In Defense of the "Rushmore Approach" for Valuing the Real Property Component of a Hotel
by
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Does it sound reasonable that the real property component for a hotel accounts for only 36% of the hotel's total property value?

While the results cited above seem extremely low to me, this is typical of what will be achieved if you utilize the "new" approach for separating the real property component from a hotel's total property value. The so-called "business enterprise approach" espoused by a prominent member of the Appraisal Institute utilizes a methodology that essentially moves much of a hotel's total property value into areas such as tangible and intangible personal property, thus deflating the value of the real property component and significantly reducing a hotel's ad valorem tax assessment.

As you might know, I have written all five textbooks for the Appraisal Institute on the valuation of hotels and motels. My procedure for separating the real property component from a hotel's overall value has been termed by a number of tax courts around the United States as the "Rushmore Approach." It has been utilized by both hotel property owners and taxing jurisdictions for the past 20 years. During this time, I have represented an almost equal number of owners and jurisdictions in property tax disputes, indicating the universal acceptance of my approach by both parties.

I have been asked by many of my appraiser colleagues who specialize in the valuation of hotels and motels and view the business enterprise approach as a real threat to the future of asset-based hotel mortgage financing to write this defense of the Rushmore Approach. The real issue is not the huge reduction in the value of the real property component used for tax assessment purposes, but the possible reduction in mortgage asset security that lenders rely upon when making hotel loans. If the business enterprise approach is universally mandated for all hotel appraisals, it could severely restrict hotel owners from leveraging their acquisitions, which could lead to a significant decline in hotel values.

During my 30-year career as a hotel appraiser and investor, I have worked with thousands of hotel owners, operators, and lenders. I do not know of any industry participant who utilizes the procedures set forth in the business enterprise approach for evaluating a hotel acquisition or determining market value for purchase or financing. It appears that the business enterprise approach is simply an academically contrived procedure used for the sole purpose of lowering property tax assessments for hotel owners.

So let me lay out the facts and arguments for both approaches, demonstrate the results in a side-by-side example, and let you decide which approach produces the most reasonable findings.

Background

The valuation of hotels is a highly specialized form of real estate appraisal, requiring not only a thorough understanding of the many principles and procedures of general appraising, but also an in-depth knowledge of hotel operations. Later in the article, you will see that the underlying premises behind the business enterprise approach are flawed because, while they might be applicable to shopping centers and office buildings, they do not reflect the economic realities of basic hotel operations.

Lodging facilities are more than land, bricks, and mortar; they are retail-oriented, labor-intensive businesses operating on daily leases and requiring a high level of managerial expertise. In addition, hotels contain a significant investment in personal property (furniture, fixtures, and equipment – FF&E) that has a relatively short useful life and is subject to rapid depreciation and obsolescence.

A hotel is a unique form of real estate consisting of four components: land, improvements, personal property, and the going business. When valuing hotels and motels for real property assessment purposes, where only the market value of the land and improvements are at issue, the appraiser must break down or subdivide the overall total property value into its individual components. This procedure requires an understanding of hotel operations as well as the economic relationship of each component to the entire property. The Rushmore Approach for valuing the real property components of a hotel was devised to address the allocation of value among the four components in a manner that reflects actual hotel operating structures, customs, and economics. Because the underlying structure and economics of the hotel industry have not changed since this approach was originally introduced, it still remains a viable methodology for accomplishing the allocations.

The basis for valuing a hotel's real property component is the income approach, which takes a property's stabilized net income and capitalizes it into an estimate of value. The stabilized net income is intended to reflect the anticipated operating results of the hotel over its remaining economic life, given any or all applicable stages of buildup, plateau, and decline in the life cycle. Therefore, such stabilized net income contains all of the revenue generated and expenses incurred by a hotel in carrying out its ongoing day-to-day functions of taking reservations, selling rooms, hiring, training, and directing staff, performing maintenance, purchasing equipment, and the myriad other activities needed to keep a hotel operating. In many instances, when a hotel has been open for several years, the appraiser may utilize the hotel's most recent actual net income as the stabilized net income if it conforms to the definition cited above.

The capitalization rate is the weighted cost of invested capital that takes the form of mortgage debt and equity. For property tax appraisals, the capitalization rate will also include the local tax rate expressed as a percentage of market value. This allows the appraiser to capitalize the net income before real estate taxes by assuming that the ultimate tax burden will equate to the municipally mandated relationship to market value.

