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# Ethics in Hotel Appraising

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**The ethical issues involved with performing appraisal services for hotels and, by extension, any property are examined here. By analyzing how appraisals are commissioned, performed, and ultimately used, it is possible to understand how the unscrupulous can benefit from unethical practice. Some recommendations are made for ridding the appraisal system of such potential pitfalls.**

The demise of the savings and loan industry presents an appropriate time to investigate ethics in hotel appraising. Many of the bank failures that plague the economy today can be traced to either inept or unethical real estate lending practices. Since appraisers had a significant role in reviewing many of these real estate transactions, industry observers and regulators are now questioning both the ability and moral integrity of these professionals. This article discusses the various ethical issues involved with performing appraisal services. By understanding how appraisals are commissioned, performed, and ultimately used, you will easily see how the unscrupulous can benefit through unethical behavior. Because my personal background has been focused on hotel appraising, I will probably slant my viewpoint in that direction. However, ethics in hotel appraising will apply to all types of real estate. Lastly, the term "hotel appraisal" is intended to encompass a variety of professionals who perform consulting services for the hotel industry. While their products may be called feasibility studies, market studies, financial projections, or appraisals, they all have a common ethical bond-to render unbiased professional advice that can be relied on by lenders and investors.

## REASONS FOR APPRAISALS

A hotel appraisal (or other similar study) is generally used to justify an investment in a hotel project. Because hotel developers and professional operators usually have their own capability to evaluate potential opportunities, appraisals are looked upon as independent verification of pre-

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conceived conclusions performed to satisfy the needs of lenders and less sophisticated investors. For example, most major hotel owners do not need an MAI appraisal to tell them how much one of their hotels is worth. However, in order for them to obtain lender and investor financing, independent appraisal services become essential.

In most investment situations, the appraisal is commissioned after the hotel developer or purchaser has conducted extensive analysis and concluded that the opportunity exhibits economic viability. Once preliminary interest is shown by a suitable lender, the appraisal then becomes one of the final hurdles between conducting or not conducting the transaction.

You can imagine the stress involved in this process. The developer or purchaser has spent thousands and sometimes millions of dollars on research, legal fees, broker expenses, professional time, and so forth. The prospective lender or equity investor has been identified and shows interest. The fate of the entire deal rests on the appraiser. If there is going to be a breakdown of ethics, it will probably occur at this point.

**PRESSURES**

I have been in these situations many times and have experienced the various types of pressures exerted on appraisers. Sometimes these pressures are subtle and indirect, while occasionally the client's demands become obvious and abusive. In most cases, the pressure is monetary, but once I was threatened with physical harm.

As an appraiser, you become sensitive to the comments and innuendos used by some clients to influence your final value conclusion. A few of the pressure tactics and remarks I have heard over the years include the following:

- Let's work together on this one, I have many projects coming down the line.
- If we do this deal, I'll introduce you to all my partners.
- Do you want to be added to our approved appraiser list?
- Do you want to remain on our approved appraiser list?
- We really want to do this deal.
- I can find other appraisers who will give me the right number.
- If you kill this deal, I'll sue you for the damages.
- You better come up with the value or I'll file charges against you.
- You did not give me the value I needed so I will not pay your fee.

This ethical breakdown occurs when an appraiser yields to these pressures and places immediate monetary gain above long-term credibility. It might seem easy to just give in, please the client, get paid for the assignment, and line up future business. But in reality, this shortsighted approach will usually create long-term problems.

**NEED FOR HONESTY**

Appraisers are in the business of selling credibility. Lenders and investors depend on objective and unbiased findings. Knowledge and skill are important, but an appraiser's reputation for honesty and integrity is essential. Those who have sold out their reputations eventually begin to lose clients and friends. Since the nature of the appraisal profession requires the sharing of data and information, those who exhibit unethical behavior soon become ostracized by their peers. The downward spiral continues.

How can you spot an unethical appraiser? It is usually very difficult because there are so many components of a hotel appraisal that small adjustments at each step can ultimately result in a substantial change in the final value. Investors and lenders should carefully scrutinize each appraisal they receive and be alert to some of the techniques that unethical appraisers use to distort the final estimate of value.

