CUSHMAN & WAKEFIELD®

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May 25, 2005

Mr. Paul Smith
Senior Counsel
American Bankers Association
1120 Connecticut Avenue, NW
Washington, DC 20036

Re: EGRPRA Burden Reduction: **FDIC** 12 CRF Chap. III; **FRB** Docket No. OP-1220; **OCC** Docket No. 05-01: **OTS** Docket No. 2005-02; 70 Federal Register 5571; February 3, 2005

Dear Mr. Smith:

I read with great interest your May 4, 2005, memo in reference to the above. As a 25-year veteran in the real estate appraisal and one who has exclusively specialized in the valuation of lodging facilities (hotels, resorts, conference centers, casinos, and timeshare/fractional ownership properties), I was particularly interested in pages 6 and 7 of the document which address "Going Concern".

As you are aware, an intense debate is raging within the valuation community concerning Business Enterprise Value (BEV) and how the concept relates to hotels and other property types that house an on going business. A small but vocal number of generalist real estate valuation professionals, generalist real estate academic types, corporate tax directors, and generalist property tax attorneys have been motivated to publish articles that have posited unsubstantiated theories and methodologies which isolate an inordinate amount of a hotel's income, and income with other property types, to non-realty components, therefore minimizing the market value of the taxable real estate. Essentially, these theories and methodologies are merely contrived academic hypothetical constructs without any market foundation that have been developed by advocates for advocates with the intent to obtain reduced property tax burdens.

As of 2005, the Appraisal Institute has withdrawn Course 800: Separating Real & Personal Property from Intangible Business Assets, and is re-evaluating it. I have recently been involved in a number of litigation cases concerning hotels and BEV in Canada and the United States. Attached is a decision on the latest case in this country, which I thought would be of interest. Although I was not involved in this case, my passionate opinions about the topic are quoted in the decision. More importantly, this decision reversed earlier decisions that had been decided in favor of opposing opinions on the topic, which could have set precedents in this country. I have also attached my recent article titled "Total Assets of the Business" and Lodging Facilities: What Should be the Final Chapter," which appeared in the Q4 2004 issue of the *Journal of Property Tax Assessment & Administration.*

I trust that the enclosed material is of interest to the American Bankers Association and the federal banking agencies. Please feel free to contact me with any questions or comments you may have

Very truly yours,

CUSHMAN & WAKEFIELD, INC.

Daniel H. Lesser, MAI, CRE, CHA
Senior Managing Director - Industry Leader
Hospitality & Gaming Group

DHL:tam

cc: Brian Corcoran, MAI, CRE, FRICS
Alexander Hesterberg, MAI, CRE FRICS
Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Board of Governors of the Federal Reserve System
Office of Thrift Supervision

For Bill

BEV Lenhoff Method Rejected
CEP overruled

BEFORE THE TENNESSEE STATE BOARD OF EQUALIZATION

IN RE:	Wolfchase Galleria Ltd. Partnership Ward 092, Block 007, Parcel 00054 Commercial Property Tax Years 2001 & 2002	))))	
			Shelby County
	Wolfchase Galleria Ltd. Partnership Ward 092, Block 007, Parcel 00072 Commercial Property Tax Year 2003	))))	

INITIAL DECISION AND ORDER

Statement of the Case

The subject property is presently valued as follows:

	LAND VALUE	IMPROVEMENT VALUE	TOTAL VALUE	ASSESSMENT
Tax Year 2001	$6,496,100	$126,503,900	$133,000,000	$53,200,000
Tax Year 2002	$6,496,100	$126,503,900	$133,000,000	$53,200,000
Tax Year 2003	$6,428,000	$124,522,000	$130,950,000	$52,380,000

An appeal has been filed on behalf of the property owner with the State Board of Equalization. The undersigned administrative judge conducted a hearing in this matter on January 11, 2005 in Memphis, Tennessee. The taxpayer was represented by David C. Scruggs, Esq. and A. Kent Gieselmann, Jr. of Stokes Bartholomew Evans Petree, P.A. The assessor of property was represented by Thomas E. Williams, Assistant County Attorney and John Zelinka, Legal Administrator.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

I. Background and Contentions of Parties

Subject property consists of the in-line portion of an enclosed two-level super-regional mall that opened in February of 1997 on a 44.717 acre site at 2760 North Germantown Parkway in Memphis, Tennessee. Subject in-line portion of the mall has a gross building area of 591,149 square feet, consisting of approximately 130 tenants with 392,067 square feet of leasable area and 199,082 square feet of concourse and service area. The four anchors attached to the mall (Dillard's, J.C. Penney, Goldsmith's-Macy's and Sears) are independently owned and assessed and not a part of this appeal. These anchors are subject to fifteen-year reciprocal operating agreements. The site for the in-line stores has been reduced from 46.170 acres in 2002 to 45.590 acres in 2002 to the current size of 44.717 acres.

The taxpayer contended that the subject property should be valued at $71,000,000 for tax year 2001, $73,000,000 for tax year 2002 and $75,000,000 for tax year 2003. In support of its contention, the taxpayer introduced an appraisal report prepared by David C. Lennhoff, MAI, CRE. Mr. Lennhoff testified at the hearing regarding his appraisal report.