The four hotel value components of land, improvements, personal property (FF&E), and the going business work together to generate income. The land creates revenue based on its locational attributes. The improvements house the guestrooms. The guests sleep on the FF&E, and the business manages the entire operation. The resulting revenue, expenses, and income stream are therefore a conglomeration of these four components, and must be separated and subdivided in order to derive the portion of the income stream that is attributed to the real property components of land and improvements. The Rushmore Approach accomplishes this task by stripping out of the conglomerated income stream any income attributed to the business and personal property components, leaving the income attributed to the land and improvements, which then can be capitalized into an estimate of the real property value.

Isolating the Business Component

The business component of a hotel's income stream accounts for the fact that a lodging facility is a labor-intensive, retail-type activity that depends upon customer acceptance and highly specialized management skills. In contrast to shopping centers or office buildings where tenants sign leases that can extend for ten to fifteen years, most hotels experience a complete turnover of tenants every one to four days. A hotel must therefore constantly market and sell itself in order to maintain a profitable level of occupancy. In addition, finding and retaining qualified labor has been an ongoing problem in the hotel industry because of the generally undesirable prevailing wage rates and working conditions. All of these challenges demonstrate the need for qualified hotel management to handle the complex business of operating a lodging facility.

Another facet of the business component is the benefits that accrue from an association with a recognized hotel company brand through either a franchise or management contract affiliation. Chain hotels generally out-perform independents, and the added value created by this increased income is considered part of the business component.

Ninety years ago, an inexperienced hotel property owner was able to obtain qualified hotel management and a brand affiliation through a lease structure where the property owner leased the land and the building to a hotel company (tenant) that operated the property and paid rent. The rent paid to the owner represented the portion of the income attributed to the land and building.

Today, the hotel lease structure has been replaced by the management contract and franchise. Under this structure, when an inexperienced hotel property owner wants qualified hotel management, he/she enters into a management contract with a hotel company to take over the hotel's day-to-day operation, which allows the owner to assume a totally passive role with respect to various business activities involved with running the hotel. The hotel company is paid a management fee for these services, which can be recognized as compensation for running the business, or in the Rushmore Approach, the management fee represents a portion of the income steam attributed to the business component.

When a hotel owner wants a hotel chain affiliation and the benefits associated with a brand and reservation system, there are two options. The first is to engage a hotel management company that brings both management expertise and a brand. These are called first-tier management companies and include chains such as Hyatt, Marriott, and Hilton. The second option is to use a hotel management company without a brand and contract separately with a hotel franchise company that will provide the affiliation and reservation system. While some of the first-tier management companies will also provide franchises (without management), some of the pure hotel franchise companies are Comfort Inn, Days Inn, Ramada, and Microtel. The franchise fee and other associated costs such as reservation expenses, frequent traveler programs, training, information technology, and so forth paid to the franchisor also represent a portion of the income stream attributed to the business component.

Management fees for hotel companies providing both management services and a brand are typically structured using a base fee and an incentive fee. The base fee is calculated as a percentage of total revenue and generally ranges from 2% to 4%. The incentive fee is usually structured as a percentage of profit, which when compared to the total revenue, could add another one or two percentage points.

Management fees for hotel companies providing only management services (no brand) are typically structured using just a base fee ranging from 2% to 4% of total revenue. Under this scenario, when a brand affiliation is desired, the franchise fee paid to the franchisor ranges from 3% to 5% of rooms revenue. Every two years, HVS International publishes a study of the costs associated with utilizing a hotel franchise. When all of the other costs such as reservation expense, advertising assessment, frequent traveler program, training, and so forth are added to the franchise fee, the total cost of a franchise affiliation typically ranges from 6% to 10% of rooms revenue. Furthermore, these other costs are not typically allocated to the franchise fee expense line item; rather they are allocated to the rooms expense in the case of the reservation expense and frequent traveler program, or the marketing expense in the case of the advertising assessment, thereby removing additional income attributed to the business.

While both the Rushmore Approach and the business enterprise approach consider management and franchise fees as income attributed to the business component, the business enterprise approach goes further and allocates additional income to the business component. These additional allocations will be discussed later in the article.

Isolating the Personal Property Component

The personal property within a hotel is known as furniture, fixtures, and equipment (FF&E). Although some jurisdictions assess and tax personal property separately, these items must be isolated and excluded from the real property components.