**Example**

Let us assume that the purpose of the appraisal is to estimate the market value of a hotel in order to justify a certain level of financing. The borrower wants to "finance out" (i.e., not have to put any equity into the deal), so he attempts to influence the appraiser to produce a value that is approximately 25% above the total cost so the amount of the mortgage would be sufficient to fund the entire acquisition. Let us also assume that the hotel has a marginal location, so to come up with the desired results the appraiser will have to push for additional value at every available opportunity in the appraisal process. Having performed thousands of hotel appraisals and reviewed the work of many other appraisers, I know the areas in which slight distortions of the data and conclusions will create an inflated valuation. This unethical practice is also cumulative so that each small and usually insignificant distortion will produce a higher final value.

## STEPS IN THE HOTEL VALUATION PROCESS

Looking at the entire hotel valuation process, the following sections describe some of the techniques unscrupulous appraisers will apply to their analyses in order to pump up the final estimate of value.

### Supply and demand analysis

The first step of a hotel appraisal is the supply and demand analysis in which the room night demand in the market is quantified and projected into the future. The existing and proposed supplies of hotel accommodations are then brought into the calculation based on the competitive attributes of each property. The final result of the supply and demand analysis is a projection of occupancy for the subject property out to a point where it reaches a stabilized level. Any overstatement of the existing demand or the expected demand growth rate tends to inflate the area occupancy levels and increases the market potential for any proposed lodging properties. Techniques to look out for include the following:

- **Increasing the size of the primary market area so that more hotels are included in the analysis.** By padding or inflating the base level of demand, the impact of additional proposed hotel rooms on the area's overall occupancy will be lessened. For example, assume the primary market area has five hotels with a total of 1,250 rooms. The area occupancy is 75%. Current room night demand is calculated as follows.

  1,250 x .75 x 365
  = 342,188 room night demand

  If 300 new rooms were added to this market, the area-wide occupancy would decline to 60%:

  1,250 + 300 = 1,550 x 365
  = 565,750 room night supply

  Occupancy
  = 342,188 + 565,750 = 60%

  An unscrupulous appraiser could lessen the impact of the new rooms on the area-wide occupancy by increasing the size of the market area to include hotels that would probably not be competitive. Assume that the primary market area was increased to include ten hotels totaling 2,500 rooms operating at an average occupancy of 71% (looks more conservative). The current room night demand is calculated as follows:

  2,500 x .71 x 365
  = 647,875 room night demand

  If the same 300 new rooms were added to this market, the area-wide occupancy would decline to only 63%

  2,500 + 300 = 2,800 x 365
  = 1,022,000 room night supply

  Occupancy
  = 647,875 + 1,022,000 = 63%

- **Using a higher demand growth rate.** Most hotel appraisals analyze the future and projected growth in hotel room night demand. Compounding the yearly increase in hotel demand by a slightly higher growth rate greatly inflates occupancy levels. For example, local economic and demographic trends indicate that hotel room night demand will probably grow at an annual rate of 2% per year. Figure 1 shows the impact of both a 2% and a more aggressive 4% growth rate on the area-wide occupancy.

  The combination of a wider, less diluted market area and an over-aggressive demand growth rate produces seven additional points of occupancy by year 4 that can greatly enhance the ultimate market value.

- **Inflating the competitiveness of the subject property.** Once an area-wide occupancy has been projected, the supply and demand analysis fits the subject property within the market

FIGURE 1

| | Year 1 | Year 2 | Year 3 | Year 4 |
|---|---|---|---|---|
| Room Night Demand 1,250 Rooms (2%) | 342,188 | 349,032 | 356,013 | 363,133 |
| Room Night Demand 2,500 Rooms (4%) | 647,875 | 673,790 | 700,742 | 728,772 |
| Area-wide Occupancy 1,250 Rooms | 60% | 62% | 63% | 64% |
| Area-wide Occupancy 2,500 Rooms | 63% | 66% | 69% | 71% |

based on its relative competitiveness. One of the techniques used to accomplish this analysis is known as penetration positioning. This process takes the area-wide occupancy and multiplies it by a penetration factor that represents the percentage of the area-wide occupancy the subject property is expected to achieve. For example, a new hotel in its first year of operation generally achieves an occupancy that is between 80% and 90% of the area-wide level. In the second year, a new hotel should normally produce an occupancy of between 95% and 105% of the area-wide level. In its third year of operation, this average hotel will probably reach an occupancy that is 105% to 115% above the area-wide. Using the area-wide occupancies calculated above, Figure 2 shows the impact of using aggressive penetration percentages.

The total impact of the enlarged market area, aggressive growth, and competitive positioning amounts to 14 points of inflated occupancy by the third year.