The assessor contended that subject property should be valued at $123,765,700 for tax year 2001, $114,670,200 for tax year 2002 and $120,500,000 for tax year 2003.[1] In support of her contention, the assessor introduced an appraisal report prepared by Gregory W. Moody, CAE. Mr. Moody testified at the hearing regarding his appraisal report.

The administrative judge finds that the appraisers' methodology differed in two respects. First, Mr. Lennhoff relied on both the cost and income approaches in reaching his conclusions of value whereas Mr. Moody's conclusions of value were based solely on the income approach.[2] Second, and more importantly, the appraisers took diametrically opposite approaches in their income approaches with respect to how any value attributable to tangible and intangible personal property should be treated.

Mr. Lennhoff asserted that since he was appraising the fee simple value of the real property only, any value attributable to tangible and intangible personal property must be separated from the value of the real property. Accordingly, Mr. Lennhoff's income approach began with the calculation of the net operating income ["NOI"] of the going concern (total assets of a business). In order to determine the NOI for the real property only, all tangible and intangible personal property that could be quantified such as furniture, fixtures and equipment, business start-up costs, etc., was removed from NOI. The administrative judge previously summarized Mr. Lennhoff's methodology in *Essex House Condo Corp.* at 4-6 (Shelby Co., Tax Years 2001 and 2002). ["Essex House"]. That decision has been appended to this order as exhibit A for ease of reference.

Mr. Moody, in contrast, maintained that although intangibles are not assessed per se, it is inappropriate to deduct their value from NOI when the value of the real property is inextricably intertwined with the value of the intangible personal property such as in the case of a mall. Thus, Mr. Moody's income approach simply included a personal property reserve and a deduction from the indicated value each year equal to the reported value of the personal property for that year.[3]

The basis of valuation as stated in Tennessee Code Annotated Section 67-5-601(a) is that "[t]he value of all property shall be ascertained from the evidence of its sound, intrinsic

[1] The assessor originally contended that values of $133,791,200, $117,972,500 and $126,287,400 should be adopted for tax years 2001, 2002 and 2003 respectively. Following the conclusion of the hearing, Mr. Moody modified his appraisal as summarized on page 8 of the assessor's proposed findings of facts and conclusions of law. The values set forth in the proposed findings failed to include the personal property reserves Mr. Moody allowed for each year. The contended values recited by the administrative judge reflect the corrected computations as summarized in the taxpayer's memorandum dated February 24, 2005.

[2] The parties submitted evidence for all three tax years in question, but the questioning during the hearing was limited to tax year 2001. The parties agreed and the administrative judge finds that the issues are the same for each tax year, and the actual numbers constitute the only difference for each year.

[3] Mr. Moody's original appraisal report did not include either a personal property reserve or personal property deduction. These revisions were made following the conclusion of the hearing.

and immediate value, for purposes of sale between a willing seller and a willing buyer *without consideration of speculative values*. . . [emphasis supplied].

Since the taxpayer is appealing from the determination of the Shelby County Board of Equalization, the burden of proof is on the taxpayer. See State Board of Equalization Rule 0600-1-.11(1) and *Big Fork Mining Company v. Tennessee Water Quality Control Board*, 620 S.W.2d 515 (Tenn. App. 1981).

For the reasons discussed below, the administrative judge finds that Mr. Lennhoff's appraisal report cannot be adopted as the basis of valuation. Normally, the administrative judge would simply affirm the current appraisals based upon the presumption of correctness attaching to the decisions of the Shelby County Board of Equalization. In this case, however, the administrative judge finds that Mr. Moody's somewhat lower conclusions of value are tantamount to admissions establishing the upper limit of value.

II. Cost Approach

The administrative judge finds that Mr. Lennhoff's cost approach lacks probative value in this particular appeal. Indeed, Mr. Lennhoff stated on pages 34 and 35 of his appraisal report that the "[t]ypical mall investor acquisition motivation is income-oriented and not cost-based, and investors for this property type rarely rely on cost." Moreover, the administrative judge finds Mr. Lennhoff's discussion of entrepreneurial incentives at pages 64 and 65 of his appraisal report does not constitute sufficient evidence to reliably establish an appropriate figure for a successful super-regional mall.

III. Income Approach

A. Precedential Value of *Essex House*

With respect to the income approach, the administrative judge finds that the threshold issue which must be addressed concerns the administrative judge's previous adoption of Mr. Lennhoff's methodology in *Essex House*. The administrative judge finds that several factors have caused him to reconsider that decision and conclude it should be overruled.

The administrative judge finds that *Essex House* must initially be re-examined because one of the key findings that was the basis for the decision has been shown in this appeal to be incorrect. In particular, page 7 of the initial decision and order stated that Mr. Lennhoff's methodology had been endorsed by the Appraisal Institute.[4] The administrative judge finds the proof in this case established that the Institute is impartial with respect to the particular methodology that should be utilized for separating real and personal property from intangible business assets. In particular, in a letter dated December 7, 2004 (exhibit 11), the Executive Vice President of the Appraisal Institute, John W. Ross, stated in pertinent part as follows:

[4] The administrative judge finds that any misunderstanding on this point was almost certainly the fault of the administrative judge and *not* the result of misleading testimony or the like.

