Why the "Rushmore Approach" is a Better Method for Valuing the Real Property Component of a Hotel

BY STEPHEN RUSHMORE, MAI, CHA

Does it sound reasonable that the real property component for a hotel accounts for only 36% of its total property value?

This was the result quoted for a hotel property valued for a recent court case (Chesapeake Hotel v. Saddle Brook Township 1999) using the "business enterprise approach." Calculating the same hotel's value using the Rushmore approach, the figure was closer to 60% of total property value.

How can two appraisal methods obtain such disparate results? The difference can be attributed to how each approach separates the real property component from a hotel's total property value. The business enterprise approach moves much of a hotel's total property value into the areas of business value and personal property, thus deflating the value of the real property component. While this significantly reduces a hotel's ad valorem tax assessment, it also has the potential of reducing its mortgage asset security value which could severely restrict hotel owners from leveraging their acquisitions.

This article describes how the Rushmore approach is better suited to the valuation of hotel properties, first by offering background information on the business practices in the hotel industry and how they differ from other business enterprises and then by using as an example, a step-by-step valuation of the hotel that was the subject of the litigation.

Business Practices in the Hotel Industry

The business enterprise approach may be applicable to the valuation of

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shopping centers and office complexes, but its theories break down when applied to the specialized business practices of hotel operations. The value of a hotel is made up of four components: land, improvements, personal property, and the going business. The land creates revenue based on its locational attributes. The improvements house the guest rooms. The guests sleep on the FF&E, and the business manages the entire operation.

When valuing hotels and motels for real property assessment purposes, where only the market value of the land and improvements is at issue, the appraiser must address the allocation of value among the four components in a manner that reflects actual hotel operating structures, customs, and economics.

Lodging facilities are more than land, bricks, and mortar; they are retail-oriented, labor-intensive businesses operating on daily leases and requiring a high level of managerial expertise. In addition, hotels contain a significant investment in personal property (furniture, fixtures, and equipment or FF&E) that has a relatively short useful life and is subject to rapid depreciation and obsolescence.

The basis for valuing a hotel's real property component is the income approach which takes a property's stabilized net income and capitalizes it into an estimate of value. The stabilized net income is intended to reflect the anticipated operating results of the hotel over its remaining economic life, given any or all applicable life-cycle stages of buildup, plateau, and decline. Therefore, such stabilized net income contains all of the revenue generated and expenses incurred by a hotel in carrying out its ongoing day-to-day functions of taking reservations; selling rooms; hiring, training, and directing staff; performing maintenance; purchasing equipment; and the myriad other activities needed to keep a hotel operating. In many instances, when a hotel has been open for several years, the appraiser may utilize the hotel's most recent actual net income as the stabilized net income if it conforms to the definition cited above.

The capitalization rate is the weighted cost of invested capital that takes the form of mortgage debt and equity. For property tax appraisals, the capitalization rate will also include the local tax rate expressed as a percentage of market value. This allows the appraiser to capitalize the net income before real estate taxes by assuming that the ultimate tax burden will equate to the municipally mandated relationship to market value.

Analyzing the "Going Business" Component

The business component of a hotel's income stream accounts for the labor-intensive, retail nature of its business activity which depends upon continual customer acceptance and highly specialized management skills. In contrast to shopping centers or office buildings where tenants sign leases that can extend for ten to fifteen years, most hotels experience a complete turnover of tenants every one to four days. A hotel must therefore constantly market and sell itself in order to maintain a profitable level of occupancy. In addition, finding and retaining qualified labor has been an ongoing problem in the hotel industry because of the generally undesirable prevailing wage rates and working conditions. All of these challenges demonstrate the need for and the value of qualified hotel management to handle the complex business of operating a lodging facility.

