

HOTEL VALUATION



LINCOLN INSTITUTE
OF LAND POLICY

THE PANEL

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JUDGE, MINNESOTA TAX COURT

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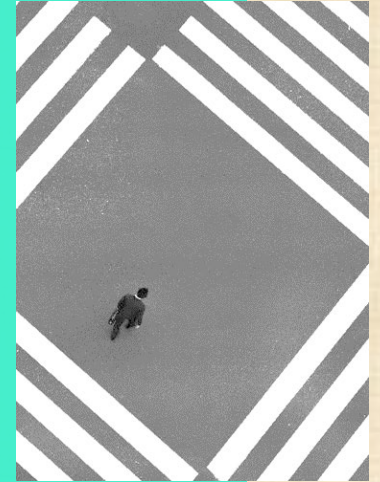
OVERVIEW

- BRIEF HISTORY
- TWO METHODS TO ADDRESS THE **INCOME APPROACH** TO VALUE
- CASES & TRENDS IN LITIGATION

HISTORY

(IT HASN'T ALWAYS BEEN THIS WAY.)

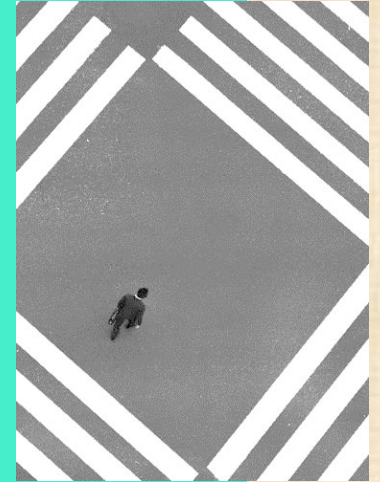
The current hotel ownership practice is that the hotel owner owns both the hotel *building* and the hotel *business*, engaging a third party such as Sheraton to operate that business. This practice has existed for about 50 years.



HISTORY

(IT HASN'T ALWAYS BEEN THIS WAY.)

During the 1970s, the hotel lease arrangement was replaced by the hotel management contract where the owner retained the fee simple estate and paid the hotel operator a management fee (and franchise fees) for running the day-to-day operations.



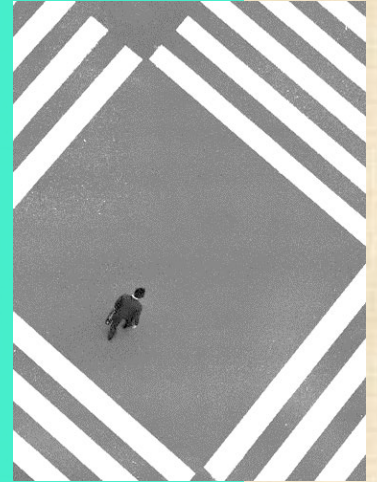
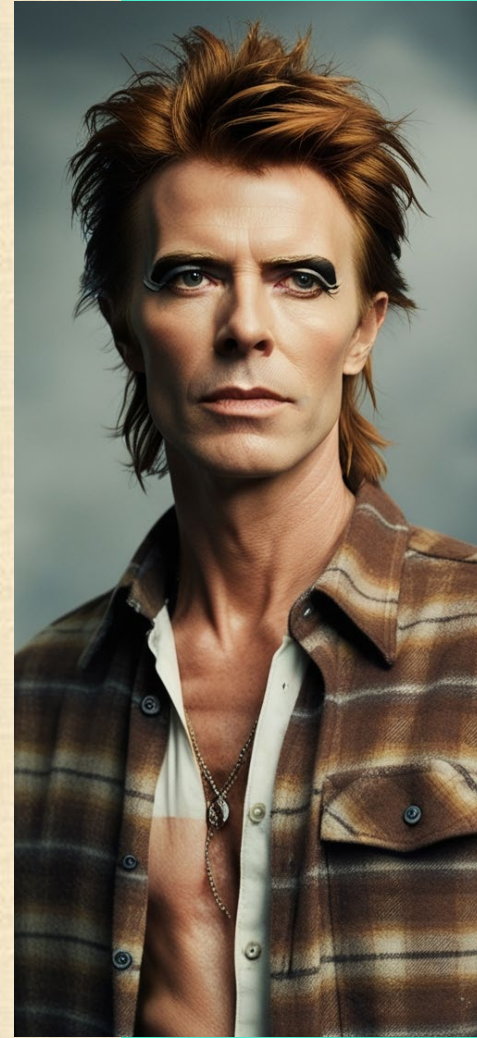
HISTORY

(IT HASN'T ALWAYS BEEN THIS WAY.)

Under the current arrangement, the net operating income to the owner includes both:

- Rental income from the real property; and
- Income to the business(es) operating there.

Disentangling these incomes is our aim.



VALUATION IMPLICATIONS



- Certain types of real estate improvements, such as hotels, are designed and constructed solely for use in a business operation.
- Often, this type of real property is sold together with the business. This **going concern**, can include:
 - real property,
 - tangible personal property (such as furniture, fixtures, and equipment), and
 - intangible assets (such as franchise agreements, other business contracts, and business goodwill).
- *The Appraisal of Real Estate 663 (15th ed. 2020).*

TIMELINE

1970s

Hotel Lease Agreement business model replaced by Hotel Management Agreement business model.

