the three approaches to value: the cost, sales comparison, and the income capitalization approach.

Market value is defined by the Appraisal Institute:

The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self interest, and assuming that neither is under undue duress.

The fundamental assumptions and conditions presumed in this definition are:

Buyer and seller are typically motivated.

Both parties are well informed or well advised and acting in what they consider their best interest.

A reasonable time is allowed in the open market.

Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto.

The price represents the normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

The market value of a lodging facility may include the value of the going concern, which consists of the business value and the value of all furniture, fixtures, and equipment. For the purpose of ad valorem valuation, these items need to be accounted for separately, as only the real estate value is to be determined.

COST APPROACH

The cost approach is based on the assumption that an informed purchaser will pay no more for a property than the cost of producing a substitute property with equal utility.

IMPROVEMENTS

In the cost approach, market value is estimated by computing the current cost of replacing a property and subtracting any accrued depreciation resulting from one or more of the following factors:

Physical deterioration - the physical wearing out of the property

Functional obsolescence - a lack of desirability in the layout, style and design of the property as compared to a new property serving the same function

External obsolescence - a loss in value from causes outside the property itself

The cost of replacing the property is generally estimated on a square foot basis using figures from a construction cost manual published by a recognized cost reporting service, such as Marshall and Swift Valuation Service or Boeckh's cost manual. The value of the land as if vacant and available for development is then added to the depreciated value of the improvements to produce a total value estimate.

LAND VALUE

HIGHEST AND BEST USE

The price paid for the most profitable use of the property is the fundamental concept of highest and best use.

Highest and best use for vacant land is defined:

The use that yields the highest present land value after labor, management, and capital have been satisfied

After determining the appropriate improvement value for the subject property the appraiser must then calculate the land value. There are six methods in which to determine land values: sales comparison, abstraction, allocation, anticipated use, capitalization of ground rent, and land residual.

Sales Comparison

The sales comparison method is the most reliable method of land valuation. This method first compares comparable vacant land parcels that have sold during the selected data collection period and then appropriate adjustments are made to these sales prices to determine the estimated value for the subject property.

The adjusted sales prices of the comparables are then correlated to a value indicator representing the estimated sales price for each subject property.

In the reconciliation process, the greatest weight is given to those sales that are the most comparable to the subject property and have the least number of adjustments.

Abstraction

Abstraction is based on the principle that land has a defined relationship to the total property value. This method involves determination of the contributory value of the improvements as part of the total sales price of an improved property. The balance of the sales price is attributed to the land.

When there are no sales of similar vacant lots, the appraiser may either apply land values established by comparable sales from similar or comparable areas or abstract the value of the land from improved sales. The abstraction procedure involves inspection, listing, and grading the quality of the improvement and applying the appropriate cost and depreciation schedules to arrive at the depreciated value of the structure at the time of the sale.

By deducting the depreciated value of the improvements from the sales price of the entire property, the appraiser can obtain the abstracted value of the land.

Example:

Sales Price		\$550,000
Replacement Cost New	\$525,000	
Depreciation (10%)	<u>-\$52,500</u>	
RCNLD	\$472,500	<u>-\$472,500</u>
Abstracted Land Value		\$77,500

This method should be used with caution. The accuracy of the land value indicated by the use of this method depends largely on the reliability of the market value of comparable improvements. This method is most appropriate when the improvements are new.

Allocation

In the allocation method, a portion of the total property value is assigned to the land. Relationships between land and improvements are usually determined from the following sources:

- a. Site value in previous years
- b. Land to building ratios in similar neighborhoods
- c. Analysis of new construction on similarly classified sites

Example:

You are trying to determine commercial land value in a neighborhood where there are no commercial land sales. Research in commercial neighborhoods similar to that of the subject property indicates that a typical land to building ratio is 1:9 (one part land to nine parts building), or the land value is approximately 10% of the total value.

If the typical improved commercial sale for the neighborhood is \$1,400,000 then the indicated land value is:

$$\$1,400,000 \times .10 = \$140,000$$

Caution must also be recognized when using this method. There must be a high degree of comparability among the sites and among the properties.

Anticipated Use or Developmental Cost Method

The anticipated use or development cost method may be considered in cases where there are limited useful sales data. It is used primarily to value land in transition from agriculture to residential or commercial use.

For example, after the highest and best use has been established, the appraiser "hypothetically" develops the site. The total developmental costs are then subtracted from the projected sales prices of the developed lots to indicate the value of the raw land.

Capitalization of Ground Rent

This method employs the income approach, which is based on the premise that value is the present worth of future benefits. This method is reliable only if the estimate of income and the capitalization rate are supportable and accurate.