Start-up Costs

One of the main drivers the business enterprise approach uses for allocating additional income stream to the business component is a deduction it calls "business start-up costs." Proponents say that business start-up costs benefit any going concern over the long term. These costs include: assembled and trained work force, management and administration team, regulatory compliance, accounting and other business systems, pre-opening marketing, initial operating losses, working capital, and so forth. For a hotel, start-up costs are determined by utilizing typical pre-opening costs for similar lodging facilities as outlined in franchise offering circulars and calculating an amortization amount that would spread these costs over a 25-year period. The Rushmore approach makes no such deduction. Here's why.

All types of real estate incur a certain amount of business start-up costs. Before opening a new regional shopping mall, for example, the developer must spend a considerable amount of time and money searching for the desired mix of tenants, negotiating suitable leases, and preparing the space for occupancy. This effort requires targeted marketing and sales materials, professional leasing agents, attorneys, accountants, and the like. The mall itself needs to be heavily marketed to the local community through all types of media in order to build awareness and traffic. The mall's administration team needs to be recruited, and suitable accounting and management systems need to be implemented. And finally, as opening day approaches, the mall's operating and security staffs need to be hired and trained.

A similar business start-up process is followed during the development and opening of a hotel. However, the primary difference between the start-up process for a retail mall or office building and the one for a hotel is that the process essentially ends for the mall or office building opens and the space becomes fully leased. Aside from some minimal ongoing re-leasing activity and marketing, the large initial start-up cost becomes a one-time, non-recurring event because the tenants of retail and office space are obligated to stay typically five to fifteen years.

A hotel, on the other hand, is constantly seeking new tenants because hotel guests typically stay for only one to four days, and they usually do not make their reservations many weeks in advance. Therefore, a hotel's sales, marketing, and leasing efforts must be perpetual. Because start-up activities are such an integral part of a hotel's business operations, these expenses are included in the income statement. Recognizing this fact, the Rushmore approach does not make a separate deduction for initial start-up costs.

Work Force Assembly

The same thinking applies to the appropriateness of taking a special deduction for the start-up cost associated with assembling a work force. During a hotel's pre-opening phase, management personnel are recruited, staff and line employees hired, and everyone is trained—much like any other business. This process generally occurs over a two- to three-month period prior to opening. However, in the hotel industry, because of extremely high employee turnover, the process does not stop with the hotel's grand opening.

Timothy Hinkin and Tony Simons (2001) performed a study that showed that the mean level of turnover for a 98-hotel sample (ranging from 72 to 652 rooms) was 47% over a six-month period. This result indicates that the level of turnover is so high in the industry that hotels are constantly going through a hiring process. The authors further stated that these costs are directly reflected in the net operating income of the hotel.

Hinkin and J. Bruce Tracey (2000) of the Cornell University Hotel School co-authored an article based on their study which sought to capture the true costs of turnover in hotels. These included recruiting and attracting costs, selection costs, hiring costs, lost productivity costs, and separation costs. In one example, the authors compared the turnover costs for a front desk employee at four hotels—two in New York City and two in Miami. They found that the cost of turnover for a front desk associate averaged $5,827 for the two Miami hotels and $12,245 for the two New York City hotels. This example shows that the total cost of replacing a line-level employee can be significant.

Because the cost of assembling a work force is a continual expense for the hotel industry and because it is accounted for as part of net operating income, the Rushmore approach, unlike the business enterprise approach, does not deduct this expense as a start-up cost item.

Other Start-up Costs

Other business start-up costs cited by the business enterprise approach and included in its start-up cost deduction are feasibility studies and appraisals, telephone systems, upgrading property management software, paying for licenses, complying with government regulations, purchasing inventories, and so forth. However, the Rushmore approach believes that none of these expenses are unique to the pre-opening phase of a hotel start-up. They are all recurring expenses that take place throughout the life of a hotel and are already accounted for in either the income and expense statement or the reserve for replacement. Therefore, under the Rushmore approach, no separate deduction is warranted.