1980s

Management Fee Method for Income Approach created.

2000s

Business Enterprise/Parsing Income Method grows.

2020s

Both methodologies are used. Some Management Fee proponents have expressed a strong concern about USPAP requiring the Parsing Income method for all hotels.

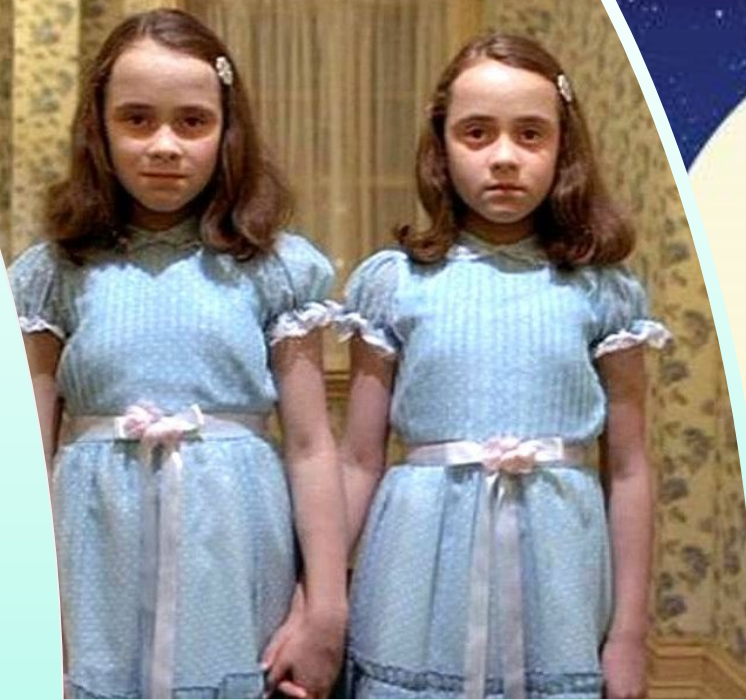


METHODS

- Disentangling these incomes is crucial as many jurisdictions only tax the value of the real estate.
- When constructing an Income Approach to valuation, it then becomes necessary to determine what revenue is generated from the real estate and what revenue is generated in another way.



REAL OR NOT?



ATTRIBUTABLE TO THE REAL ESTATE?





PORTLANDIA

AMENITIES MATTER




ROSEBUD



OR



BELLAGIO?



IT USED TO BE A GOOD HOTEL,
BUT THAT PROVES NOTHING—I
USED TO BE A GOOD BOY.

