Notes & Comments

Hotel Business Value and Working Capital: A Clarification

By Stephen Rushmore, MAI

In the October 1986 issue of *The Appraisal Journal*, Anthony Reynolds, MAI, wrote an article for the Notes and Comments section entitled "Attributing Hotel Income to Real Estate and to Personalty." His comment essentially focused on an article that Thomas Arasi and I coauthored entitled "Adjusting Comparable Sales for Hotel Assessment Appeals," *The Appraisal Jornal*, vol. 54, no. 3 (July 1986): 356–366. This response should clarify some of the issues involved.

The first question raised by Reynolds concerns the meaning of the phrase "going concern" in the real estate valuation context.

Hotels and motels are going businesses composed of four primary components: land and improvements (real property), personal property (furniture and equipment), and business or going concern value.

The business component of a hotel's overall value accounts for the fact that a lodging facility is a labor-intensive, retail-type activity that depends on customer acceptance and highly-specialized management skills. In contrast to an apartment or office building where tenants sign leases for one or more years, a complete turnover of patronage occurs in a hotel every two to four days. Continuous marketing and attention to guest services are two examples

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of elements that comprise this unique business component. A hotel operation is further complicated by food and beverage outlets, and requires additional business and managerial talents.

Several procedures have evolved to estimate the income attributable to the business component of a lodging facility. The most appropriate theory for today's environment is based on the premise that by employing a professional management agent to take over the day-to-day operation of the hotel, thereby allowing the owner to maintain only a passive interest, the income attributed to the business or going concern has been taken by the management agent in the form of a management fee. A fair range for this management or going business deduction would be 2% to 4% of total revenue.

Another facet of business value are the benefits that accrue from an association with a recognized hotel company through either a franchise or management contract affiliation. The income attributed to this type of identification might have elements of what Reynolds termed "good will." It includes brand recognition, national marketing, a central reservation system, and other similar benefits. Some renowned independent hotels such as the Stanford Court, Hay Adams, and the Carlyle Hotel that have created their own national or regional identification also possess this added business value component.

An additional business value deduction is appropriate for properties that benefit from a chain affiliation or a strong independent status. This is accomplished by either increasing the management fee expense to 4% to 8% of total revenue, or adding a separate franchise fee deduction of 3% to 5% of rooms revenue to the basic 2% to 4% management fee previously described.

By deducting a management and franchise fee from the forecast of income and expense utilized in the income capitalization approach, the overall property value will decrease 20% to 30%, reflecting the business or going concern component. To say that there is an additional element of good will or intangible value beyond a 20% to 30% business value component seems to be infringing on the real property components.

Reynolds questioned whether personal property, which was stated in the article to consist of furniture, fixtures and equipment, also includes items such as receivables and inventories. When a hotel sales transaction is negotiated, the final price agreed on by the buyer and seller generally does not include receivables and inventories. These items are inventoried and valued at the closing and become a closing adjustment. An analogous situation is the sale of a single-family house where the sales price, the price on the deed, and the market value exclude the value of the oil in the fuel tank.

The final area of concern has to do with a hotel's working capital. The hotel working capital issue has been around for many years and hopefully the following explanation will put the matter to rest. Many appraisers who

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perform hotel appraisals for property tax purposes contend that a hotel owner is entitled to a return on a hotel's working capital. They arbitrarily establish that the initial working capital for a hotel is $1,000 to $2,000 per room and that the return on this amount should be 12%. They then conclude that $120 to $240 per unit should be deducted from the stabilized income stream to remove the value attributed to the working capital component. While this procedure appears logical, its premise has one basic flaw–hotels typically have no working capital! Working capital is defined as current assets minus current liabilities. Almost every hotel operates at a negative current ratio, which means the current assets are less than the current liabilities. Essentially, hotel owners finance their current assets with their accounts payable and, therefore, allocating a return on a nonexistent amount of working capital is not appropriate. The following table shows the working capital ratio of several typical hotels.

Working Capital Ratio

Hotel	Current Assets	to	Current Liabilities
Sheraton	1	to	3.5
Independent	1	to	2.3
Hilton	1	to	1.1
Holiday Inn	1	to	1.4
Ramada	1	to	2.1
Marriott	1	to	2.8

In conclusion, I believe the four basic components of a hotel continue to be land, improvements, furniture and equipment, and the going business. Deducting a management and franchise fee adequately covers income attributed to the going business and accounts for the benefits of a product image, or what Reynolds calls good will. The sales price that a buyer typically arrives at by capitalizing the property's anticipated earnings does not include normal adjusting entries such as cash, supplies, uniforms, silver, china, and so forth, which are paid for separately as a closing adjustment. And finally, because most hotels operate without real working capital, none of the income stream should be allocated to this component.

Those who carefully read "Adjusting Comparable Sales for Hotel Assessment Appeals" probably found that the $177,000 management fee deduction for income attributed to the business was mistakenly deducted twice, once on page 358 and again on page 360. There was no intention to attribute one deduction to one type of business value and the other deduction to another. Because the Sheraton Hotel was operated by its owners and the $177,000 yearly management fee represents a below market return for this service (1.9% of total revenue), the actual deduction utilized in the article,

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$354,000 or 3.8% of total revenue, would be more in line with the actual income attributed to the business.

Readers interested in a more complete discussion of my theory of separating the personal property and going business components from hotel real estate, should refer to my article "Valuation of Hotels and Motels for Assessment Purposes," *The Appraisal Journal*, vol. 52, no. 2 (April 1984): 270–289. In this work a logical procedure is presented for accomplishing such a value allocation.

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