Working Capital Deduction

A deduction for a return on a hotel's working capital is another device the business enterprise approach uses to decrease the income attributed to the real property component. Working capital is defined as current assets less current liabilities. For manufacturing businesses that carry large inventories and work-in-progress as current assets, a deduction for positive working capital may be appropriate. However, in a well-operated hotel, no working capital should exist because the hotel should be financing its accounts receivables with its accounts payables, thus keeping the ratio of current assets to current liabilities one to one. For this reason, the Rushmore approach does not include a deduction for working capital.

Benefits of Brand Affiliation

Another facet of the going business component that shows the divergence between the business enterprise approach and the Rushmore approach is how to account for the benefits that accrue from an association with a recognized hotel company brand through either a franchise or management contract affiliation. Chain hotels generally out-perform independents, and the added value created by this increased income is considered part of the business component.

Ninety years ago, an inexperienced hotel property owner was able to obtain qualified hotel management and a brand affiliation through a lease structure where the property owner leased the land and the building to a hotel company (tenant) that operated the property and paid rent. The rent paid to the owner represented the portion of the income attributed to the land and building.

Today, the hotel lease structure has been replaced by the management contract and franchise. Under this structure, when an inexperienced hotel property owner wants qualified hotel management, he or she enters into a management contract with a hotel company to take over the hotel's day-to-day operation. This allows the owner to assume a totally passive role with respect to the various business activities involved in running the hotel. The hotel company is paid a management fee for these services, which can be recognized as compensation for running the business, or as in the Rushmore approach, a portion of the income stream attributed to the business component.

When a hotel owner wants a hotel chain affiliation and the benefits associated with a brand and reservation system, there are two options. The first is to engage a hotel management company that brings both management expertise and a brand. These are called first-tier management companies and include chains such as Hyatt, Marriott, and Hilton. The second option is to use a hotel management company without a brand and contract separately with a hotel franchise company that will provide the affiliation and reservation system. Although some of the first-tier management companies will provide franchises (without management), most of these arrangements are made with pure hotel franchise companies such as Comfort Inn, Days Inn, Ramada, and Microtel. The franchise fee and other associated costs including reservation expenses, frequent traveler programs, training, information technology, and so forth which are paid to the franchiser also represent a portion of the income stream attributed to the business component.

Fees for hotel companies providing both management services and a brand are typically structured using a base fee and an incentive fee. The base fee is calculated as a percentage of total revenue and generally ranges from 2% to 4%. The incentive fee is usually structured as a percentage of profit, which when compared to the total revenue, could add another one or two percentage points.

Fees for hotel companies providing just management services (no brand) are typically structured using just a base fee ranging from 2% to 4% of total revenue. Under this scenario, when a brand affiliation is desired, the franchise fee paid to the franchisor ranges from 3% to 5% of rooms revenue (HVS International 2003a). When all of the other costs such as reservation expense, advertising assessment, frequent traveler program, training, and so forth are added to the franchise fee, the total cost of a franchise affiliation typically ranges from 6% to 10% of rooms revenue. Furthermore, these other costs are not typically allocated to the franchise fee expense line item; rather they are allocated to the rooms expense in the case of the reservation expense and frequent traveler program, or the marketing expense in the case of the advertising assessment, thereby removing additional income attributed to the business.

Impact of Management Quality

While both the Rushmore approach and the business enterprise approach consider management and franchise fees as income attributed to the business component, the business enterprise approach goes further and allocates additional income to what it calls "residual intangibles." The business enterprise approach defines residual intangibles as the contribution to or impact upon the operating performance of properties with superior brand affiliations and everything these brands embody, as evidenced by marketplace preference relative to competing brands. In the Rushmore approach, this deduction is called the "superior management adjustment and is included in the income and expense statement." When valuing a hotel for property tax purposes, it is appropriate to adjust revenues down and/or expenses up if the financial performance reflects superior management. Conversely, it is appropriate to adjust revenues up and/or expenses down if the financial performance reflects inferior management. The goal in making these adjustments is for the stabilized income and expense statement to reflect competent management.