Example:

A vacant lot is leased for \$1,000 a month. This rental amount is determined to be market rent. The owner has no expenses in maintaining the lot. A site value can be estimated converting the income into value using capitalization.

$$\$1,000 \times 12 = \$12,000 \text{ (income is based on annual amount)}$$

$$\$12,000 \div .11 = \$109,091 \text{ (assuming a land capitalization rate of 11\%)}$$

Estimated site value equals \$109,091.

Land Residual

The net operating income attributable to the building is deducted from the net operating income to the property; the remaining income is attributable to the land and capitalized into value.

Example:

Net income to the property	\$120,000
Income to improvements	<u>-\$96,000</u>
Residual income to the land	\$24,000

Income to land	\$24,000
Capitalized into value	<u>:- .11</u>
Indicated site value	\$218,182

Site value equals \$218,182 (assuming a land capitalization rate of 11%)

WEAKNESSES OF THE COST APPROACH

Most appraisal literature recommends using the cost approach only for new properties, which have not been affected by the various forms of depreciation, and for unique or specialized improvements that have no comparable market or income potential.

The cost approach is seldom used to value existing hotels and motels because lodging facilities are particularly vulnerable to physical deterioration, functional changes, and uncontrollable external factors.

Sometimes a hostelry can suffer from functional and external obsolescence before its construction is finished. As the building and other improvements age and depreciate, the resultant loss in value becomes difficult to quantify. Estimating the impact of even minor forms of obsolescence may require unsupportable judgments that could undermine the credibility of the cost approach.

A more significant reason why this approach is not given more consideration in the valuation of hotels and motels is that its underlying assumptions do not reflect the investment rationale of typical hostelry buyers. Lodging facilities are income producing properties that are purchased to realize future profits. Replacement or reproduction cost has little bearing on an investment decision when the buyer is primarily concerned with the potential return on equity.

Because the cost approach does not reflect any of these income related considerations, but may require a number of highly speculative and unsubstantiated depreciation estimates, this approach is usually given minimal weight in the hotel valuation process.

SALES COMPARISON APPROACH

The sales comparison approach is based on the assumption that an informed purchaser will pay no more for a property than the cost of acquiring an existing property with equal utility.

The sales comparison approach estimates the value of a property by comparing it to similar properties sold during the data collection period. To obtain a supportable estimate of value, the sales prices of comparable properties must be adjusted to reflect any dissimilarities between the comparables and the subject property.

The reliability of the sales comparison approach depends on three factors:

Availability of timely, comparable sales data.

Verification of sales data.

Degree of comparability, i.e. the extent of adjustment needed to account for the differences between the subject and the comparable property.

The sales comparison approach provides a useful value estimate for simple forms of real estate, such as vacant land and single family residences, where the properties are homogeneous and the adjustments are few, relatively simple to compute, and supported by market data. In the case of more complex investments such as shopping centers, office building, restaurants, and lodging facilities, where the adjustments are numerous and more difficult to quantify and support, the sales comparison approach loses much of its reliability.

Unlike office buildings and shopping malls, most hotels are essentially dissimilar from one another in type of hotel operation, the quality and condition of physical improvements, the locational attributes, and the character of the local hotel market's supply and demand. Numerous adjustments thus are required to render a sale comparable to a subject property. Most of these adjustments however, are typically unsupported from the market and are difficult to estimate.

Several other circumstances can lessen the comparability of hotel sales data. For example, the sale of a hotel property may include an assumption by the purchaser of existing financing at nonmarket terms; a note may be taken back by a seller under duress; cash flow, equity, or debt service guarantees may exist; a partial interest in a property rather than an entire fee simple interest may be transferred; a leasehold or leased fee interest in a property subject to a nonmarket lease may be sold; and a property may be transferred as part of a package of several other properties in which the sales price of the particular comparable property may be merely an allocation of the whole.

Obtaining specific information on which to base adjustments for any of the previously cited differences can be extremely difficult. Even if information is available, attempts to derive market-supported adjustments are, in general, merely speculative.

Hotel investors typically do not employ the sales comparison approach in reaching their final purchase decisions. Various factors, such as the lack of timely comparable hotel sale data, the numerous unsupported adjustments that are necessary, and the general inability to determine the true financial terms and human motivations of comparable transactions often make the results of the sales comparison approach questionable. Although the sales comparison approach may provide a range of values to bracket and support the final estimate of value, any reliance beyond the establishment of broad perimeters generally is not normally justified by the quality of data.

Because appraisers are obligated to mirror the actions of the marketplace, an appraiser needs to be cautious when using the sales comparison approach to value hotel properties. A good use of hotel

sales, in the valuation of a hotel, would be for bracketing the final estimate of value.

Example:

Assume the appraiser is valuing a mid-rate commercial hotel. The appraiser has researched the market and discovered two recent sales. One sale involved a first class hotel with a value of \$90,000 per room. The other sale was of a mid-rate hotel that was obviously less attractive than the property being appraised; it has a sales price of \$45,000 per room.