- MARK TWAIN -

INCOME APPROACH METHODS

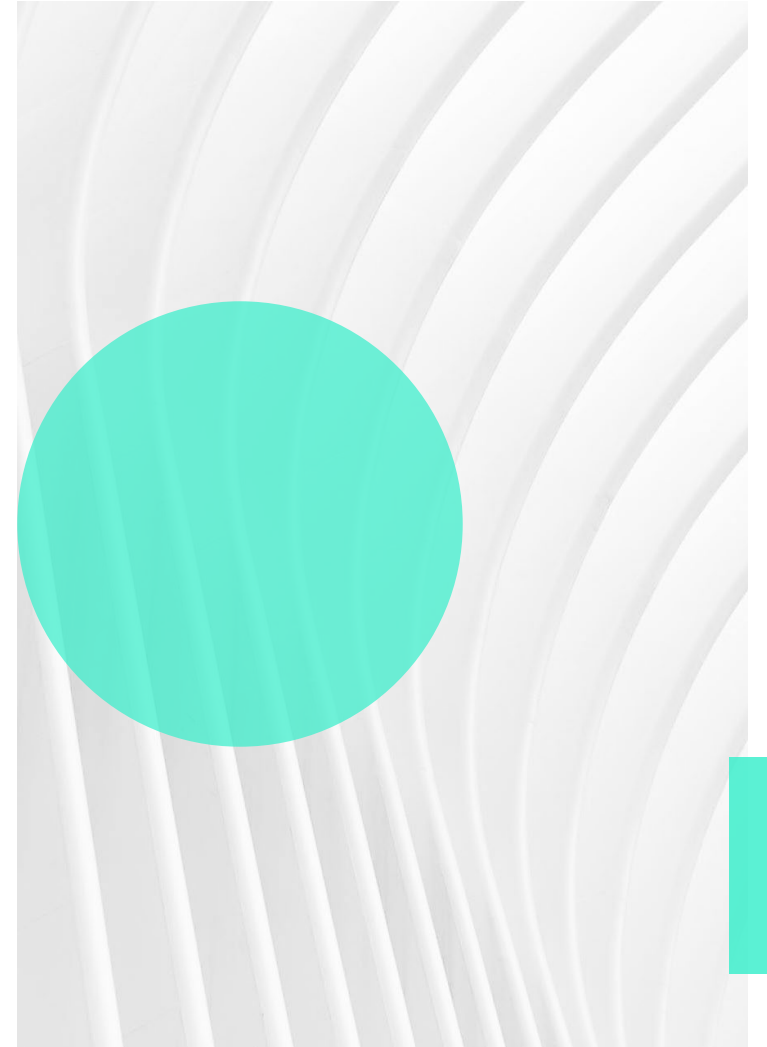


Management Fee Method

Parsing Income Method

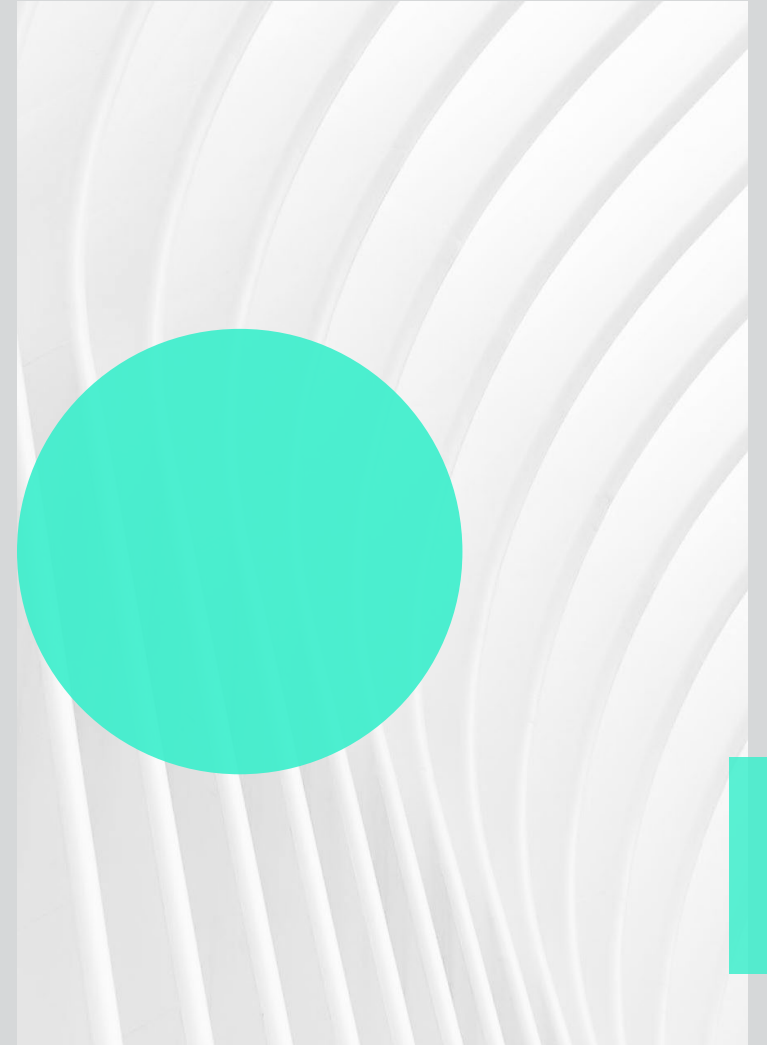
MANAGEMENT FEE METHOD

- Values tangible assets exclusive of intangible assets; capturing all intangibles by deducting a management fee.
- Usually expressed as a percentage of effective gross income (commonly 3%); there may be an incentive fee on top of the base fee. There may also be separate franchise fees, which are also deducted.
- Widely recognized; used by a number of states.



MANAGEMENT FEE METHOD

- Critics of this approach argue that it does not value and exclude all intangible assets used to generate operational income.
 - The management fee itself does not relate to all of the intangible utilized by the business.
 - Merely deducting a management fee fails to provide a return on the investment on the intangible asset represented by that fee. (*TARE 677*)
 - **Why franchise if no *return on*?**



WHO'S NOI??

Hotel

Revenue

Room Revenue

Expenses

Room Related

Management Exp.

NOI (Rooms)

Restaurant

Revenue

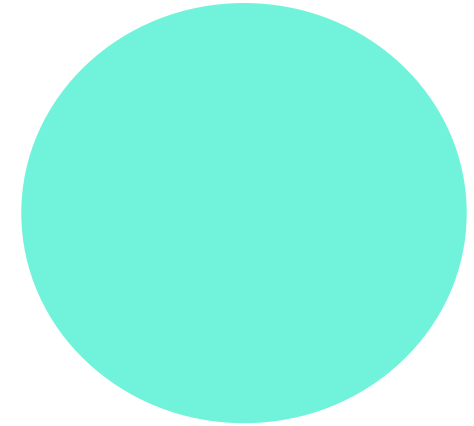
Food Revenue

Expenses

Food Related

Management Exp.

NOI (Food)



- The Management Fee Approach combines all revenue.
- It subtracts expenses.
- It also excludes Management Fees, purportedly to eliminate intangibles.
- For hotels operating restaurants, this would thus seem to attribute restaurant NOI to the real property (to the hotel owner as property owner rather than as restaurant owner).
- This becomes more apparent by considering a proxy rent hypothesis.