> . . . In relation to Course 800, the Appraisal Institute has always held a position of impartiality and has never formally recommended, endorsed or adopted a single methodology for separating real and personal property from intangible business assets (the BEV issue). There is no specific methodology appearing in Course 800 that constitutes official Appraisal Institute Policy.

The administrative judge finds Mr. Ross also addressed the Institute's position and the controversial nature of Course 800 in a letter to the editor that appeared in the January/February 2005 issue of *Probate & Property* published by the American Bar Association. Mr. Ross' letter provided in relevant part as follows:

> This letter is in response to the article by David Lennhoff, MAI, SRA, that appeared in the September/October issue of *Probate & Property*. David C. Lennhoff, *Intangibles Are the Real Thing,* Prob. & Prop. 46 (Sept./Oct. 2004). The Appraisal Institute's 'Course 800: Separating Real and Personal Property from Intangible Assets' was referenced prominently throughout the article. While the Appraisal Institute appreciates acknowledgement of its educational offerings, I am concerned that readers may not fully understand the complexity of the issues presented in the article and the Appraisal Institute's position on the subject.
>
> The conclusions and opinions contained in Course 800 are not intended to represent the policy of the Appraisal Institute; rather, they are the opinions and views of the authors of the course. Your readers should be aware that the author of the article, Mr. Lennhoff, is also one of the two authors of Course 800 and has been teaching the course. Some of the concepts and conclusions addressed in the course are quite controversial, a fact that the course acknowledges in numerous places. Course 800, as is common with other Appraisal Institute courses dealing with advanced and/or unsettled issues, will now be reviewed and evaluated and will not be offered this year until the review and evaluation have been completed and revisions to the Course, if any, have been made.

The administrative judge finds that although he is not bound by the Appraisal Institute, he routinely cites Institute textbooks as persuasive authority on various appraisal issues.

At the time the administrative judge issued his decision in *Essex House*, he was not aware of various articles taking issue with Mr. Lennhoff's approach. The administrative judge finds that Stephen Rushmore, MAI, CHA persuasively argues that Mr. Lennhoff's methodology for separating the real property component from a hotel's total value understates the value of the real property component. See Rushmore, *Why the 'Rushmore Approach' is a Better Method for Valuing the Real Property Component of a Hotel*, Journal of Property Tax Assessment and Administration, Volume 1, Issue 4 at 15-27 (International Association of Assessing Officers and the International Property Tax Institute, 2004). The administrative judge finds that Daniel H. Lesser, MAI has taken an even harsher view of approaches such as Mr. Lennhoff's stating in pertinent part as follows:

> During the past two decades, much has been written relative to what is commonly referred to today as 'Total Assets of the Business,' and how the concept relates to lodging facilities. However, most of what has been posited has been unsubstantiated by 'the market.' Essentially, these theories and methodologies are merely contrived academic constructs which have been developed to reduce hotel property tax burdens. Analysis of the actions of hotel investors proves that the purchase of a hotel property reflects the acquisition of real and personal property only. Hotel investors account for income attributable to the business through the expense deduction of management and, in some cases, franchise fees. An investor purchasing a hotel 'unencumbered' by a management agreement will not pay for a seller's assembled work force, business name, patents, copyrights, working capital and cash, operating procedures and manuals, and such. A passive investment in a first class hotel 'encumbered' by a long-term hotel management agreement is riskier, but no different than a passive investment in a class A office building occupied by a long-term creditworthy tenant. Either passive investment yields a risk-adjusted return on property and not a business.
>
> *Richard Marchitelli, MAI, could not have said it better than in his July 1996 Appraisal Journal Letter to the Editor, 'How Should Appraisers View Business Enterprise Value?' Marchitelli wrote,* 'I continue to be astounded by the creative rationalizations of business enterprise value (BEV) posited by a handful of appraisers and other consultants. In my view, the answer is, and always has been, quite clear. *The business value, if any, of malls is reflected in the deduction of a management fee as an operating expense.* It works for hotels, apartments, office buildings, and any other property' (Marchitelli 1996).
>
> *Marchitelli continued, 'The real and most compelling proof, however, is not a matter of personal opinion. Market participants reflect it every day. Buyers and sellers of regional malls do not acknowledge the existence of business enterprise value. Most are unfamiliar with the concept altogether. Other than a deduction for management, this factor is not reflected in their analysis, negotiations, or in any other thinking. Why all the fuss? Proponents of BEV are a very small, but highly vocal, minority of appraisers, who are involved regularly in tax appeal cases, usually on the side of the property owners. The issue of BEV provides their clients with another argument for a tax reduction.* The vast majority of appraisers do not write on the subject because, until recently, it had been a non-issue and explanation is so simple that it can be articulated in just three or four sentences. I fear, however, the proponents of BEV are papering academic journals with articles on the subject to create the impression that theirs is a widely held belief when it is not . . . . .'
>
> [Emphasis Supplied]

Lesser, "Total Assets of the Business" and Lodging Facilities: What Should be the Final Chapter, Journal of Property Tax Assessment and Administration, Volume I, Issue 4 at 43-44 (International Association of Assessing Officers and the International Property Tax Institute, 2004).