Other techniques that are sometimes employed to create higher occupancy levels during the supply and demand analysis include: leaving out proposed hotels that have a good possibility of being developed; adding large amounts of latent demand; and including properties that are not competitive.

**Forecast of income and expense**

The next step in the hotel valuation process is the forecast of income and expense that uses as its basis the projected occupancy determined in the supply and de-

FIGURE 2

| | Year 1 | Year 2 | Year 3 |
|---|---|---|---|
| Area-wide Occupancy | | | |
| 1,250 Rooms | 60% | 62% | 63% |
| Realistic Penetration | 85% | 100% | 110% |
| Projected Occupancy | 51% | 62% | 69% |
| Area-wide Occupancy | | | |
| 2,500 Rooms | 63% | 66% | 69% |
| Aggressive Penetration | 95% | 110% | 120% |
| Projected Occupancy | 60% | 73% | 83% |

mand analysis. Obviously, if this occupancy projection has been overstated as demonstrated previously, the forecast of income and expense will likewise represent these inflated assumptions. But even if the occupancy levels were realistic, there are many ways unscrupulous appraisers can juice up the bottom line during the forecast. Techniques to look out for include the following:

- **Using an unrealistic inflation rate.** Most forecasts of income and expense use inflated dollars that require certain inflation assumptions. The compounding effect of an aggressive inflation factor has been demonstrated previously with the use of the high room night demand growth rate. While sometimes it may be justified to inflate revenues at a rate greater than expenses, this technique is often used to increase the bottom-line profits.
- **Omitting certain expense categories.** Hotels' projections will normally follow the Uniform System of Accounts for Hotels and should include all categories of revenue and expenses. In addition, a reserve for replacement is usually included as a normal cost of doing business. If the reserve is overlooked, the projected net income will be overstated.
- **Using insupportable operating ratios.** The technique that can easily create a substantial increase in bottom-line profit is to project unachievable operating ratios. Understating departmental expenses by three to five points will greatly inflate the net income. Just a little change in each expense category has a cumulative impact on the bottom line. Minor alterations in the operating ratios usually go undetected, particularly by those who are unfamiliar with hotel financial statements. Sometimes unusual effects can be created during the forecasting process. For example, a projection of income and expense for a hotel with a 15% food and beverage departmental profit will generally produce decreasing net income as the food and beverage revenue increases. Therefore, an unscrupulous appraiser can overstate the bottom line and create more value by merely decreasing the amount of food and beverage revenue projected.

**Income capitalization approach**

The last step in the hotel valuation process is the income capitalization approach that typically includes a ten-year discounted valuation model. The input for this calculation comes from the forecast of income and expense which by this point can be greatly inflated. In addition, more value can be created with some minor modifications to the model. Techniques to look out for include the following:

- **Using a high inflation rate.** Most appraisers will take the projection of income and expense and inflate the net income as of the stabilized year for as many as ten years using an overall rate of inflation. If this inflation factor is overstated, the final estimate of value produced by the model will also be overstated.
- **Using mid-year discounting factors.** Most hotel investors and valuation models assume that the net income is received at the end of each year so the proper discount factor would be an end-of-the-year factor. A higher value will be achieved if a mid-year or a beginning-of-the-year factor is used. This technique of creating value often goes undetected.
- **Using low discount and capitalization rates.** Low discount and capitalization rates produce high values. In fact, a small change will often produce a significant difference. For example, lowering an overall capitalization rate a single point from 11% to 10% will increase the value by approximately 10%. Since discount and capitalization rates are largely judgmental, unethical appraisers tend to home in on this area when additional value is required.

Other techniques that are sometimes used during the capitalization process to create value include: extending the discounting period from five to ten years without adjusting the discount rates; understating brokerage and legal fees; understating the cost of debt and equity capital; and failing to consider the age of the property at reversion.

As you can see, appraisers have many

opportunities to adjust the inputs during the appraisal process in such a way that the ultimate value can be greatly increased. Likewise, in instances where a low valuation is required (i.e., property tax appeals), reverse techniques can be employed to deflate the final outcome.

Unfortunately, since the hotel valuation process is so complicated and sophisticated, very few people can recognize when abusive practices are taking place.

As is the case with most unethical behavior, unethical appraisals are a means to an end. In most instances, appraisers resort to these practices to satisfy an unethical client and ensure that the appraisal fee for the assignment will ultimately be received. In addition, the threat of losing future business by not producing the desired results further entices those with low moral values to conform to the demands of the client.

