MAAO
Minnesota Association of Assessing Officers

WHAT THE FF&E?
A GUIDE TO HOTEL VALUATION*

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CIA Valuations Committee

2016 Summer Seminars
“The Valuation of Big Box Retail”

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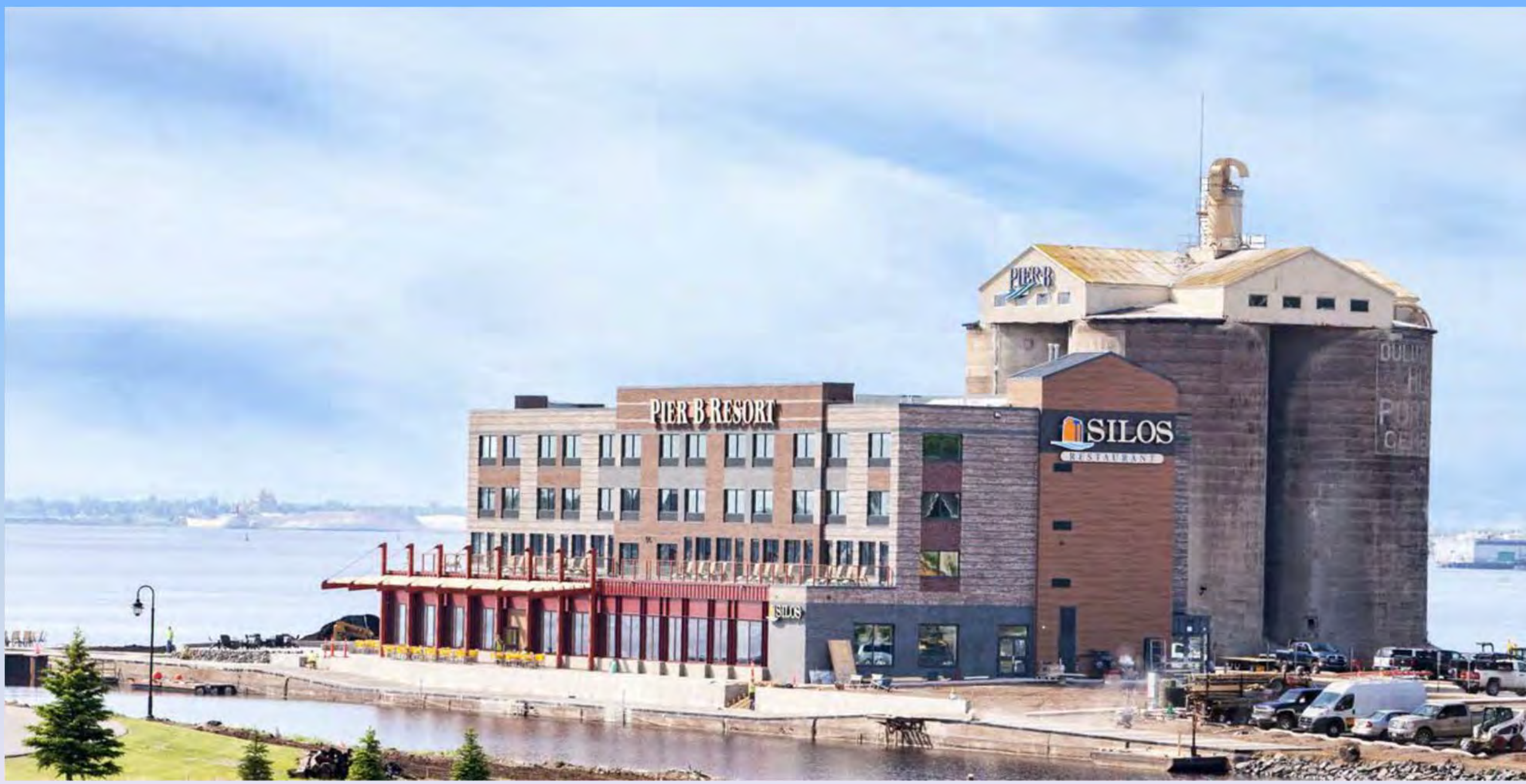
2016 Fall Conference
“Silos and Suites”



CIA Valuations Committee

2017 Summer Seminars
"Multi-Topics for Multi-Family – An Apartment Symposium"

CIA Valuations Committee

2017 Fall Conference
"Tanks A Lot"

CIA Valuations Committee

2018 Summer Seminars
“Food n Fuel”

CIA Valuations Committee

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CIA Valuations Committee

WHAT THE FF&E?
A GUIDE TO HOTEL VALUATION

CIA Valuations Committee

Tanya Pierson, MAI

- HVS- Managing Director
- Grew up on a dairy farm in Colorado
- Developed a strong passion for hotels at a very early age
- University of Denver- Hotel and Restaurant Management
- Moved to Minnesota in 2011

CIA Valuations Committee

Alyssa Browne, MAI, SAMA

- City of Minneapolis- Principal Appraiser
- Born in Laramie, WY
- St Thomas University-

  BA in Finance and BS in Real Estate Studies
- Has always worked in Appraisal
- Loves to travel and spend time with family

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Lucian Hamilton Browne, Candidate for Designation

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Valuing Hotels: Key Factors

Tanya Pierson, MAI | (303) 588-6558 | tpierson@hvs.com

Thousands of hotel owners, developers, investors, lenders, management companies, and public agencies around the world rely on HVS to support confident, informed business decisions.

50+ Offices

LOCATED THROUGHOUT FIVE CONTINENTS

60,000+ Assignments

WHERE WE HAVE ADDED VALUE

350+ Industry Specialists

TO HELP YOU MAKE INFORMED BUSINESS DECISIONS

6,000+ Markets

HAVE BEEN ANALYZED

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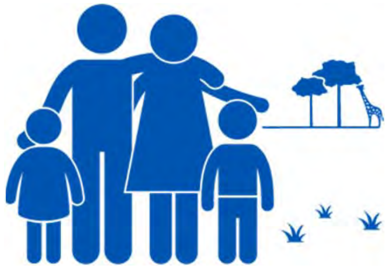
Agenda

- Review of Different Hotel Types
- Key Considerations in Hotel Valuation
- Cap Rates/Discount Rates/RRM
- Recent Trends in Hotel Transactions
- Minneapolis-St. Paul Trends
- Allocation of Value Components

Who Stays in Hotels?

Three Principal Sources of Lodging Demand

Corporate



Leisure

Meeting and Group

***Subgroups**: Extended-Stay, Contract, Wholesale, Government*

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REVIEW OF HOTEL TYPES

Typical Full-Service Hotels

- Rooms
- Restaurant(s)
- Bar(s)
- Ballroom
- Junior Ballroom
- Small Meeting Rooms
- Fitness Center and Pool
- Other amenities:
  - Business Center
  - Gift Shop
  - Spa

Typical Full-Service Hotels

Luxury Brands:

FOUR SEASONS

THE RITZ-CARLTON®

ST REGIS

WALDORF ASTORIA®
HOTELS & RESORTS

Upper-Upscale Brands:

Marriott®

Hilton

WESTIN®
HOTELS & RESORTS

HYATT®

Upscale Brands:

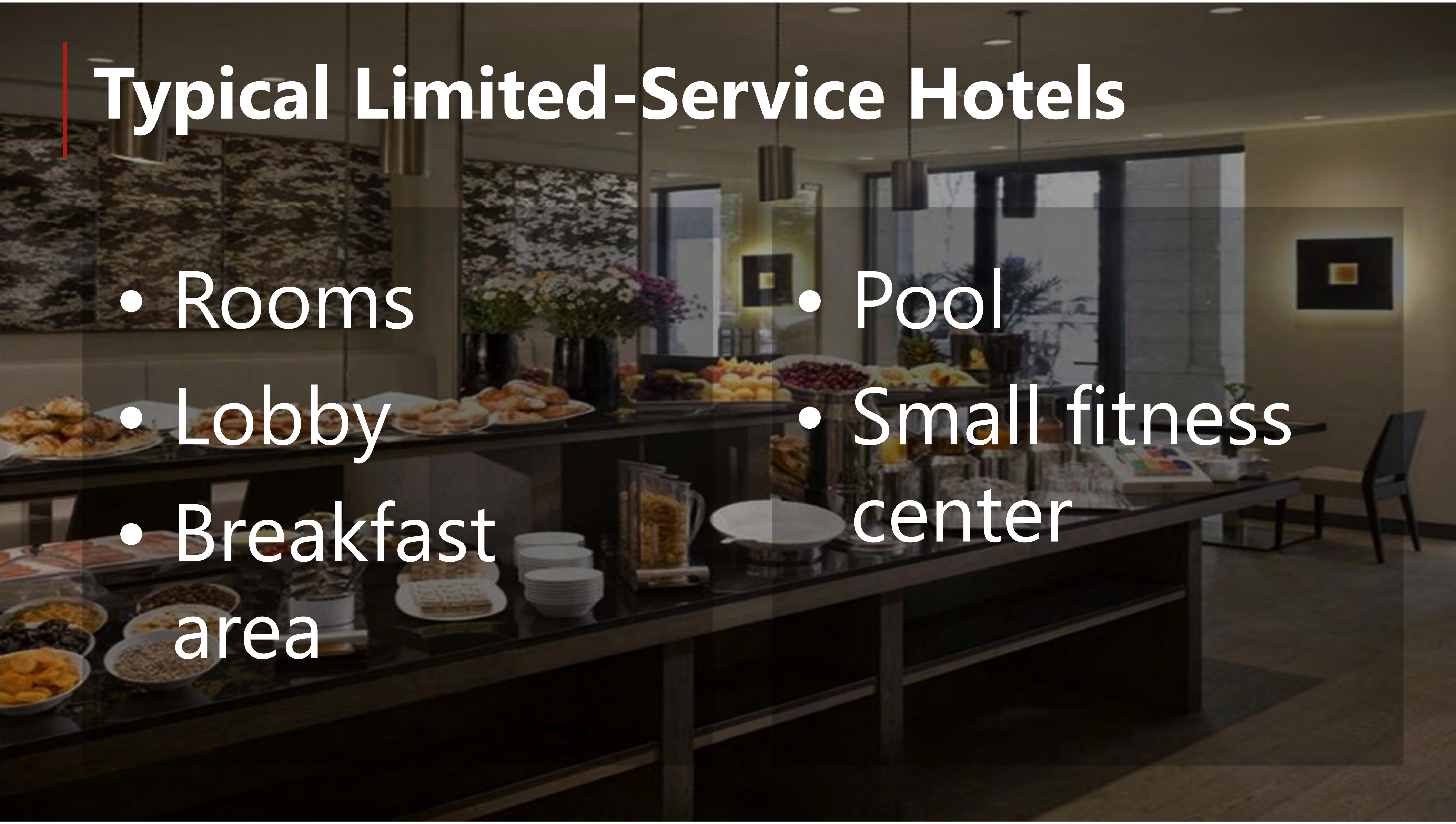
Radisson®

DOUBLETREE
BY HILTON™

WYNDHAM
HOTEL GROUP

CROWNE PLAZA®
HOTELS & RESORTS

Typical Limited-Service Hotels



- Rooms
- Lobby
- Breakfast area
- Pool
- Small fitness center

Typical Limited-Service Hotels

Comfort INN

Holiday Inn Express

Hampton Inn

Best Western

Days Inn

Shilo Inns

COUNTRY INNS & SUITES BY CARLSON

LAQUINTA INNS & SUITES

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Typical Select-Service Hotels

- Rooms
- Lobby
- Combined food and beverage outlet
- One or two Meeting Rooms
- Fitness Center and Pool
- Other amenities:
  - Market Pantry
  - Business Center

Typical Select-Service Hotels

Typical Extended-Stay Hotels

- Rooms
  - Suite Layout
  - Kitchenettes
- Lobby
- Breakfast area
- Pool
- Small fitness center
- Outdoor Amenities
  - BBQ, Sport Court, etc.

Typical Extended-Stay Hotels

extended STAY AMERICA

HYATT house

CANDLEWOOD SUITES

element BY WESTIN

Residence Inn Marriott

STAYBRIDGE SUITES

HOMEWOOD SUITES Hilton

Other Types of Hotels

Chain Scales (as defined by STR Global)

- **Luxury**
  - Four Seasons, InterContinental, JW Marriott, Ritz-Carlton, W Hotel
- **Upper-Upscale**
  - Hilton, Hyatt, Marriott, Westin, Sheraton, Renaissance
- **Upscale**
  - DoubleTree, Hilton Garden Inn, Courtyard by Marriott, Crowne Plaza, Aloft
- **Upper Midscale**
  - Fairfield Inn, Hampton Inn, Holiday Inn, Country Inn
- **Midscale**
  - Best Western, La Quinta, Quality Inn, AmericInn
- **Economy**
  - Days Inn, Econo Lodge, America's Best Value Inn, Motel 6

Key Considerations in Hotel Valuation

- Supply and Demand Trends
- Franchise Agreements
- Capital Improvement Needs
- Management Company
- Operating Ratios and Value Parameters
- Sales Comparables

Fieldwork

- Fieldwork
  - Subject Property Interview and Inspection
  - Competitor Interviews and Inspections
  - Neighborhood
  - Planning and Zoning
  - Chamber of Commerce / Economic Development
  - Broker Interviews
  - Convention and Visitors Bureau
  - Assessor and Tax Office

Room Night Analysis

- Selection of Primary and Secondary Competitors
- Considering Competitive Additions to Supply
- Competitive Property Expansion or Closure
- Forecast of Market Occupancy and Average Daily Rate
- Forecast of Subject Property Occupancy and Average Daily Rate

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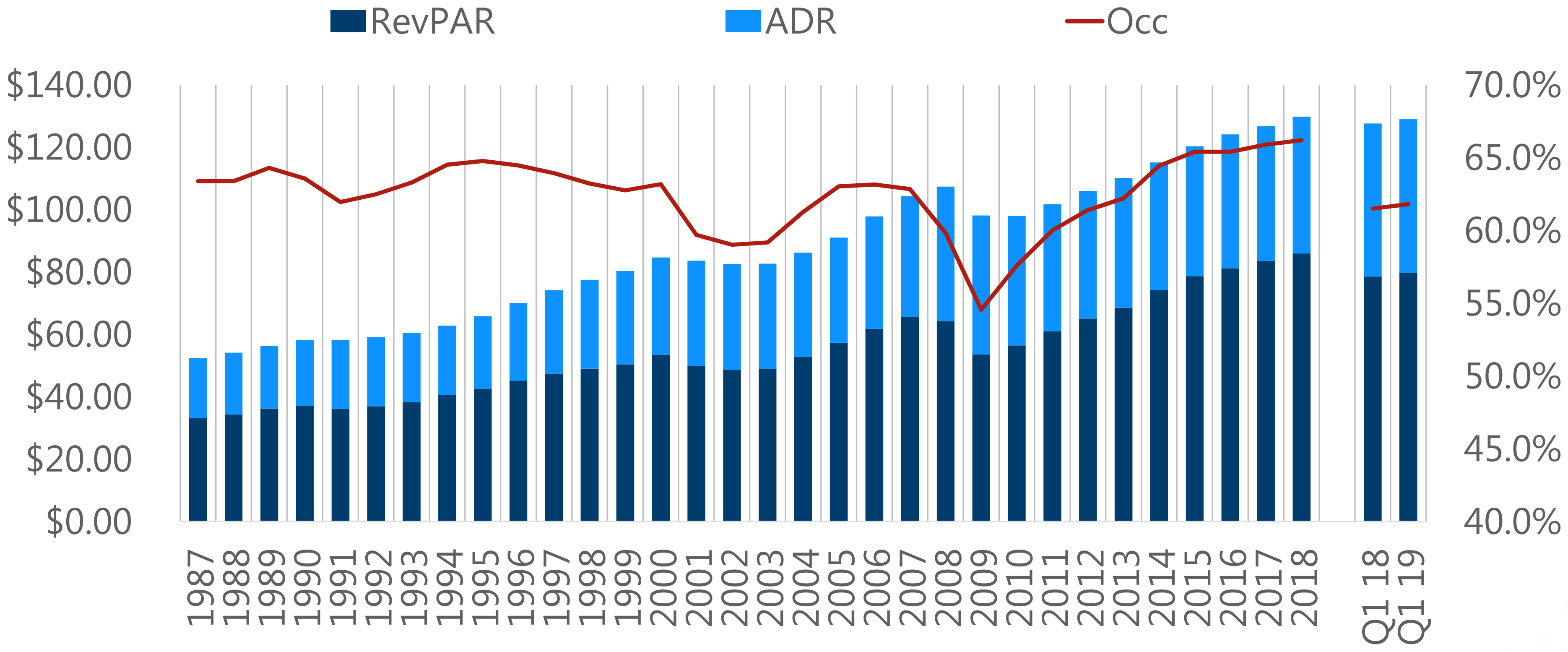
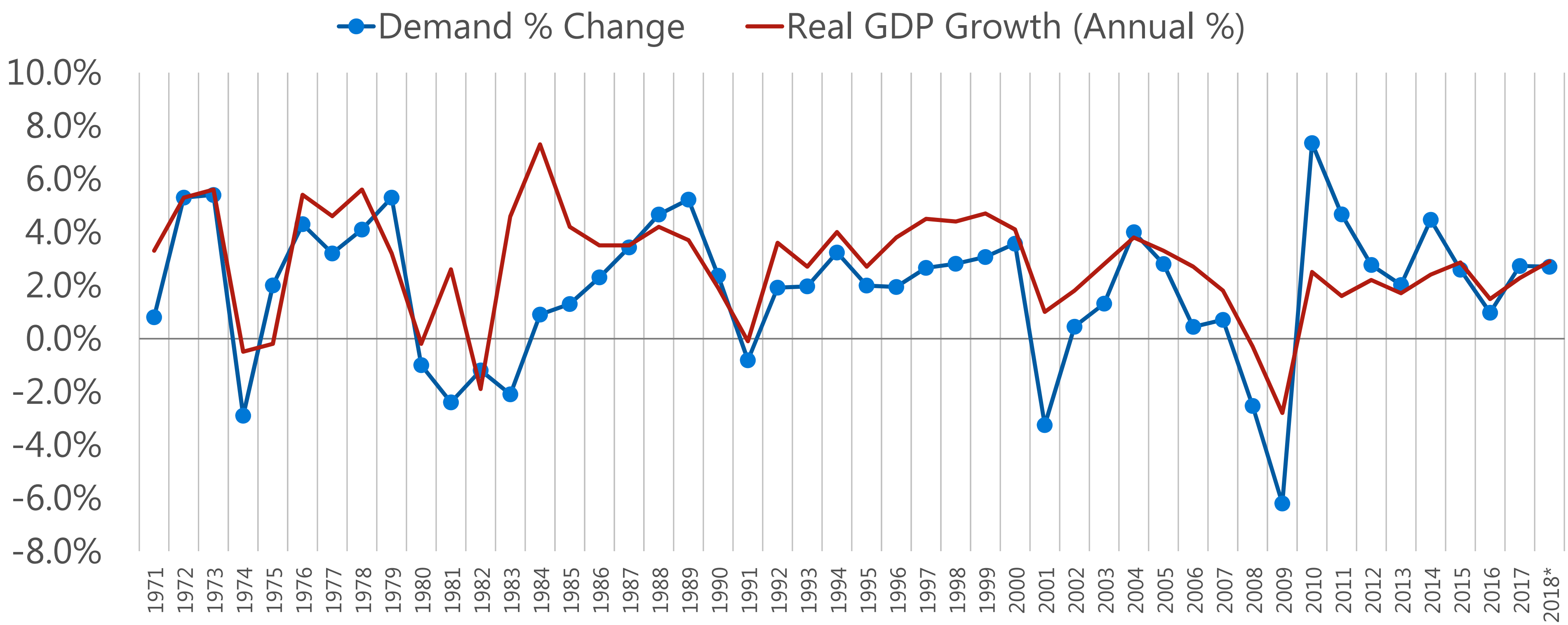
National Trends