The administrative judge finds that even if Mr. Lennhoff's methodology was generally accepted in the appraised community, it does not necessarily constitute an acceptable approach for Tennessee property tax purposes. The administrative judge finds this concept best illustrated by the discounted cash flow analysis ["DCF"]. The administrative judge finds that a DCF clearly represents a generally accepted appraisal practice. Yet, the State Board of Equalization has typically rejected such an approach in most cases as unduly speculative. See, e.g., *MetroCenter Holdings, Inc.* (Davidson Co., Tax Years 1993-1995) wherein the Assessment Appeals Commission rejected the taxpayer's DCF reasoning in relevant part as follows:

> The administrative judge found that even if a discounted cash flow analysis is an appropriate method of valuing the subject properties, the taxpayer failed to show that the assumptions on which its appraisal was based are not speculative. At the hearing before this commission, the taxpayer likewise failed to show that the assumptions upon which its appraisal was based are not speculative. The statute which governs assessment of property provides that the '. . .value of all property shall be ascertained from the evidence of its sound, intrinsic and immediate value, for the purposes of a sale between a willing seller and a willing buyer without consideration of *speculative values. . .*' T.C.A. 67-5-601(a). (Emphasis supplied.)

Final Decision and Order at 2.

Respectfully, the administrative judge finds that whatever the merits of Mr. Lennhoff's methodology may be from an academic standpoint, it is unduly speculative and cannot provide a basis of valuation under Tenn. Code Ann. § 67-5-601(a).

The administrative judge finds the fact that generally accepted appraisal practices are not always consistent with the requirements of Tennessee law most strikingly illustrated by *National Life and Accident Insurance Co. v. Keaton*, No. 85-326-II, 1986 WL 4846 (Tenn. Ct. App. April 23, 1986) ["National Life"] which was recently reaffirmed in *Spring Hill, L.P. v. Tennessee State Board of Equalization*, No. M2001-02683, 2003 WL 23099679 (Tenn. Ct. App. December 31, 2003) ["Spring Hill"].[5]

In *National Life*, the Court dealt with the issue of the value of a used computer for Tennessee personal property tax purposes. It was undisputed that an identical computer could be purchased on the open market for $82,000 on the relevant assessment date. Nonetheless, the Court concluded that the Assessment Appeals Commission properly valued

[5] See page 13 of the Court's opinion.

the computer at $875,103 because it was being rented for $31,000 per month on the relevant assessment date. The Court reasoned that the assessment was not discriminatory because an identical computer could have been purchased for $82,000 on the relevant assessment date. The Court stated on page 8 of its opinion that "[s]uch a computer would not have been identical unless it were the subject of a lease providing an identical rental."

The administrative judge finds the Court implicitly rejected the notion that what an appraiser would typically consider excess rent should always be disregarded for ad valorem tax purposes. The administrative judge finds that an appraiser valuing the fee simple interest would normally disregard what he or she considered an above-market rental rate.

The administrative judge finds that his decision in *Essex House* was entered on August 26, 2003. The administrative judge finds that *Spring Hill* was subsequently decided on December 31, 2003. In that case, the Court ruled it was proper to include the present value of tax credits in valuations of low-income housing properties for Tennessee property tax purposes. As contended by the assessor, the administrative judge finds that *Spring Hill* supports the proposition that although intangibles are not normally assessed per se, to the extent intangibles are inextricably intertwined with the real property, their value-enhancing or value-decreasing effect must be considered when establishing the fair market value of the real property for ad valorem tax purposes.

B. Tenant Improvements

Putting aside the issue of capitalized economic profit, the most significant difference between the appraisers' income approaches concerned their treatment of tenant improvements. In order to account for rent concessions attributable to tenant improvements, Mr. Lennhoff reduced his estimated market rental rates of $27.50, $28.00 and $29.00 for the years in question by $2.46, $2.31 and $2.06 per square foot respectively. This equates to deductions of $964,485, $905,675 and $807,658 for 2001, 2002 and 2003 respectively.

The administrative judge finds Mr. Lennhoff estimated the rent concessions attributable to tenant improvements by calculating the contribution of the original build-out, trending that figure to the date of appraisal, and dividing the result by the square footage of the in-line tenants. For example, in 2001 this equated to $46.76 per square foot. Mr. Lennhoff concluded that tenants would remove the equivalent of $19.20 per square foot of their improvements resulting in net concessions of $26.58 per square foot. Mr. Lennhoff then deducted $0.20 per square foot from his net concessions estimate of $2.66 per square foot to account for revenue from average termination fees. Thus, Mr. Lennhoff ultimately reduced his estimated market rental estimate of $27.50 per square foot by $2.46 per square foot resulting in an effective rental rate of $25.04 per square foot for 2001.