A hotel's FF&E has a relatively short useful life, ranging from three to ten years. Heavy usage and constant changes in fashion and design require hotel operators to replace

FF&E on an ongoing basis in order to remain competitive. Most operators require hotel owners to set aside a reserve for replacement to fund future purchases of FF&E.

In order to isolate the personal property component, the appraiser needs to make two deductions. The first is a deduction for the personal property currently in place at the hotel. The logic of this is obvious: If you need to determine the value of the real property components, you must deduct the value of the personal property currently being used by the hotel. The second deduction is somewhat esoteric. Because a hotel requires an ongoing replacement of FF&E to maintain its competitiveness (and future flow of income), the cost of future FF&E replacements in the form of a reserve for replacement deduction must be made. This reserve for replacement also represents income attributed to personal property.

The calculation for deducting the personal property in place can be accomplished utilizing one of two procedures – but not both. The first procedure removes from the income stream any income attributed to the FF&E in place by taking the value of the FF&E and multiplying it by the capitalization rate. When the reduced income stream is capitalized, it excludes the value of the FF&E in place. The Rushmore Approach calls this deducting a return "on" FF&E. The second procedure simply deducts the value of the FF&E in place from the capitalized value of the overall net income. Both procedures produce identical results, which is to isolate the value of the FF&E currently in the hotel. The business enterprise approach utilizes both of these procedures concurrently, which effectively double counts and thus overstates by 100% the value of the FF&E in place. The following Table A is an example of how these two procedures should be utilized.

Table A

Assumptions	
Net Income	$1,000,000
Capitalization Rate	12.5%
Total Property Value	$8,000,000
Value of FF&E in Place	$750,000
Procedure 1	
Value of FF&E in Place	$750,000
Capitalization Rate	12.5%
Income Attributed to FF&E in Place	$93,750
Net Income	$1,000,000
Less: Income Attributed to FF&E in Place	-$93,750
Net Income Without FF&E in Place	$906,250
Capitalization Rate	12.5%
Property Value Without FF&E in Place	$7,250,000
Procedure 2	
Total Property Value	$8,000,000
Less: Value of FF&E in Place	-$750,000
Property Value Without FF&E in Place	$7,250,000
Business Enterprise Approach	
Property Value Without FF&E in Place (Procedure 1)	$7,250,000
Less: Value of FF&E in Place	-$750,000
Property Value Without FF&E in Place	$6,500,000

Assume that a hotel's net income, including the income attributed to the FF&E currently in the hotel, is $1,000,000. The value of the FF&E in place is $750,000. An appropriate capitalization rate would be 12.5%. The value of the hotel, including the FF&E in place, is $1,000,000 divided by the 12.5% capitalization rate, which equals $8,000,000.

Under the first procedure, the income attributed to the FF&E in place is calculated by multiplying the value of the FF&E in place ($750,000) by the 12.5% capitalization rate, producing an income attributed to the FF&E in place of $93,750. Deducting this amount from the $1,000,000 Net Income produces a Net Income without FF&E in place of

$906,250. When this amount is capitalized at 12.5%, the resulting property value of $7,250,000 excludes the $750,000 of FF&E in place.

Under the second procedure, the Net Income of $1,000,000 is capitalized at the 12.5% rate, producing a value of $8,000,000, which includes the value of the FF&E in place. To obtain the value of the property without the FF&E in place, the $750,000 value of the FF&E is deducted from the $8,000,000 property value, leaving a property value without the FF&E in place of $7,250,000.

Although both procedures produce the same results, Procedure 2 is simpler to explain to a jury than Procedure 1. Procedure 1 is typically utilized when the jurisdiction assesses personal property taxes and the tax rate needs to be loaded into the capitalization rate.

At no time should the amount deducted for the FF&E in place ever be more than the actual value of the FF&E. The business enterprise approach, however, creates a deduction larger than the value of the FF&E in place by applying both procedures simultaneously, which is simply double counting and ignores the reality that the FF&E in place can be worth only its current value. Table A shows how the business enterprise approach double counts the value of the FF&E in place.

The business enterprise approach starts off with Procedure 1 calculating the income attributed to the FF&E in place and determining the property value without the FF&E in place to be $7,250,000. It then deducts the $750,000 value of the FF&E in place once again, resulting in a final version of the property value without the FF&E in place of $6,500,000. This process is clearly improper double counting, which has no rational logic.