National Occupancy, ADR, and RevPAR Grew



Source: STR

GDP and Demand Growth Correlation



Source: STR, Bureau of Economic Analysis

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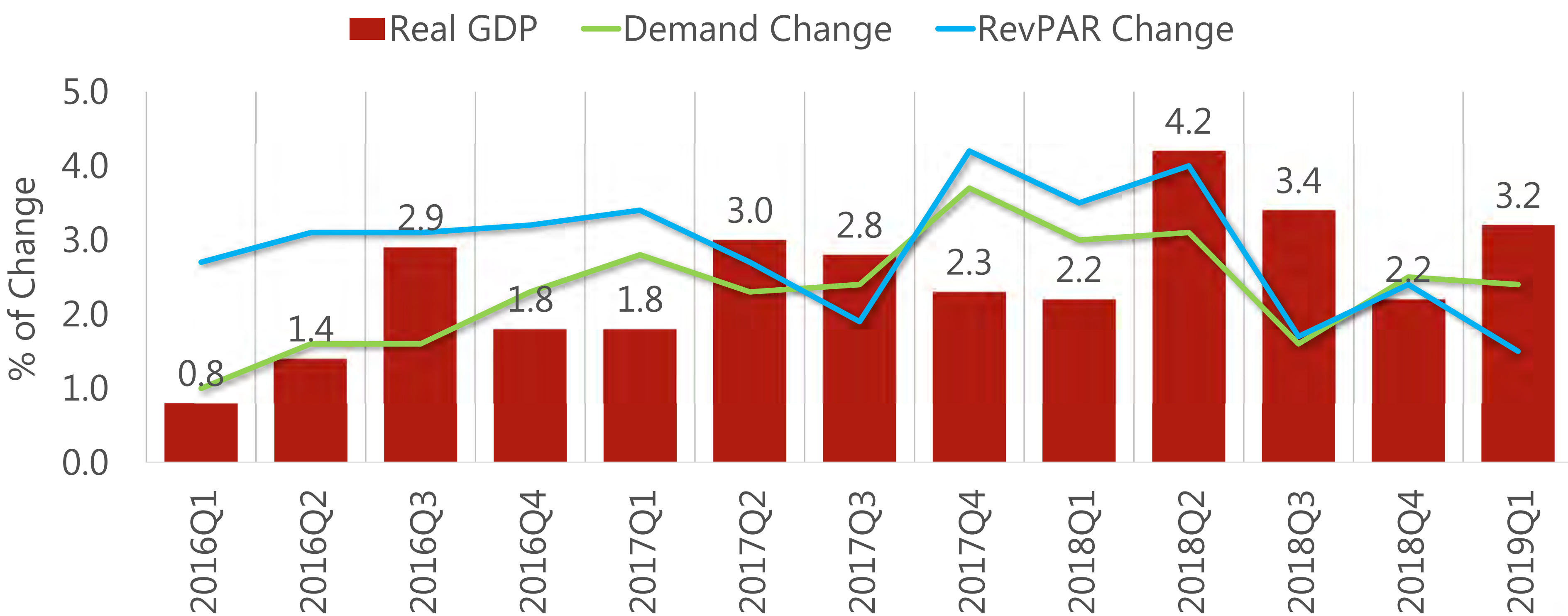
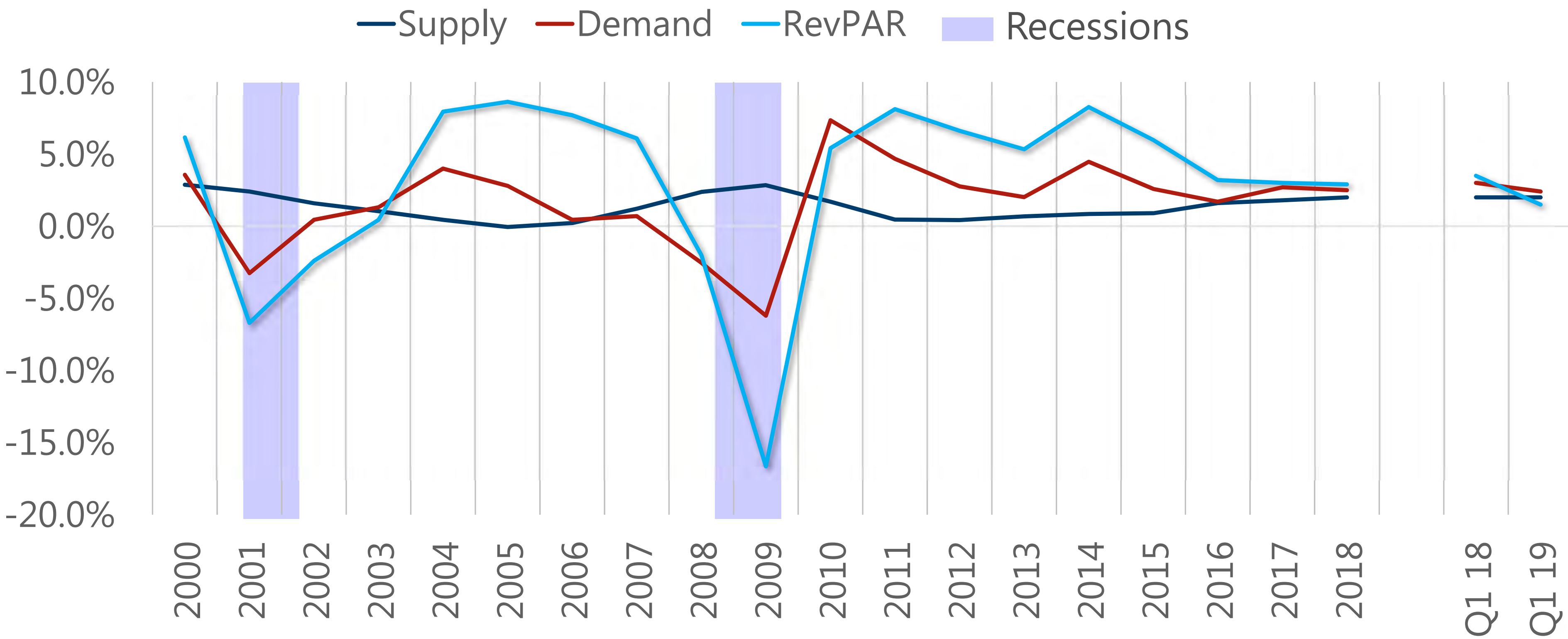
National GDP Growth vs. Demand and Revenues



Source: STR, Bureau of Economic Analysis

Historical Change of Supply & Demand



Source: HVS, STR

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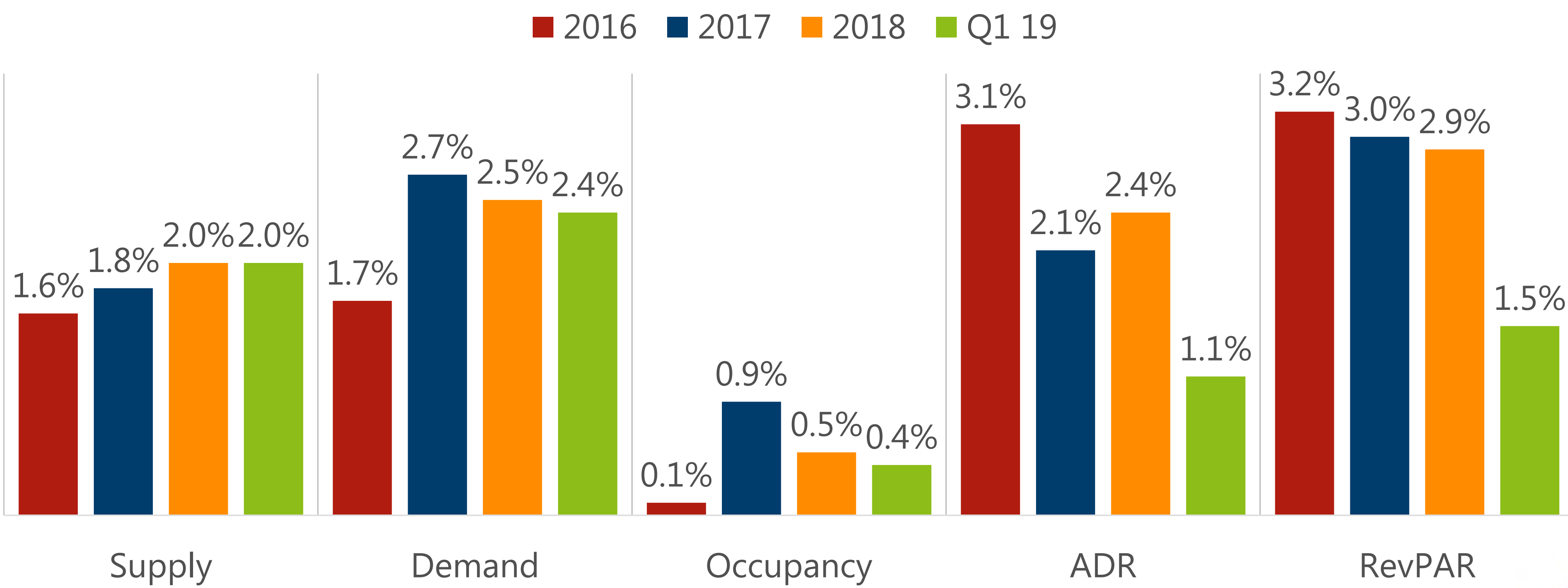
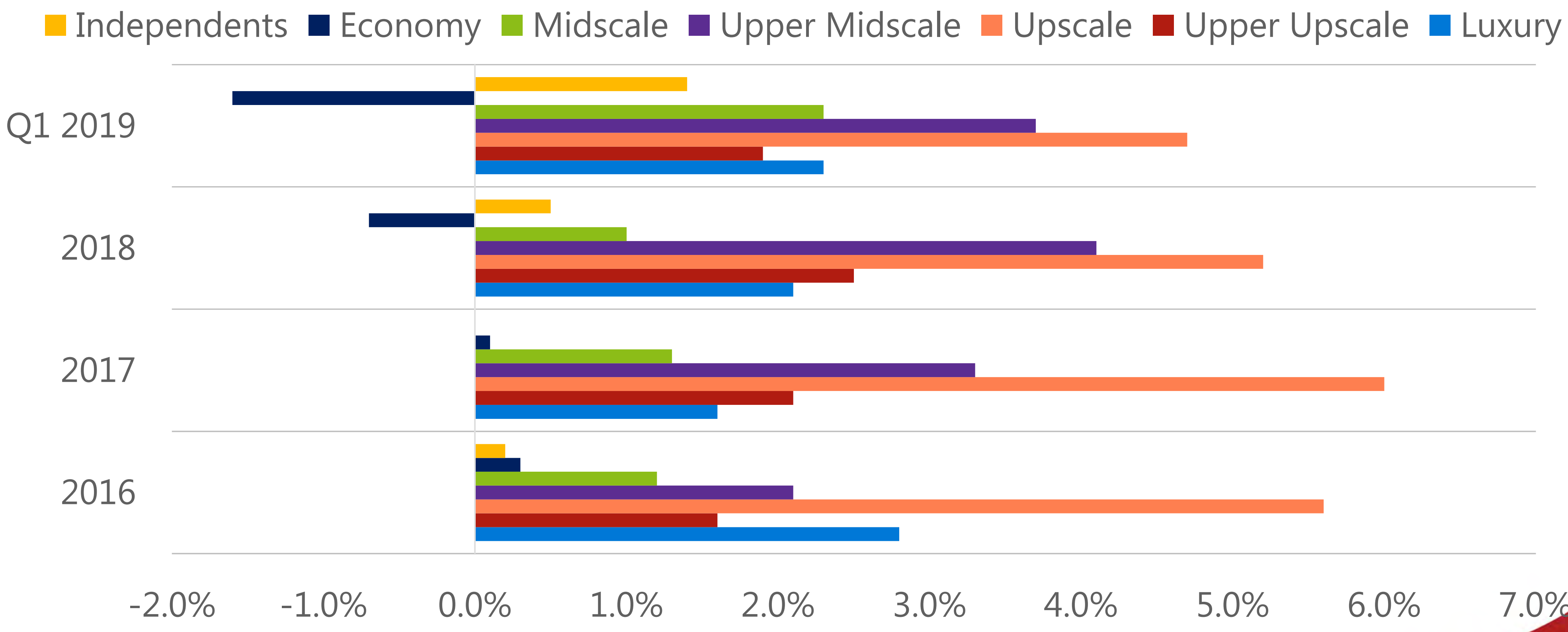
Supply Escalating, ADR and RevPAR Moderating



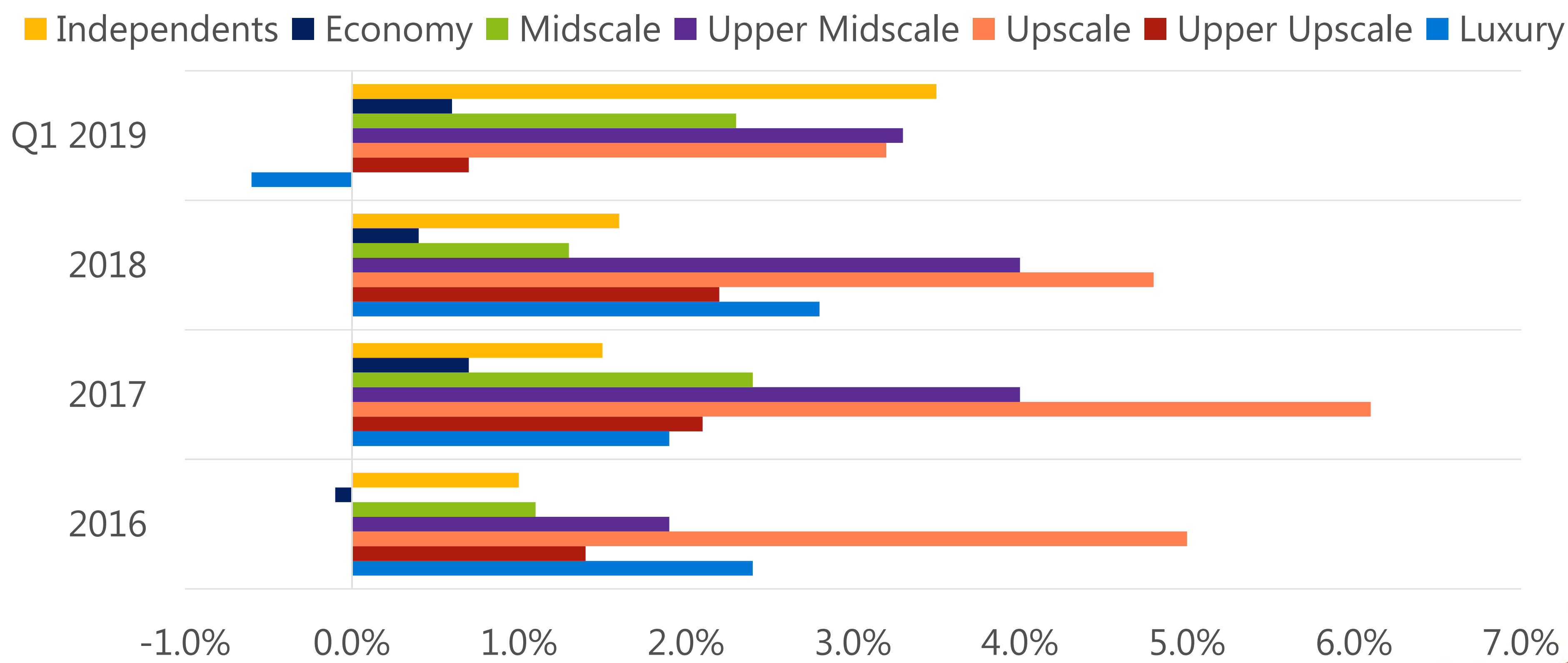
Source: STR

Upscale Supply Growth Driving the Market



Source: STR

Demand for Upscale Hotels Continues to Lead



Source: STR

Way to Minimize Risk: Thorough Evaluation of Key Factors Impacting Hospitality Assets

- Addressed New Supply/Economic Factors

Next:

- Management & Management Agreements
- Franchise Agreements & Branding Issues
- Capital Improvements/PIPs &Obsolescence

Key Considerations: Management Agreements

- **Management agreement** can significantly **impact value** and may be a major risk factor
  - Term of agreement and termination provisions upon sale and default should be analyzed
  - Non-brand management agreements vary greatly and offer greater flexibility than brand management agreements
- Is Hotel Brand Managed? (Ritz-Carlton/Westin/Hilton)
  - Typically no franchise fees, but incentive management fees are generally charged and must be factored into value
  - Brand managed hotels typically require payment of a termination fee and renewal is at the option of the management company; some cannot be terminated.
- Management encumbrance can impact value, for better and for worse

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Management Agreements

- Is agreement Terminable Upon Sale?
  - Not as much an issue with Limited-Service hotels
  - More prevalent in Full-Service hotels
- Is Hotel Brand Managed?
- What kind of fees?
  - Base Management Fee
  - Incentive Management Fee

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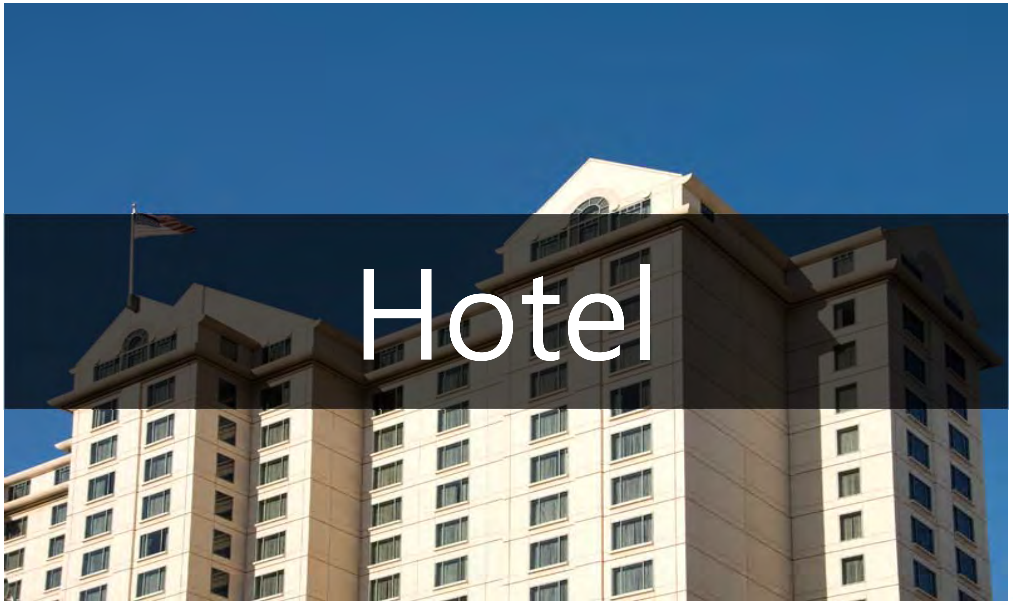
Franchise Agreements

Major driver of revenue and value



Franchise Agreements

- Initial term of typical franchise agreement for a new hotel is **20 years**; 10 to 15 years on a renewal
- Brand will require periodic **PIPs** (Product Improvement Plans) whether they are economically justified or not
- **Franchise does not automatically transfer upon sale** – must be newly negotiated with buyer, at which point franchisor has opportunity to require significant improvements to current brand standards.
- **Capital upgrades** for an **existing franchisee** are **not** as **extensive** as for a new buyer, which represents a **significant risk** that is typically not recognized when a hotel is **refinanced**.

Franchise Agreements

Operating Costs

- Royalty Fee: *3.0% to 7.0% of Rooms Revenues*
- Program Fees: *1.5% to 4.0% of Rooms Revenues (includes marketing, advertising and reservations)*
- Food and Beverage Fees: *2.0% to 7.0% of F&B Revenues*
- Frequent Guest Program costs: *$2.00 to $5.00 per room per member*

Franchise Agreements

Brand Standards:

- Services or Amenities
  - Specific size flat panel televisions
  - Minimum bandwidth wireless internet
  - Life-safety systems
  - Interior corridors
  - Sliding barn door in rooms

Franchise Agreements

Construction Costs

- Brand mandated facilities
- Brand mandated materials and quality standards

Renovation Costs

• Replace soft goods every 6 to 7 years:	$6,000 to $8,000/room
• Replace case goods every 12 to 14 years:	$6,000 to $8,000/room
• Fully renovate bathrooms after 18 years:	$8,000 to $20,000/room

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Capital Improvements

- Age of Overall Improvements
  - Increasing number of aging hotels
  - Defensive Capital vs. Repositioning
- Existing Improvements Could Limit Branding & Redevelopment
  - Exterior Corridor
  - Life Safety Systems
  - Parking Requirements
- Brand Mandated Upgrades

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Branding/Franchise

Pros

- National marketing efforts by parent company
- Participation in brand loyalty program
- Lower negotiated commission rates
- Standardized operating procedures and training programs
- Brand standards ensure consistent product quality

Cons

- Franchise fees can be significant (up to 10% of revenues)
- Stringent requirements on reinvestment in property every 6-8 years
- Brand space is becoming crowded and creating competition within parent companies

Going Independent

Pros

- Not tied to brand standards in design or service offerings – can create something more 'experiential'
- No costly royalty or chain marketing fees results in expense savings

Cons

- No national marketing efforts – reliant on the success of the property's sales team
- Typically more reliant on OTA-driven business with less favorable commission structure
- Guests may be wary of "what they're getting"

Franchise Agreements

Source: HVS

Marriott Plan Renovation Protocols

	Courtyard	Residence Inn
6 year "Refresh"		
Guestrooms (per room)	$7,500	$9,500
Public Space	$600,000	$200,000
Total for 120 room hotel	***$1,500,000***	***$1,340,000***
12 Year "Refresh"		
Guestrooms (per room)	$10,000	$12,000
Public Space	$800,000	$300,000
Total for 120 room hotel	***$2,000,000***	***$1,740,000***
18 Year "Renovation"		
Guestrooms (per room)	$17,500	$27,500
Public Space	$800,000	$400,000
Total for 120 room hotel	***$2,900,000***	***$3,700,000***
24 Year "Refresh"		
Guestrooms (per room)	$7,500	$9,500
Public Space	$800,000	$300,000
Exterior	Varies	Varies
Total for 120 room hotel	***$1,700,000 +***	***$1,500,000 +***

Source: Marriott.com | Actual costs vary based on specific property and location

Hampton Forever Young Renovations

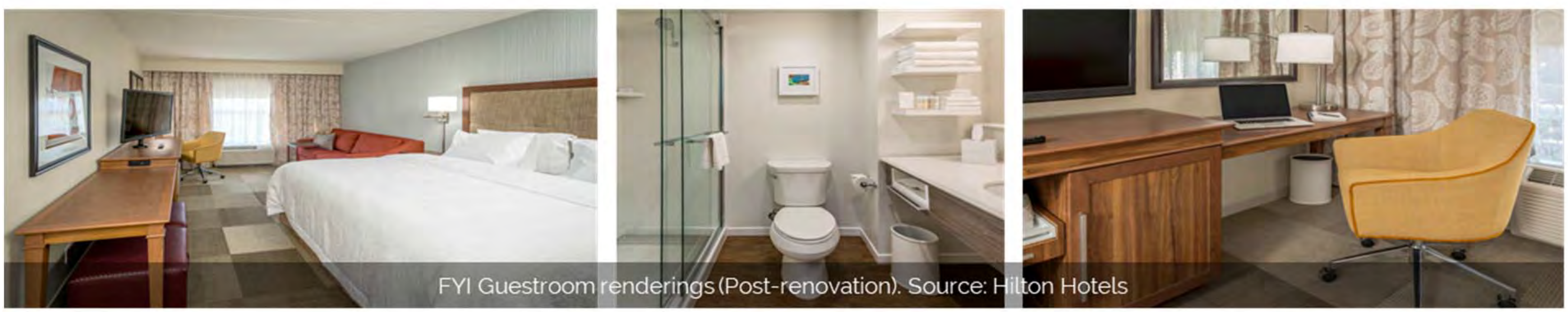

FYI Exterior Renderings (Post-renovation). Source: Hilton Hotels

Total Renovation:

$15,000 - $25,000 / Room
(After 1995)