The administrative judge finds that Mr. Moody, in contrast, did not adjust his market rental rates. Instead, Mr. Moody maintained that he accounted for tenant improvements in his selection of capitalization rates. Mr. Moody asserted that Mr. Lennhoff's approach results in "double-dipping" insofar as tenant improvements are concerned.

The administrative judge finds that although Messrs. Lennhoff and Moody disagree methodologically, no dispute exists that rent concessions attributable to tenant improvements must be accounted for. The administrative judge finds that the key consideration in weighing the two approaches is which better reflects the market. The administrative judge finds that the importance of the market has been summarized in one authoritative text as follows:

> When real estate markets are oversupplied, landlords may give tenants concessions such as free rent for a specified period of time or extra tenant improvements. In shopping center leases, retail store tenants are sometimes given rent credit for interior store improvements. *All rent concessions result from market conditions and the relative negotiating strengths of the landlord and the tenant.* It is not unusual for free rent concessions to be given outside of the lease term so that the concessions do not appear on the written lease contract. In these situations appraisers must still consider the lease concessions when calculating the effective rent being paid.

Appraisal Institute, *The Appraisal of Real Estate* at 505 (12th ed. 2001).

Respectfully, the administrative judge finds that Mr. Lennhoff's treatment of tenant improvements must be rejected in this particular instance. The administrative judge finds nothing in the record to establish that the markets were the same when the mall first opened in 1997 and on the relevant assessment dates. The administrative judge finds Mr. Lennhoff's own appraisal suggests that such concessions decreased after the initial lease-up period. For example, on page 45 of his appraisal report, Mr. Lennhoff's analysis of six recent leases (for purposes of January 1, 2001) indicates no allowance for tenant improvements was given in four of the leases. Moreover, one of the leases had concessions equal to only 43¢ per square foot.[6]

The administrative judge finds Mr. Lennhoff's handling of tenant improvements is also seemingly inconsistent with his treatment of percentage rent. The administrative judge finds no allowance was made for percentage rent on the theory that all leases reflect market rental rates when appraising in fee simple. Yet, Mr. Lennhoff's use of historical build-out data appears more appropriate for a leased fee valuation.

C. Temporary Tenant Rent

The next issue before the administrative judge concerns the treatment of temporary tenant rent from kiosks and the like. Mr. Moody developed a stabilized estimate based upon

[6] The other lease reflects concessions equal to $2.08 per square foot.

the subject property's experience in prior years. For example, Mr. Moody utilized a stabilized estimate of $565,000 for tax year 2001 given actual temporary tenant rents of $377,232, $500,389 and $565,275 in 1998, 1999 and 2000 respectively.

The administrative judge finds Mr. Lennhoff described his approach to this issue as follows:

> What I did here, the best analogy of what you have to do here is an apartment where you have laundry. If you're the owner of an apartment property and you have got a basement space that you could put some washers and dryers in, you could open up yourself a washer and dryer business, a laundry business. And the revenues that you got from your tenants using your coin-operated machines, that would be all revenue to the business.
>
> Now, part of that you have to figure goes to the rent because these machines are occupying some real estate, so part of the revenue that you get needs to be attributed to the space they're occupying. But certainly all of it doesn't. In fact, you could cut to just the rent and then get out of the laundry business and contract it to somebody who comes in and does it, and he just pays you a percentage of the revenues paid. That is the idea here. These kiosks are businesses and the amount of rent that the landlord should consider representative of the space they are occupying should be based on the standard percentage of the sales that they generate, rather than some enormous number that is sharing in the business.
>
> And so I used the – I took the sales from these kiosks, which was rather significant, $2 million, and used 13 percent of that as the benchmark for cost on occupancy. They are not paying any CAM so that would represent, in my opinion, the rent that these kiosks would be paying to occupy the quarters and that is how I did that.

Transcript at 37-38.

The administrative judge finds that the Appraisal Institute briefly addresses this issue at pages 511-512 of its previously cited text as follows:

> Appraisers usually analyze potential gross income on an annual basis. Potential gross income comprises
>
> - Rent for all space in the property – e.g., contract rent for current leases, market rent for vacant or owner-occupied space, percentage and overage rent for retail properties
> - Rent from escalation clauses
> - Reimbursement income
> - All other forms of income to the real estate – e.g., income from services supplied to the tenants, such as switchboard service, antenna connections, storage, garage space, and *income from coin-operated equipment* and parking fees.
>
> Because service-derived income may or may not be attributable to the real property, an appraiser might find it inappropriate to

> include this income in the property's potential gross income. The appraiser may treat such income as business income or as personal property income, depending on its source. If a form of income is subject to vacancy and collection loss, it should be incorporated into *PGI*, and the appropriate vacancy and collection charge should be made to reflect effective gross income.

[Emphasis supplied]

The administrative judge finds that temporary tenant rents are properly treated as income to the real estate rather than as business income. The administrative judge finds Mr. Moody's stabilized estimates are adequately supported and should be adopted.