MANAGEMENT FEE METHOD

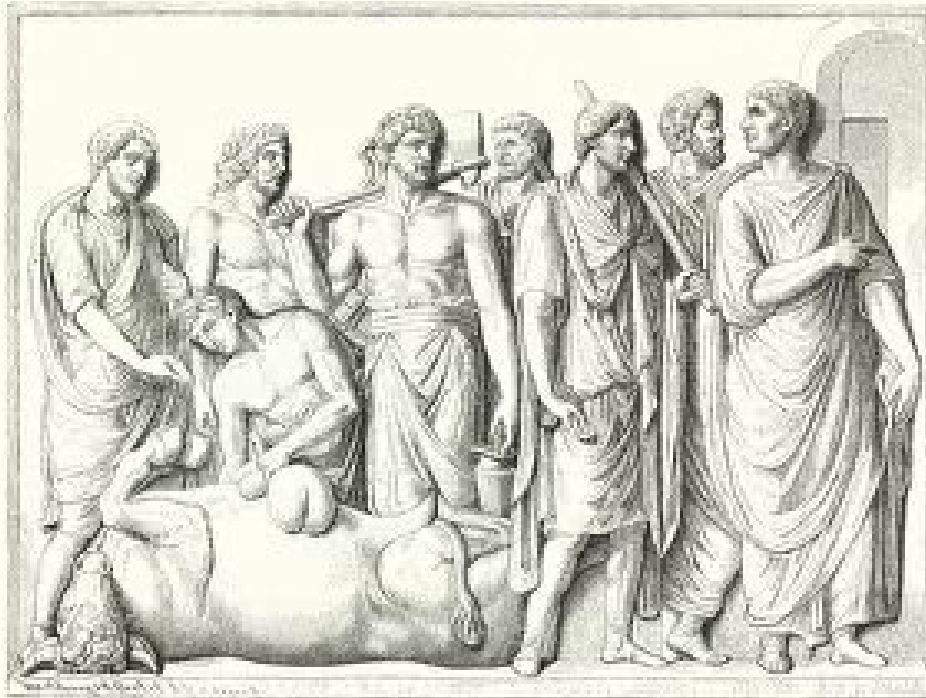
Bloomington Hotel Investors, LLC v. Hennepin, 993 N.W. 2d 875 (Minn. 2023).



- Hilton DoubleTree in Bloomington with convention space, restaurant, bar, & café.
- Other income generated by the restaurant business derived from non-real property sources:
 - Food and beverage sales; ambience and service, & effective restaurant management.
- Court refuses to preclude Mgmt. Fee method; explains why in this instance parsing was used.

MANAGEMENT FEE METHOD

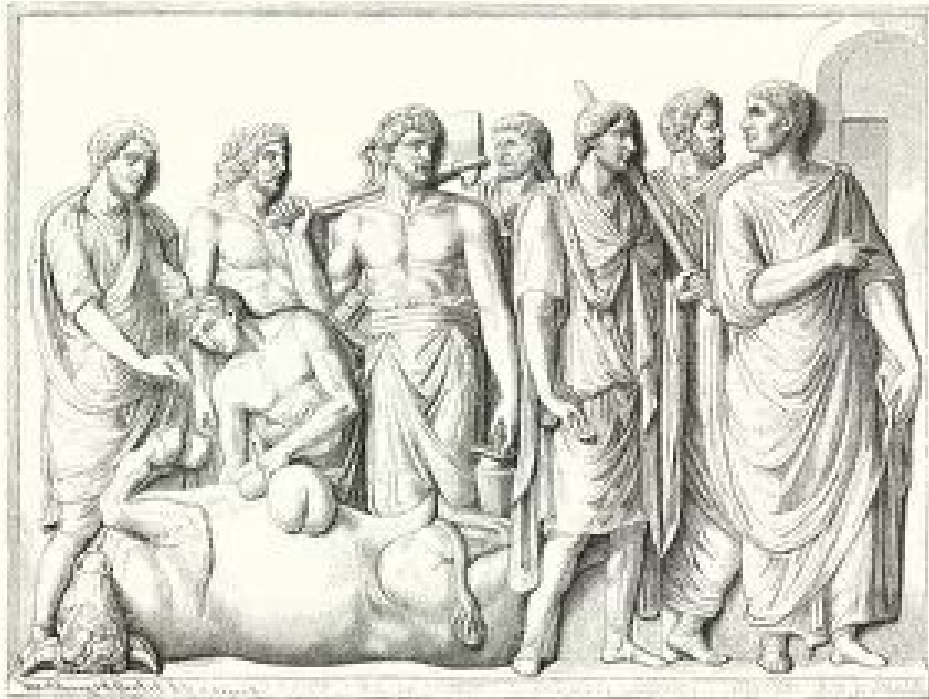
Switzerland County Assessor v. Belterra Resort Indiana, LLC, 101 N.E. 3d 895 (Ind. 2018).