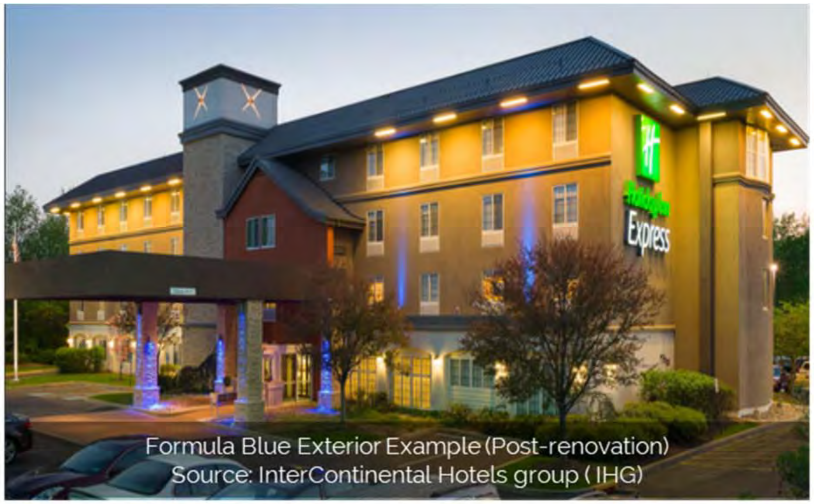
$20,000 - $30,000 / Room
(1990-1995)

$40,000+ / Room
(1980, if it can be renovated)


FYI Guestroom renderings (Post-renovation). Source: Hilton Hotels

Source: HVS

Holiday Inn Express Formula Blue Renovations



Formula Blue Exterior Example (Post-renovation)
Source: InterContinental Hotels group (IHG)

Total Renovation:

As low as $5,000/ Room
(On Design Scheme)

$10,000 - $20,000 / Room
(After 2001)

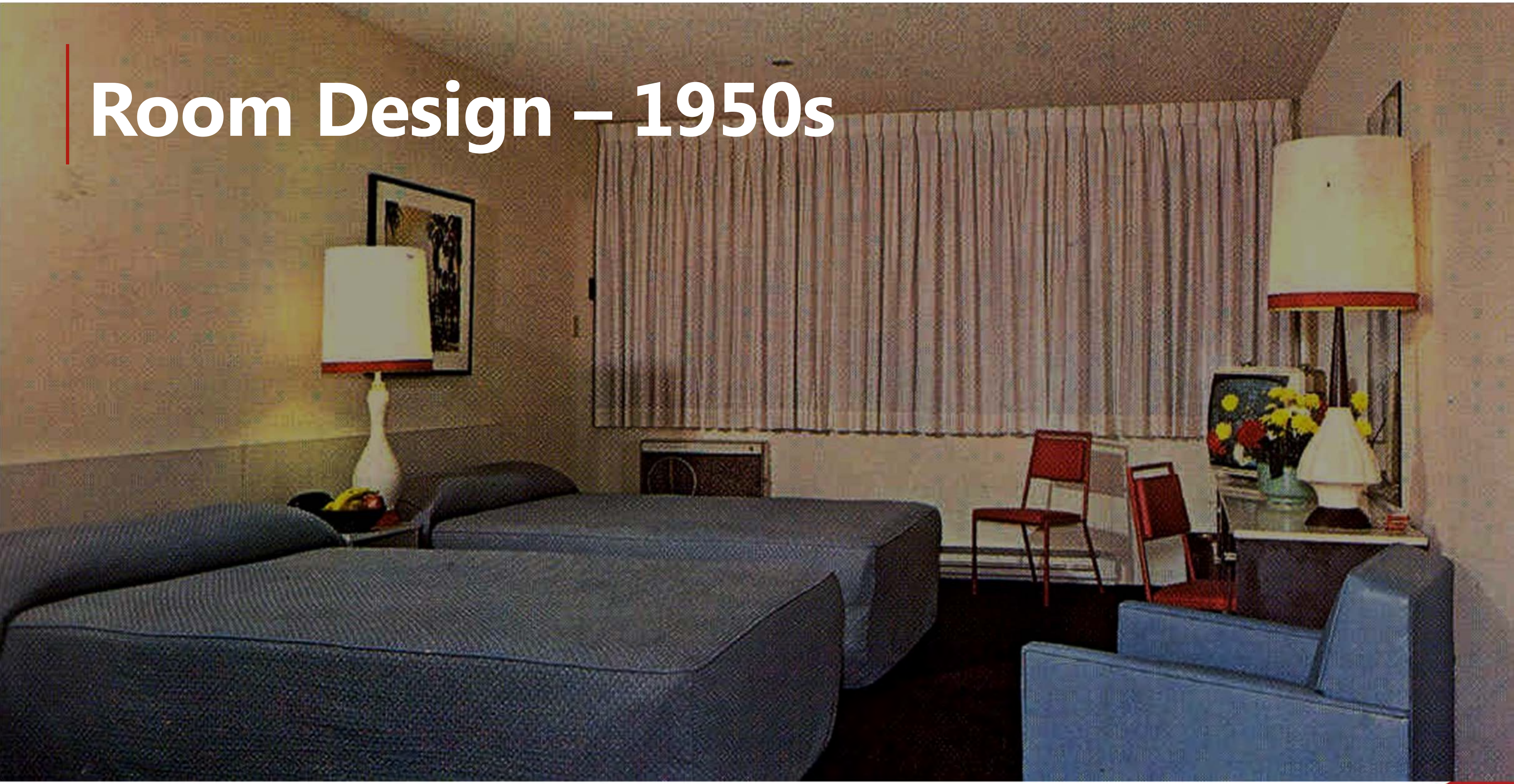
$20,000 - $30,000 / Room
(Before 2001)

Source: HVS

Formula Blue Exterior Example (Post-renovation). Source: InterContinental Hotels group (IHG)

Source: HVS

Room Design – 1950s



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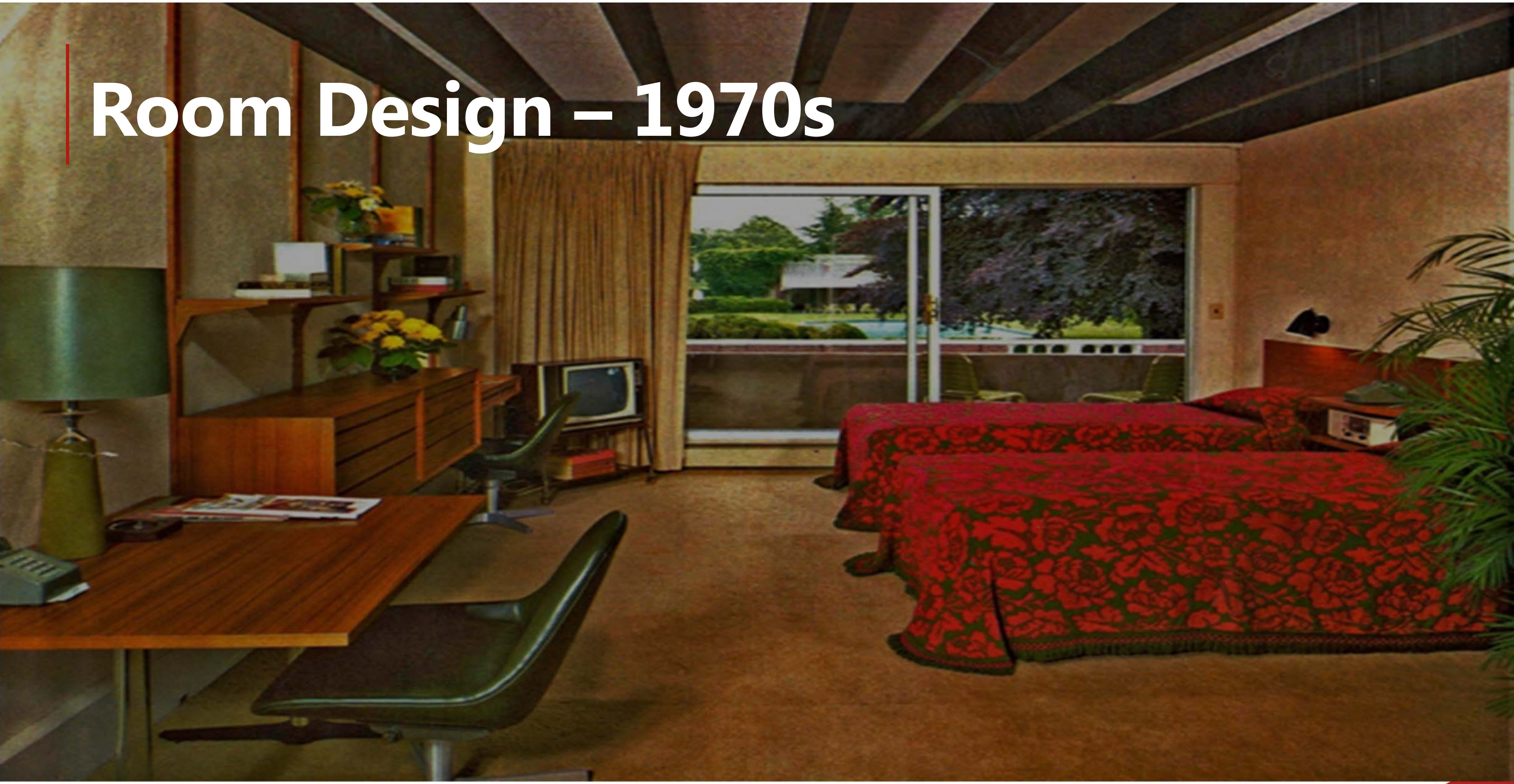
Room Design – 1970s



Room Design – 1980s

Room Design – 1990s

Room Design – 2000s

Bathroom Design – 1950s

Bathroom Design – 1960s

Bathroom Design – 1990s

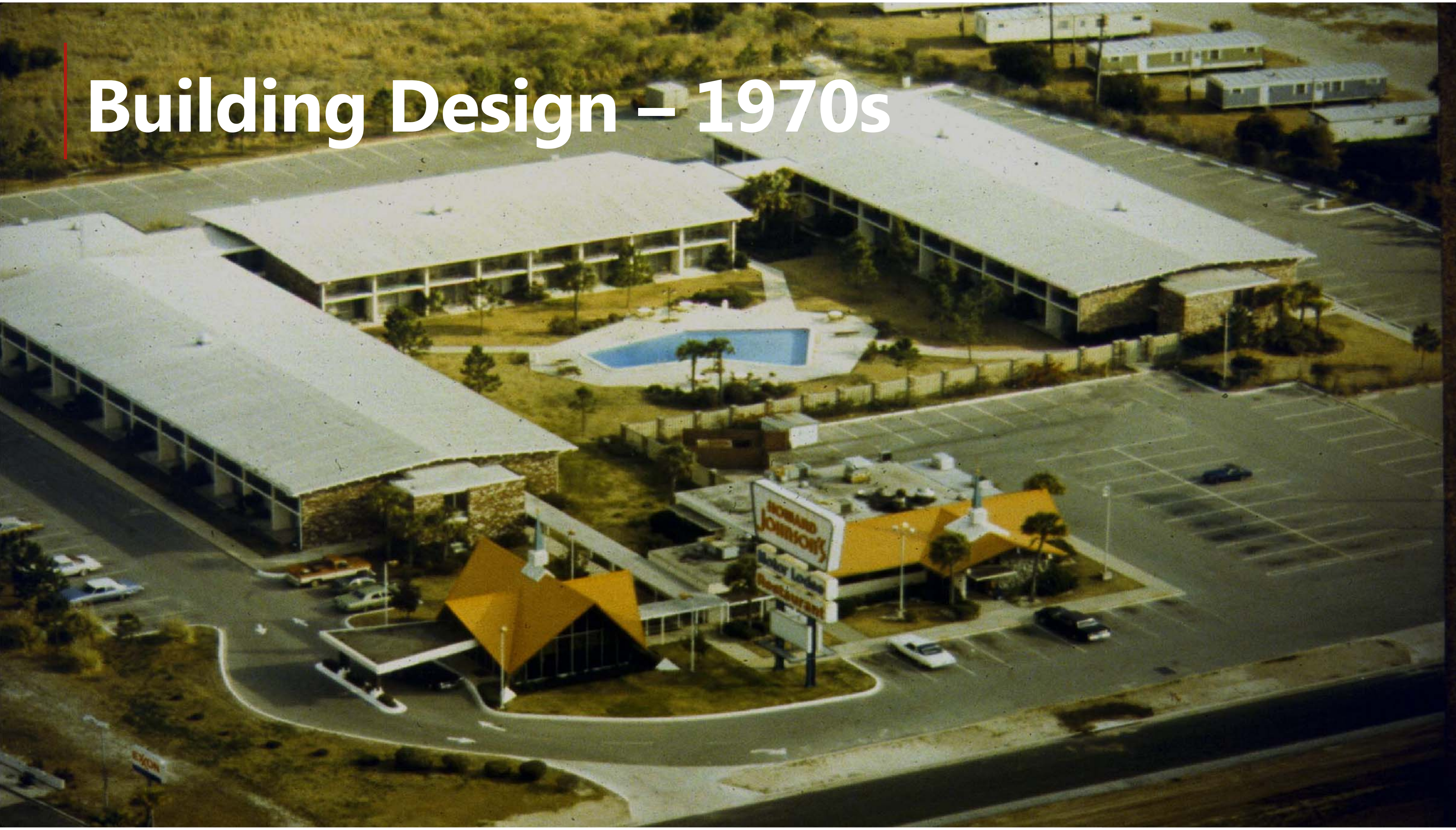
Bathroom Design – 2000s

Heavenly Bed

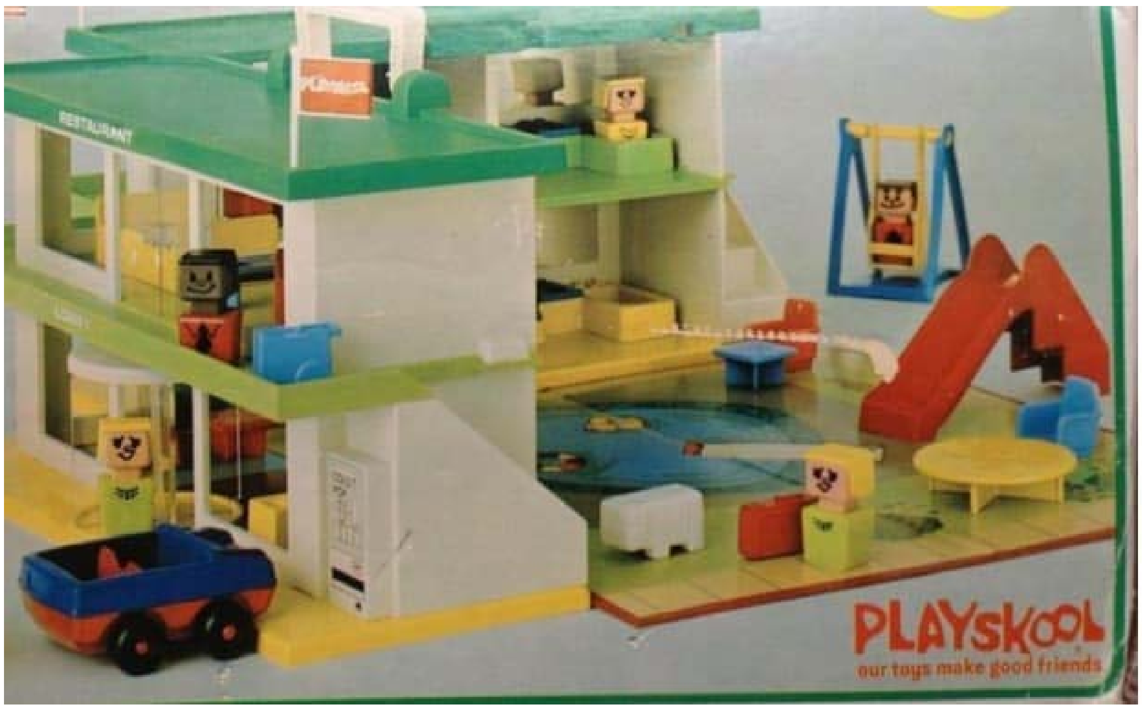
Heavenly Shower

Wigwam Motels – patented 1936

Building Design – 1970s



In 1974, Playskool debuted a hotel play set complete with guestrooms, restaurant, lobby, outdoor pool area, and this brand's sign



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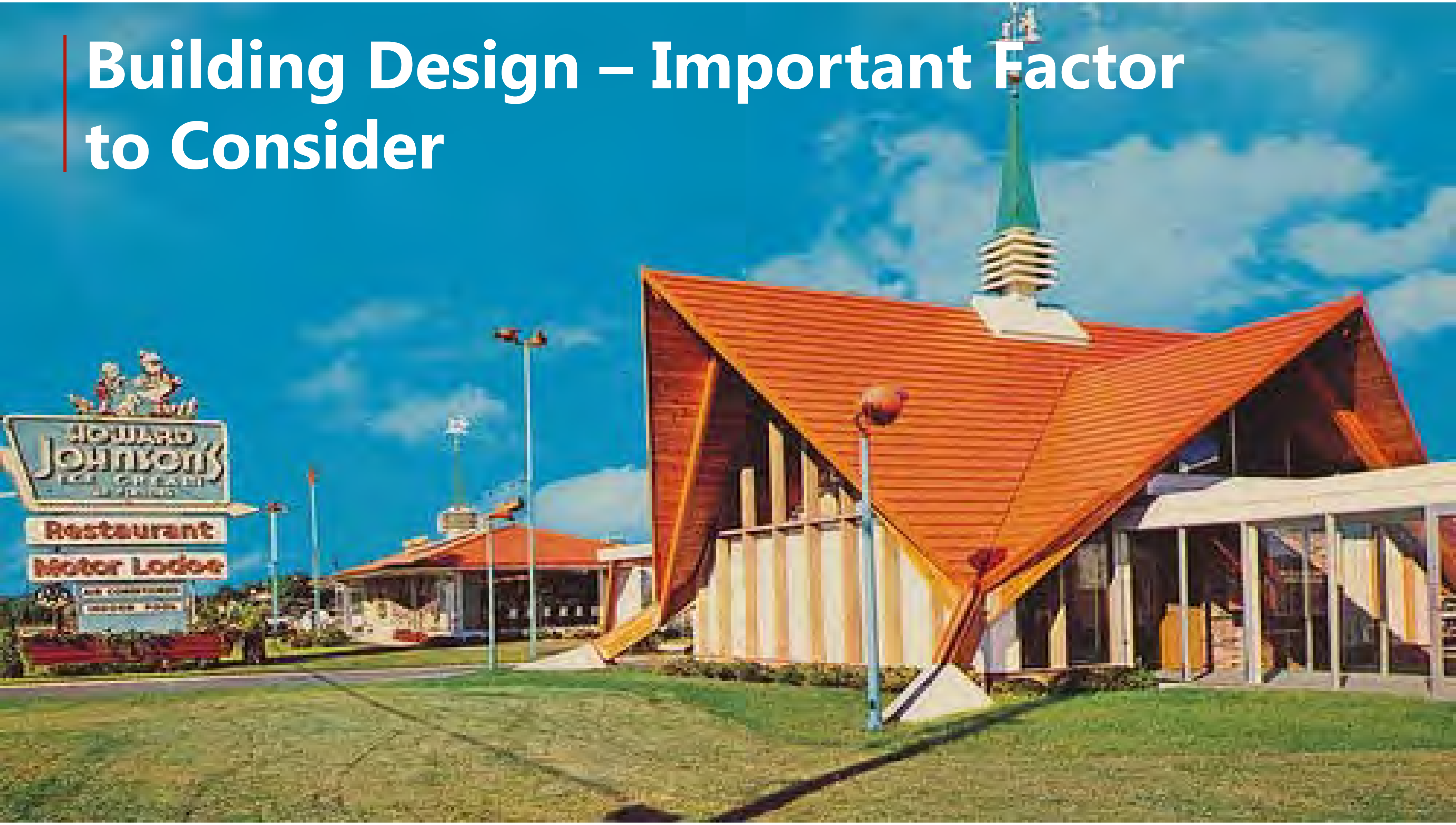
Building Design – Important Factor to Consider