Although a value estimate based on these two sales would be difficult to support, a range of values where the final estimate should fall could be established. If the income capitalization approach results in a value indication that is outside of this range, the appraiser should reevaluate the data.

For estimation of the market value of a hotel's real property components for ad valorem purposes, the sales comparison approach is particularly cumbersome. Typical hotel investors purchase hotels in anticipation of income from the real property, personal property, and business components. Most sales of hotels include the transfer of both the realty and the nonrealty components, and the per-room price of even the most comparable sale is difficult to use as an indication of value for another hotel's isolated real property component.

For example, hotels routinely sell with personal property in place; thus the sales price for a typical hotel includes such relatively short-lived items such as furniture, fixtures, and equipment (FF&E), and an allocation must be made to the comparable sales prices in order to adjust for the personalty's inclusion.

The same is true of the business housed within a typical hotel. Hotels routinely transfer as going concerns, with buyers buying into the hotel business that is operated on the premises and anticipating income from the continued operation of the hotel business. This element of a hotel's value, like the personal property, needs to be excluded from a hotel's value when only the real property elements are to be considered, such as for ad valorem purposes. Another unsupportable adjustment to the comparable sale price would be required to account for the portion of the price that was paid for the going concern. As is the case for the personal property element, virtually no market data exist that could be used as a basis from which to derive an appropriate adjustment.

INCOME CAPITALIZATION APPROACH

The income capitalization approach converts the anticipated future benefits of property ownership (dollar income) into an estimate of present value. In hotel-motel valuation this approach involves direct capitalization or a discounting procedure. For the purposes of this course the focus will be on the direct capitalization technique and not the discounted cash flow. The discounted cash flow procedure can be used to determine value and is often the income approach used in fee appraising, but for the purposes of ad valorem valuation we recommend using discounted cash flow only in conjunction with and as a check for the value determined from the direct capitalization approach.

The income approach is generally the preferred technique for appraising income-producing properties because it closely simulates the investment rationale and strategies of knowledgeable buyers. The approach is particularly relevant to hotel and motel properties, which involve relatively high risks and are bought mostly for investment purposes. Most of the data used in the income approach is derived from the market, which reduces the need for unsupportable, subjective judgment.

The income capitalization approach for hotels and motels is applied in several steps.

Estimate the effective annual stabilized gross income. This includes the income generated from rental of rooms, the food and beverage operation and any other source of revenue.

Deduct the appropriate expenses to determine the net operating income. This would include recognition of management and franchising fees, if appropriate, as well as the recognition for the return on and the return of personal property when necessary.

Select and apply the proper capitalization rate.

Deduct personal property value if it was not recognized as an expense item.

INCOME

Forecasts of income and expenses are usually based on competent management because the quality of management plays an important role in the profit potential of a lodging facility. The appraiser must equalize the effects of varying managerial expertise by assuming that the property being appraised will be managed competently.

In reality, management quality may be poor, competent, or superior. If the subject property is currently under poor management, the appraiser is justified in projecting improved operating results based on competent management. If, on the other hand, the subject has superior management, the income and expense used to estimate market value should reflect less managerial skill - i.e., lower revenue and/or higher expenses.

Market value must represent the actions of typical buyers and reflect average, competent management.

In order to determine the gross income of a hotel property the appraiser has to first determine the stabilized average daily room rate and stabilized annual occupancy rate. Based on this information, room revenue and other sources of income such as food and beverage sales can be computed. Expense data can be obtained from actual operating statements or from comparable properties or nationally published averages.

Room Revenue

The base room's revenue is calculated by multiplying the number of rooms by the average daily room rate, times 365 (the number of days in the year), times the annual stabilized occupancy rate.

For example, if a hotel has 180 rooms, an average daily room rate of \$95 and a stabilized annual occupancy of 65%, the base room revenue would be calculated as follows.

$$180 \times \$95 \times 365 \times .65 = \$4,057,000 \text{ (rounded)}$$

Food and Beverage Revenue

Food and beverage revenue is generated by a hotel's restaurants, lounges, coffee shop, snack bar, banquet rooms, and room service. These outlets are both revenue sources and necessary amenities for the sale of guestrooms. Although some hotels have active lounges and banquet facilities that draw local residents, in most hotels guests represent a substantial portion of the food and beverage patrons.

The *Uniform System of Accounts for Hotels* defines food revenue as "revenue derived from the sale of food, including coffee, milk, tea and soft drinks. Food sales do not include meals charged on employee's (staff) checks.

Beverage revenues are derived from the sale of all beverages not served with meals. In addition to the revenue generated through the sale of food and beverages, hotels normally produce other related income derived from meeting room rental, cover charges, service charges, and miscellaneous revenue. The combination of food income, beverage income, and other food and beverage income equals total food and beverage income.