Analysis of the Business Enterprise Approach

The business enterprise approach does not seem to be at odds with the various deductions utilized by the Rushmore Approach. It just makes additional deductions (like the double counting of the FF&E) that significantly moves more of a hotel's total property value into the non-realty components of business value and personal property. The ultimate effect is to drastically reduce the value of the real property components of land and improvements and inflate the value of the personal property and business components.

One of the main drivers for allocating additional income stream to the business component is a deduction the business enterprise approach calls "business start-up costs." They say that business start-up costs benefit any going concern over the long term and include: assembled and trained work force, management and administration team, regulatory compliance, accounting and other business systems, pre-opening marketing, initial operating losses, working capital, and so forth. They calculate this cost by utilizing typical pre-opening costs for similar hotels outlined in various franchise offering circulars and calculating an amortization amount that would spread these costs over a 25-year period. This results in another deduction from the income stream for business start-up costs.

The flaw in this logic comes down to another instance of double counting, coupled with a basic lack of understanding of how hotels actually operate.

All types of real estate incur a certain amount of business start-up costs. For example, before opening a new regional shopping mall, the developer must spend a considerable amount of time and money searching for the desired mix of tenants, negotiate suitable leases, and prepare the space for occupancy. This effort requires appropriate marketing and sales materials, professional leasing agents, attorneys, accountants, and so forth. The mall itself needs to be heavily marketed to the local community through all types of media in order to build awareness and traffic. This initial marketing blitz is usually coordinated through advertising and public relations firms. The mall's administration team needs to be recruited, and suitable accounting and management systems need to be implemented. And finally, as opening day approaches, the various mall employees are hired and trained.

A similar business start-up process is followed during the development and opening of an office building and also a hotel. However, the primary difference between the start-up process for a retail mall and an office building and the start-up process for a hotel is that the process essentially ends when the mall and office building opens and the space becomes fully leased. Aside from some minimal ongoing re-leasing activity and marketing, the large initial start-up cost becomes a one-time, non-recurring event because the tenants of retail and office space are obligated to stay typically five to fifteen years. A hotel, on the other hand, is in a constant state of start-up because the tenants are there for only one to four days, and the sales, marketing, and leasing activities must therefore be perpetual. When a hotel looks out three weeks into the future, it generally has very few reservations on the books and therefore continuously faces the need to implement this business start-up process. Because a hotel is constantly in a start-up mode and expending money for future sales and marketing activities, these expenses are always part of the income statement. Making a separate deduction for the business start-up expenses is simply double counting expenses that have already been deducted from each year's income stream. I can see the logic of amortizing the business start-up costs for retail malls and office buildings because these are large, non-recurring, one-time expenditures that will never appear in the income statement until the existing leases expire. Applying the same theory to the start-up costs for hotels is inappropriate because of the short duration of the tenancy and the ongoing need for start-up-level sales and marketing efforts.

The same argument applies to the special deduction for assembling a work force. During a hotel's pre-opening phase, management personnel are recruited, staff and line employees hired, and everyone is trained. This process generally occurs over a two- to three-month period prior to opening. What the business enterprise approach fails to understand is the fact that most of the staff hired to open a hotel are not there for the hotel's first anniversary. Hotels have extremely high employee turnover rates, and as a result, they must constantly recruit and train new staff. Like the pre-opening sales and marketing efforts described above, the activity of assembling a work force is an ongoing expense that is always being deducted from the income stream. Making a separate deduction is double counting.

Support for the employee turnover and training costs described above is provided by the following industry research.

Timothy Hinkin and Tony Simons[1] performed a study that shows that the mean level of turnover for a 98-hotel sample (ranging from 72 to 652 rooms) was 47% over a six-month period. This example alludes to the fact that the level of turnover is so high in this industry that hotels are constantly going through a hiring process. They further state that these costs are directly reflected in the net operating income of the hotel.

Timothy Hinkin and J. Bruce Tracey[2] of Cornell University's Hotel School performed a study and co-authored an article capturing the essence of the concept of the cost of turnover in hotels. This article reflects the elements of turnover in a hotel, which include recruiting and attracting costs, selection costs, hiring costs, lost productivity costs, and separation costs. In one example, the article compares the turnover costs of a front desk employee at four hotels – two in New York City and two in Miami. They found that the cost of turnover for a front desk associate averaged $5,827 for the two Miami hotels, and $12,245 for the two New York City hotels. This example shows that the total cost incurred in the recruiting, selection, hiring, productivity loss, and separation of line-level employees can be significant.