Building Design – Important Factor to Consider

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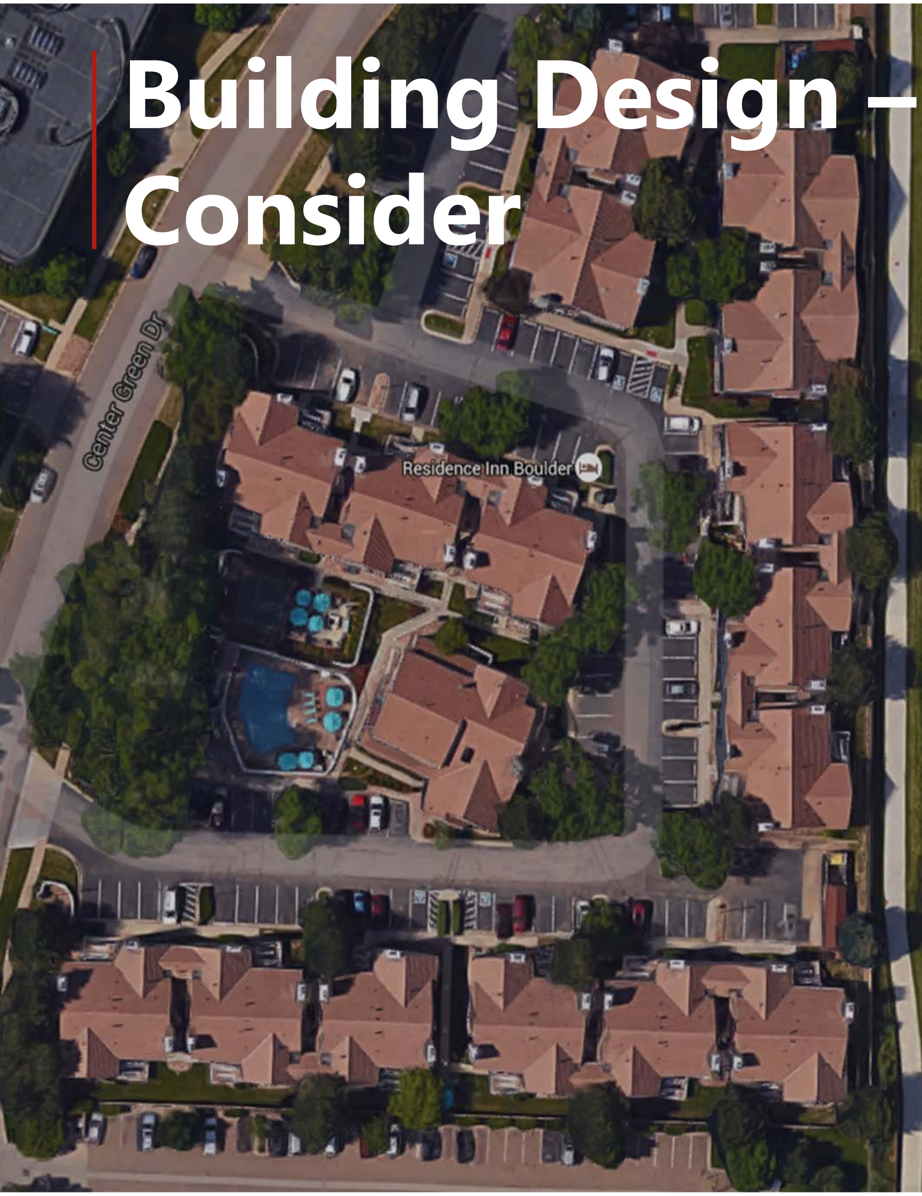
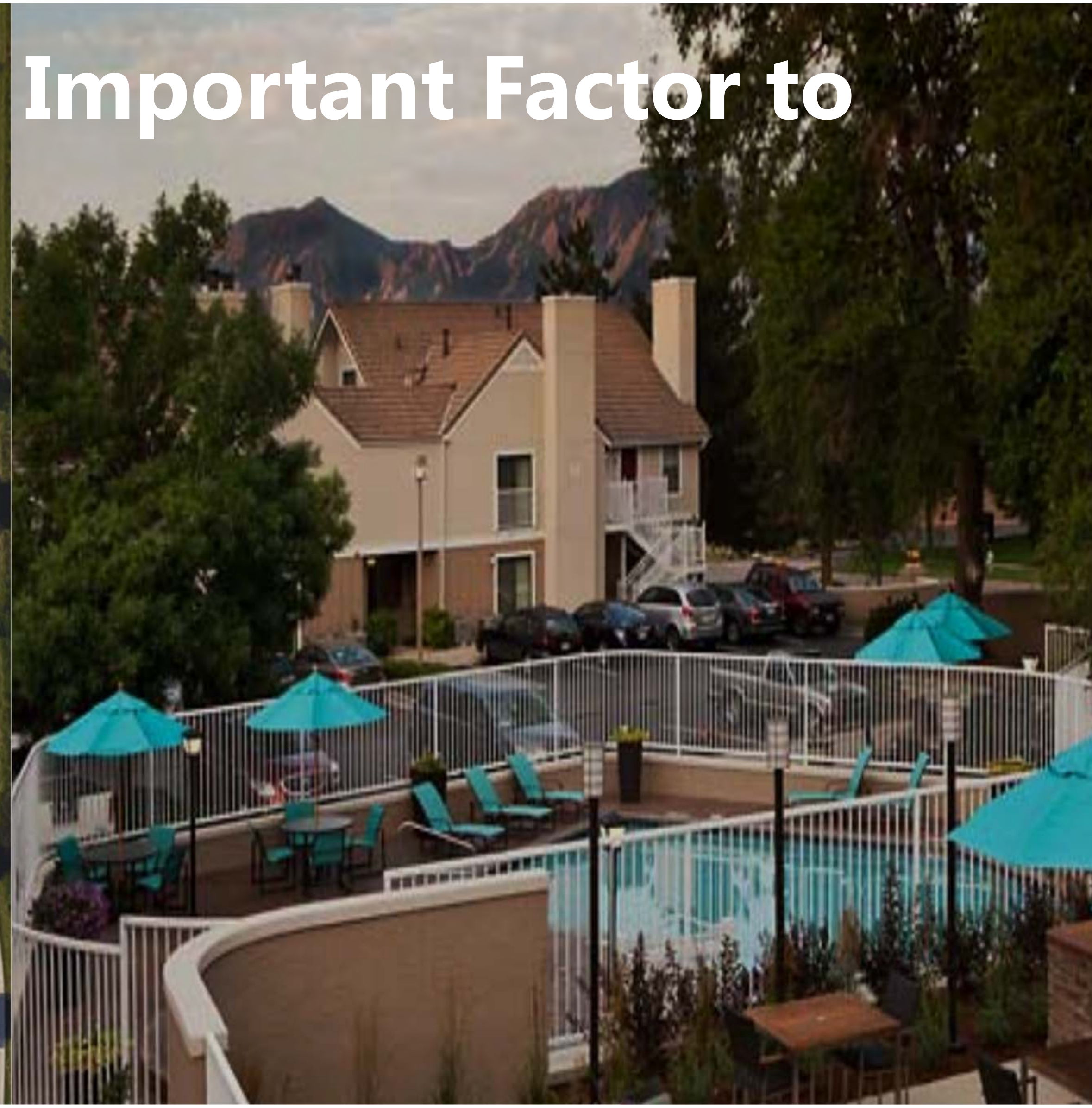


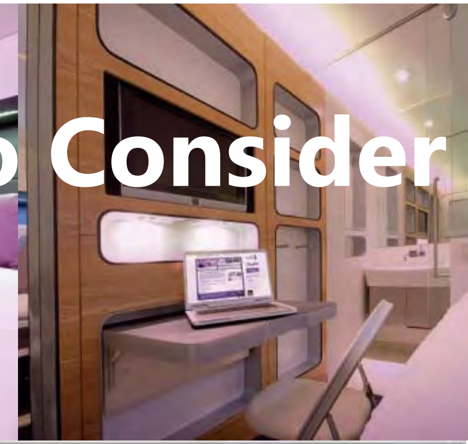


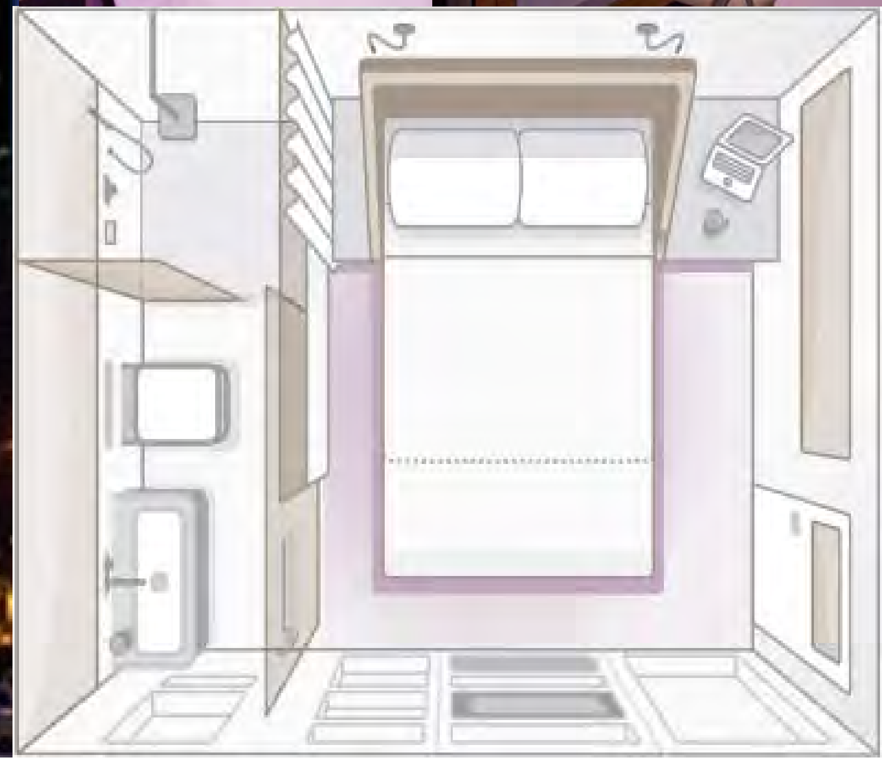
Building Design – Important Factor to Consider

New Design – Important Factor to Consider

What Happens to This Roofline Upon a Brand Change?

New Design – Important Factor to Consider





New Design – Important Factor to Consider

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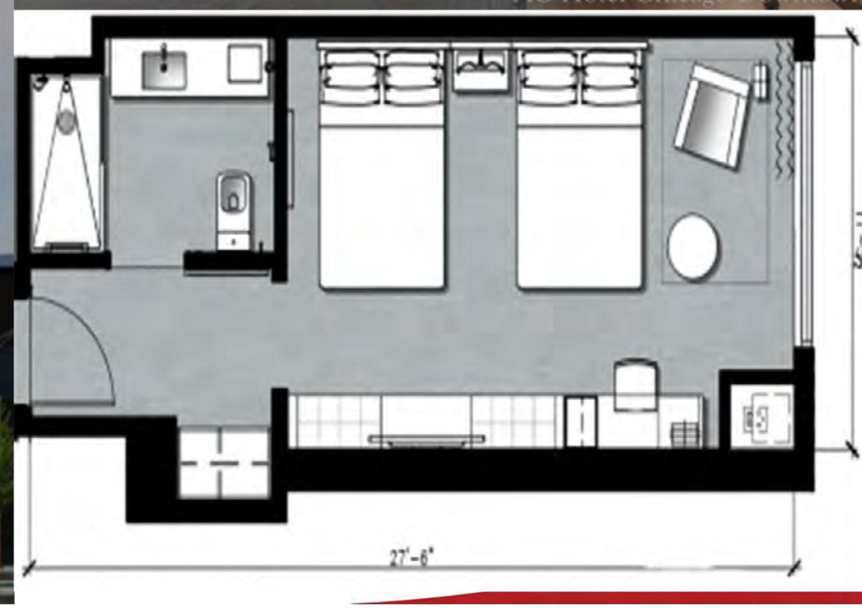
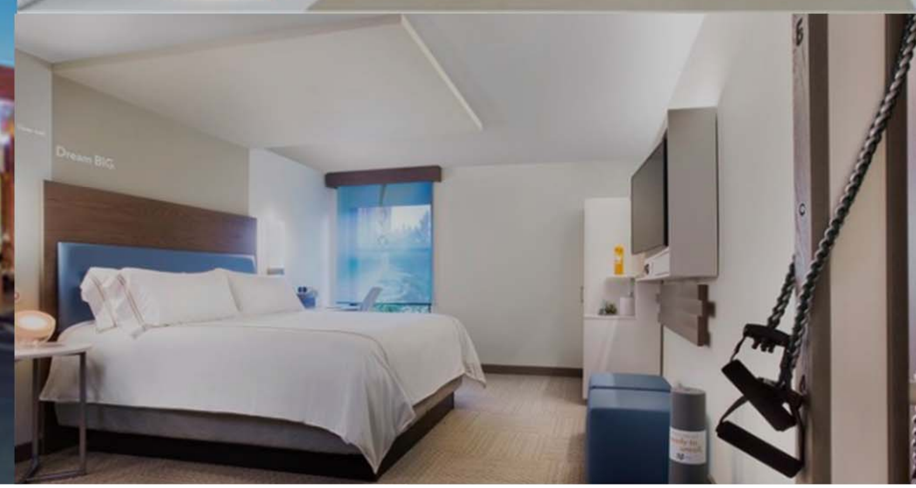


New Design – Important Factor to Consider



Key Considerations: Franchise

Examples of Strong Limited- and Select-Service "New Build" Brands:

Examples of "Conversion" Brands:

New Hampton Inn – Tempe, AZ

Value Impact: Hampton Rebranding to Conversion Brand

Operating Stats:
Occupancy: 64%
ADR: $106

Value: $7.5 million;
$65,000/Room

Operating Stats:
Occupancy 49%
ADR: $63

Value: $2.8 million;
$24,000/ Room

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Cap Ex: Property Condition Reports Generally Do Not Tell the True Story

Generalist building inspectors do not have expertise regarding hotel brand standards

Renovation Costs: Light to Full Refurb/Reno Range: $8,000 to $50,000+/Room

Replace soft goods every 5 to 7 years	Replace case goods every 12 to 14 years	Fully renovate bathrooms after 18 years	Lobby Renovation – Communal Seating
$6,000 to $10,000+/room	$6,000 to $10,000+/room	$8,000 to $20,000+/room	$1,000,000+

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Example of Pending Brand Conversion

Impact of PIP Costs on Value

Upscale	Low	High	Average	Selected	Unit Type	Unit	Total
Guestrooms							
Rooms (Full Renovation)	$14,360	$18,542	$16,324	$17,000	Per Guestroom	349	$5,933,000
Bathrooms (Partial Renovation)	$1,416	$2,402	$1,895	$2,000	Per Guestroom	349	$698,000
Corridors (Full Renovation)	$1,156	$1,520	$1,329	$1,300	Per Guestroom	349	$453,700
Guestrooms Total							**$7,084,700**
Per Room							**$20,300**
Public Spaces (Modest Updates)	$432,905	$586,310	$500,312	$500,000	Total	1	$500,000
Exterior Signage	$58,855	$69,556	$63,537	$65,000	Total	1	$65,000
Public Space & Exterior Total							**$565,000**
Contingency @ 10%							**$764,970**
						Total:	**$8,414,670**
						Per Roor	**$24,111**

Future Capital Assumption		**Total**	**Per Room**
CapEx Assumed by HVS		$8,414,670	$24,111
Less: Year 1 Allocation Reserve for Replacement of	75%	$402,864	$1,154
Less: Year 2 Allocation Reserve for Replacement of	50%	$294,139	$843
Indicated Capital Deduction:		$7,717,667	$22,114
Capital Deduction Rounded to:		**$7,700,000**	**$22,100**

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“Superior” Unsustainable Management

	Subject	Subject Stabilized $
Year:	2014/15	2014/15
Number of Rooms:	349	349
Days Open:	365	365
Occupancy:	69.4%	70%
Average Rate:	$120.05	$126
RevPAR:	$83.35	$88
REVENUE		
Rooms	76.2 %	75.3 %
Food & Beverage	22.2	23.2
Other Operated Departments	0.0	0.0
Rentals & Other Income	1.6	1.5
Total	100.0	100.0
DEPARTMENTAL EXPENSES*		
Rooms	26.5	25.3
Food & Beverage	51.8	60.3
Other Operated Departments	3,631.1	7,522.8
Total	32.3	34.1
DEPARTMENTAL INCOME	67.7	65.9
OPERATING EXPENSES		
Administrative & General	9.8	9.3
Marketing	2.6	5.3
Franchise Fee	4.9	6.0
Property Operations & Maintenance	5.3	5.0
Utilities	5.9	5.6
Total	28.5	31.2
HOUSE PROFIT	39.2	34.7
Management Fee	3.0	3.0
INCOME BEFORE FIXED CHARGES	36.2	31.7

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Stabilized Income After Cap Ex Will Be Lower Than Historical

	Subject	Subject Stabilized $
Year:	2014/15	2014/15
Number of Rooms:	349	349
Days Open:	365	365
Occupancy:	69.4%	70%
Average Rate:	$120.05	$126
RevPAR:	$83.35	$88
REVENUE		
Rooms	$30,423	$32,170
Food & Beverage	8,850	9,895
Other Operated Departments	6	6
Rentals & Other Income	654	658
Total	39,934	42,729
DEPARTMENTAL EXPENSES		
Rooms	8,068	8,128
Food & Beverage	4,587	5,969
Other Operated Departments	230	480
Total	12,885	14,577
DEPARTMENTAL INCOME	27,048	28,152
OPERATING EXPENSES		
Administrative & General	3,933	3,990
Marketing	1,028	2,260
Franchise Fee	1,976	2,574
Property Operations & Maintenance	2,097	2,127
Utilities	2,359	2,392
Total	11,393	13,343
HOUSE PROFIT	15,655	14,809
Management Fee	1,206	1,282
INCOME BEFORE FIXED CHARGES	14,449	13,527

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Hotel Required to Undergo PIP With Branding Downgrade – No Upside in Income, Valued at 35% of replacement cost

Year	Net Operating Income	Market Value "As Is"	Derived Capitalization Rate	Market Value With Capital Deduction (Total Investment)	Capitalization Rate On Total Investment
2014/15 Historical*	$3,230,000	$26,200,000	12.3 %	$33,900,000	9.5 %
Forecast 2016/17	1,952,000	$26,200,000	7.5	$33,900,000	5.8
Deflated Stabilized (2016/17) Dollars	3,104,000	$26,200,000	11.8 %	$33,900,000	9.2

*2014/15 historical net operating income has been adjusted to reflect a 3.0% management fee and a 4.0% reserve for replacement

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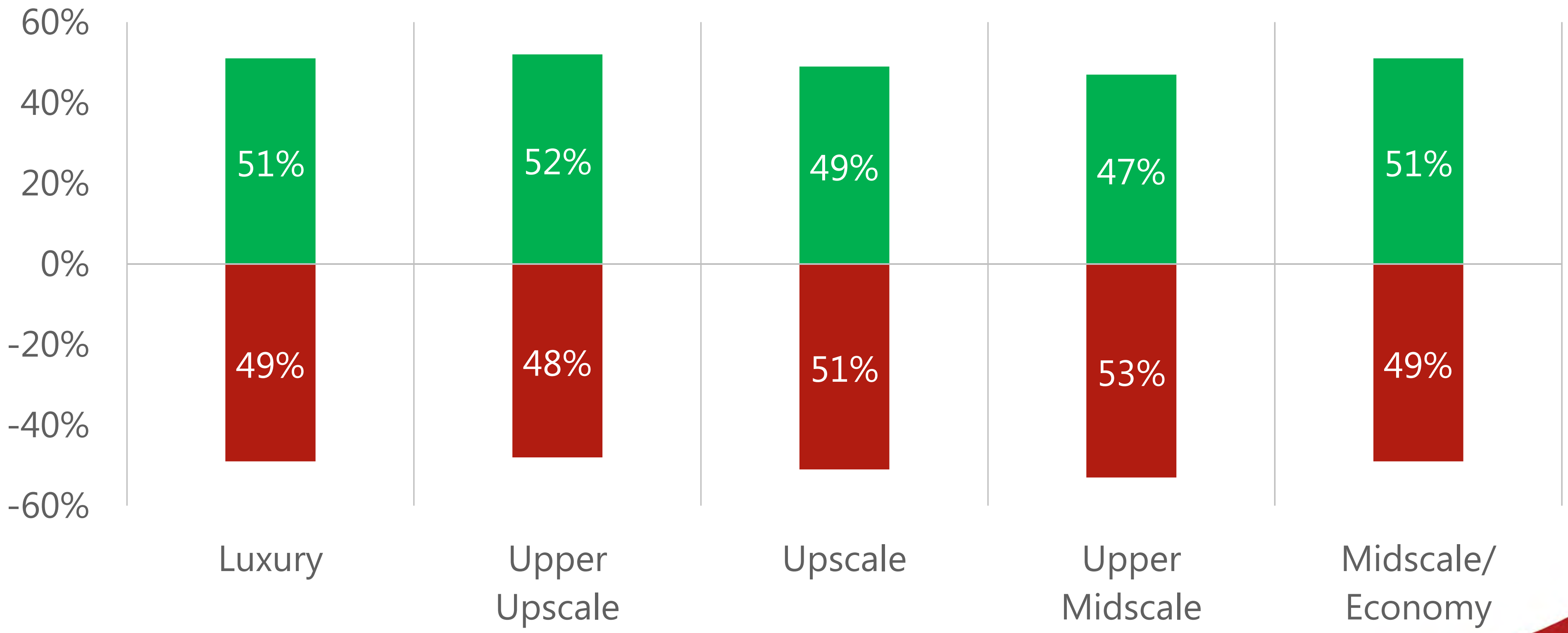
Hotel Investment Risk Factors

STR Host Almanac – 2017 "Same Store" Statistics

	Total Revenue		EBITDA	
Luxury	3.1	%	4.1	%
Upper Upscale	1.4		2.1	
Upscale	1.5		-1.7	
Upper Midscale	1.4		-2.8	
Midscale/Economy	2.0		-0.2	

Source: HVS. STR

In 2017 >50% of Hotels in U.S. Reported GOP Decline



Source: HVS. STR

HOST Operating Stats – Labor Expenses Rise at Greater Rate than RevPAR

	Rooms Revenue	Total Revenues	Departmental Profit	GOP	EBITDA	Total Labor
Luxury	2.9%	3.1%	2.8%	3.1%	4.1%	3.8%
Upper Upscale	1.5%	1.4%	1.4%	1.0%	2.1%	2.6%
Upscale	1.3%	1.5%	0.8%	-0.3%	-1.7%	3.9%
Upper Midscale	1.6%	1.4%	0.9%	-0.3%	-2.8%	3.9%
Midscale/ Economy	1.7%	2.0%	0.6%	0.3%	0.2%	4.2%

Source: HVS, STR

U.S. Full-Service Hotel Operating Leverage Analysis

Full-Service Hotels	2007	2009	2014	2017	'07-'09	CAGR '09-'14	'14-'17
Occupancy	70.0%	62.5%	73.9%	74.2%	-2%	3%	0%
Avg. No. Rooms	306	292	299	287			
Average Rate	$166.7	$146.74	$180.94	$193.8	-3%	4%	2%
RevPAR	$116.7	$91.7	$133.7	$143.8	**-5%**	**8%**	**2%**
% Change		**-21%**	**46%**	**7.5%**			
Revenue PAR	$67,301	52,650	74,975	$81,619	-5%	7%	3%
Expenses PAR	$50,298	43,143	55,911	$61,300	-3%	5%	3%
NOI PAR	$17,003	9,507	19,064	$20,319	**-11%**	**15%**	**2%**
% change		**-44%**	**101%**	**6.6%**			
NOI %	25.3%	18.1%	25.4%	24.9%			
Multiple of NOI Change to RevPAR Change:		**2.1 X**	**2.2 X**	**0.9 X**			

Source: HVS, STR

U.S. Limited-Service Hotel Operating Leverage Analysis

Limited-Service Hotels	2007	2009	2014	2017	CAGR '07-'09	CAGR '09-'14	CAGR '014-'17
Occupancy	69.2%	63.3%	74.2%	75.5%	-2%	3%	1%
Avg. No. Rooms	117	113	116	118			
Average Rate	$94.94	$85.26	$102.45	$118.62	-2%	4%	5%
RevPAR	$65.70	$53.97	$76.01	$89.56	**-4%**	**7%**	**6%**
% Change		**-18%**	**41%**	**18%**			
Revenue PAR	$24,349	$20,128	28,516	33,636	-4%	7%	6%
Expenses PAR	$14,606	$13,583	17,710	21,390	-1%	5%	6%
NOI PAR	$9,743	$6,545	10,806	12,246	**-8%**	**11%**	**4%**
% Change		**-33%**	**65%**	**13%**			
NOI %	40.0%	32.5%	37.9%	36.4%			
Multiple of NOI Change to RevPAR Change:		**1.8 X**	**1.6 X**	**0.7 X**			