Examining the Personal Property Component

The personal property within a hotel consists of its furniture, fixtures, and equipment. Although some jurisdictions assess and tax personal property separately, it must be isolated and excluded from the real property components. Two calculations are needed to remove the personal property value from the income flow—a return of personal property and a return on personal property.

The return of personal property is necessary because FF&E has a relatively short useful life and must periodically be replaced. The Internal Revenue Service depreciation guidelines state that the life expectancy of hotel furnishings averages six to ten years. Although the replacement of the FF&E is a capital expenditure and is not included on an accountant's income and expense statement, it does represent a reduction in cash flow and equity return and has a negative effect on a property's market value. Hotel companies and appraisers account for the frequent replacement of FF&E by establishing an expense deduction known as a reserve for replacement. This fund, which reduces the hotel's cash flow in annual installments, is set at the amount necessary to replace all existing FF&E with new FF&E over an assumed useful life.

The return on personal property is the second calculation required to estimate the income attributed to the personal property so that it can be removed from the income stream. 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.

The Rushmore approach considers the "Return on FF&E" to be the calculation in Table 3. Either formula can be used; both return the same results. The business enterprise approach considers the "return on" as procedure 1 in the same table and its "return of" to be procedure 2 in table 3. It then takes a reserve for replacement separately. The Rushmore approach considers the reserve for replacement to be the "return of FF&E." In essence, the reserve for replacement is the replacement of FF&E.

Side-by-Side Comparison

Now, to illustrate how the business enterprise approach and the Rushmore approach differ in their estimation of value, let's use as a real-life example, the hotel that was the subject of a property tax dispute. This case was recently tried in the New Jersey Tax Court. The business enterprise approach had been used to prepare the original appraisal on behalf of the property owner. While an appraisal using the Rushmore approach was not performed for the case, testimony was presented that established the differences between the principles of the Rushmore approach and the tenets of the business enterprise approach.

The facts and figures used in this example are from the actual case and are part of the public record.

The subject property is the Saddle Brook Marriott Hotel in Saddle Brook, New Jersey. The hotel has a highly visible location adjacent to both Interstate 80 and the Garden State Parkway. Drive time to New York City is less than 30 minutes. The property is a 221-room, full-service, first-class hotel with restaurant, lounge, meeting facilities, and indoor pool. On the date of value, which was January 1, 1999, the hotel was operated by Marriott International under a management contract.

The owner's appraiser developed a stabilized income and expense statement using the hotel's actual operating results for 1998, making some slight adjustments and projecting them to 1999. His capitalization rate loaded with the equalized local tax rate was 12.4122%. Both the stabilized income and expense statement and the loaded capitalization rate seemed reasonable and were thus utilized by the Rushmore approach in its valuation. (See table 1.)

The result is what the Rushmore approach calls Net Income Before Business and Personal Property Deductions for 1999. In calculating this Net Income, all items of revenue and expense nor-

TABLE 1. Net Income Before Business and Personal Property Deductions

	Business Enterprise Approach		Rushmore Approach	
Number of Rooms	221		221	
Occupancy	81%		81%	
Average Room Rate	$128.10		$128.10	
Revenue				
Rooms	$8,369,881	68.5%	$8,369,881	68.5%
Food and Beverage	$3,347,952	27.4%	$3,347,952	27.4%
Telecommunications	$259,466	2.1%	$259,466	2.1%
Other	$234,357	1.9%	$234,357	1.9%
Total Revenue	$12,211,656	100.0%	$12,211,656	100.0%
Departmental Expenses				
Rooms	$2,176,169	26.0%	$2,176,169	26.0%
Food and Beverage	$2,678,362	80.0%	$2,678,362	80.0%
Telecommunications	$168,653	65.0%	$168,653	65.0%
Other	$199,203	85.0%	$199,203	85.0%
Total Departmental Expenses	$5,222,387	42.8%	$5,222,387	42.8%
Departmental Profit	$6,989,269	57.2%	$6,989,269	57.2%
Undistributed Expenses				
General and Administrative	$1,221,166	10.0%	$1,221,166	10.0%
Operations & Maintenance	$793,758	6.5%	$793,758	6.5%
Utilities	$488,466	4.0%	$488,466	4.0%
Marketing	$781,546	6.4%	$781,546	6.4%
Total Undistributed Expenses	$3,284,936	26.9%	$3,284,936	26.9%
Gross House Profit	$3,704,333	30.3%	$3,704,333	30.3%
Fixed Expenses				
Insurance	$175,000	1.4%	$175,000	1.4%
Equipment Rental	$65,000	0.5%	$65,000	0.5%
Total Fixed Expenses	$240,000	2.0%	$240,000	2.0%
Net Income Before Business and Personal Property Deductions	$3,464,333	28.4%	$3,464,333	28.4%