Food and beverage revenue, if known, can be based on the actual income received or can be determined based on a percentage of room revenue that was determined from market studies of similar properties or published national averages.

Telephone/Communication Revenue

Telephone revenue is generated from hotel guests charging local and long distance calls to their rooms and from out of town patrons using the hotel's public phones. It may also include revenue generated from other communication resources such as faxes, E-mail, or modem use. Before deregulation of the telephone industry in the early 1980s, hotels were limited to a 15% commission charge on long distance calls. Today, however, the mark up at which hotels can resell telephone service to guests is not regulated. Because of this freedom the telephone department has become a profit center.

Telephone revenue varies directly with changes in occupancy.

Telephone revenue can be measured by using a hotel's actual phone revenue received or can be estimated as a percent of room revenue based on market studies made on similar local properties or from national publications.

Other Income

Other income represents revenue derived from sources other than the sale of guestrooms, food and beverages, and telephone service. Depending on the type of hotel and the facilities and amenities offered, other income may include the following revenue items.

Rents charged for store, office, concession, club, or storage space.

Commissions from auto rental, movie rentals, photography, telegrams, and vending services.

Concession revenue paid by others for the privilege of operating departments that might otherwise be operated by the hotel itself. Gift shops, barbershops, and beauty shops are typical concessions.

Electronic games and pinball machines.

Forfeited advance deposits and guaranteed no-shows.

Interest income from hotel banking house accounts.

Salvage revenue from the sale of old and obsolete items.

Other income is highly sensitive to occupancy and only slightly sensitive to food and beverage usage so the appropriate units of comparison would be a percentage of total room revenue.

When a hotel has extensive retail or office rental space, recreational amenities, or other significant sources of other income, a separate category may be used to show this income.

Total Revenue

The base total revenue is calculated by adding the four revenue components:

Rooms
Food and Beverage
Telephone
Other Income

EXPENSES

Rooms Expenses

Room expenses consist of items relating to the sale and upkeep of guestrooms and public space. According to the *Uniform System of Accountants for Hotels*, the following components make up the room expenses:

Salaries and wages
Employee benefits
China, glassware, and linen
Contract cleaning
Laundry and dry cleaning
Operating supplies
Reservation expenses
Uniforms

Most of the categories comprising room expenses are moderately occupancy-sensitive and slightly rate sensitive, which indicates this expense category, is occupancy-sensitive.

Salaries, wages and employee benefits account for a substantial portion of room expenses. Because most of these payroll expenses are dependent upon occupancy, the applicable unit of comparison should be either a percentage of room revenue or an amount per occupied room.

Food and Beverage Expense

The food and beverage department expense consists of the combined costs incurred for the operation of a hotel's food, beverage, and banquet facilities.

Although food revenue and beverage revenue can be projected separately, the expenses for these revenue sources are combined into a single expense category called food and beverage expense.

The components of the food and beverage department expense category are:

- Cost of food consumed
- Cost of employee meals
- Cost of beverage sales
- Salaries and wages
- Employee benefits
- Contract cleaning
- Laundry and dry cleaning
- Licenses
- Music and other entertainment
- Operating supplies
- Other operating expenses
- Uniforms

The cost of sales, salaries, and wages comprise the major portion of food and beverage expenses. These components are moderately too highly food and beverage sensitive in that they vary directly with changes in food and beverage volume.

As a result, the appropriate unit of comparison is a percentage of food and beverage revenue.

When using this unit of comparison, care must be taken since the profit margin from the sale of beverages is considerably higher than the profit from the sale of food. Therefore, a hotel with a higher ratio of beverage to food sales should have a lower food and beverage departmental expense ratio.

Telephone/Communication Expenses

Telephone expenses consist of all costs associated with the operation of a hotel's telephone department. For hotels with automated phone systems, the telephone department may be simply an additional responsibility for the front desk personnel. In most large properties the telephone department will have one or more full time telephone operators to provide the necessary phone service to guests.

Telephone expenses consist of

- Local calls
- Long distance calls
- Rental of equipment
- Salaries and wages
- Employee benefits
- Equipment charges
- Other operating expenses
- Printing and stationary

The bulk of telephone expense is attributable to the cost of local and long distance calls billed by the telephone companies providing this service.

Since most of these calls are made by in-houseguests, these expenses are occupancy sensitive. Since telephone revenue is largely driven by a hotel's occupancy, the appropriate unit of comparison would be a percentage of telephone revenue.

Other Expenses

Other income expense covers all the expenses associated with other income revenue. Typically the appropriate unit of comparison is a percentage of other income.

The first four expenses listed, (rooms, food & beverage, telephone/communication, and other) are typically matched to their appropriate revenue source and can often be calculated as a percentage of their matching revenue category.

The remaining expenses are not matched to any specific revenue source.