Other business start-up costs cited by the business enterprise approach include feasibility studies and appraisals, telephone systems, upgrading property management software, paying for licenses, complying with government regulations, purchasing inventories, and so forth. None of these expenses are unique to the pre-opening phase of a hotel start-up. They are all recurring expenses that appear throughout the life of a hotel and are accounted for in either the income and expense statement or the reserve for replacement. Making separate deductions for any of these expenses is once again double counting.

The deduction for a return on a hotel's working capital is another ploy some property tax appraisers use to decrease the income attributed to the real property component. This deduction has no basis in reality because hotels do not usually have positive working capital. Working capital is defined as current assets less current liabilities. For manufacturing businesses that carry large inventories and work in progress as current assets, positive working capital exists. However, a well-operated hotel will finance its accounts receivable with its accounts payable, thus keeping the ratio of current assets to current liabilities one to one.

[1] Timothy Hinkin and Tony Simons "The Effect of Employee Turnover on Hotel Profits," Cornell Hotel and Restaurant Quarterly, Vol. 42, No. 4, August, 2001, pp. 65-69.

[2] Timothy Hinkin and J. Bruce Tracey "The Cost of Turnover: Putting a Price on the Learning Curve," *Cornell Hotel and Restaurant Quarterly*, Vol. 41, No. 3, June, 2000, pp. 14-21.

The second driver for allocating additional income stream to the business component is a deduction the business enterprise approach calls “residual intangibles.” The business enterprise approach defines residual intangibles as the contribution to or impact upon the operating performance of properties with superior brand affiliations and everything these brands embody, as evidenced by marketplace preference relative to competing brands. In the Rushmore Approach, I call this the “superior management adjustment.” When valuing a hotel for property tax purposes, it is appropriate to adjust revenues down and/or expenses up if the financial performance reflects superior management. Conversely, it is appropriate to adjust revenues up and/or expenses down if the financial performance reflects inferior management. The ultimate standard for developing a stabilized income and expense statement is competent management, not superior or inferior management.

Side-by-Side Comparison

Now let’s perform a side-by-side comparison utilizing both the business enterprise approach and the Rushmore Approach for valuing the real property component of a hotel. I will use an actual property tax dispute that was recently tried in the New Jersey Tax Court. The previously describe appraiser who has been advocating the business enterprise approach prepared an appraisal of the hotel on behalf of the property owner and gave testimony in the case. I did not perform an appraisal but gave testimony relative to the differences between the Rushmore Approach and the business enterprise approach. The following side-by-side comparison is based on actual numbers from the case, which are all in the public domain.

The subject property is the Saddle Brook Marriott hotel in Saddle Brook, New Jersey. The hotel has a highly visible location adjacent to both Interstate 80 and the Garden State Parkway. Drive time to New York City is less than 30 minutes. The property is a 221-room, full-service, first-class hotel with restaurant, lounge, meeting facilities, and indoor pool. At the date of value, which was January 1, 1999, the hotel was operated by Marriott International under a management contract.

The owner’s appraiser developed a stabilized income and expense statement using the hotel’s actual operating results for 1998, making some slight adjustments and projecting them to 1999. His capitalization rate loaded with the equalized local tax rate was 12.4122%. Both the stabilized income and expense statement and the loaded capitalization rate seemed reasonable.

The following (Table B) is his projected stabilized income and expense statement for 1999 showing what I will term as Net Income Before Business and Personal Property Deductions. In calculating this Net Income, all items of revenue and expenses normally contained in a hotel’s income and expense statement have been deducted with the exception of the following items: Management Fees, Reserve For Replacement, and Property Taxes. Management Fees and Reserve for Replacement will be deducted in a subsequent calculation, and Property Taxes are loaded into the capitalization rate. Up until this point, we are both in agreement.