Source: HVS, STR

Optimizing Hotel Room Revenue

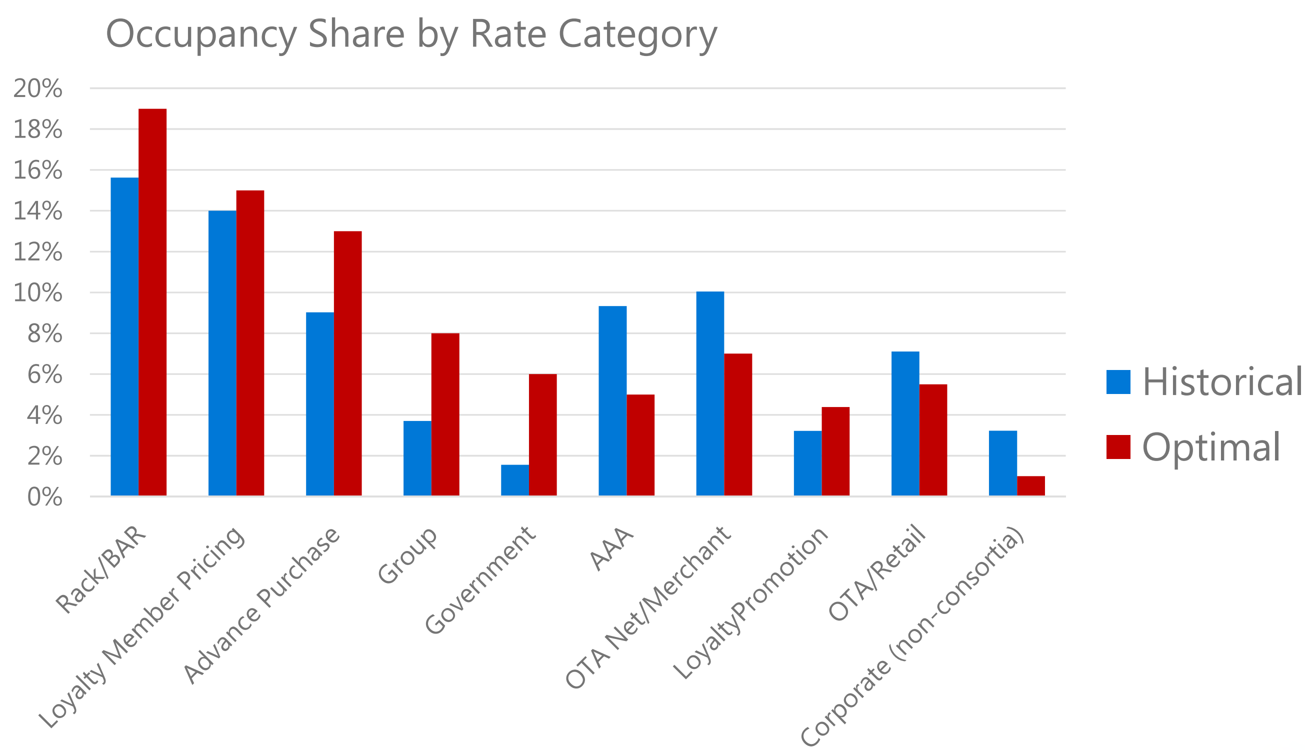
- Slowing RevPAR growth
- Losing market share to OTA booking sites and home sharing
- Wholesale booking sites like Expedia
- Retail booking sites like Booking.com
- IDEAS and Duetto - live dynamic pricing models
- Kalibri Labs provides data to analyze impact

Change by Rate Category—Sample Hotel

Occupancy Share (adds to total Occupancy)

- Opportunity to acquire additional **Rack/Bar, Group, Advance Purchase and Government** business for high occupancy dates.

- There is an opportunity to reduce reliance on lower-rated **AAA** and **OTA** business for high occupancy dates.



*Occupancy share adds up to total occupancy %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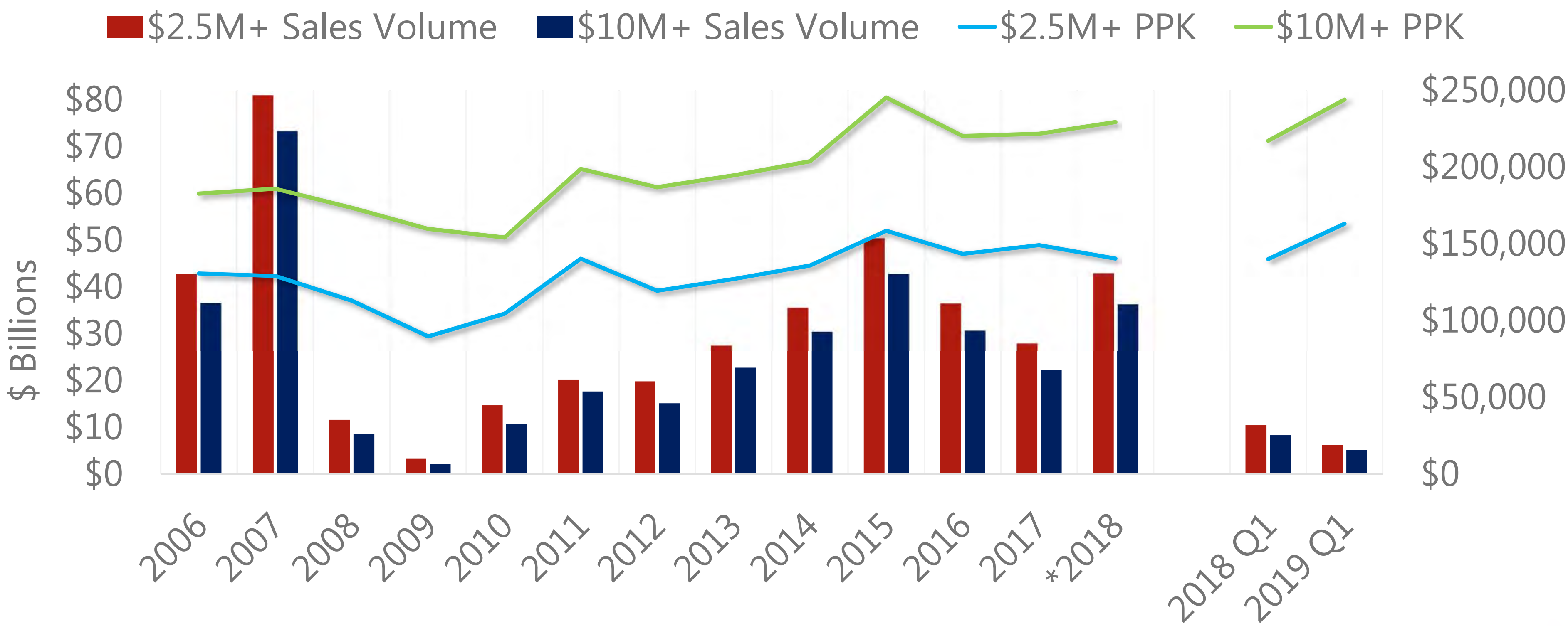
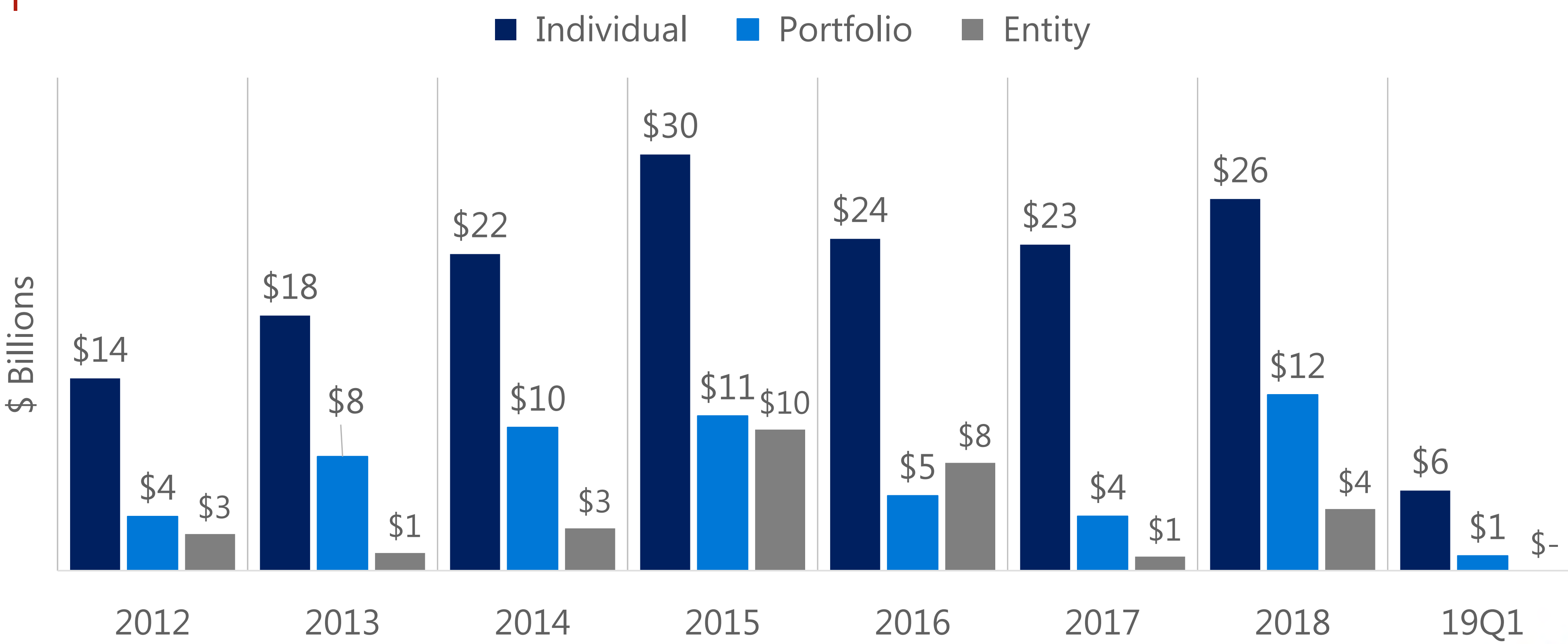
National Transactions

U.S. Hotel Sales Volume Slow Q1 2019



Source: RCA

Hotel Quarterly Transaction Volume



Source: HVS, RCA

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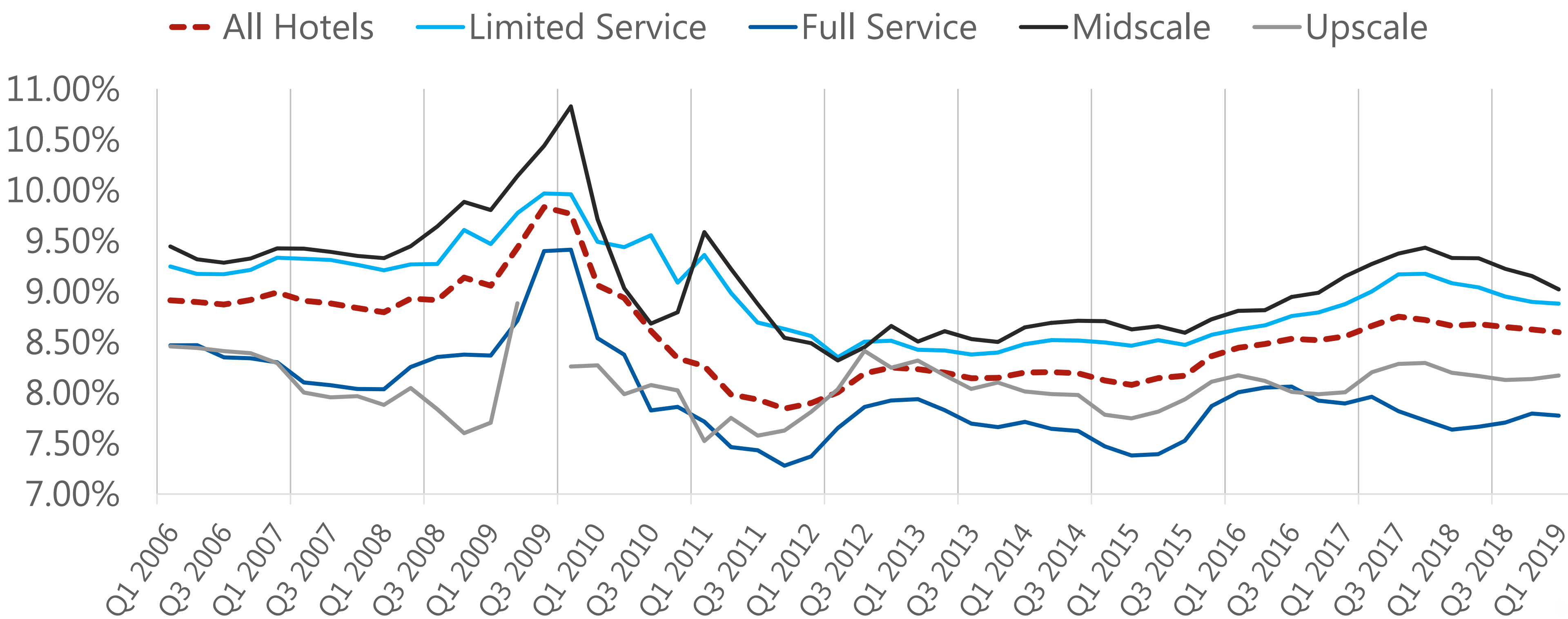
Modest Contraction in Cap Rates *



Source: RCA

* Derived from sales transactions

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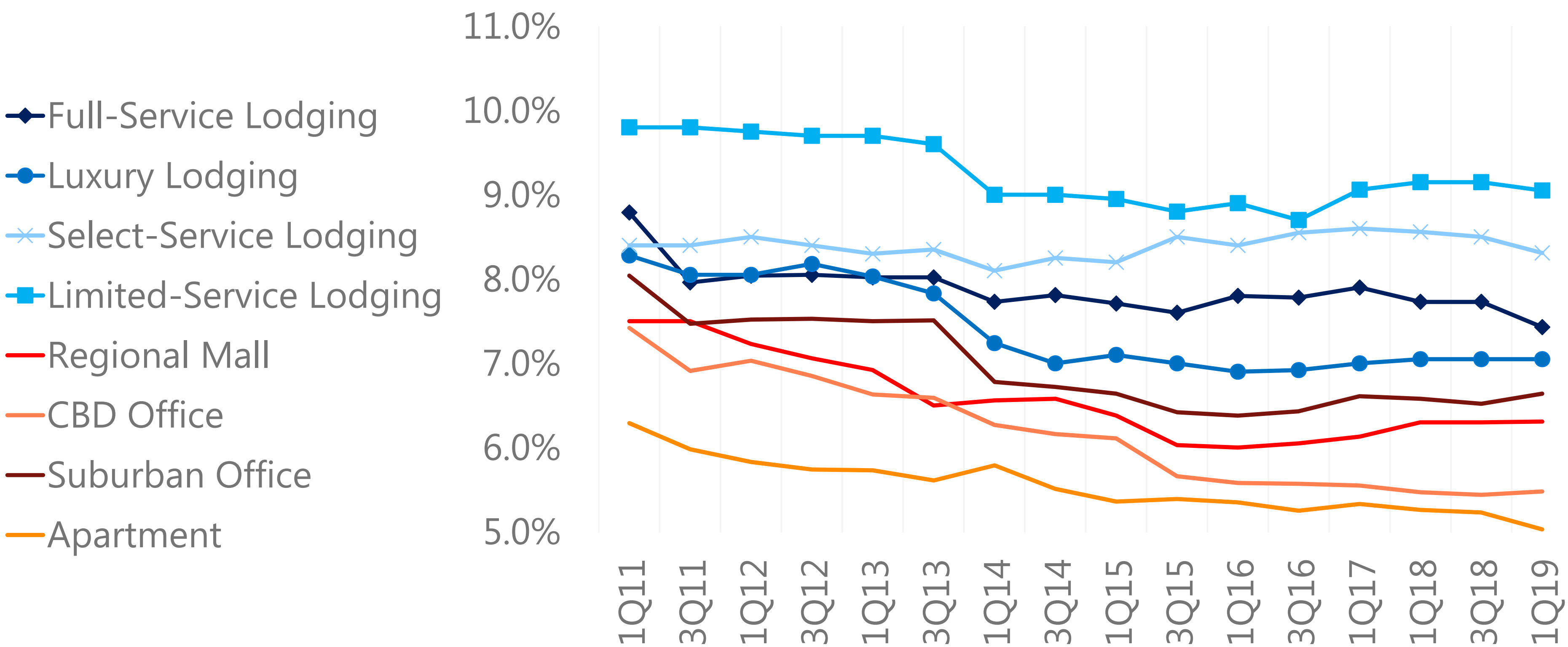
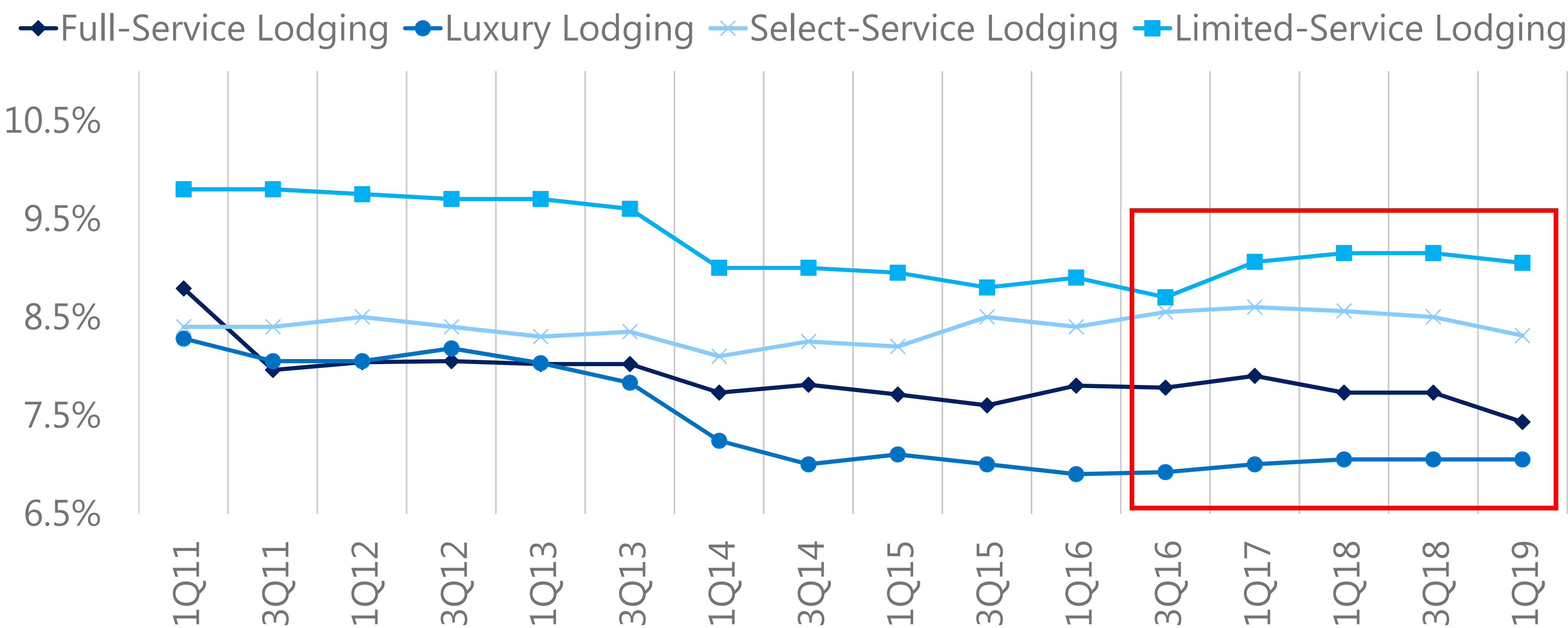
Hotel Survey Cap Rates Maintain Return Premium



