

Reduce Property Taxes by Recognizing Hotel Profit Centers - By David C. Lennhoff, MAI, SREA, CRE
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Assessors all too often base their hotel property tax assessments on the revenues derived from a hotel's total assets, wildly exceeding the appropriate amount for just the 'taxable' real property. This occurs because the assessor fails to separate the real property from the total assets of the business.

A simple reason explains this failure. Hotels owners rarely rent a building and open up a hotel business. More typically they own the property and operate the business. As a result, very few leases of buildings used for hotel businesses are available to enable an appraiser to develop an estimate of rent. The same is true of sales, unless distressed, they, too, reflect transfers of the total assets.

Because the income approach is the most meaningful in hotel valuation, sales comparison rarely is applicable at all. Thus, some secondary method is needed to identify the rent. This step in the valuation process presents difficulties even for appraisals of a limited-service hotel. When you add ancillary profit centers-such as, day spas, convention centers, water parks, trendy restaurants, private clubs, and golf courses-the job becomes too daunting for most assessment offices.

Many real estate appraisers in private practice and most real estate assessment officers have a difficult time recognizing and allocating the total assets of a hotel. Those that attempt an allocation at all often rely on a simplistic-and fatally flawed-method that suggests deducting management fees and franchise costs, hoping this will somehow remove the intangibles or business elements. Suffice it to say, this just does not work because it really values the total assets of the hotel, and in most jurisdictions, taxing intangibles as real property is against the law.

A brief review of income capitalization basics helps to understand how an appraiser must develop an income approach that correctly reflects just the value of the real property. Most income approaches for assessment purposes use direct capitalization, as opposed to discounted cash flow analysis. The model is simple: the value of the asset to be appraised is equal to the net income of that asset divided by a capitalization rate. Stated algebraically,

$$V = I / R$$

To value the real property, net rent for the space represents income. With office buildings or warehouses, which usually just rent space, identifying the market rent isn't particularly difficult. The appraiser simply finds comparable rents for office or warehouse space and adjusts them to an amount that reflects the property's physical, legal and locational specifics and then deducts operating expenses-which consist of fixed, variable and replacement allowances.

Some intermediate steps are necessary for hotels, even limited service products, although the result still produces an income number. Ultimately, the appraiser wants to calculate net income of the real property so that it can be divided by a capitalization rate. But because the revenue for most hotels reflects the total assets, additional deductions from it become necessary to remove the tangible and intangible personalty. So, in this case, the formula is gross revenues divided by the total assets, minus operating expenses, minus business revenue, minus income representing a return on and of the tangible personal property (FF&E). When the property being appraised is a convention hotel with a day spa, a golf course and a trendy restaurant (a profit center, not the usual hotel restaurant loss leader), the difference can be significant.

The magnitude of the difference can be illustrated by reviewing a typical retail lease, in which the rent for the real estate often is expressed as a percent of total revenues to the business. A look at tenant information tables for shopping centers published by Urban Land Institute reveals that, for example, typical rent for the space occupied by a national chain restaurant with liquor in a super regional mall is 6% of sales (median). The same percentage rent is indicated for a Day Spa. Imagine the implications for an assessment based on gross revenues less only operating expenses! For instance, the same source shows median sales per square foot for the restaurant to be \$499.94. Rent at 6% would indicate \$30 per square foot per year. Using the total revenue amount, \$499.94, and deducting a typical chain-affiliated full-service hotel expense ratio of about 75% from it, results in net income of \$125.00, an amount nearly 320% too high.

It requires real expertise to value just the real estate portion of an operating hotel with significant profit centers in addition to the rooms revenue. Much too often appraisers respond to a question about their methodology for accomplishing the task with, 'I know it is necessary, I just don't know how to do it.' Nothing wrong with an answer like this, it's honest and straightforward. Nonetheless, appraisers should spare no effort in learning how to do it.

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