TABLE 2. Total Income Attributed to the Business

	Business Enterprise Approach		Rushmore Approach	
Base Management Fee	$366,350	3.0%	$366,350	3.0%
Incentive Management Fee	$235,480	1.9%	$235,480	1.9%
Business Start-up Costs	$337,919	2.8%	$0	0.0%
Residual Intangibles	$337,788	2.8%	$0	0.0%
Total Income Attributed to the Business	$1,277,537		$601,830	

mally contained in a hotel's income and expense statement have been deducted with the exception of the following items: Management Fees, Reserve for Replacement, and Property Taxes. Management Fees and Reserve for Replacement will be deducted in a subsequent calculation, and Property Taxes are loaded into the capitalization rate. Both methods, up to this point, are in agreement.

Computing the Business Component

Table 2 shows the calculation of the Income Attributed to the Business. Both approaches agree on deducting a Base Management Fee equal to 3% of total revenue plus an Incentive Fee of 1.9% of total revenue. Management fees for hotel companies providing just management services (no brand) are typically structured using just a base fee ranging from 2% to 4% of total revenue.

Now, the two approaches start to diverge. Under the business enterprise approach, $337,919 is then deducted for Business Start-up Costs. The rationale is that hotels, like shopping malls or office buildings, incur costs before they open that benefit the business over its lifetime, but that are not reflected in its yearly operating budget. The Rushmore approach, on the other hand, takes no such deduction. Because of the high turnover inherent in hotel operations, both in terms of guest stays and staff retention, a property could be considered to be in continuous start-up mode. Therefore, these expenses have already been accounted for in the income and expense statement.

Another difference is that the business enterprise example makes an additional deduction of $337,788 for Residual Intangibles. This deduction is explained as necessary because the Marriott's Revenue per Available Room (RevPAR) is approximately 15% above the RevPAR of the other hotels in its competitive set. He then takes 15% of what he defines as Net Operating Income to Going Concern ($2,251,920) or $337,788.

While the concept of adjusting for superior results is consistent with the Rushmore approach, it is open to question whether its application in this case is appropriate. The Saddle Brook Marriott did indeed perform 15% above its "competitive" set, but the competitive set is not at all "comparable" to the Marriott. It consisted of a Howard Johnson, a Crowne Plaza, and a Holiday Inn. A Marriott hotel is classified by Smith Travel Research (n.d.) as an Upper Upscale chain based on the quality of its facilities and the room rates it is able to achieve. Howard Johnson and Holiday Inn are classified by Smith Travel as Midscale Chains (two categories below a Marriott) and Crowne Plaza is classified as an Upscale Chain (one category below a Marriott). While these three hotels might compete with the Marriott, they are certainly not comparable based on the quality of facilities and their ability

TABLE 3. Two Procedures for Computing the Personal Property in Place

Assumptions	
Net Income	$1,000,000
Capitalization Rate	12.5%
Total Property Value	$8,000,000
Value of FF&E in Place	$750,000
Procedure 1	
Value of FF&E in Place	$750,000
Capitalization Rate	12.5%
Income Attributed to FF&E in Place	$93,750
Net Income	$1,000,000
Less: Income Attributed to FF&E in Place	-$93,750
Net Income Without FF&E in Place	$906,250
Capitalization Rate	12.5%
Property Value Without FF&E in Place	$7,250,000
Procedure 2	
Total Property Value	$8,000,000
Less: Value of FF&E in Place	-$750,000
Property Value Without FF&E in Place	$7,250,000

to achieve similar room rates. Consequently, it should follow that they have lower RevPARs and overall values.