- Casino resort in Florence, Indiana with a riverboat, hotel and golf course.
- Indiana Board of Tax Review is the fact finder for all property tax appeals in Indiana; appeals from the Board go to the Judicial Tax Court.
- "Indiana's property tax system taxes the value of real property – and not intangible business value, investment value, or the value of contractual rights."
- The Board likened valuing the casino to ancient divination using animal entrails.
 - No rental income, no comparable sales, and the market "never considers the value of the real property separate from the business assets."

MANAGEMENT METHOD FEE

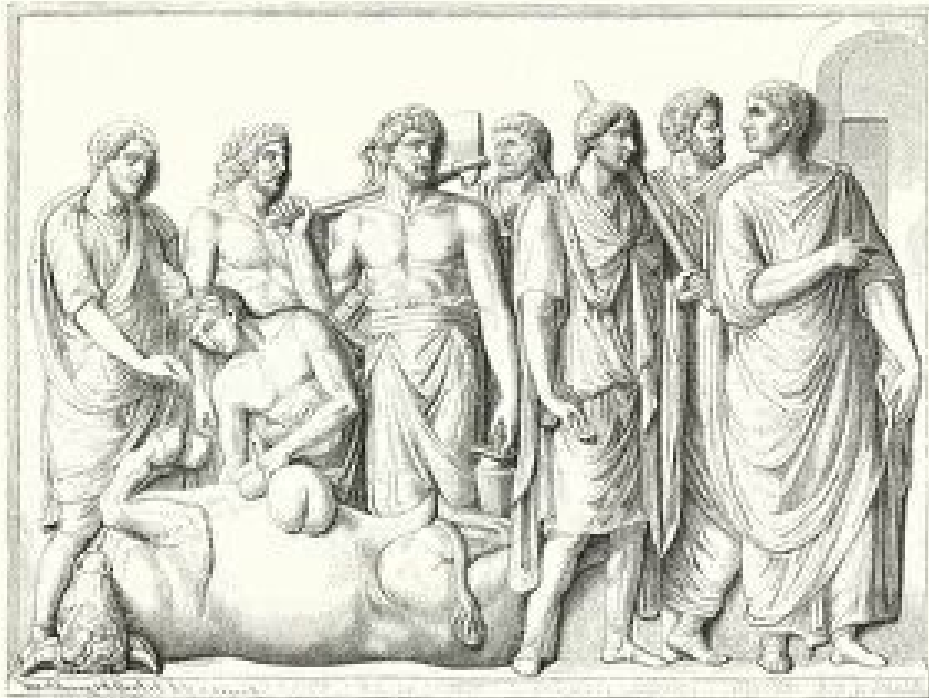
*Switzerland County Assessor v. Belterra Resort
Indiana, LLC, 101 N.E. 3d 895 (Ind. 2018).*



- The Tax Court of Indiana accepted the Board's rejection of the Parsing Income method because of the lack of adjustments from the comps to the subject.
- The Tax Court also reversed the Board's acceptance of the going concern value, with the exception of the value of the riverboat and golf course.
- In the end, the hotel's assessment was reinstated.

MANAGEMENT FEE METHOD

Switzerland County Assessor v. Belterra Resort Indiana, LLC, 101 N.E. 3d 895 (Ind. 2018).



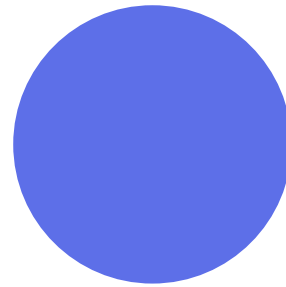
- Jon Elrod, Chair of the Indiana Board of Tax Review
 - Served as a Commissioner at the Board level in this case.
- Martha Wentworth, Senior Judge of the Indiana Tax Court
 - Presided over the appeal at the Tax Court level.