D. Cumulative Effect

The administrative judge finds that if just the foregoing modifications are made to Mr. Lennhoff's appraisal, the following indications of value result prior to consideration of the personal property:

2001	$115,023,912
2002	$114,665,457
2003	$114,690,825

The administrative judge finds if the reported value of the personal property is deducted from the above values, the following indications of market value result:

2001	$114,768,612
2002	$114,380,257
2003	$114,482,325

The administrative judge finds that the above indications of market value differ from Mr. Moody's ultimate conclusions of market value by the following percentages:

2001	7.3%
2002	0.3%
2003	5%

The administrative judge finds that other modifications could reasonably be made to Mr. Lennhoff's appraisal which would result in values that differ insignificantly from Mr. Moody's conclusions of value. For example, the administrative judge finds that Mr. Lennhoff's estimates of miscellaneous income, percentage rent and capitalization rates are certainly not beyond challenge.

Based upon the foregoing, the administrative judge cannot recommend adoption of any lower values than those proposed by Mr. Moody.

IV. Equalization

The final issue before the administrative judge concerns equalization. The taxpayer alleged that the current appraisal of subject property does not achieve equalization because the anchor stores attached to the mall are appraised at much less per square foot. According to the taxpayer, the current situation is analogous to *Payton & Melissa Goldsmith* (Shelby

Co., Tax Year 2001) wherein the Assessment Appeals Commission essentially created an exception to *Carroll v. Alsup*, 107 Tenn. 257, 64 S.W. 193 (Tenn. 1901) based upon the unique factual situation before it.

The administrative judge finds the taxpayer's argument without merit. The administrative judge finds that in *Goldsmith* the taxpayer had been appraised at or near market value whereas "practically identical properties, literally next door to the subject, [were] uniformly underassessed in the original reappraisal." Final Decision and Order at 3.

Respectfully, the administrative judge finds no evidence in the record to even suggest the anchors have been underassessed. Moreover, the administrative judge finds anchors and in-line shop space are fundamentally different and typically have different per square foot values. Indeed, applying the assessor's methodology for valuing the anchors to the in-line space would result in a market value indication of $24,200,000. Not surprisingly, although the taxpayer alleges a lack of equalization, the taxpayer did not ultimately contend such a value should be adopted.

The administrative judge finds the Assessment Appeals Commission made clear the limited applicability of *Goldsmith* in *A.L. & Mertice Alma Meyer* (Hamilton Co., Tax Year 2001) when it rejected a homeowner's comparative appraisal argument reasoning in pertinent part as follows:

> Comparing assessments with a neighbor is equally problematic. Is Mr. Meyer overvalued or Mr. Whitener undervalued? Certainly this case does not present the systematic undervaluation of an entire neighborhood of which the Commission took notice in *Appeal of Peyton & Melissa Goldsmith* (Shelby County, Tax Year 2001, February 27, 2002).

Final Decision and Order at 2.

The administrative judge would also note that the taxpayer's argument is also very similar to the equalization argument rejected in *Green Hills Associates v. State Board of Equalization*, No. 94-3013-III (Davidson Chancery, July 21, 1995).

The administrative judge finds that the concept of equalization only has relevance to this appeal insofar as the 2003 appraisal ratio for Shelby County is 95.23%.[7] The administrative judge finds that the adopted market value for 2003 of $120,500,000 must be reduced by the appraisal ratio of 95.23% which results in an equalized value of $114,752,150 before rounding. This conclusion stems from a finding that under the Constitution of the State of Tennessee, Article II, Section 28, the "ratio of assessment to value of property in each class or subclass shall be equal and uniform throughout the state." Equalization relief must be granted in order to comply with this constitutional mandate. This is also required by *Louisville and Nashville Railroad v. Public Service Commission*,

[7] The appraisal ratio for both 2001 and 2002 is 100%.

493 F. Supp. 162 (M.D. Tenn. 1978), the decisions of the State Board of Equalization in regard to public utility appeals since 1977, Tenn. Code Ann. § 67-5-601 and *Laurel Hills Apartments, et al.* (State Board of Equalization) (Davidson County, Tax Years 1991-1992).

ORDER

It is therefore ORDERED that the following values and assessments be adopted for tax years 2001, 2002 and 2003:

	LAND VALUE	IMPROVEMENT VALUE	TOTAL VALUE	ASSESSMENT
Tax Year 2001	$6,496,100	$117,269,600	$123,765,700	$49,506,280
Tax Year 2002	$6,496,100	$108,174,100	$114,670,200	$45,868,080
Tax Year 2003	$6,428,000	$108,324,200	$114,752,200	$45,900,880

Pursuant to the Uniform Administrative Procedures Act, Tenn. Code Ann. §§ 4-5-301—325, Tenn. Code Ann. § 67-5-1501, and the Rules of Contested Case Procedure of the State Board of Equalization, the parties are advised of the following remedies:

1. A party may appeal this decision and order to the Assessment Appeals Commission pursuant to Tenn. Code Ann. § 67-5-1501 and Rule 0600-1-.12 of the Contested Case Procedures of the State Board of Equalization. Tennessee Code Annotated § 67-5-1501(c) provides that an appeal **"must be filed within thirty (30) days from the date the initial decision is sent."** Rule 0600-1-.12 of the Contested Case Procedures of the State Board of Equalization provides that the appeal be filed with the Executive Secretary of the State Board and that the appeal **"identify the allegedly erroneous finding(s) of fact and/or conclusion(s) of law in the initial order"**; or

2. A party may petition for reconsideration of this decision and order pursuant to Tenn. Code Ann. § 4-5-317 within fifteen (15) days of the entry of the order. The petition for reconsideration must state the specific grounds upon which relief is requested. The filing of a petition for reconsideration is not a prerequisite for seeking administrative or judicial review; or

3. A party may petition for a stay of effectiveness of this decision and order pursuant to Tenn. Code Ann. § 4-5-316 within seven (7) days of the entry of the order.