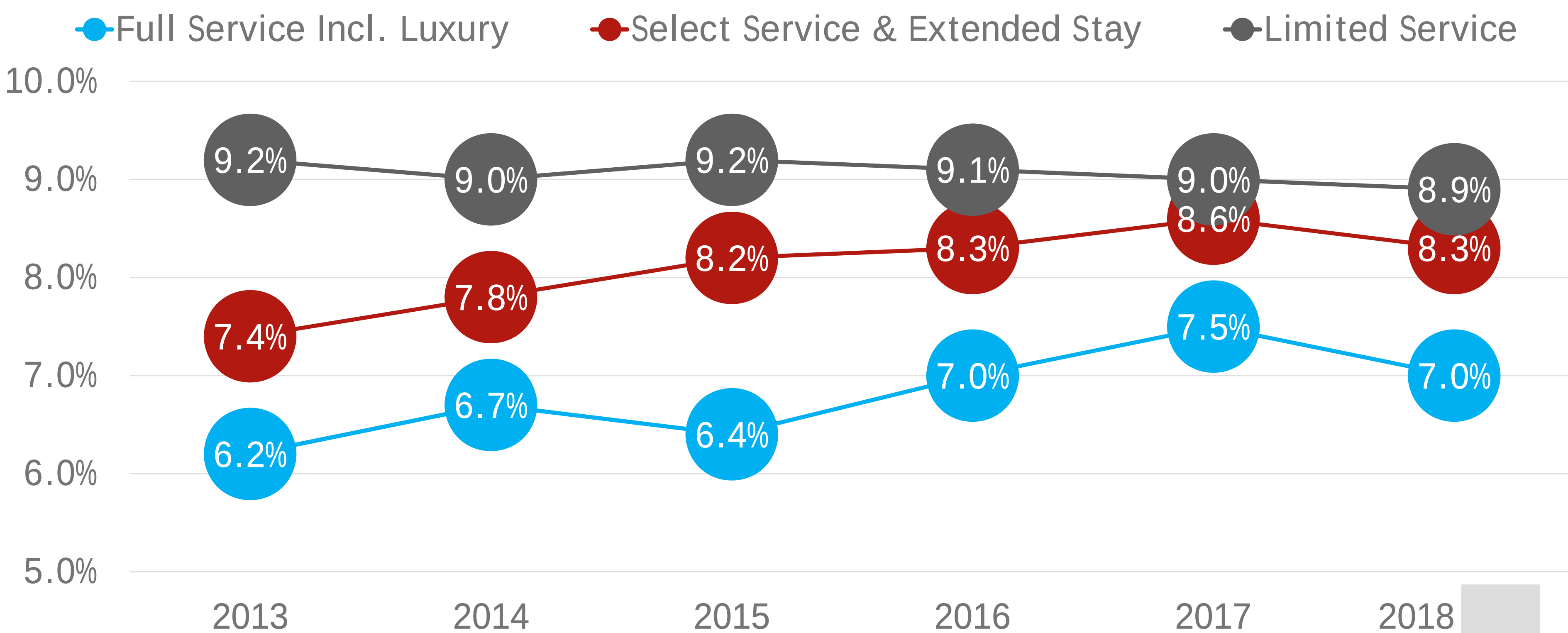
Source: PWC

Hotel Survey Cap Rates Maintain Return Premium



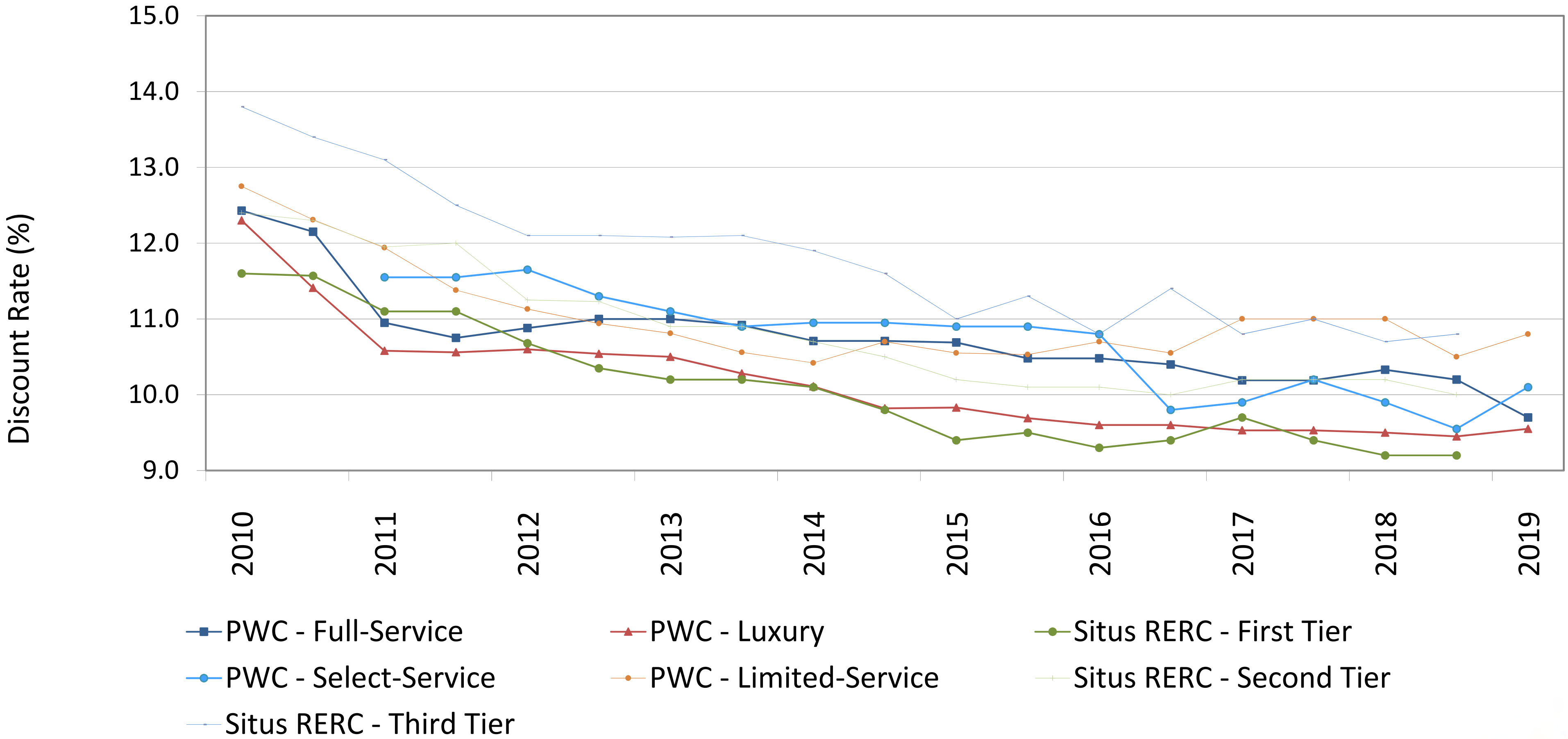
Source: PWC

Cap Rates Derived From Sales of Hotels Appraised



Source: HVS

Hotel Survey Discount Rates (Unlevered IRR)



Source: RERC, PWC

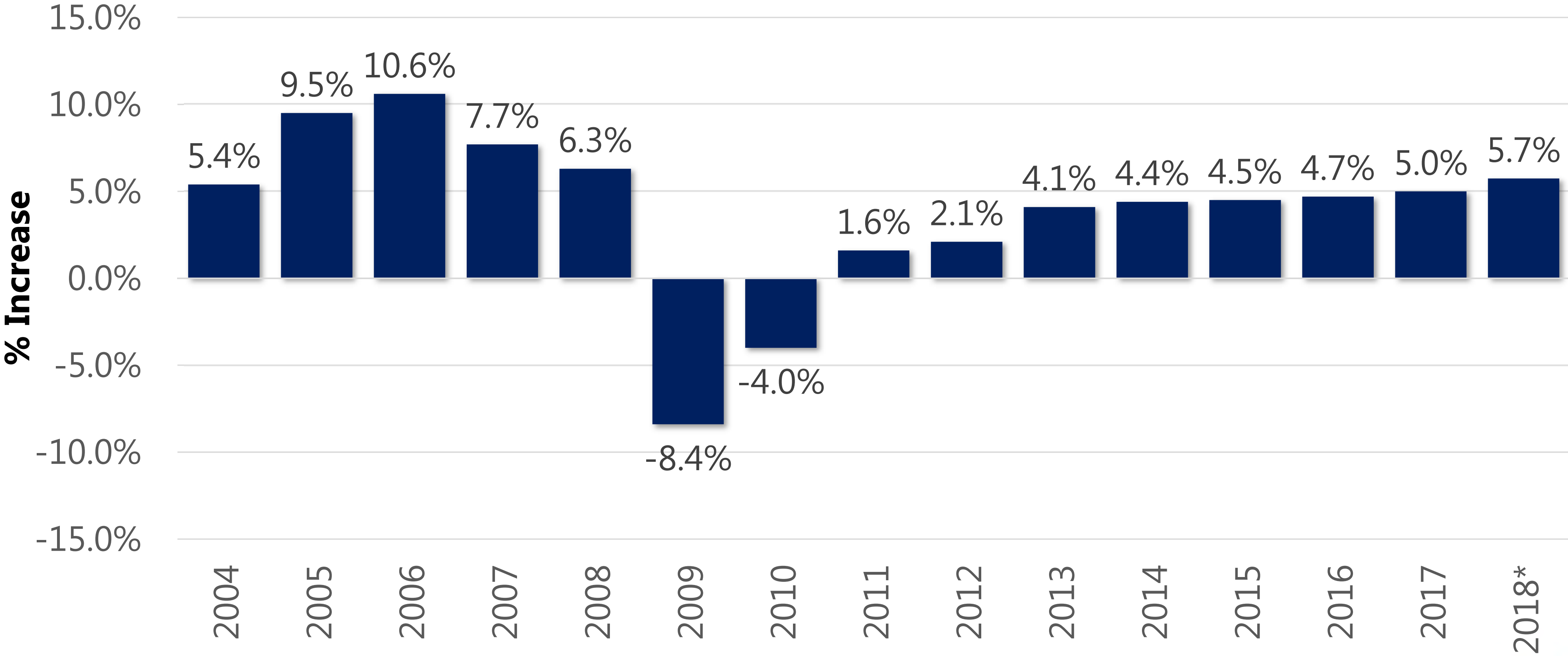

DEVELOPMENT COSTS

Hotel Development Cost Survey – 2017/18

	Land	Building and Site Improvements	Soft Costs	FF&E	Pre-Opening and Working Capital	Total
Budget/Economy Hotels						
Average	$7,700	$56,000	$5,700	$8,600	$3,800	$79,300
Limited-Service Hotels						
Average	16,200	91,800	16,700	17,100	5,200	139,700
Extended-Stay Hotels (Midscale)						
Average	12,700	93,200	16,800	18,700	3,800	139,100
Extended-Stay Hotels (Upscale)						
Average	20,200	124,700	25,200	24,400	5,100	192,900
Dual-Branded Hotels						
Average	41,200	133,200	19,700	19,600	11,600	218,900
Select-Service Hotels						
Average	34,000	137,600	29,800	20,800	6,300	221,000
Full-Service Hotels						
Average	30,600	222,500	41,800	28,900	10,100	318,200
Lifestyle/Soft-Branded Hotels						
Average	47,300	217,400	42,200	30,200	12,900	346,300
Luxury Hotels						
Average	74,300	353,100	102,300	60,800	13,700	604,200

Source: 2017/18 HVS Hotel Development Cost Survey

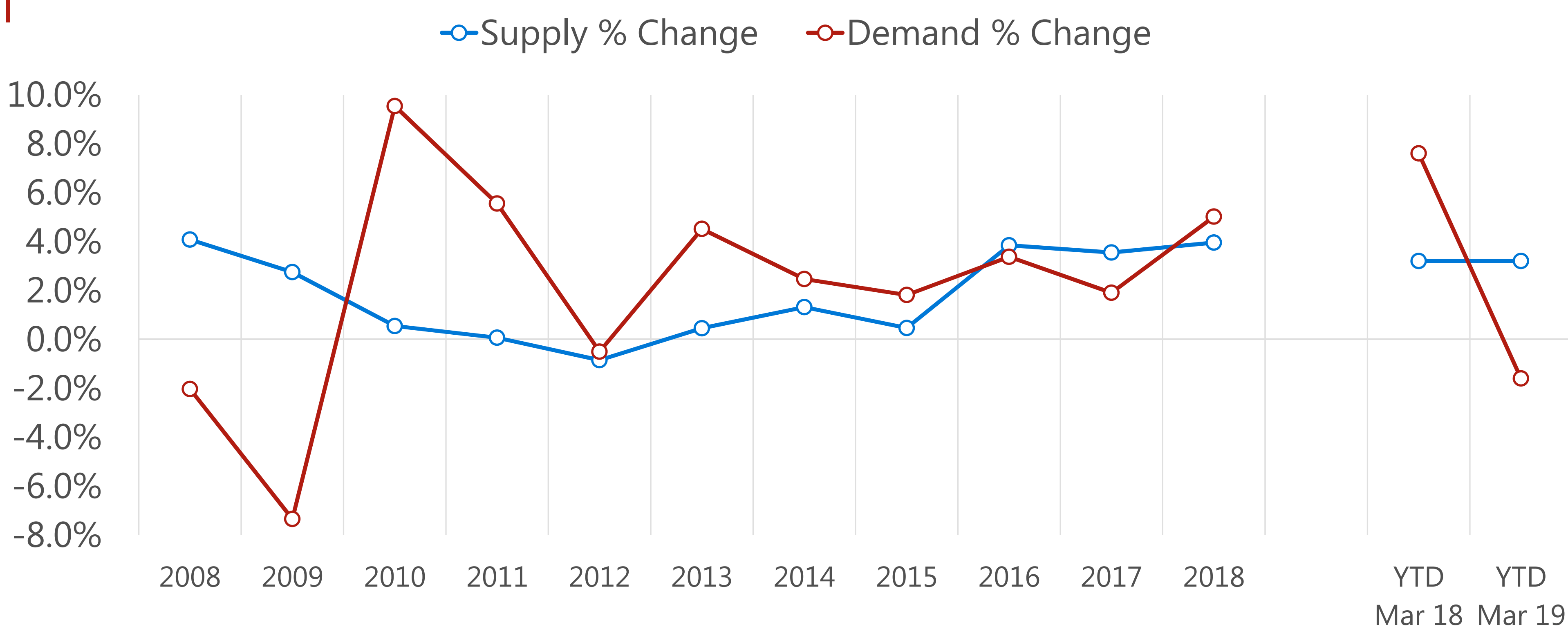
Hotel Development Cost Survey – 2017/18



Source: Turner Building Cost Index | 2018* Estimated

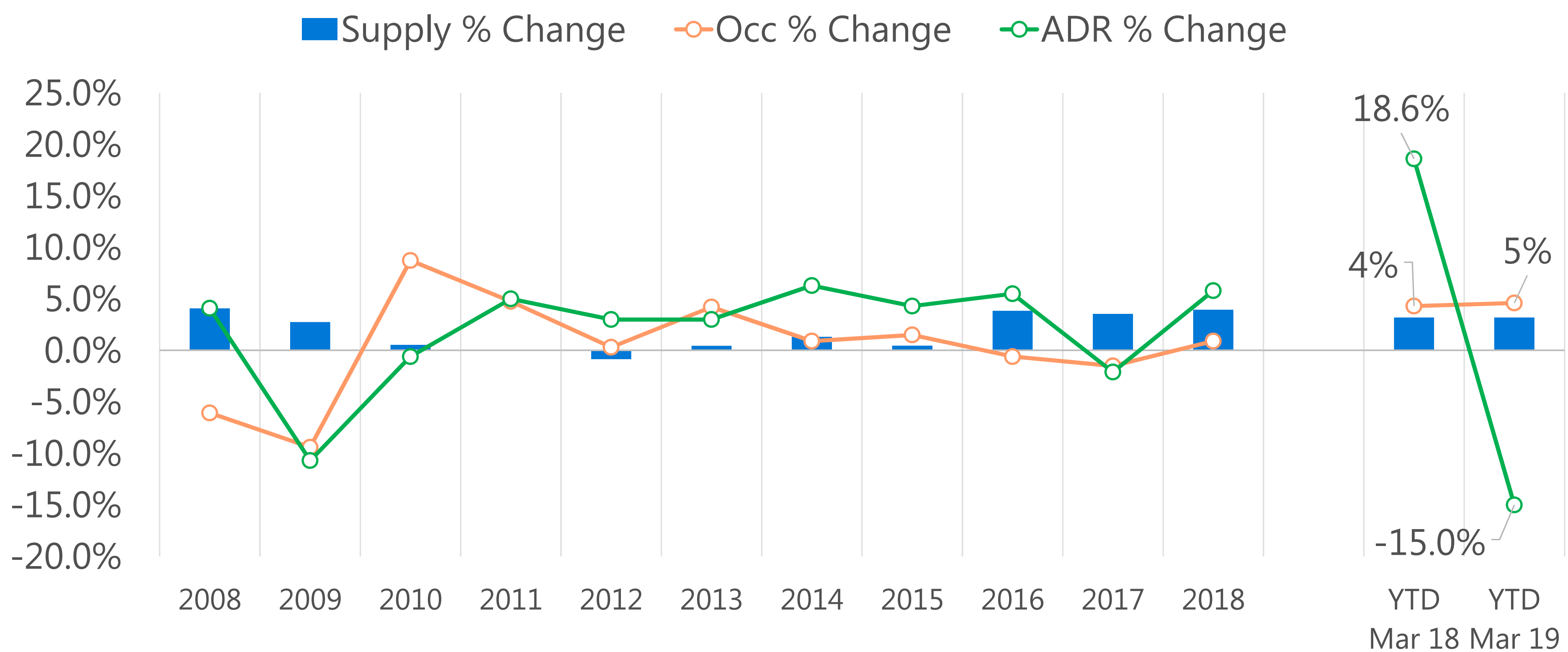
TWIN CITIES LODGING MARKET

Demand Outpaced Supply in 2018



Source: STR and HVS

ADR Has Declined Significantly YTD



Source: STR and HVS

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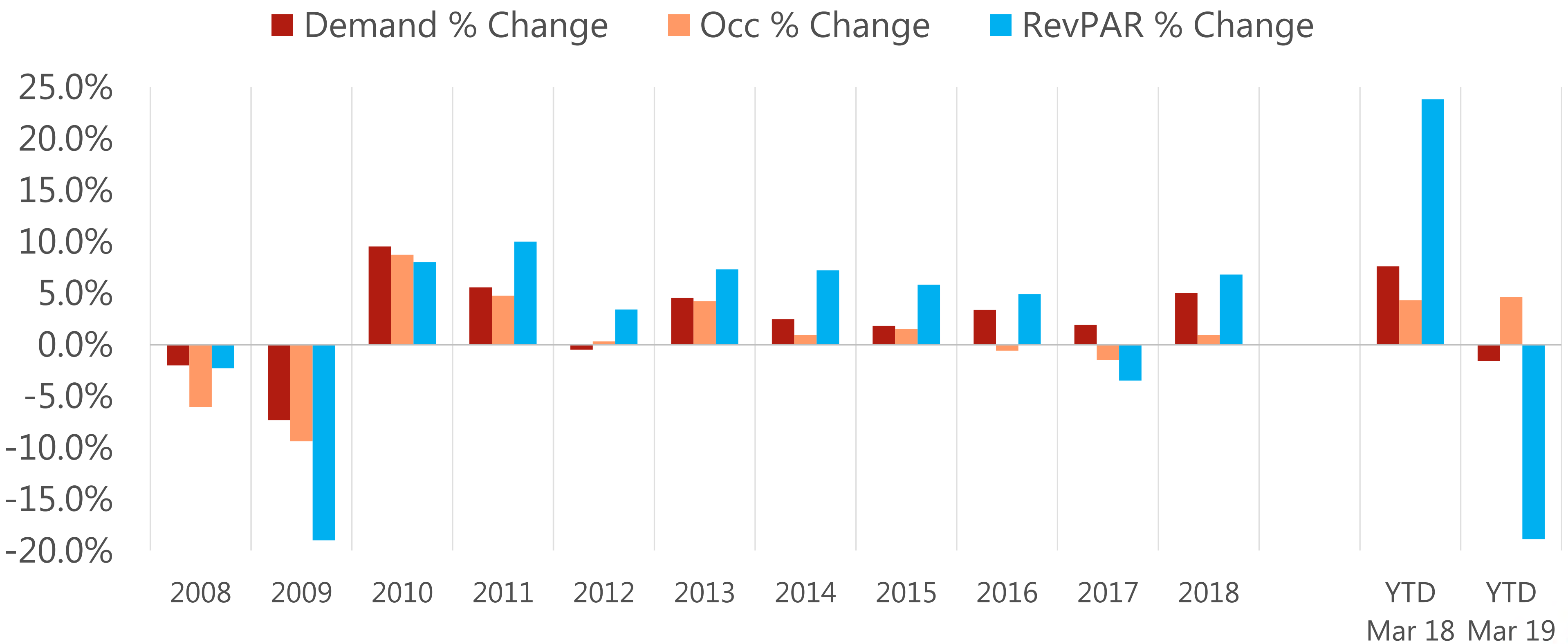
2019 YTD RevPAR is Declining



Source: STR and HVS

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Twin Cities Noteworthy Sale

Grand Hotel Minneapolis

Most Recent Sale
December 2018
$30,000,000
$214,286 PPK

Previous Sale
September 2010
$33,000,000
$235,714 PPK

Noteworthy National Sales YTD 2019

Property:	1 Hotel South Beach
Location:	Miami Beach, FL
Date:	Feb. 2019
No. Rooms:	426
Total Price:	$610,000,000
Average PPK:	$1,431,925
Buyer:	HOST Hotels & Resorts
Seller:	Starwood Cap JV Lefrak

Property:	Beacon Hill
Location:	Boston, MA
Date:	Feb. 2019
No. Rooms:	13
Total Price:	$13,000,000
Average PPK:	$1,000,000
Buyer:	Andrew Flynn
Seller:	Saunders Hotel Group

Property:	Raleigh Hotel
Location:	Miami Beach, FL
Date:	Feb. 2019
No. Rooms:	105
Total Price:	$103,000,000
Average PPK:	$980,952
Buyer:	SHVO JV Bilgili
Seller:	Hilfiger Hosp Group

Source: HVS, RCA

VALUATION CONCERNS

Widely Accepted Approach to Extracting Value of Intangibles

- Hotel valuation experts agree that the **value** of the **real property** can be readily **isolated** in the same manner employed by buyers and sellers, by **deducting**:
  - A **management fee** and **franchise fee** (business value)
  - The **value** of the **personal property** and **a reserve for replacement** of FF&E (return on and of)
- When surveyed, **hotel acquisition** professionals will tell you they are **buying real** and **personal property**
- Lodging REITS
- The theory that **additional deductions** are necessary for starting up the going concern, **returns** on **operating expenses**, and **residual intangible value** due to concept of **CEP (capitalized economic profit)** is being **promulgated**

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GGP-Maine Mall LLC et al vs. City of South Portland (Maine)

N.Y. Sup. Ct. (Westchester Cty.), Docket No. 14267/98 (Mar. 15, 2004) ("BEV…is not persuasive because it places profits ahead of expenses in a normal sequence of business expenses")); *In re Wolfchase Galleria Ltd. Partnership*, Tenn. State Bd. of Eq. (Shelby Cty. Mar. 16, 2005) (rejecting prior tax assessment decision on the grounds that Mr. Lennhoff's BEV theory of subtracting intangible business assets is not endorsed by the Appraisal Institute, that BEV and TAB are "contrived academic constructs which have been developed to reduce hotel property taxes," and that "buyers and sellers of regional malls do not acknowledge the existence of business enterprise value, but rather proponents of BEV are a very small, but highly vocal, minority of appraisers who are regularly involved in tax appeal cases and …are papering academic journals with articles on the subject to create the impression that theirs is a widely held belief when it is not…"); *In re Appeal of Winston-Salem Joint Venture*, 551 S.E.2d 450 (N.C. Ct. App.