INCOME APPROACH



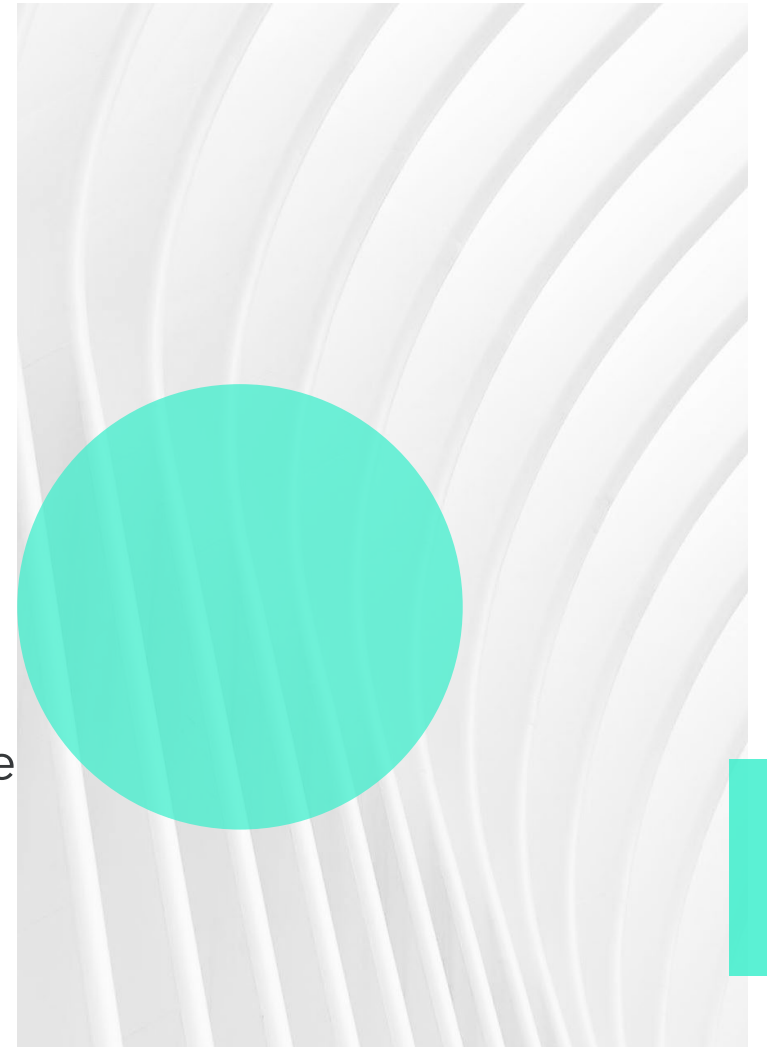
Maumee City Schools Board of Education v. Lucas County Board of Revision, 2024 WL 2702998 (Ohio Bd.Tax.App. (May 10, 2024).

- Hotel received a reduction in value at the Board of Review (\$5.1M down to \$3.5M) for tax year 2020, citing financial hardship related to the COVID-19 pandemic.
- Board of Education appealed.
- Business financial information does not necessarily reflect the value of the real property. Hotel owner did not present probative evidence of value.
- Assessed value reinstated.



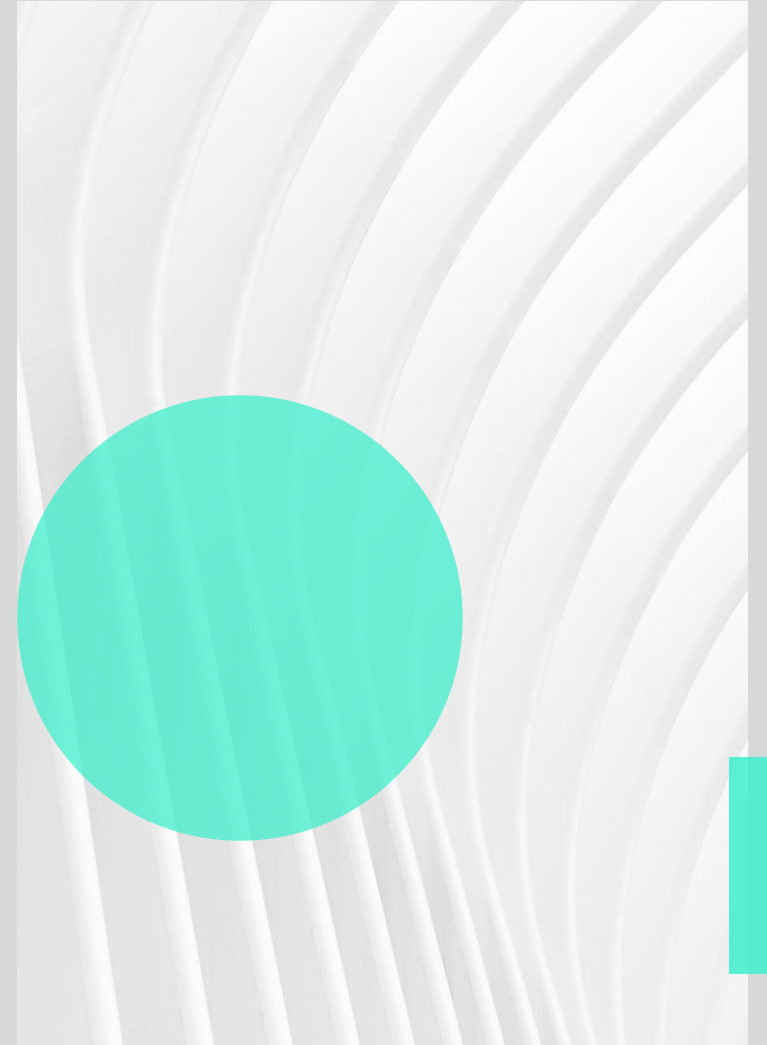
PARSING INCOME METHOD

- Separates real property value from business and other intangible value.
- Consistent with the going-concern premise.
- Intangible assets are identified, and an income allocation is assigned to each.
- Example: using third party proxy rent for food and beverage revenue attributed to the real estate.
- Considers management and franchise fees as routine expenses, not as a vehicle to address intangible assets.



PARSING INCOME METHOD

- Critics state the identification of an appropriate cap rate to convert the residual income to different asset classes can be difficult.
- Critics state this method is a new, creative way to lower taxes and the Management Fee method is widely accepted and approved in many states.