Administrative and General Expenses

The administrative and general expenses of a hotel include all the managerial and operational expenses that cannot be attributed to a particular department. For example, the general manager might work part of the day solving a problem in the rooms department and then spend the remainder of the day on booking an important food and beverage function. It would be difficult to allocate the manager's salary to the individual departments served, so the category of administrative and general is used.

The components that make up this expense category are:

Salaries and wages	Employee benefits
Cash overages and shortages	Donations
Commissions on credit cards	Insurance
Credit and collection charges	Internal audit
Internal communicating systems	Data processing
Executive offices	Loss and damages
Management fees	Miscellaneous
Postage and telegrams	Professional fees
Printing and stationary	Trade publications
Trade association dues	Traveling expenses
Human resources	Security
Courtesy transportation	Leasing expense

Most administrative and general expenses are relatively stable. Considering the components of administrative and general expenses, the appropriate unit of comparison is a percentage of total revenue.

Property Operations and Maintenance Expenses

Property operations and maintenance (PO & M) is another expense that is largely controlled by management.

Several factors influence the level of maintenance required for a lodging facility:

The age of the hotel

Some new hotels are protected for several years by the manufacturer's warranties on new equipment, which reduces PO&M costs during the initial years of operation. As hotels age, maintenance costs tend to escalate.

Use of a preventive maintenance system

Some hotel operators adopt preventive maintenance programs, this allows management to anticipate possible maintenance problems and correct them early with a minor repair rather than a major overhaul.

Quality of facility

The quality and type of the initial construction can have a direct impact on future maintenance requirements. The use of quality building materials and sound construction methods will generally reduce maintenance expenditures over the long term. During the physical inspection, the appraiser should carefully investigate the physical condition and quality of the original construction.

Property operations and maintenance are considered operating expenses and, as such, must only contain components that can be expensed rather than capitalized under IRS regulations. For example, if a table leg breaks, repairing the leg would be considered an expense chargeable to property operations and maintenance. If the table is replaced, that becomes a capital expenditure that would not fall into the property operations and maintenance category.

Capital replacement costs are recognized in either a replacement reserve account or with an expense line item recognizing the return of personal property. These expense items will be addressed later in this section.

Since the items in the property operations and maintenance category are slightly influenced by occupancy levels, the appropriate unit of comparison is an amount per room.

Property operations and maintenance expenses typically include the following:

Salaries and wages	Employee benefits
Building	Curtain and draperies
Electrical & mechanical	Elevators
Engineering supplies	Floor covering
Grounds and landscaping	Furniture
Operating supplies	Painting & decorating
Removal of waste matter	Uniforms
Refrigeration supplies	Miscellaneous

Energy\Utility Costs

Energy consumption within a lodging facility typically takes several forms: water and space heating, air conditioning, lighting, cooking fuel, and other miscellaneous power requirements.

Energy costs also include the cost of water service.

A large portion of a hotel's energy consumption varies little with changes in occupancy. Restaurants, kitchens, public areas and corridors must be continuously lighted, heated, and air conditioned, whether the hotel is full or nearly empty. The energy costs of an additional occupied room is minimal. Therefore, the unit of comparison is the total number of available rooms.

Business value

As previously noted the hotel business is a labor intensive, retail type business that relies on customer acceptance and highly specialized management. The tenants of an industrial property or office building sign leases for one or more years, but a hostelry experiences a complete turnover of patronage every two to four days. A bad reputation spreads rapidly and can have an immediate impact on occupancy. Further, in addition to the sale of guestrooms lodging facilities typically derive income from several sources including the sale of food, beverages, and telephone service, which requires additional business and management expertise.

The business value of a hotel is also composed of the benefits that accrue from an affiliation with a brand name hotel company either through a franchise agreement or management contract. Typically, chain-affiliated lodging facilities outperform independent property interests.

The total market value of a hotel is considered to consist of four components:

Value of the land

Value of the improvements

Value of the business or going concern and franchise affiliation

Value of the FF & E (furniture, fixtures & equipment; i.e., personal property)

The total of these four components equates to the total market value of the hotel as a whole. For property tax purposes, for which only the value of the real and personal property must be considered, the business value needs to be addressed.

Separating the value of a hotel's business from the value of the real estate is difficult, but necessary for ad valorem purposes. Deducting the income of the non-realty items from the property's total stabilized net income leaves the income attributed to the real estate, which can then be capitalized into an estimate of value.

The business value can be made up of two components, management and franchise affiliation.

Management Fee

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 operations of the property, an owner maintains only a passive interest. The managing agent in the form of a management fee has taken the income attributable to the business.

Therefore, deduction of a management fee (base and incentive), from the stabilized net income removes a portion of the business component from the stabilized income stream.

Hotel management fees for an independent nonchain management company typically run 2% to 4% of total revenue.

Large chains and nationally recognized agents typically charge 4% to 8% of total revenues.

If a hotel is professionally managed, the appraiser should request to see this contract to ensure that the correct and reasonable management deduction is made.