A more useful comparison would be to the RevPARs of other Upper Upscale hotels in Northern New Jersey. A specially commissioned Smith Travel Research trend report for all the Hilton Hotels, Hyatt Hotels, Sheraton Hotels, and Marriott Hotels in the Northern New Jersey area found that in 1999 the 25 hotels in this group achieved an occupancy of 76%, an average rate of $135.61, and a RevPAR of $103.65. The owner's appraiser projected that in 1999 the hotel would achieve an 81% occupancy, at an average rate of $128.10, which produces a RevPAR of $103.76—almost identical to its "comparable" set. This leads us to conclude that there is no residual intangible value for the subject property.

Therefore, the total Income Attributed to the Business is $1,277,537 under the business enterprise approach compared to $601,830 for the Rushmore approach—more than two times higher.

Computing the Personal Property Component

The next step is to account for the personal property component of the value. In the Rushmore approach, the calculation for deducting the personal property in place can be accomplished utilizing one of two procedures. (See table 3.) The first procedure removes from the income stream any income attributed to the FF&E in place by taking the value of the FF&E and multiplying it by the capitalization rate. When the reduced income stream is capitalized, it excludes the value of the FF&E in place. The Rushmore approach terms this deduction a return "on" FF&E or the income that was earned on the FF&E in place. The sec-

TABLE 4. Value of the Real Property Only

	Business Enterprise Approach		Rushmore Approach
Reserve for Replacement	$610,583	5.0%	$610,583
Return on FF&E	$143,606		$0
Total Income Attributed to the Personal Property	$754,189		$610,583
Net Income Before Business and Personal Property Deductions	$3,464,333		$3,464,333
Less: Total Income Attributed to the Business	-$1,277,537		-$601,830
Less: Total Income Attributed to the Personal Property	-$754,189		-$610,583
Income Attributed to Real Property and FF&E In Place	$1,432,607		$2,251,920
Cap Rate Loaded with Real Estate Taxes	0.124122		0.124122
Value with FF&E in Place	$11,541,926		$18,142,795
Less: FF&E in Place	$1,511,640		$1,511,640
Value of the Real Property Only	$10,030,286		$16,631,155

ond procedure simply deducts the value of the FF&E in place from the capitalized value of the overall net income. Both procedures produce identical results, which is to isolate the value of the FF&E currently in the hotel.

These calculations can best be illustrated by using a hypothetical example. Assume a hotel's net income, including the income attributed to the FF&E currently in the hotel, is $1,000,000. The value of the FF&E in place is $750,000. An appropriate capitalization rate would be 12.5%. The value of the hotel, including the FF&E in place, is $1,000,000 divided by the 12.5% capitalization rate, which equals $8,000,000.

Under the first procedure, the income attributed to the FF&E in place is calculated by multiplying the value of the FF&E in place ($750,000) by the 12.5% capitalization rate, producing an income attributed to the FF&E in place of $93,750. Deducting this amount from the $1,000,000 Net Income produces a Net Income without FF&E in place of $906,250. When this amount is capitalized at 12.5%, the resulting property value of $7,250,000 excludes the $750,000 of FF&E in place.

Under the second procedure, the Net Income of $1,000,000 is capitalized at the 12.5% rate, producing a value of $8,000,000, which includes the value of the FF&E in place. To obtain the value of the property without the FF&E in place, the $750,000 value of the FF&E is deducted from the $8,000,000 property value, leaving a property value without the FF&E in place of $7,250,000.

Although both procedures produce the same results, Procedure 2 is simpler to explain to a jury than Procedure 1. Procedure 1 is typically utilized when the jurisdiction assesses personal property taxes and the tax rate needs to be loaded into the capitalization rate.