PARSING INCOME METHOD

1300 Nicollet, LLC v. Hennepin, 990 N.W.2d 422 (Minn. 2023).



- Hyatt Regency Hotel in downtown Minneapolis with convention space, two restaurants, and a convenience store.
- Estimated a proxy rent equal to 10% (a market rental rate) of projected food & beverage sales.
- This rental value of food & beverage space is attributable to the real estate; the food & beverage sales are not.

PARSING INCOME METHOD



Singh v. Walt Disney Parks & Resorts US, Inc., 325 So. 3d 124 (Fla.App. 5 Dist. 2020).

- Large Disney resort next to Epcot with ~1,200 rooms, large conference center, multiple restaurants and retail stores, a spa and other recreational amenities.
- Given the complexity of the site and the variety of income streams, the court found that the Management Fee method does not remove all business value.
- Remanded for reassessment.

PARSING INCOME METHOD

SHC Half Moon Bay, LLC v. County of San Mateo, 171 Cal.Rptr 3d 893 (Cal.App.1st 2014).



- Ritz-Carlton on the bluffs of the Pacific coast with ~260 rooms, restaurant, spa, conference center, and lounge.
- Two golf courses neighbor the hotel and guests have access to both courses.
- Court here found that the Management Fee method did not identify and exclude intangible assets (here: assembled workforce, hotel's leasehold interest in an employee parking lot, & agreements with the golf course operator).

PARSING INCOME METHOD

SHR St. Francis, LLC ("Strategic") v. City and County of San Francisco, 94 Cal.App.5th 622 (2023).



- Change of ownership of the Westin St. Francis located in Union Square (~1,200 rooms) triggered reassessment.
- Court here found that the Management Fee method improperly subsumed the value of the management agreement and other income sources (guest cancellations, in-room movies & guest laundry services).

PARSING INCOME METHOD

Olympic and Georgia Partners, LLC v. County of Los Angeles, 90 Cal.App.5th 100 (2023).



- Ritz-Carlton & Marriott (1,000 rooms) convention hotel in downtown L.A.
- Issue of whether to add an \$80M subsidy from the City of L.A. to the assessment.
 - Court here says NO.
- Additionally, whether to add a \$36M discount payment from the mgmt. company to the owners to the hotel's assessment.
 - No. "Discounts are not income."
- "No empirical support for the illogical premise that every franchise fee wipes out all intangible benefits a franchise agreement might offer a hotel owner."

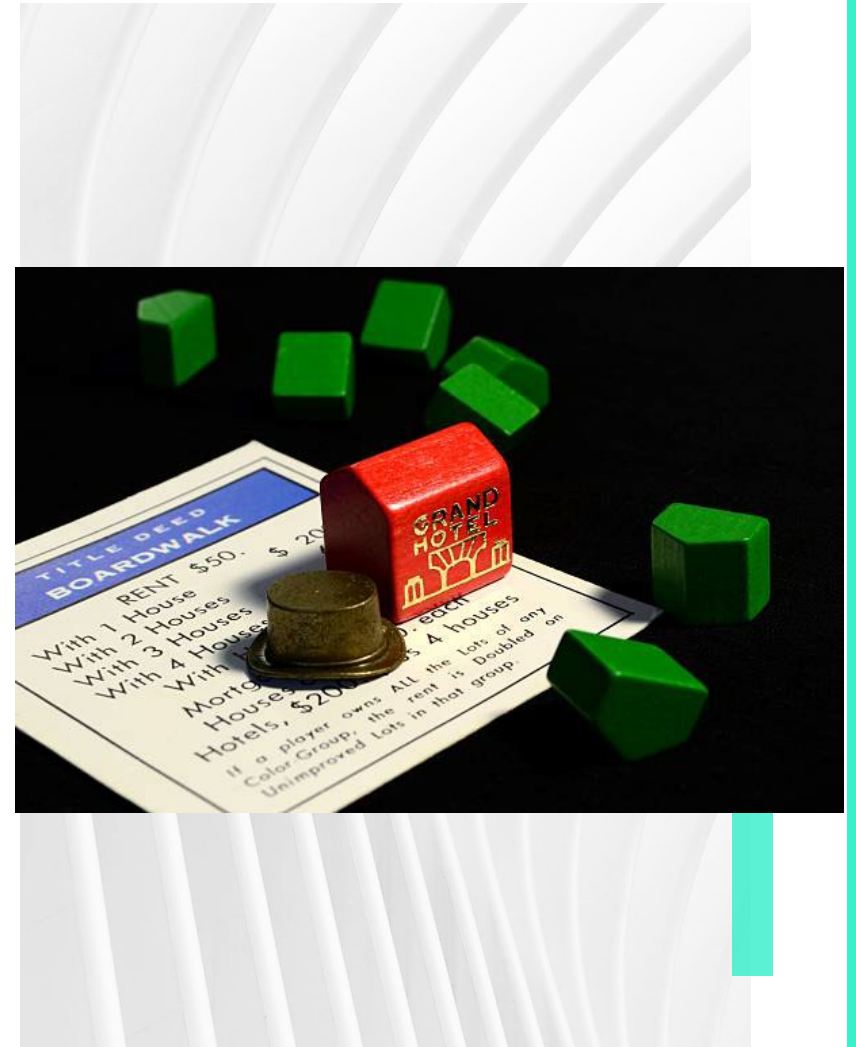
WHAT NOW?