If both management and franchise fee are present, apply both.

Franchise Fee

Lodging facilities operated with a franchise affiliation are subject to the payment of franchise fees. Deducting the franchise fees from the stabilized net income removes the remaining portion of the business component from the income stream.

Chain hotels generally outperform independents, and the additional value created by increased profits is exclusively business related.

Franchise fees typically include payment for one or more of the following: a royalty fee that represents compensation for the use of the franchiser's name and logo, an advertising or marketing fee for a chain's entire spectrum of advertising and marketing services; and a reservation fee for the costs associated with operating a central reservation system. Franchising fees are structured based on varying formulas.

Some typical ranges for the fees associated with franchising are listed below.

Royalty fees are most often based on a percentage of room revenue and typically range from 3% to 6%.

Advertising and marketing fees, which are typically based on a percentage of room revenues, may range from 1% to 3%.

Reservation fees can range from 1% to 2.5% of room revenue.

When all the fees associated with a hotel franchise company are measured as a percentage of room revenue, they typically range from 4% to 9%.

If total property leases were still the norm, identifying the income stream to the hotel's real estate component would not be difficult. But the use of management contracts has resulted in confusion as to how much of a hotel's income stream represents the tenant's income, (i. e., income attributable to the business or going concern), and how much represents the income to property ownership (i. e., income attributable to the real estate).

By failing to deduct all amounts payable to the management company and franchiser from the hotel's income stream, an appraiser would be valuing hotel properties based on income attributable to the realty and nonrealty elements.

Appropriate deductions from a typical hotel's income stream to account for income attributable to the going concern include base and incentive management fees, royalty fees, reservation fees, and advertising royalties. If these items are included in the income stream and then capitalized into an estimate of the property's value, then that value includes nontaxable elements.

An example of the calculations of the business value deduction for a hotel is:

Managed by a nationally recognized hotel chain

<u>Total Revenue</u>		<u>Management Fee</u>		<u>Bsnss Income</u>
\$15,000,000	x	5%	=	\$750,000

Managed by independent with franchise affiliation

<u>Total Revenue</u>		<u>Management Fee</u>		<u>Bsnss Income</u>
\$15,000,000	x	3%	=	\$450,000

<u>Rooms Revenue</u>		<u>Franchise Fee</u>		
\$9,000,000	x	3.5%	=	\$315,000

Total Business Income	=	\$765,000
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Personal Property Adjustment

Furniture, fixtures, and equipment, or FF&E as they are called in the trade, are essential to the operation of a lodging facility and their quality often influences the class of a property.

FF&E includes, guest room, dining room, and lounge furnishings, kitchen equipment, front office and administrative equipment and items of decor.

There are two deductions that need to be made to recognize the personal property component that is included in a hotel's total value: return of and return on the investment in the FF&E.

Return of Personal Property Investment

A hotel's FF&E are a wasting asset exposed to heavy use and must be replaced regularly. The periodic replacement of furniture, fixtures, and equipment is essential to maintain the quality, image, and income of a lodging facility. Capitalized expenditures are not included in the hotel's operating statement, but they do effect an owner's cash flow, so an appraiser should reflect these expenses in an appropriate reserve for replacement. The reserve for replacement is most often stated in the management contract or franchise agreement.

This account, 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.

A reserve for replacement allowance can be estimated using one of two procedures; a percentage of the gross revenue or as a lump sum deduction that is made after the net operating income has been capitalized into a value.

Percentage of Revenue Method

The industry norm for a reserve for replacement, expressed as a constant percentage, typically ranges from 3% to 5% of total revenue.

Example:

Total Revenue x % of Revenue = Return of PP

$$\$12,000,000 \times 3\% = \$360,000$$

In using this approach the income attributable to the FF&E is treated as an expense and deducted from the income stream, so when the net operating income is calculated, it only contains the income attributable to the real estate.

Therefore, when the appraiser capitalizes the net income into a value estimate the resulting value is only the value attributable to the real estate component.

Lump Sum Deduction

Another way in which to account for the value of the FF&E is with a lump sum deduction made after the net operating income has been capitalized into a final estimate of value.

When this method is employed, the personal property replacement reserve account has not been accounted for in the income stream. The final value when capitalized includes the real estate as well as the personal property components.

In order to account for the value of the personal property the appraiser must make an adjustment to the final value conclusion.

This is done by making a deduction to the final value. The lump sum deduction for the FF&E is the depreciated value of the subject's personal property that is reported on their *Personal Property Declaration Schedule*.

Example:

NOI =	\$1,250,000
Cap rate =	13.5%
Declared P. P. =	\$450,000
NOI	\$1,250,000
Cap Rate	<u>-:- .135</u>
Total Value	\$9,259,000
Minus P.P. value	<u>-\$450,000</u>
Value of R.E. =	\$8,809,000

In the lump sum deduction method, no deduction is made in the income stream to reflect the return of personal property (replacement reserve account). Therefore, the value of the personal property has to be removed after the total value (which includes personal property) has been determined to get the value of only the real estate.