This order does not become final until an official certificate is issued by the Assessment Appeals Commission. Official certificates are normally issued seventy-five (75) days after the entry of the initial decision and order if no party has appealed.

ENTERED this 16th day of March, 2005.

MARK J. MINSKY
ADMINISTRATIVE JUDGE
TENNESSEE DEPARTMENT OF STATE
ADMINISTRATIVE PROCEDURES DIVISION

c: Rita Clark, Assessor of Property
Kent Gieselmann, Esq.
David C. Scruggs, Esq.
Tameaka Stanton-Riley, Appeals Manager
Thomas Williams, Esq.
John Zelinka, Esq.

EXHIBIT A

TENNESSEE STATE BOARD OF EQUALIZATION
BEFORE THE ADMINISTRATIVE JUDGE

In Re:	Essex House Condo Corporation a/k/a Marriot Courtyard Airport Ward 60, Block 222, Parcel 345 Commercial Property Tax Years 2001 and 2002	)) Shelby County)))

INITIAL DECISION AND ORDER

Statement of the Case

For the 2001 tax year, the assessor originally valued the subject property at $7,234,600. The value was appealed to the Shelby County Board of Equalization which set the following value:

LAND VALUE	IMPROVEMENT VALUE	TOTAL VALUE	ASSESSMENT
$1,107,500	$5,193,500	$6,301,000	$2,520,400

For the 2002 tax year, the assessor originally valued the subject at $7,234,600. The value was appealed to the Shelby County Board of Equalization which set the following value:

LAND VALUE	IMPROVEMENT VALUE	TOTAL VALUE	ASSESSMENT
$1,107,500	$5,193,500	$6,301,000	$2,520,400

Appeals have been filed with the State Board of Equalization. This matter was reviewed by the administrative judge pursuant to Tenn. Code Ann. Section 67-5-1412, 67-5-1501 and 67-5-1505. The administrative judge conducted a hearing in this matter on July 16, 2003. The taxpayer was represented by David C. Scruggs and A. Kent Gieselmann, Jr. of Stokes Bartholomew Evans & Petree, P.A. The assessor of property was represented by staff member Larry Bankston, T.C.A.

Findings of Fact and Conclusions of Law

Subject property consists of a three-level hotel built in 1987 containing 145 rooms situated on a 5.0829 acre site at 1780 Nonconnah Boulevard, Memphis, Shelby County, Tennessee. Subject building has a gross building area of 76,946 square feet.

The taxpayer contended that the subject property should be valued at $4,200,000 for tax year 2001 and $3,750,000 for tax year 2002. In support of its contention, the taxpayer introduced appraisal reports for tax years 2001 and 2002 prepared by David C. Lennhoff, MAI, CRE. Mr. Lennhoff testified at the hearing regarding his appraisal reports.

The assessor contended that the property should be valued the same for tax years 2001 and 2002, at $6,301,000. In support of his position, Mr. Bankston relied on the income approach.

Since the taxpayer is appealing from the determination of the Shelby County Board of Equalization, the burden of proof is on the taxpayer. See State Board of Equalization Rule 0600-7-.11(1) and *Big Fork Mining Co. v. Tenn. Water Quality Control Bd.*, 620 S.W.2d 515 (Tenn. Ct. App. 1981).

After having reviewed all of the evidence in the case, the administrative judge finds subject property should be valued as contended by the taxpayer. As will be discussed below, the administrative judge finds that Mr. Lennhoff's appraisal report and testimony should receive greatest weight for two reasons. First, the administrative judge finds that Mr. Lennhoff considered all three approaches to value whereas Mr. Bankston relied solely on the income approach. Second, the administrative judge finds Mr. Lennhoff's analysis constitutes the most thorough and best substantiated evidence in the record. In particular, the administrative judge finds that Mr. Lennhoff properly separated the value of the real property from the value of the tangible and intangible personal property whereas Mr. Bankston did not.

The basis of valuation as stated in Tennessee Code Annotated Section 67-5-601(a) is that "[t]he value of all property shall be ascertained from the evidence of its sound, intrinsic and immediate value, for purposes of a sale between a willing seller and a willing buyer without consideration of speculative values . . ."

I. Application of Three Approaches to Value

General appraisal principles require that the market, cost and income approaches to value be used whenever possible. Appraisal Institute, *The Appraisal of Real Estate* at 50 and 62 (12th ed. 2001). However, certain approaches to value may be more meaningful than others with respect to a specific type of property and such is noted in the correlation of value indicators to determine the final value estimate. The value indicators must be judged in three categories: (1) the amount and reliability of the data collected in each approach; (2) the inherent strengths and weaknesses of each approach; and (3) the relevance of each approach to the subject of the appraisal. *Id.* at 597-603.