GGP-Maine Mall LLC et al vs. City of South Portland (Maine)

40. The Board notes that other courts and tax authorities across the country have the same misgivings about the BEV and TAB valuation theories. *See RRI Acquisition Co., Inc. v. Supervisor of Assessments of Howard County*, 2006 WL 925212 (Md. Tax Ct. Feb. 10, 2006) (rejection of Mr. Lennhoff's BEV theory as to a hotel property as an "academic construct unsupported by the market"); *Chesapeake Hotel, LP v. Saddle Brook Township*, 22 N.J. Tax 525 (2005) (rejection of Mr. Lennhoff's BEV theory as to a hotel as "not persuasive either for theoretical or empirical reasons."); *Spring Hill, L.P. v Tennessee State Bd. of Equalization*, 2003 WL 23099679 (Tenn. Ct. App. Dec. 31, 2003)

Hotel Franchise and Management Companies Own, Invest in and Earn Profit on their Management Business and Brand

Franchise Profit
50%+

Management
Company Profit
40 - 50%

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Intangible Dispute – Rushmore Presentation
Does Not Reflect True Brand and Management Expenses

	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%

	Business Enterprise Approach		Rushmore Approach	
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%

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Hotel Financial Statements Reflect Deduction of "Intangible" Income/Value

28% of Available Cash Flow to Brand and Management

	2015	Calendar Year			
Number of Rooms:	119				
Paid Occupied Rooms:	28,310				
Days Open:	365				
Paid Occupancy:	65.2%				Amount
Average Rate:	$141.61	Percentage		Available	Occupied
RevPAR:	$92.30	of Revenue		Room	Room
OPERATING REVENUE					
Rooms	$4,009	99.4	%	$33,688	$141.61
Other Operated Departments	14	0.3		114	0.48
Miscellaneous Income	9	0.2		74	0.31
Total Operating Revenue	4,031	100.0		33,877	142.40
DEPARTMENTAL EXPENSES*					
Rooms	783	19.5		6,576	27.64
Other Operated Departments	42	307.7		351	1.48
Total	824	20.4		6,927	29.12
DEPARTMENTAL INCOME	3,207	79.6		26,950	113.28
UNDISTRIBUTED OPERATING EXPENSES					
Administrative & General	437	10.8		3,675	15.45
Marketing	232	5.7		1,947	8.19
Franchise Fee	361	9.0		3,032	12.75
Prop. Operations & Maint.	238	5.9		1,997	8.39
Utilities	162	4.0		1,362	5.72
Total	1,430	35.5		12,013	50.50
GROSS HOUSE PROFIT	1,777	44.1		14,937	62.79
Management Fee	121	3.0		1,016	4.27
INCOME BEFORE NON-OPER. INC. & EXP.	1,657	41.1		13,921	58.51
NON-OPERATING INCOME AND EXPENSE					
Property Taxes	219	5.4		1,838	7.73
Insurance	43	1.1		360	1.51
Total	262	6.5		2,197	9.24
EBITDA LESS RESERVE	$1,395	34.6	%	$11,724	$49.27
NOI adjusted to reflect a 3.0% mgmt fee and a 4.0% reserve	$1,234	30.6	%		

*Departmental expenses are expressed as a percentage of departmental revenues.

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Questions?

HOTEL VALUATION: WHAT THE FF&E?

Personal Property and Intangibles

OUTLINE

Develop an understanding on Intangible Assets

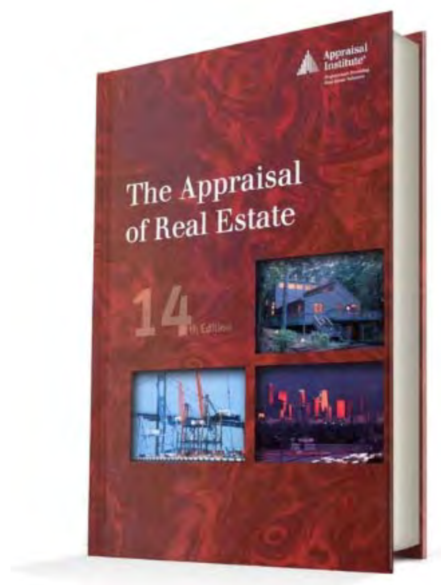
Approaches to Value for Hotel Properties

- Cost Approach
- Sales Approach
- Income Approach
  - Management Fee Method
  - Business Enterprise Valuation
  - Other Argument

Franchise Fees

THE BIBLE SAYS,

"The primary benefit of private real estate ownership is its ability to house human activates."



WHY SHOULD WE CARE?

USPAP Standards Rule 1-4 states, "In developing a real property appraisal, an appraiser must collect, verify, and analyze all information necessary for credible assignment results." It goes on to note that, "(w)hen personal property, trade fixtures, or intangible items are included in the appraisal, the appraiser must analyze the effect on value of such non-real property items."

IDENTIFYING INTANGIBLE ASSETS

All property can be categorized into three types:

- Real Property (Bundle of rights, different from real estate)
- Tangible personal property (Not affixed to the real estate)
- Intangible property – "*Nonphysical assets, including but not limited to franchises, trademarks, patents, copyrights, goodwill, equities, securities, and contracts as distinguished from physical assets such as facilities and equipment.*" (PER Appraisal Institute)

WHEN DOES SOMETHING INTANGIBLE HAVE VALUE?

IAAO notes that there are four tests to determine the existence of an intangible asset:

1. An intangible asset should be identifiable.
2. An intangible asset should have evidence of legal ownership, that is, documents that substantiate rights.
3. An intangible asset should be capable of being separate and divisible from the real estate.
4. An intangible asset should be legally transferable.

IDENTIFIABLE

Must be explicitly described and identified

- Sometimes there is an automatic presumption that there are intangibles but they cannot specifically identify the source.
- If it cannot be defined, it may not rise to the level of an asset.

IDENTIFIABLE

Goodwill

- Goodwill is defined by the Dictionary of Real Estate Appraisal as follows.
  - Unidentifiable intangible asset
  - The amount by which the acquisition price exceeds the fair value of identified assets
    - Goodwill is determined only after all other assets have been separately identified and quantified
  - That intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified
  - That intangible asset arising as a result of elements such as a name, reputation, customer loyalty, location, products and related factors not separately identified and quantified.
- Not to be confused with Business Value.
- For accounting purposes, goodwill has no basis unless it is purchased as a part of the business (Not separable)

IDENTIFIABLE

Goodwill - Example

Value Metrics		
Rooms		[redacted]
ADR	$	166.00
Occupancy		68%
Expense Ratio		75%
Reserves/Room		$1,500
Personal Property/Room		$6,000
Goodwill		5.00%
Cap Rate		7.00%

NOI	$	5,148,176
Less Goodwill	$	(257,409)
Adjusted NOI	$	4,890,767
Estimated Value	$	69,868,096
Less Personal Property		($3,510,000)
Final Estimated Value	**$**	**66,358,096**

EVIDENCE OF LEGAL OWNERSHIP

Without legal ownership

- Owner cannot protect their rights from theft, harm or damages
- Cannot legally transfer ownership

Examples:

- Contract
- Licenses
- Franchise Agreements
- Management Agreements
- Leases

SEPARATE AND DIVISIBLE

The tangible and intangible are sometimes intertwined, making this difficult to determine.

If the real estate cannot be sold without the intangible, then the intangible is probably not an asset on its own, but instead, part of the real property

- Southridge Mall in Greendale, WI
  - *"The key of the analysis is whether the value is appended to the property and is thus transferrable with the property, or whether it is, in effect, independent of the property so that the value either stays with the seller or dissipates upon sale."*

LEGALLY TRANSFERABLE

Need to show there is a market for the sale of these ownership interests.

Example – Tenant runs successful car wash in leased building. Sells her business to another person.

IS THIS AN INTANGIBLE ASSET?

Historic Significance - Hotel sells at a premium because it is historical.

- No, hotel cannot be sold without the historic premium so it is intertwined with the real property.
- This is an example of an enhancement to the value similar to a location or view premium. They contribute to the overall value of the real property and cannot be transferred without the enhancement.

COST APPROACH

METHODS FOR ESTIMATING OR ALLOCATING INTANGIBLE ASSETS – COST APPROACH

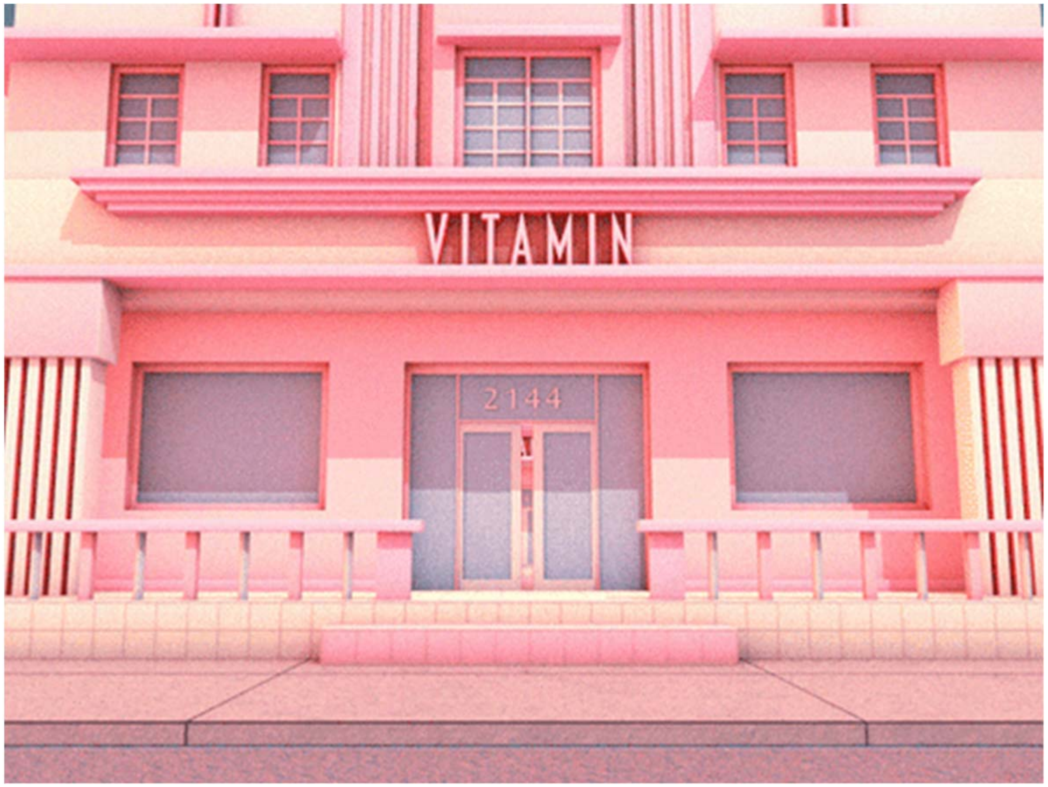
Pro

- Inherently excludes intangible value and it is the preferred method for valuing personal property.
- Excellent cross-check to Sales Comparison and Income Approaches when these approaches include deductions for intangibles.

Con

- Depreciation is difficult to estimate.
- Not always the approach buyers use to determine sale prices.

SALES COMPARISON APPROACH



METHODS FOR ESTIMATING OR ALLOCATING INTANGIBLE ASSETS – SALES COMPARISON APPROACH

Pro

- Can be reliable when the sale data is complete and accurate

Con

- Need to be able to identify the intangible asset and verify its value

Need to research and verify each sale and discuss with market participants.

- Publicly traded companies report their acquisitions and allocations in annual reports and other financial documents.

DEAL PRICING ALLOCATIONS

- Accounting functions and may not reflect the true market value of these components.
- Valuation and allocation for accounting purposes may be different from and possibly not applicable to the value of real property in a property tax scenario.
- They do provide additional information to the appraiser and may help determine the value of the personal property or intangibles.

DEAL PRICING ALLOCATIONS – PER ARTICLE

"A Deal Pricing Analysis performed for the closing of your deal provides you with maximum tax benefits in the form of:

1. *Reduced transfer taxes at closing*
2. *Reduced exposure to prospective real estate tax increases*
3. *Federal income tax benefits from booking the value of the Section 197 intangible assets."*

Maximize Your Tax Benefits with Deal Pricing Analysis by Bernice Dowell

DEAL PRICING ALLOCATIONS – W HOTEL

Per DPA

- *Real Property - $59,245,541*
- *Personal Property - $3,435,000*
- *Intangibles - $23,319,459*
- *Total - $86,000,000*

Per SEC 10K Filing

- *Land - $8,430,000*
- *Building and improvements - $75,842,000*
- *Furniture, fixtures and equipment – $3,868,000*
- *Total - $88,140,000*

INCOME CAPITALIZATION APPROACH

METHODS FOR ESTIMATING OR ALLOCATING INTANGIBLE ASSETS – INCOME APPROACH

Pro

- Most similar to how market participants make pricing decisions

Con

- Multiple arguments on how to properly remove the value related to the personal property and intangibles

MANAGEMENT FEE METHOD (AKA RUSHMORE METHOD)

Stephen Rushmore developed the approach back in 1980s.

Approach most commonly upheld by courts

- When this approach is rejected, it is usually in a state where laws or assessor handbooks prevent the use of the method. (Example - California)

MANAGEMENT FEE METHOD (AKA RUSHMORE METHOD)

Remove Intangibles

- Management fee
- Franchise Fee (if necessary)

Remove Personal Property

- Reserve expense
- Value of the FF&E

MANAGEMENT FEE METHOD (AKA RUSHMORE METHOD)

Critical Arguments

- Capitalization of the Management and Franchise Fees do not go far enough to remove the business value of the hotel.
  - Since the management and franchise fees are based on a percentage of sales, these fees increase or decrease based on the success of the management company. The corresponding deductions for the intangible values increase when a property is doing well and decrease when a property isn't performing well.

MANAGEMENT FEE METHOD (AKA RUSHMORE METHOD)

Critical Arguments

- Management fee is already a standard expense in an income approach therefore removing it does not go far enough to include the value of the intangible asset.
  - These management fees refer to the management of a business not the real estate.

MANAGEMENT FEE METHOD (AKA RUSHMORE METHOD)

Critical Arguments

- Including the management and franchise fees do not provide a return on those intangible assets, therefore more needs to be deducted from the NOI.
  - The management company and franchise brand are not owned by the hotel owner.
  - The presence of an expense does not automatically necessitate a return on that expenses. (Example - Insurance does not require a return on expenses)

BUSINESS ENTERPRISE VALUATION

Developed by David Lennhoff

Reduced presence in the 14th edition from previous editions

Defined as, "The value contribution of the total intangible assets of a continuing business enterprise such as marketing and management skill, an assembled workforce, working capital, trade names, franchises, patents, trademarks, contracts, leases, customer base, and operating agreements."

BUSINESS ENTERPRISE VALUATION

Removes Intangibles

- Management Fee
- Franchise Fee (If necessary)
- Residual Intangibles
- Start-up Costs

Removes Personal Property

- Reserve Expense
- Value for FF&E in Place
- Return on FF&E

BUSINESS ENTERPRISE VALUATION

Developer of this method believes these items are not properly removed in the Management Fee Method:

- Return on investment in the franchise
- Value of favorable contracts
- Contributory value of assembled workforce
- Value of business start-up costs
- Value of residual intangibles, etc.
- Return "of" or recapture of initial investment in FF&E and inventory

BUSINESS ENTERPRISE VALUATION

Critical Arguments

- Techniques applied to Ad Valorem appraisals aren't used in other appraisal assignments
  - "Appraisers should be valuing hotels the same way under any circumstances, including property tax appeals. In other words, the assets and the rights being apprised do not change just because the use of an appraisal varies. Appraisers should also value hotels the same way that investors analyze deals." (IAAO Intangible paper p. 13)
  - "Mr. Lennhoff uses a method of appraisal that he has developed, which has not be generally accepted and certainly not in Virginia. The Court finds Mr. Lennhoff a seductively slick witness, but finds that his professionalism is more as a witness than as a realistic assessor." (BPG Hotel Partners VII, LLC v. Board of Supervisors of Loudoun County, Virginia (Dec 2014))

BUSINESS ENTERPRISE VALUATION

Critical Arguments

- Residual Intangibles should be considered but aren't always a necessary deduction.
  - Chesapeake Hotel LP v. Saddle Brook Township (New Jersey)
    - "A final theoretical point is that superior management, if present, presumably commands a premium in the franchise and management fees charged to the property owner. Since both Rushmore and Lennhoff exclude all franchise and management fees from net operating income to be capitalized, <u>the management differential is, to a significant extent, self-adjusting</u>."

BUSINESS ENTERPRISE VALUATION

Critical Arguments

- Start-up costs should be considered on newer properties but aren't appropriate on an older property.
  - Chesapeake Hotel LP v. Saddle Brook Township (New Jersey)
    - "Similarly, the start-up cost adjustment may have some theoretical soundness where the hotel business is actually still benefiting from start-up costs, and the costs can be specifically identified and limited to those that produce business value as opposed to real estate value. In the present case, however, empirical considerations do not support the adjustment. Lennhoff proposes a 25-year amortization of start-up costs for a business already more than 30 years old on the valuation date, and the cost estimate is derived from data having no relation to the subject. This adjustment also is not accepted."

BUSINESS ENTERPRISE VALUATION

Critical Arguments

- Deduction of Replacement allowance, Return on FF&E and Return of FF&E is excessive.
- *CHH Capital Hotel Partners, LP v. District of Columbia* - District of Columbia Court of Appeals (2017)
  - "Judge Campbell agreed with Mr. Menkes and the District that the additional FF&E deduction double-counted the value of personal property, and he 'd[id] not find . . . plausible on either a practical or theoretical level'."

BASED ON TAB (TOTAL ASSETS OF BUSINESS)

$V_{TAB} = V_{RE} + V_{TPP} + V_{IPP}$

Where:

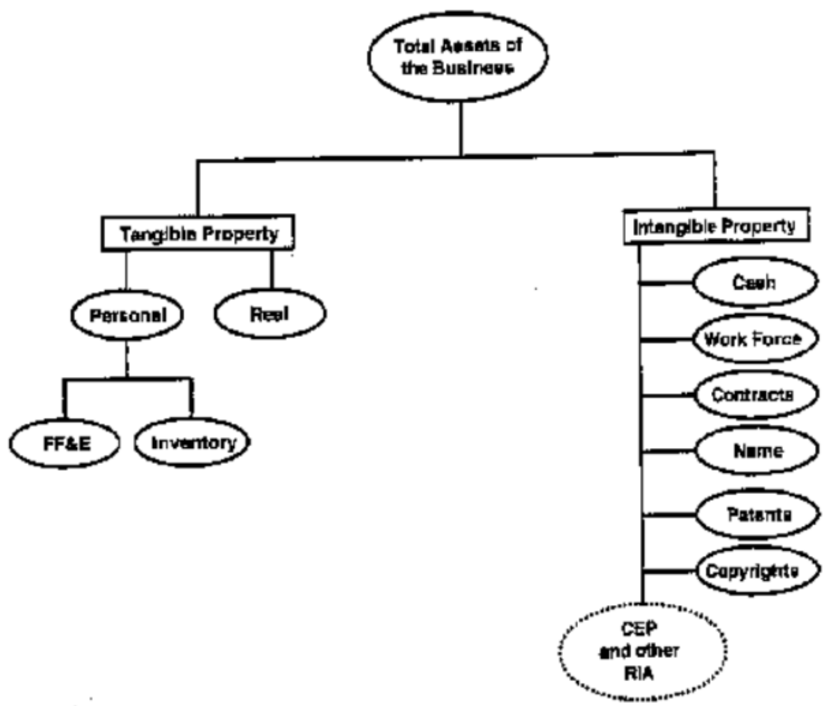
- TAB = Total Assets of the business
- RE = Real Estate
- TPP = Tangible personal property
- IPP = Intangible personal property

Formula becomes

- $I_{RE} = I_{TAB} - I_{TPP} - I_{IPP}$
- Then, $V_{RE} = I_{RE} \div R_O$

BEV - TAB

Components of a Going Concern or Business



TIME FOR SOME MATH

COMPARING THE TWO MAJOR APPROACHES

		Management Fee Method		BEV Method	
Number of Rooms	221				
Occupancy	81%				
Average Room Rate	$128				
Revenue					
Rooms		$8,369,881	68.5%	$8,369,881	68.5%
Food & 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 & 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 Revenue		$5,222,387		$5,222,387	
Departmental Profit		$6,989,269	57.2%	$6,989,269	57.2%
Undistributed Expenses					
General & 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		$3,284,935	26.9%	$3,284,935	26.9%
Gross House Profit		$3,704,334	30.3%	$3,704,334	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 & Personal Property Deductions		$3,464,334	28.4%	$3,464,334	28.4%

Loaded Cap Rate

- 12.41%

MANAGEMENT FEE VS. BEV

Management Fee Method

Net Income Less:

Business Component
- Management Fee
- Adjust for Residual Intangibles

Personal property Component
- Reserve for Replacement
- Value for FF&E in Place

Business Enterprise Valuation Method

Net Income Less:

Business Component
- Management Fee
- Adjust for Residual Intangibles
- Business Start-up Costs

Personal property Component
- Reserve for Replacement
- Value for FF&E in Place
- Return on FF&E

MANAGEMENT FEE VS. BEV

Management Fee Method

Net Income Less:

Business Component

- Management Fee
- Adjust for Residual Intangibles

Personal property Component

- Reserve for Replacement
- Value for FF&E in Place

Business Enterprise Valuation Method

Net Income Less:

Business Component

- Management Fee
- Adjust for Residual Intangibles
- Business Start-up Costs

Personal property Component

- Reserve for Replacement
- Value for FF&E in Place
- Return on FF&E

HOW TO ADJUST FOR 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."
- aka Competent Management Adjustment
  - Fee Simple market value assumes competent management

HOW TO ADJUST FOR RESIDUAL INTANGIBLES

How to adjust – Compare subject to Competitive Set

- RevPAR differences
- Expense Ratio difference
- Exceptional brand contributions

Two Methodologies found:

- Deduction to NOI
- Increased Cap Rate

HOW TO ADJUST FOR RESIDUAL INTANGIBLES

DEDUCTION TO THE NOI

- RevPAR of subject is 15% greater than comparable properties.
  - NOI of Going Concern = NOI less Management fees and Replacement Reserves

Net Income before Business & Personal Property Deductions	$3,464,334
Less: Management Fee	($601,830)
Less: Replacement Reserve	($610,583)
	$2,251,921

  - NOI x 15% = $2,251,921 x 15% = $337,788 = Residual Intangibles deduction

HOW TO ADJUST FOR RESIDUAL INTANGIBLES

LOADING THE CAP RATE

Argument: Branded hotels contribute between 20% to 39% value compared to independent hotels. The Overall Rate is multiplied by a lesser percentage (5% to 10%) to account for the hotel having <u>any type</u> of flag.