Table 4 shows the calculation of the Income Attributed to the Personal Property for the subject property along with the Value of the Real Property Only. Both the business enterprise approach and the Rushmore approach deduct a Reserve for Replacement equal to 5% of total revenue, which is at the high end of industry standards. The business enterprise approach then deducts a Return on FF&E of $143,606, which is designed to remove the value of the FF&E in place. The Rushmore approach

TABLE 5. Difference in Value Between the Two Approaches

	Business Enterprise Approach	Rushmore Approach	Difference
Effect on Value For Business Deductions			
Base Management Fee	$366,350	$366,350	
Incentive Management Fee	$235,480	$235,480	
Business Start-up Costs	$337,919	$0	
Residual Intangibles	$337,788	$0	
Total	$1,277,537	$601,830	
Cap Rate Loaded with Real Estate Taxes	0.124122	0.124122	
Effect on Value for Business Deductions	$10,292,591	$4,848,697	$5,443,894
Effect on Value - Personal Property Deductions			
Reserve for Replacement	$610,583	$610,583	
Return on FF&E	$143,606	$0	
Total	$754,189	$610,583	
Cap Rate Loaded with Real Estate Taxes	0.124122	0.124122	
Value	$6,076,191	$4,919,217	
Plus FF&E in Place	$1,511,640	$1,511,640	
Effect on Value for Personal Property Deductions	$7,587,831	$6,430,857	$1,156,975
	Total Difference in Value		$6,600,869

opts for deducting the value of the FF&E in place after the value of the property is determined. This calculation produces a Total Income Attributed to the Personal Property of $754,189 for the business enterprise approach and $610,583 for the Rushmore approach. The next calculation takes the Net Income Before Business and Personal Property Deductions from table 1 and deducts Total Income Attributed to the Business and Total Income Attributed to the Personal Property, resulting in Income Attributed to Real Property and FF&E in Place. This amounts to $1,432,607 for the business enterprise approach and $2,251,920 for the Rushmore approach. Using a capitalization rate loaded with real estate taxes of 0.124122, the value with FF&E in place is $11,541,926 for the business enterprise approach and $18,142,795 for the Rushmore approach. Both approaches then deduct $1,511,640, representing the value of the FF&E in place, producing a Value of the Real Property Only of $10,030,286 for the business enterprise approach and $16,631,155 for the Rushmore approach. Table 5 shows the effect on value for each approach from the business and personal property deductions. The total business deductions for the business enterprise approach of $1,277,537 are capitalized by the Cap Rate Loaded with Real Estate Taxes, resulting in an Effect on Value for Business Deductions of $10,292,591. The same calculation applied to the Rushmore approach results in an effect of $4,848,697, or a difference of $5,443,894 between the two approaches.

A similar calculation for quantifying the Effect on Value for Personal Property Deductions takes the deductions for the Reserve for Replacement and Return on FF&E and capitalizes them with the loaded capitalization rate and adds back the FF&E in Place. The total effect on value is $7,587,831 for the business enterprise approach and $6,430,857 for the Rushmore approach. The difference between the two approaches for this calculation is $1,156,975.

The total difference in value resulting from the application of the business enterprise approach and the Rushmore approach is more than $6,600,000.

TABLE 6. Proof of Value

	Business Enterprise Approach	Rushmore Approach
Net Income Before Business and Personal Property Deduction	$3,464,333	$3,464,333
Cap Rate Loaded with Real Estate Taxes	0.124122	0.124122
Total Property Value	$27,910,709	$27,910,709

Proof of Value	Business Enterprise Approach	% of Total	Per Room	Rushmore Approach	% of Total	Per Room
Value - Personal Property Component	$7,587,831	27%	$34,334	$6,430,857	23%	$29,099
Value - Business Component	$10,292,591	37%	$46,573	$4,848,697	17%	$21,940
Value - Real Property Component	$10,030,286	36%	$45,386	$16,631,155	60%	$75,254
Total Property Value	$27,910,709	100%	$126,293	$27,910,709	100%	$126,293

Does it Pass the Reasonableness Test?