Table B

	Business Enterprise Approach		Rushmore Approach	
Number of Rooms	221		221	
Occupancy	81%		81%	
Average Room Rate	$128.10		$128.10	
Revenue				
Rooms	$8,369,881	68.5%	$8,369,881	68.5%
Food and Beverage	$3,347,952	27.4%	$3,347,952	27.4%
Telecommunications	$259,466	2.1%	$259,466	2.1%
Other	$234,357	1.9%	$234,357	1.9%
Total Revenue	$12,211,656	100.0%	$12,211,656	100.0%
Departmental Expenses				
Rooms	$2,176,169	26.0%	$2,176,169	26.0%
Food and Beverage	$2,678,362	80.0%	$2,678,362	80.0%
Telecommunications	$168,653	65.0%	$168,653	65.0%
Other	$199,203	85.0%	$199,203	85.0%
Total Departmental Expenses	$5,222,387	42.8%	$5,222,387	42.8%
Departmental Profit	$6,989,269	57.2%	$6,989,269	57.2%
Undistributed Expenses				
General and Administrative	$1,221,166	10.0%	$1,221,166	10.0%
Operations & Maintenance	$793,758	6.5%	$793,758	6.5%
Utilities	$488,466	4.0%	$488,466	4.0%
Marketing	$781,546	6.4%	$781,546	6.4%
Total Undistributed Expenses	$3,284,936	26.9%	$3,284,936	26.9%
Gross House Profit	$3,704,333	30.3%	$3,704,333	30.3%
Fixed Expenses				
Insurance	$175,000	1.4%	$175,000	1.4%
Equipment Rental	$65,000	0.5%	$65,000	0.5%
Total Fixed Expenses	$240,000	2.0%	$240,000	2.0%
Net Income Before Business and Personal Property Deductions	$3,464,333	28.4%	$3,464,333	28.4%

Table C, which follows, shows the calculation of the Income Attributed to the Business. We both agree on deducting a Base Management Fee equal to 3% of total revenue plus an Incentive Fee of 1.9% of total revenue. The owner's appraiser then deducts $337,919 for Business Start-up Costs, which is inappropriate as explained previously in this article. The owner's appraiser then makes an additional deduction of $337,788 for Residual Intangibles, which also is not appropriate. The appraiser explains that his Residual Intangibles deduction is necessary because the Marriott's RevPAR is approximately 15% above the RevPAR of the other hotels in the competitive set. He then takes 15% of what he defines as Net Operating Income to Going Concern ($2,251,920) or $337,788. While I concur with his concept, I believe it was inappropriately applied in this case. The Saddle Brook Marriott did indeed perform 15% above its "<u>competitive</u>" set, but the competitive set was not at all "<u>comparable</u>" to the Marriott. It consisted of a Howard Johnson, a Crowne Plaza, and a Holiday Inn. A Marriott hotel is classified by Smith Travel Research as an Upper Upscale chain based on the quality of its facilities and the room rates it is able to achieve. Howard Johnson and Holiday Inn are classified by Smith Travel as Midscale Chains (two categories below a Marriott) and Crowne Plaza is classified as an Upscale Chain (one category below a Marriott). While these three hotels might be competitive with the Marriott, they are certainly not comparable based on the quality of facilities and their ability to achieve comparable room rates, and thus they should have lower RevPARs and overall values. A more logical comparison is to compare the RevPAR of other comparable, Upper Upscale hotels in Northern New Jersey to the RevPAR of the Saddle Brook Marriott. We had Smith Travel Research run a trend report for all the Hilton Hotels, Hyatt Hotels, Sheraton Hotels, and Marriott Hotels in the Northern New Jersey area. The report contains a total of 25 hotels achieving in 1999 an occupancy of 76%, an average rate of $135.61, and RevPAR of $103.65. In 1999, the owner's appraiser projected the subject property to achieve an 81% occupancy, at an average rate of $128.10, which produces a RevPAR of $103.76 – almost identical to its "<u>comparable</u>" set. This proves that there is no residual intangible value for the subject property. Under the business enterprise approach, the total Income Attributed to the Business is $1,277,537, compared to $601,830 for the Rushmore Approach – more than two times higher.

