

Use Caution When Applying Cap Rates from Sales Surveys - By Mark Hutcheson

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When assessors use cap rates from national surveys to value a hotel, the taxpayer stands a very good chance that his property will be over assessed.

Assessors in most jurisdictions assess hotels by utilizing a direct capitalization approach. This method follows the standard appraisal formula of $V=I/R$, that is, V = value, I = net income and R represents the capitalization 'cap' rate. For property tax purposes, assessors seek to determine the value of the hotel at a specified point in time (usually January 1st of the tax year). They derive a net income for the property -- through actual year-end performance or published room rates and market data -- then divide that net income by a cap rate. While there are several methods for determining cap rates, most assessors utilize national surveys of indicated cap rates from hotel transactions.

To understand why cap rates from national surveys may result in overstated property tax assessments, it is important to understand the appraisal formula referenced above. Survey participants provide cap rates by dividing the net income by the sales price. For example, a hotel with an annual income of \$1 million that sold for \$10 million would indicate a 10% cap rate. If at the time of sale, however, the same hotel had an underperforming annual income of only \$750,000, the indicated cap rate from the sale would be 7.5%. The disconnect here is that the buyer may have assumed in his pro forma that through better management he could get the income up to market levels at \$1 million. As a result, the \$10 million sales price made sense to the buyer at a forecasted 10% cap rate, while it might not have at the actual 7.5% rate.

Surveys may include cap rates based on actual incomes, pro forma incomes, or some combination of the two. As a result, the cap rates shown in the surveys may be artificially low due to the impact of underperforming properties. This problem translates into higher property tax assessments when assessors use these survey cap rates to appraise well performing properties. In the above hotel example, if the property were performing well with \$1 million in net income and the assessor used a 7.5% cap rate (rather than the 10% the buyer actually forecasted), the resulting assessment would be \$13,333,333 - one-third higher than it would have been at a 10% cap rate.

Understanding this relationship and the pitfalls of using survey data becomes critical to the valuation of hotels for property tax purposes. To achieve accurate tax appraisals, you should ensure that the cap rates used to value your property are derived from transactions involving comparable properties with consistent levels of income performance.

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