10% Residual Intangible Adjustment Calculation	
NOI of Going Concern	$2,251,921
Cap Rate for Real Property	6.50%
Indicated Value (Prior to Tax Load)	$34,644,940
Value after 10% deduction for Residual Intangibles	$31,180,446
Indicated Capitalization Rate (NOI / Value after adjustment)	7.22%
Basis Point Adjustment	0.72%

5% Residual Intangible Adjustment Calculation	
NOI of Going Concern	$2,251,921
Cap Rate for Real Property	6.50%
Indicated Value (Prior to Tax Load)	$34,644,940
Value after 10% deduction for Residual Intangibles	$32,912,693
Indicated Capitalization Rate (NOI / Value after adjustment)	6.84%
Basis Point Adjustment	0.34%

MANAGEMENT FEE VS. BEV

Management Fee Method	**Business Enterprise Valuation Method**
Net Income Less:	Net Income Less:
Business Component	Business Component
Management Fee	Management Fee
Adjust for Residual Intangibles	Adjust for Residual Intangibles
	Business Start-up Costs
Personal property Component	Personal property Component
Reserve for Replacement	Reserve for Replacement
Value for FF&E in Place	Value for FF&E in Place
	Return on FF&E

BUSINESS START-UP COSTS

Include costs for:

- Assembling and training the staff, management and administration team
- Regulatory compliance
- Accounting and other business systems
- Pre-opening marketing
- Initial operating losses

Argument

- "An adjustment for the costs to establish the business must be considered. We must adjust for the seasoned skillset of the staff and the considerable training and systems proficiency that contribute to the business goals (as measured by the operating income analyzed herein), if the real estate value only is sought."

BUSINESS START-UP COSTS

Skilled and Assembled Workforce

Employees must be bound by contract or noncompete agreements,

Argument by Canadian Court,

- *"With respect to an assembled workforce, while we accept that there must have been an initial investment in hiring and training a workforce, <u>we do not accept that the initial investment necessarily continues to have discreet market value or that its value is separable from the real estate</u>."*
- *"To the extent there is or could be value in an assembled workforce, <u>we find that such value is, necessarily, inextricably intertwined with the realty</u>… Furthermore, the evidence was that the workforce of a hotel is constantly turning over, which means that a hotel is constantly re-investing in its workforce… all of the expenses associated with this activity are already deducted from the income stream. <u>To deduct the cost of replacing the existing workforce and equating that cost to an intangible value for the assembled workforce is in our view double counting.</u> "*

BUSINESS START-UP COSTS

Calculate by reviewing Franchise Disclosure Documents for Initial Business Start-Up costs for similar sized rooms and similar flags and discussions with property owners.

Franchise Disclosure Document - Per 2018 Hilton Hotels & Resorts			
Initial Business Start-Up Costs for 300 Room Hotel			
Category	Low	High	Average
Franchise Application Fee	$75,000	Increases $400 Per Key over 250 Keys	
Miscellanious Pre-opening and project management; Organizational Expense; Permits and Licenses	$1,075,000	$3,225,000	$2,150,000
Additional Funds (working capital for 3 months)	$1,100,000	$1,700,000	$1,400,000
Required Pre-Opening Training	$5,000	$20,000	$12,500
Computer Hardware and Software; Guest Internet Access Program; Delphi Sales and Events System	$212,700	$432,650	$322,675
Other Required Opening Services Fees	$20,000	$20,000	$20,000
Total:	$2,507,700	$5,492,650	$4,000,175
Total Per Key:	$8,359	$18,309	$13,334

BUSINESS START-UP COSTS

After concluding the total business start-up costs, the annual interest rate for the hypothetical loan on the business start-up costs is estimated to amortize that payment over the term of the loan.

PV = Total Business start-up costs	$3,315,000 ($15,000 per room)
i = Interest rate (annual)	8.0%
N = Term of the loan	20 years
PMT = ?	$337,640

BUSINESS VALUE DEDUCTION

	Management Fee Method		BEV Method	
Business Value Deductions				
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			$337,640	2.8%
RevPAR = 15% above Comp Set				
Residual Intangibles = NOI x 15%			$337,788	2.8%
Total Income Attributed to the Business	$601,830	4.9%	$1,277,258	10.5%

BUSINESS VALUE DEDUCTION

	Management Fee Method		BEV Method	
Business Value Deductions				
Management Fee	$366,350	3.0%	$366,350	3.0%
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Business Start-up Costs			$337,640	2.8%
RevPAR = 15% above Comp Set				
Residual Intangibles = NOI x 15%			$337,788	2.8%
Total Income Attributed to the Business	$601,830	4.9%	$1,277,258	10.5%
Cap Rate 0.124122				
Value Attributed to the Business	$4,848,693		$10,290,339	
	Difference		$5,441,646	

MANAGEMENT FEE VS. BEV

Management Fee Method

Net Income Less:

Business Component
- Management Fee
- Adjust for Residual Intangibles

Personal property Component
- Reserve for Replacement
- Value for FF&E in Place

Business Enterprise Valuation Method

Net Income Less:

Business Component
- Management Fee
- Adjust for Residual Intangibles
- Business Start-up Costs

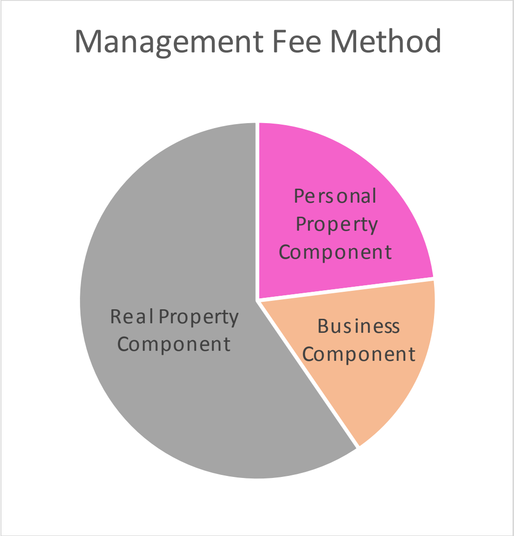
Personal property Component
- Reserve for Replacement
- Value for FF&E in Place
- Return on FF&E

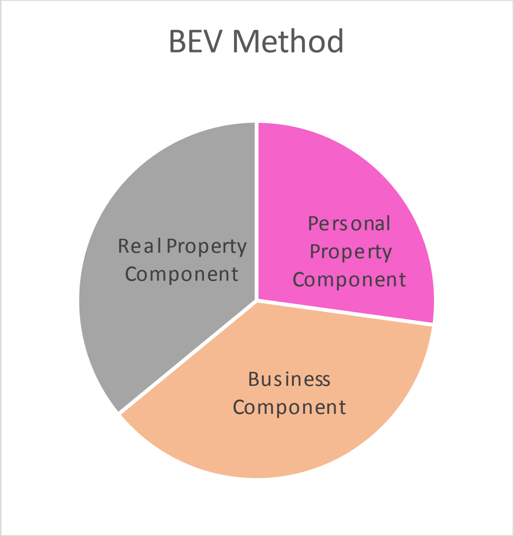
VALUE OF THE FF&E IN PLACE

	Management Fee (A)	Management Fee (B)	BEV Method
Reserves for Replacement (5.0%)	$610,583	$610,583	$610,583
Return on FF&E ($1,511,640 x 0.1241)	$187,628		$143,606
Total Income Attributed to the PP	$798,211	$610,583	$754,189
Cap Rate	0.124122		
Value of the Personal Property Deduction	$6,430,854	$4,919,214	$6,076,188
Value of the FF&E in Place		$1,511,640	$1,511,640
Value of the Personal Property Deduction	$6,430,854	$6,430,854	$7,587,828
Difference	$1,156,974		

VALUE SPLIT

	Management Fee Method		BEV Method	
Personal Property Component	$6,430,854	23.0%	$7,587,828	27.2%
Business Component	$4,848,693	17.4%	$10,290,339	36.9%
Real Property Component	$16,631,163	59.6%	$10,032,542	35.9%
Total Property Value	$27,910,709		$27,910,709	





NON-REALTY REVENUE ARGUMENT

Rely solely on the Income Approach

Do not use the revenue from the food and beverage and other revenue generating departments.

- "Hotels operate multiple profit centers which provide a variety of guest services, such as restaurants, retail markets, laundry centers, and health clubs. These profit centers contribute non-realty revenue not subject to ad valorum taxation. We have therefore excluded from our analysis sources of revenue not attributable to the real estate, such a telephone income and food and beverage revenue (please note, however, that we likewise do not deduct the expenses associated with these items from the real estate revenue)."

Apply rental rates to the areas these spaces occupy.

NON-REALTY REVENUE ARGUMENT

	Rooms 221			
Income	**Actual**		**Non-Realty Revenue**	
ADR	$128.10		$128.10	
Occupancy	81.00%		81.00%	
RevPAR	$103.76	$103.76	$103.76	$103.76
Total Rooms Available	80,665		80,665	
Total Revenue	**$8,369,881**		**$8,369,881**	
Departmental Revenue	**Amount**	**Ratio**	**Amount**	**Ratio**
Rooms	$8,369,881	68.5%	$8,369,881	91.0%
Food & Beverage	$3,347,952	27.4%	$334,795	3.6%
Other Operating Division	$259,466	2.1%	$259,466	2.8%
Miscellaneous Income	$234,357	1.9%	$234,357	2.5%
Total Revenues	**$12,211,656**	**100.0%**	**$9,198,499**	**100.0%**

- Argument – To remove the non-real estate component of this revenue generating center, an assumption that it was leased to a restaurant operator. “Typical rental rates for restaurants range from 6.0% to 9.0% of Gross Sales.”
- 10% was applied in this analysis.

NON-REALTY REVENUE ARGUMENT

No Food and Beverage Departmental Expenses were removed.

	Rooms 221			
Income	**Actual**		**Non-Realty Revenue**	
ADR	$128.10		$128.10	
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Miscellaneous Income	$234,357	1.9%	$234,357	2.5%
Total Revenues	**$12,211,656**	**100.0%**	**$9,198,499**	**100.0%**
Departmental Costs & Expenses				
Rooms	$2,176,169	26.0%	$2,176,169	26.0%
Food & Beverage	$2,678,362	80.0%		0.0%
Telephone	$168,653	65.0%	$168,653	65.0%
Other Operating Expenses	$199,203	85.0%	$199,203	85.0%
Total Departments C & E	**$5,222,387**	**42.8%**	**$2,544,025**	**27.7%**
Total Gross Income	**$6,989,269**	**57.2%**	**$6,654,474**	**72.3%**

NON-REALTY REVENUE ARGUMENT

However, all of the expenses were applied at their full dollar amount.

	Rooms 221			
	Actual		**Non-Realty Revenue**	
Expenses				
General & Unapplied Expenses				
General & Administration	$1,221,166	10.0%	$1,221,166	13.3%
Advertising & Promotion	$793,758	6.5%	$793,758	8.6%
Property Ops & Maintenance (R/N	$488,466	4.0%	$488,466	5.3%
Utilities	$781,546	6.4%	$781,546	8.5%
Total General & Unapplied Expenses	**$3,284,935**	**26.9%**	**$3,284,935**	**35.7%**
House Profit	**$3,704,334**	**30.3%**	**$3,369,539**	**36.6%**
Other Operating Expenses				
Management Fees	$366,350	3.0%	$366,350	4.0%
Equipment Rental	$65,000	0.5%	$65,000	0.7%
Total Other Operating Expenses	**$431,350**	**3.5%**	**$431,350**	**4.7%**
Property Insurance	**$175,000**	**1.4%**	**$175,000**	**1.9%**
Reserve for Replacement	**$610,583**	**5.0%**	**$610,583**	**6.6%**
Total Expenses	**$4,501,868**	**36.9%**	**$4,501,868**	**48.9%**

NON-REALTY REVENUE ARGUMENT

This means that $2,700,000 of value is attributed to the Business Value the Food and Beverage department.

	Actual		Non-Realty Revenue	
Net Operating Income	**$2,487,401**	**20.4%**	**$2,152,606**	**23.4%**
Loaded Cap Rate	12.41%			
Value	$20,039,964		$17,342,660	
Rounded	$20,050,000		$17,350,000	
	Difference		$2,700,000	

NON-REALTY REVENUE ARGUMENT

Net Operating Income	$2,487,401
Management Fee	$366,350
Reserve for Replacement	$610,583
NOI (No Deductions for BV & PP)	**$3,464,334**
VALUE (TAB)	**$27,910,706**
	$27,900,000

NON-REALTY REVENUE ARGUMENT

Business Value Deductions			
Management Fee			$366,350
Incentive Management Fee			$235,480
Business Value of F&B			
Original F&B Revenue	$3,347,952		
Original F&B Expenses	-$2,678,362		
F&B Rental Revenue	-$334,795		
Total			$334,795
Total Business Income Deductions			$936,624
Business Value			
Loaded Cap Rate	12.41%		$7,545,997
		Rounded	**$7,550,000**

NON-REALTY REVENUE ARGUMENT

Personal Property Deductions			
Reserve for Replacement			$610,583
Total Expenses			$610,583
Personal Property Value			
Loaded Cap Rate	12.41%		$4,919,214
Value of the Personal Property			$1,511,640
Total Value			$6,430,854
		Rounded	$6,425,000

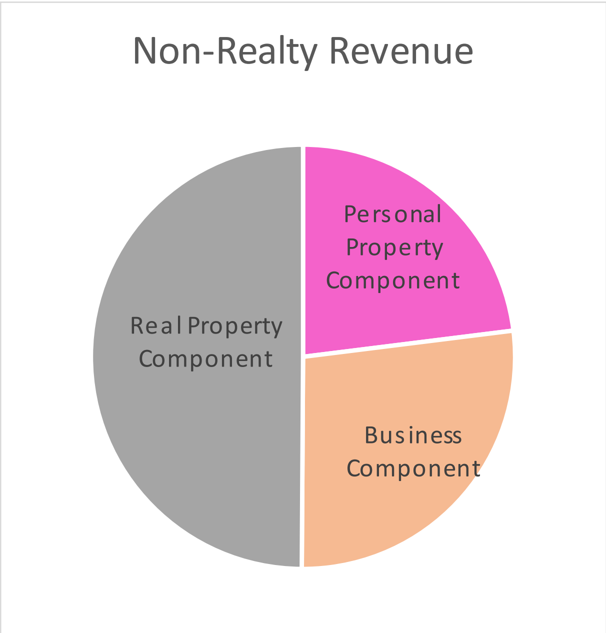
NON-REALTY REVENUE ARGUMENT

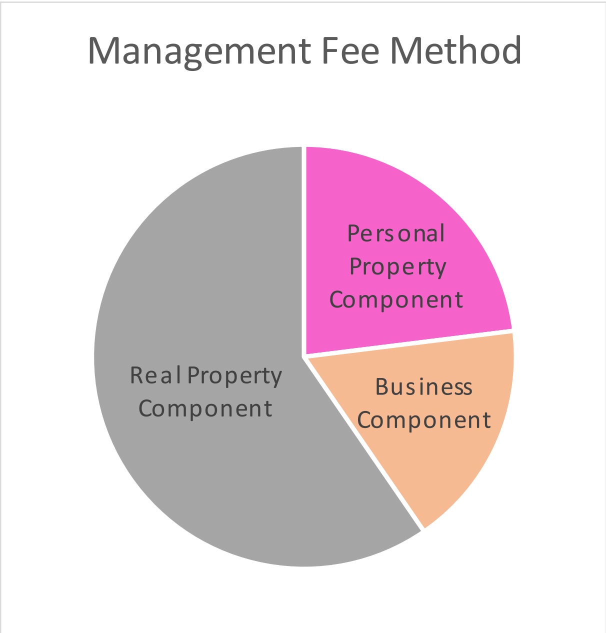
Real Estate Value			
NOI			$3,464,334
Less: Management Fee			-$366,350
Less: Incentive Management Fee			-$235,480
Less: Business Value of F&B			-$334,795
Less: Replacement Reserve			-$610,583
Total			$1,917,126
Loaded Cap Rate	12.41%		$15,445,495
Less: Value of PP			-$1,511,640
			$13,933,855
		Rounded	$13,925,000

NON-REALTY REVENUE ARGUMENT

Personal Property Component	$6,425,000	23.0%
Business Component	$7,550,000	27.1%
Real Property Component	$13,925,000	49.9%
Total Property Value	$27,900,000	

NON-REALTY REVENUE ARGUMENT





FRANCHISE FEES

Sometimes hidden in operating expenses (Sales & Marketing)

	Y-T-D(Dec) FY17 Actual Final	
Rooms Available	[redacted]	
Rooms Sold	[redacted]	
Occupancy	[redacted]	
Average Rate	[redacted]	
RevPAR	[redacted]	
Revenue	[redacted]	
Rooms Division	[redacted]	54.7%
F&B Division	[redacted]	42.5%
Other Operating Division	[redacted]	0.6%
Miscellaneous Income	[redacted]	2.2%
Total Revenue	[redacted]	**100.0%**
Departmental Expenses	[redacted]	
Rooms Division	[redacted]	28.7%
F&B Division	[redacted]	58.2%
Other Operating Division	[redacted]	110.9%
Total Departmental Expenses	[redacted]	**41.1%**
Departmental Income (Loss)	[redacted]	**58.9%**
Undistributed Operating Expenses	[redacted]	
Administration & General	[redacted]	7.9%
Info & Telcom Systms	[redacted]	2.3%
Sales & Marketing	[redacted]	6.8%
Repairs & Maintenance	[redacted]	4.3%
Heat, Light & Power	[redacted]	3.6%
Total Undistributed Expenses	[redacted]	**24.8%**
Hotel GOP	[redacted]	**34.0%**
Management Fees	[redacted]	**3.0%**
Income Before Non Operating	[redacted]	**31.0%**
Total BTL Other Income	[redacted]	0.0%
Non-Operating Income and Expenses	[redacted]	
Rent Expense Hotels	[redacted]	0.4%
Property & Other Taxes	[redacted]	5.4%
Insurance	[redacted]	0.6%
Total Non-Operating Income and Expenses	[redacted]	**6.3%**
EBITDA	[redacted]	**24.7%**
FFE Reserves	[redacted]	**4.0%**
EBITDA Less FFE Reserves	[redacted]	**20.7%**

Sales & Marketing
Overhead Operating Statement

	Y-T-D(Dec) FY17 Actual Final	
Decorations	[redacted]	0.0%
Complimentary Gifts & Services	[redacted]	0.0%
Licenses & Permits	[redacted]	0.0%
Contract Services	[redacted]	0.1%
Agency Fees	[redacted]	0.1%
Collateral Material	[redacted]	0.0%
Web-Site	[redacted]	0.1%
Franchise and Affiliation Fees - Royalties	[redacted]	1.5%
Miscellaneous Marketing	[redacted]	0.0%
Total Advertising	[redacted]	0.0%
Familiarization Trips	[redacted]	0.0%
Promotions	[redacted]	0.1%
Trade Shows	[redacted]	0.0%
Media	[redacted]	0.1%
Loyalty Programs	[redacted]	1.2%
Total Other Expenses	[redacted]	**3.3%**
Total Departmental Expenses	[redacted]	**6.8%**

TAX COURT DECISIONS – LUXEFORD HOTEL

Last Hotel Case in Minnesota?

PRKM Inc vs Hennepin County (October 4, 1991)

- Assessments for 1987 and 1988
- Property was a recently constructed hotel in Downtown Minneapolis.
- Cost Approach relied upon since the property was newly constructed.
- Sales Approach was not relied upon since there were, “no good comparable with which to compare the subject property.”

TAX COURT DECISIONS – LUXEFORD HOTEL

- Income approach was relied heavily and exclusively by the county and petitioner, respectively.
  - Both appraisers recognized the hotel was not stabilized at the time of the assessment. Additionally, the hotel market changed dramatically because the convention center closed in 1986.
  - Return of and Return on Personal Property used, "An allowance is made for return of personal property based upon depreciation over a 10 year life, and return on personal property using a 12% rate on the undepreciated balance."
    - No additional deduction was made for the value of the FF&E in place after the value conclusion.

TAX COURT DECISIONS – LUXEFORD HOTEL

Also -

- Relied upon other income including Food and Beverage.
- "Since this Court does not have the computerized facilities to conduct its own cash flow analysis, both parties agreed to supply a discounted cash flow analysis computation based upon parameters established by the Court."

TAX COURT DECISIONS – SOUTHDALE

Court rejected that 1/3 of total asset value is non-real property.

- "In reaching our final conclusion, we reject Petitioner's argument that a portion of Southdale's value is attributable to some intangible personal property which may be a business value. Mr. Leirness concluded that approximately one-third of the total asset value is a non-real property component. He describes this intangible value as the unique drawing power of Dayton's, the radius restrictions negotiated between Petitioner and both Dayton's and J.C. Penney, and the aggregate customer base drawing power of the three anchors."

TAX COURT DECISIONS – JENNIE O FOOD

Court concluded there were six tests to determine if an allocation of sale price is credible.

1. How the portion of the overall purchase price allocated to real estate was determined
2. Whether there was an appraisal upon which the allocation was based
3. Who did the appraisal
4. What was the basis of the appraisal
5. Evidence and testimony, if any, that tends to support or rebut the values listed in the CRV
6. Evidence, if any, that extraneous considerations influenced the allocation amount.

TAX COURT DECISIONS – EP MALL

Techniques used in BEV are similar to technique used by Lennhoff in EP Mall Case.

- "…began his appraisal by looking at the entire going concern or total assets of the business. From there, he identified and valued the tangible and intangible assets of the property. He then made a number of adjustments to his calculation of NOI deriving from the total assets of the business in order to arrive at the NOI from the real estate alone."

Court rejected Start-up costs argument

- "Mr. Lennhoff amortized the 2001 Mall re-opening costs of $623,326 over 12 years. Respondent argues that start-up costs are a one-time expense and, thus, would not be a factor considered by a reasonably prudent buyer. We agree. Mr. Lennhoff's expectation of the recurrence of a reopening was not supported by the record and the Mall's history. The Mall reopening costs, therefore, should not have been amortized over a 12-year period."

QUESTIONS?