## A POSSIBLE SOLUTION TO UNETHICAL APPRAISALS

Unethical behavior is self-imposed and cannot be condoned under any circumstances. However, it is hard to believe that an individual who has worked many years to learn the appraisal profession would become unethical without some persuasive, external motivating factors.

One of these external factors is an antiquated system whereby the party with the least financial exposure is often the party who selects or retains and pays for the appraisal. This inherently breeds corruption.

Basically, appraisals are used to protect someone from making an investment that exceeds the value of the property. This individual or entity is generally the money source that places at risk the major portion of the hard investment dollars. In many instances, this money source is not responsible for commissioning or paying for the appraisal. Rather, the deal-maker (i.e., general partner, syndicator, developer), who traditionally uses other people's money, finds the appraiser, commissions the study, and pays the bills.

This system is obviously prone to corruption. Because the deal-maker normally has little more than time invested in the deal, there is maximum incentive to take whatever steps are necessary to complete the transaction. The appraisal is considered a necessary evil that could kill the deal if a particular value is not achieved. Herein lies the basis for the monetary pressure applied to the appraiser. "Make my number or else," comes through loud and clear when some deal-makers commission their studies. In fact, in large transactions a few deal-makers will use several appraisal firms to maximize their chances of obtaining the desired result.

Looking further into the transaction, you will sometimes find lenders who seem to be more interested in doing the deal with an inflated appraisal rather than relying on an unbiased, objective study. In these instances, the bank's loan-originating department is probably receiving bonuses for the quantity of deals made rather than for their quality. This system also breeds corruption and provides additional incentive to unfairly influence the appraiser.

These are two examples of how people with motivations that are not exactly aligned with the transaction's money sources sometimes attempt to exert monetary pressure on appraisers. As stated previously, appraisers should never yield to these pressures. However, if the system were perfect, the appraiser could be isolated from these influences and would not feel compelled by any of these pressures.

Changing the system so that appraisers are isolated from adverse influences is one solution. In addition, the Appraisal Institute has been at the forefront of the establishment of high ethical standards for appraisers, developing and enforcing a *Code of Ethics* along with the *Uniform Standards of Professional Appraisal Practice* (USPAP), which govern the professional appraisal activities of its members and affiliates. The Preamble to the USPAP relates directly to the potential abuses set forth in this article when it states, "It is essential that a professional appraiser arrive at and communicate his or her analyses, opinions, and advice in a manner that will be meaningful to the client and will not be misleading in the marketplace." It also points out that all appraisals must:

* Correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal;

- Clearly and accurately set forth the appraisal in a manner that will not be misleading;
- Develop and communicate each analysis and opinion without bias for the client's interest and without accommodation of his or her own interests.'

## RECOMMENDATIONS

It really does not take much to rid the appraisal system of adverse influences. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) has gone a long way toward accomplishing this goal by establishing a structure for retaining appraisers that should preserve their independence. Unfortunately, these regulations do not apply to all financings, so the following list presents my recommendations to those investors who desire an unbiased appraisal:

- Anyone who is investing money in a hotel transaction should independently select, retain, and pay for the appraiser. This may mean that several appraisers would be used on any one transaction, but the end result of multiple studies would highlight any disparities between these professionals. These studies enable the investor to reach a more informed investment decision.
- Lenders should commission appraisal services through a totally independent appraisal department that is isolated from any of the lenders' origination services.
- Lenders should not compensate employees based on the number or amount of loans made without factoring in the quality of the loans.
- Lenders should not require appraisers to look to any third party (i.e., the deal-maker) for payment of the appraisal fee.
- Lenders should not accept any appraisals commissioned by prospective borrowers.
- Lenders should have a screening procedure to ensure that only highly qualified appraisal professionals are used.

In addition to these suggestions for improving the way appraisals are commissioned, the appraisal profession should constantly monitor its members and enforce the *Code of Ethics* and USPAP for those individuals who continue to perform in an unethical manner.

## CONCLUSION

While the bad news is that it is too late to correct the abuses that ruined the savings and loan industry, the good news is that the banking regulators seem to now understand how the appraisal system was pressured by unethical parties and are starting to implement some of these suggested recommendations. Hopefully, ethical appraisal practices can be enhanced through these simple lender regulations, coupled with informed investors who understand the necessity of retaining their own, unbiased hotel appraiser.

1. The Appraisal Foundation, "Preamble," *Uniform Standards of Professional Appraisal Practice* (Washington, D.C.: The Appraisal Foundation, 1990), B-1.