Table C   Total Income Attributed to the Business

	Business Enterprise Approach		Rushmore Approach	
Base Management Fee	$366,350	3.0%	$366,350	3.0%
Incentive Management Fee	$235,480	1.9%	$235,480	1.9%
Business Start-up Costs	$337,919	2.8%	$0	0.0%
Residual Intangibles	$337,788	2.8%	$0	0.0%
Total Income Attributed to the Business	$1,277,537		$601,830	

Table D, which follows, shows the calculation of the Income Attributed to the Personal Property along with the Value of the Real Property Only. Both the business enterprise approach and the Rushmore Approach deduct a Reserve for Replacement equal to 5% of total revenue, which is at the high end of industry standards. The business enterprise approach then deducts a Return on FF&E of $143,606, which as described previously, is designed to remove the value of the FF&E in place. The Rushmore Approach opts for just deducting the value of the FF&E in place after the value of the property is determined. This calculation produces a Total Income Attributed to the Personal Property of $754,189 for the business enterprise approach and $610,583 for the Rushmore Approach. The next calculation takes the Net Income Before Business and Personal Property Deductions from Table B and deducts Total Income Attributed to the Business and Total Income Attributed to the Personal Property, resulting in Income Attributed to Real Property and FF&E in Place. This amounts to $1,432,607 for the business enterprise approach and $2,251,920 for the Rushmore Approach. Using a capitalization rate loaded with real estate taxes of 0.124122, the value with FF&E in place is $11,541,926 for the business enterprise approach and $18,142,795 for the Rushmore Approach. Both approaches then deduct $1,511,640, representing the value of the FF&E in place, producing a Value of the Real Property Only of $10,030,286 for the business enterprise approach and $16,631,155 for the Rushmore Approach.

Table D Value of the Real Property Only

	Business Enterprise Approach		Rushmore Approach
Reserve for Replacement	$610,583	5.0%	$610,583
Return on FF&E	$143,606		$0
Total Income Attributed to the Personal Property	$754,189		$610,583
Net Income Before Business and Personal Property Deductions	$3,464,333		$3,464,333
Less: Total Income Attributed to the Business	-$1,277,537		-$601,830
Less: Total Income Attributed to the Personal Property	-$754,189		-$610,583
Income Attributed to Real Property and FF&E In Place	$1,432,607		$2,251,920
Cap Rate Loaded with Real Estate Taxes	0.124122		0.124122
Value with FF&E in Place	$11,541,926		$18,142,795
Less: FF&E in Place	$1,511,640		$1,511,640
Value of the Real Property Only	$10,030,286		$16,631,155

Table E, which follows, shows the effect on value for each approach from the business and personal property deductions. The total business deductions for the business enterprise approach of $1,277,537 are capitalized by the Cap Rate Loaded with Real

Estate Taxes, resulting in an Effect on Value for Business Deductions of $10,292,591. The same calculation applied to the Rushmore Approach results in an effect of $4,848,697, or a difference of $5,443,894 between the two approaches.

A similar calculation for quantifying the Effect on Value for Personal Property Deductions takes the deductions for the Reserve for Replacement and Return on FF&E and capitalizes them with the loaded capitalization rate and adds back the FF&E in Place. The total effect on value is $7,587,831 for the business enterprise approach and $6,430,857 for the Rushmore Approach. The difference between the two approaches for this calculation is $1,156,975.

Table E Difference in Value Between the Two Approaches

	Business Enterprise Approach	Rushmore Approach	Difference
Effect on Value For Business Deductions			
Base Management Fee	$366,350	$366,350	
Incentive Management Fee	$235,480	$235,480	
Business Start-up Costs	$337,919	$0	
Residual Intangibles	$337,788	$0	
Total	$1,277,537	$601,830	
Cap Rate Loaded with Real Estate Taxes	0.124122	0.124122	
Effect on Value for Business Deductions	$10,292,591	$4,848,697	$5,443,894
Effect on Value - Personal Property Deductions			
Reserve for Replacement	$610,583	$610,583	
Return on FF&E	$143,606	$0	
Total	$754,189	$610,583	
Cap Rate Loaded with Real Estate Taxes	0.124122	0.124122	
Value	$6,076,191	$4,919,217	
Plus FF&E in Place	$1,511,640	$1,511,640	
Effect on Value for Personal Property Deductions	$7,587,831	$6,430,857	$1,156,975
		Total Difference in Value	$6,600,869

The total difference in value resulting from the application of the business enterprise approach and the Rushmore Approach is over $6,600,000.

You be the Judge

Now is the time for you to look at the results and decide which approach seems the most reasonable based on the final outcomes. Both the business enterprise approach and the Rushmore Approach utilize conflicting theories in deriving their conclusions. Because there is no hard data pertaining to sales of just hotel business components, conclusive proof to support either approach is not available. Therefore, I believe that the only rational way to select the best approach is to look at the results and determine which seems to produce the most logical conclusions.