Operational income is generated by both the realty and non-realty assets. **Be thoughtful, consider your other tools.**

Cost Approach – gets directly to the real estate, but one must be careful with depreciation and market considerations. Also, does a buyer really care what a site cost to build, isn't the buyer more interested in the site's income projections?

Capturing business value indications?

- Sale price exceeds Cost Approach value.
- Sales Comparison Approach conclusion exceeds Cost Approach value. (Comps include business value?)





Schitt\$Creek



QUESTIONS?

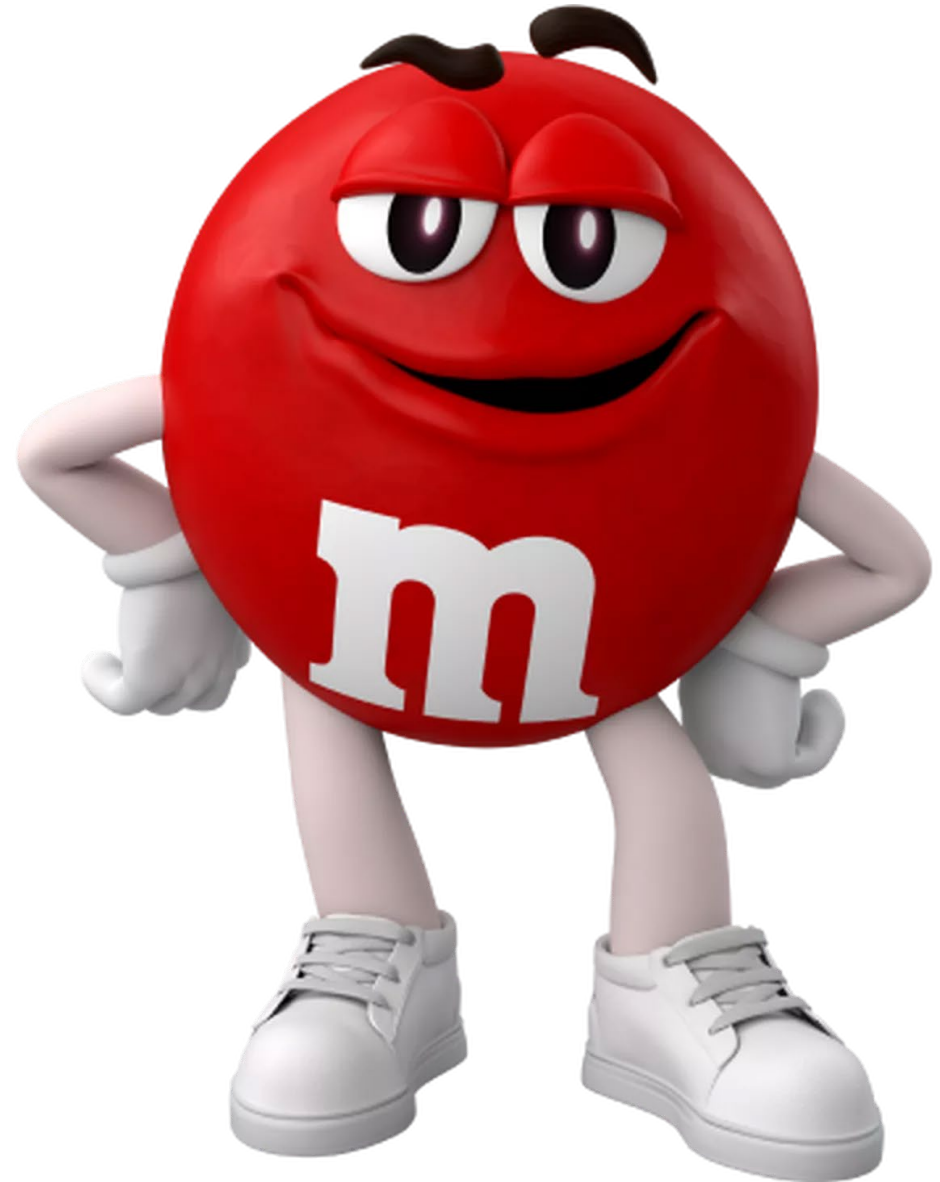
*"A PRUDENT QUESTION IS
ONE-HALF OF WISDOM."*

– FRANCIS BACON

*"HE MUST BE VERY IGNORANT
FOR HE ANSWERS EVERY
QUESTION HE IS ASKED."*

– VOLTAIRE

WHY DID THE **M&M**s GO TO COLLEGE?





**THEY
WANTED
TO
BECOME**
SMARTIES

THANK YOU

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THANK YOU!



Jane Bowman

Chief Judge

Minnesota Tax Court



Brad Delapena

Judge

Minnesota Tax Court



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Minnesota Tax Court



Bowie Lincoln

An AI Creation