Return on Personal Property

The return on personal property is the second calculation required to estimate the income attributable to personal property. This calculation is based on the premise that a property component is entitled to an annual return equal to the cost of the capital that comprises that component. In this instance the component consists of all FF&E currently in use at the subject property.

The Dictionary of *Real Estate Appraisal* defines the return on capital as "the additional amount received as compensation (profit or reward) for use of an investor's capital until it is recaptured."

The return on personal property is based on the theory that a certain cost of capital is associated with the ownership of personal property.

The rate of return to apply to determine the recognition of the return on personal property is the discount rate plus the effective tax rate.

The discount rate can be determined using the summation method which is made up of four components, the safe rate, the management rate, the nonliquidity rate, and the risk rate.

The safe rate is considered to be the 90-day Treasury Bill as of the valuation date.

The management rate is for the management of the money, not of the property. Usually, this rate is from 1% to 3% depending on the size and complexity of the investment.

The nonliquidity rate accounts for the invested dollar not being available for other investment uses within a short period of time. The rate typically used is the difference between the 90-day Treasury Bill rate and the U.S. 30-year Treasury Bond rate as of the valuation date.

The risk rate provides for an annual return that is commensurate with the risk assumed by the investor. Risk rate is determined on an individual basis depending on each marketing area. If risk can not be locally determined, a minimum risk rate can be related to the bond market by comparing AAA rated Corporate Bonds with higher risk BBB rated Corporate Bonds.

Because the personal property taxes have not been deducted from the stabilized statement of income and expenses, the effective tax rate is added or "loaded" to the required rate of return.

The American word mill comes from the Latin word "mille" which means one-thousandth of a dollar.

To convert mills to decimal equivalents, simply move the decimal point three places to the left (or divide by 1000).

The effective tax rate is computed by taking the assessment ratio times the mill levy.

E.T.R. = assessment ratio x mill levy

If the mill levy is 85 mills then the effective tax rate is:

E.T.R. = 29% x 85 mills, or $.29 \times .085 = .0246$ (rounded to 2.5%).

Example of the derivation for the rate of return on Personal Property:

Discount Rate	10.5%
Effective Tax Rate	<u>2.5%</u>
Rate of Return on PP	13.0%

After the rate of return has been determined, it is then applied to the value of the subject's personal property. The personal property value is as of the same date as the appraisal. The value of the personal property can be estimated in a couple of ways. A personal property appraiser could inventory and value each item. This procedure, although it would produce an accurate and supportable value, is time consuming and costly. A more efficient method is to use the personal property value assigned by the assessor.

Example:

If the value of personal property assigned to the subject property was \$900,000, the calculation for the return on personal property would be:

Assigned Value of Personal Property	\$900,000
Rate of Return	<u>x .13</u>
Return on Personal Property	\$117,000

The total income attributed to personal property is the combination of the return of and the return on personal property.

Return of personal property	\$360,000
Return on personal property	<u>\$117,000</u>
Income attributed to personal property	\$477,000

Deducting the income attributed to the business and the income attributed to the personal property from the stabilized net income before real estate taxes results in the income attributed to the real property components of the land and improvements.

CAPITALIZATION RATE

Capitalization rates are used to convert expected future income into an estimate of value.

There are several ways to calculate a capitalization rate. Three of these methods are; the summation method, derivation from market sales, and the band of investment.

Summation Method

In the summation method the appraiser makes a series of upward adjustments to the different components to reflect the different elements of risk and the investment burden.

For example, adjustments might be made for the following factors:

	<u>%</u>
Discount Rate	
Safe Rate	x
Risk Rate	x
Non-Liquidity	x
Management	x
Recapture Rate	x
Effective Tax Rate	<u>x</u>
Final Capitalization Rate	

Discount Rate

The discount rate is defined as the annual percentage rate reflecting the competitive return on an investment. The discount rate is made up of four components, the safe rate, the risk rate, non-liquidity rate and the management rate.

Safe Rate

The safe rate is the most obtainable with the most safety and least risk. For the summation method, it should be taken from investments having the least risk. Ninety day U. S. Treasury Bills are one of the safest investments.

Risk Rate

The risk rate is the return commensurate with the risk assumed by the investor. It is a component because the return on real estate is a desired return and may or may not be realized by the investor. Also, the property may depreciate resulting in a loss when the property is sold.

If risk can not be locally determined, a minimum risk rate can be related to the bond market by comparing AAA rated Corporate Bonds with high risk BBB Corporate Bonds.