Table F, which follows, starts with an estimate of Total Property Value. The Net Income Before Business and Personal Property Deduction of $3,464,333 is capitalized with the Cap Rate Loaded with Real Estate Taxes of 0.124122, resulting in a Total Property Value of $27,910,709, or about $126,000 per available room for both approaches. This amount seems reasonable for a full-service Marriott hotel operating at a high 81% occupancy and a projected average rate of $128.10. In fact, the rule of thumb in the hotel industry is that a hotel should by worth 1,000 times its average room rate on a per-available-room basis, which based on a $128.00 average rate should equate to $128,000 per available room.

The next part of the table takes the value of the three components (personal property, business, and real property) determined in Tables D and E and demonstrates that when added together they total the previously calculated Total Property Value.

Lastly, Table F shows the percentage relationship and the per-room value relationship of each component to the total value. It is these numbers you should focus on to determine which approach produces the most logical conclusions. You be the judge.

Table F Proof of Value

	Business Enterprise Approach	Rushmore Approach
Net Income Before Business and Personal Property Deduction	$3,464,333	$3,464,333
Cap Rate Loaded with Real Estate Taxes	0.124122	0.124122
Total Property Value	$27,910,709	$27,910,709

Proof of Value	Business Enterprise Approach	% of Total	Per Room	Rushmore Approach	% of Total	Per Room
Value - Personal Property Component	$7,587,831	27%	$34,334	$6,430,857	23%	$29,099
Value - Business Component	$10,292,591	37%	$46,573	$4,848,697	17%	$21,940
Value - Real Property Component	$10,030,286	36%	$45,386	$16,631,155	60%	$75,254
Total Property Value	$27,910,709	100%	$126,293	$27,910,709	100%	$126,293

My personal view: I just do not see how the value of the real property component for a full-service, first-class hotel in a highly visible location just outside New York City is worth only $45,000 per room, and the real property accounts for just 36% of the Total Property Value. I believe that the business enterprise approach allocates a disproportionate share of the Total Property Value to the business component, thus reducing the value of the real property component. In addition, the difference in the personal property component is pure double counting. As a further benchmark, the 2003 HVS Hotel Development Cost Survey shows the average construction cost for the real property component (land and improvements) for a first-class, full-service hotel is $123,000 per room. It therefore does not seem reasonable that the Saddle Brook Marriott's real property components are worth only $45,000 per room but are still capable of generating an 81% occupancy and a $128.10 average room rate. I believe that the 17% business component and the 60% – $75,000 per room – real property component derived by the Rushmore Approach is reasonable and well supported.

Another way to check the reasonableness of the conclusions derived from the business enterprise and Rushmore approaches is to look at how the cost approach might be applied. The theory behind the cost approach is that the value of the real property component of a new hotel is the cost to acquire the land and construct the improvements. The value of the business component would therefore be the difference in the value derived by capitalizing net income using the income approach and the value derived by the cost approach. I believe most hotel appraisers would confirm that the spread between the cost and income approaches (value of the business component) for a new hotel is generally minimal and certainly not the 37% set forth above in the business enterprise approach.

If one were to utilize the cost approach for the Saddle Brook Marriott assuming the cost to buy the land and construct the improvements was the $123,000 per room cited from the HVS Hotel Construction Cost Survey, an appraiser would have to estimate the depreciation on the improvements. Let's assume that the land component of the $123,000 per room is worth $15,000 per room, leaving an improvement cost new of $108,000 per room. The business enterprise approach estimated the value of the real property component to be $45,000 per room, which equates to an improvement value of $30,000 per room after deducting the $15,000 per room land value. The Rushmore Approach estimated the value of the real property component at $75,000 per room, which equates to an improvement value of $60,000 per room. The business enterprise approach therefore imputes a total depreciation of 72%, while the imputed depreciation under the Rushmore Approach is 44%. Although I have never been a fan of quantifying depreciation, it does not seem reasonable that an exceptionally well-located hotel, operating under Marriott's high standards and achieving an occupancy of 81% and a competitive average rate of $128.00, would ever allow its improvements to depreciate 72%.

Finally, the $6,600,000 difference in the value of the real property components between the business enterprise approach and the Rushmore Approach means that a real estate secured mortgage would be $4,620,000 lower (70% loan/value) under the business enterprise approach. Anyone who owns and operates hotels will confirm that this difference would have a devastating impact on hotel financings, transactions, and values.

Thomas Dolan assisted in the preparation of this article.