Based on the final outcomes, which approach seems to produce the most reasonable results? Because there is no hard data pertaining to sales of just hotel business components, conclusive proof to support either approach is not available. Therefore, a next-best solution would be to benchmark the results against other measures of value.

Table 6 starts with an estimate of Total Property Value. The Net Income Before Business and Personal Property Deduction of $3,464,333 is capitalized with the Cap Rate Loaded with Real Estate Taxes of 0.124122, resulting in a Total Property Value of $27,910,709, or about $126,000 per available room for both approaches. My rule of thumb is that a hotel should by worth 1,000 times its average room rate on a per-available-room basis. Based on a $128.00 average rate, this would equate to $128,000 per available room.

The next part of the table takes the value of the three components (personal property, business, and real property) determined in tables 4 and 5 and demonstrates that when added together they total the previously calculated Total Property Value.

Lastly, table 6 shows the percentage relationship and the per-room value relationship of each component to the total value. It is these numbers that should prove useful in determining which approach produces the most logical conclusions.

Now the question is: does it seem credible that the value of the real property component of a full-service, first-class hotel in a highly visible location just outside New York City is worth only $45,000 per room. That is the per room value when the real property accounts for just 36% of the Total Property Value. As a further benchmark, the HVS Hotel Development Cost Survey (2003b) shows the average construction cost for the real property component (land and improvements) for a first-class, full-service hotel is $123,000 per room. Therefore, would it seem reasonable that a hotel whose real property components are worth only $45,000 per room would still be capable of generating an 81% occupancy and a $128.10 average room rate? Or does a property with a per room value of $75,000 (based on a 17% business component and a 60% real property component) derived by the Rushmore approach seem more capable of producing these results?

Another test for the reasonableness of the conclusions derived from the business enterprise and Rushmore approaches is to look at the results if the cost approach were applied. The theory behind the cost approach is that the value of the real property component of a new hotel is the cost to acquire the land and construct the improvements. The value of the business component would therefore be the difference in the value derived by capitalizing net income using the income approach and the value derived by the cost approach.

If one were to utilize the cost approach for the Saddle Brook Marriott assuming the cost to buy the land and construct the improvements was the $123,000 per room cited from the HVS Hotel Development Cost Survey (2003b), an appraiser would have to estimate the depreciation on the improvements. Let's assume the land component of the $123,000 per room is worth $15,000 per room, leaving an improvement cost new of $108,000 per room. The business enterprise approach estimated the value of the real property component to be $45,000 per room, which equates to an improvement value of $30,000 per room after deducting the $15,000 per room land value. The Rushmore approach estimated the value of the real property component at $75,000 per room, which equates to an improvement value of $60,000 per room. The business enterprise approach therefore imputes a total depreciation of 72%, while the imputed depreciation under the Rushmore approach is 44%. While quantifying depreciation may not be the definitive test, does it nonetheless seem reasonable that an exceptionally well-located hotel, operating under the high standards required by the Marriott brand and achieving an occupancy of 81% and a competitive average room rate of $128.10 would ever allow its improvements to depreciate 72%?

Finally, if the property owner were to apply for a real estate secured mortgage using the values generated by both approaches (assuming a 70% loan/value), he or she would qualify for $11,642,000 under the Rushmore approach compared to $7,021,000 under the business enterprise approach, a $4,621,000 difference.

Summary

While the business enterprise approach significantly reduces a hotel's ad valorem tax assessment, it also has the potential of reducing the mortgage asset security value that lenders rely upon when making hotel loans. This would appear to have a significant impact on hotel financings, transactions, and values. If the business enterprise approach is universally mandated for all hotel appraisals, it could severely restrict hotel owners from leveraging their acquisitions, which could lead to a significant decline in hotel values.

Thomas Dolan assisted in the preparation of this article.

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