Rate for Non-Liquidity

The rate for non-liquidity is necessary since an investment in real estate ties up money that cannot be quickly converted to cash. Therefore, real estate is considered a non-liquid asset. The non-liquidity portion of the discount rate is typically the difference between the 90-day Treasury Bill rate and the 30-year U. S. Bond rate.

Rate for Management

The rate for management is a necessary component in order to compensate for the time and cost involved in the real estate investment to coordinate the other three agents of production, labor, capital, and land.

The management rate is for the management of the money, not the real estate.

Recapture Rate

The recapture rate is the annual percentage requirement for returning to the investor a sum equal to the property improvement's value by the end of a given period.

The calculation for computing the recapture rate is 1 divided by the remaining economic life times the building ratio.

Recapture does not apply to the land component because the return of the investment in the land occurs at the sale of the property.

For example, if the remaining economic life of the subject is 40 years the recapture rate is $(1 \div 40 = .025) \times .80$, assuming the building value is 80% of the total value..

Market Comparison

In order to develop a capitalization rate using this method you need a sufficient number of sales where you also know the net income.

The capitalization formula using the market comparison method is:

$$\text{Rate} = \text{Net Income} \div \text{Value.}$$

Income is the net income and value is the sales price.

Points to consider in the market comparison method are:

The sold properties must be reasonably comparable.

Sales prices and net incomes must be reliable. For hotels this means the sold prices have to be adjusted to reflect only the real estate, all of the non-realty value must be deducted.

There must be enough sales to reflect the market conditions.

Example:

Property Sales Price = \$3,200,000

Net Income = \$410,000

Capitalization Rate = $\$410,000 \div \$3,200,000 = .128 = 12.8\%$

Market derived capitalization rates for hotels are susceptible to the same shortcomings inherent in the sales comparison approach.

Band of Investment

Because most properties are purchased with debt and equity capital, the overall capitalization rate must satisfy the market return requirements of both investment positions. Lenders must anticipate receiving a competitive interest rate commensurate with the perceived risk of the investment or they will not make funds available. Similarly, equity investors must anticipate receiving a competitive equity cash return commensurate with the perceived risk or they will invest their funds elsewhere.

The discount rate developed by the band of investment is a composite rate, weighted in proportion to the total property investment represented by debt and equity.

To develop a discount rate using the band of investment the appraiser needs to research the cost of the debt component. One way to collect this information is by surveying lenders who are actively making hotel loans. Because this method is often difficult due to the inability to find lenders who are knowledgeable and willing to share this information, a better and more reliable approach is for the appraiser to rely on sources that regularly collect, analyze and publish this information.

One good source for this data is the American Council of Life Insurance.

In the Band of Investment technique the capitalization rate is computed as the weighed average of the returns required by the mortgage and equity funds.

Example:

If a lender is willing to make a loan for 75% of a property's value at 9.5% interest, and the equity investor demands a return of 14% on the remaining 25% position, the indicated discount rate would be

<u>Position</u>	<u>Weight</u>	<u>Rate</u>	<u>Weighed Average</u>
Mortgage	.75	x .095	= 0.07125
Equity	.25	x .14	= 0.03500

Indicated Discount Rate 0.10625 or 10.6%

For ad valorem purposes the local effective tax rate as well as the recapture rate would need to be added to the 10.6%

After the capitalization rate has been established the value of the subject can be estimated by dividing the net income by the capitalization rate.

INCOME APPROACH FOR LODGING PROPERTIES

Annual Revenue :

$$\frac{196 \text{ Rooms} \times \$60.86 \text{ ADR} \times 365 \text{ Days} \times 75.5 \% \text{ Occupancy}}{= \$ 3,287,213}$$

Food & Beverage Revenue

$$42.33 \% \text{ of Room Income} = \$ 1,391,477$$

Other Revenue

$$11.56 \% \text{ of Room Income} = \$ 380,002$$

$$\text{TOTAL ANNUAL GROSS REVENUE} = \$ 5,058,6921$$

Annual Expenses :

$$76.87 \% \text{ of Gross Revenue} = \$ 3,888,617$$

Replacement Reserve (Return of Investment in PP)

$$3.0 \% \text{ of Gross Revenue} = \$ 151,761$$

Return On Investment in PP

$$\$ 900,000 \text{ (Actual PP Value)} \times 11 \% \text{ (PP Cap Rate)} = \$ 99,000$$

$$\text{TOTAL ANNUAL DEDUCTIONS} (\$ 4,139,378)$$

$$\text{NET OPERATING INCOME} = \$ 919,314$$

$$\text{OVERALL CAP RATE (Including Tax Load)} \text{ :- } .14$$

$$\text{INDICATED VALUE OF REAL PROPERTY} = \$ 6,566,529$$

$$\text{Minus Value of PP if No Allowance for Replacement Reserve} (\$ NA)$$

$$\text{INDICATED VALUE OF REAL PROPERTY} \$ 6,566,529$$