The value to be determined in the present case is market value. A generally accepted definition of market value for ad valorem tax purposes is that it is the most probable price expressed in terms of money that a property would bring if exposed to sale in the open market in an arm's length transaction between a willing seller and a willing buyer, both of whom are knowledgeable concerning all the uses to which it is adapted and for which it is capable of being used. *Id.* at 21-22.

The administrative judge finds that the need to at least consider all three approaches to value was addressed by Mr. Lennhoff on pages 27 and 28 of his appraisal report in pertinent part as follows:

> The USPAP and Appraisal Institute recognize three basic approaches to value – sales comparison, cost, and income capitalization – and require a complete appraisal to *consider* application of all three. An explanation is necessary if a particular approach is not considered applicable and therefore not applied. . . .
>
> * * *
>
> . . . Typical hotel investor acquisition motivation is income oriented and not cost based, and purchasers of this investment property type rarely rely on cost. [footnote omitted] Considering the value sought (real property component of a going concern), however, a cost approach would seem at least potentially useful. . . . Despite [the] limitations [of the cost approach in this case], we will apply a cost approach, if only to test the reasonableness of the far more reliable and meaningful income capitalization approach conclusion.
>
> * * *
>
> . . . hotels typically trade as going concerns [unless distressed], because there is virtually no market for their individual component parts sold separately (real property, and tangible and intangible personal property). Therefore, sales comparison is not an especially valid methodology for hotels when the value sought is only the real property component – or any other 'slice' – of the going concern. Although sales comparison is seldom given substantial weight in a hotel appraisal, it can be used to bracket a value or check the value derived by the income capitalization approach. However, this role as a test of income capitalization illustrates value as a *going concern*, and thus shows only what the real property cannot possibly be worth. . . .
>
> The income capitalization approach recognizes that an investment property's value is a function of its income-producing potential. Of the three approaches to value, the income approach is usually preferred for analysis of income-producing, investment property such as the subject. This approach also allows for market-supported deductions of non-realty items, making it particularly useful for this assignment. . .
>
> [Emphasis in original]

As previously indicated, although Mr. Lennhoff placed greatest weight on the income approach, he did at least consider the cost and sales comparison approaches in accordance with generally accepted appraisal practices. In contrast, Mr. Bankston considered only the income approach.

The administrative judge has appended to this initial decision and order a summary of Messrs. Lennhoff's and Bankston's income approaches which was introduced into evidence as exhibit C. The administrative judge finds that Mr. Lennhoff actually assumed a *higher* net operating income and *lower* capitalization rate than did Mr. Bankston. Thus, the real dispute in this case concerns the methodology utilized by Mr. Lennhoff to separate the value of the real property from the value of the intangible and tangible personal property. Mr. Bankston stated that in the event the methodology employed by Mr. Lennhoff is found to be proper, he does not dispute the calculations.

II. Methodology

The administrative judge finds that when valuing the real property of a hotel for Tennessee *ad valorem* property tax purposes, the value of tangible and intangible personal property is not assessable and must be separated from the real property value. See O.L.H., L.P., Initial Decision and Order at 8-9 (Davidson Co., Tax Year 1997). See also *Morristown Medical Investors, et al.* (Hamblen Co., Tax Year 1994) wherein the Assessment Appeals Commission held that appraisals must reflect the need for an adjustment to account for the "going concern." Final Decision and Order at 2.

The administrative judge finds that the foregoing decisions addressed what the appraisal literature currently refers to as "business enterprise value" and "total assets of the business." The administrative judge finds that the 12th edition of the Appraisal Institute's *The Appraisal of Real Estate* summarizes these concepts at pages 641-42 as follows:

> The existence of a residual intangible personal property component in certain properties has been widely recognized for years. Among the many terms used to describe this phenomenon, *business enterprise value* (BEV) is the most widely used. The issue has attracted attention primarily through assessment, condemnation, and damage claim assignments, which require that an estimate of the value of the real estate component be separated from the market value of the total assets of the business (MVTAB).
>
> These assignments necessarily involve an allocation among the component parts of real property and tangible and intangible personalty. The latter can include what has traditionally been called *business enterprise value* but more recently has become known as *capitalized economic profit* (CEP). CEP is defined as the present worth of an entrepreneur's economic (pure) profit expectation. In other words, CEP is the value of a residual claim that is subordinate to the opportunity cost claims of all agents of production employed by the business (e.g., land, labor, and/or capital). . . .

* * *

Because of inconsistent definitions of the various terms related to the topic among assessors, business and real estate appraisers, and the courts, a new lexicon has been developed. In discussing business enterprise value, the term going concern, for example, has been replaced with *total assets of the business* (TAB). TAB includes

- Real property
- Tangible personal property
- Intangible personal property

The personal property is broken down into

- Furniture, fixtures, and equipment (FF&E)
- Inventory

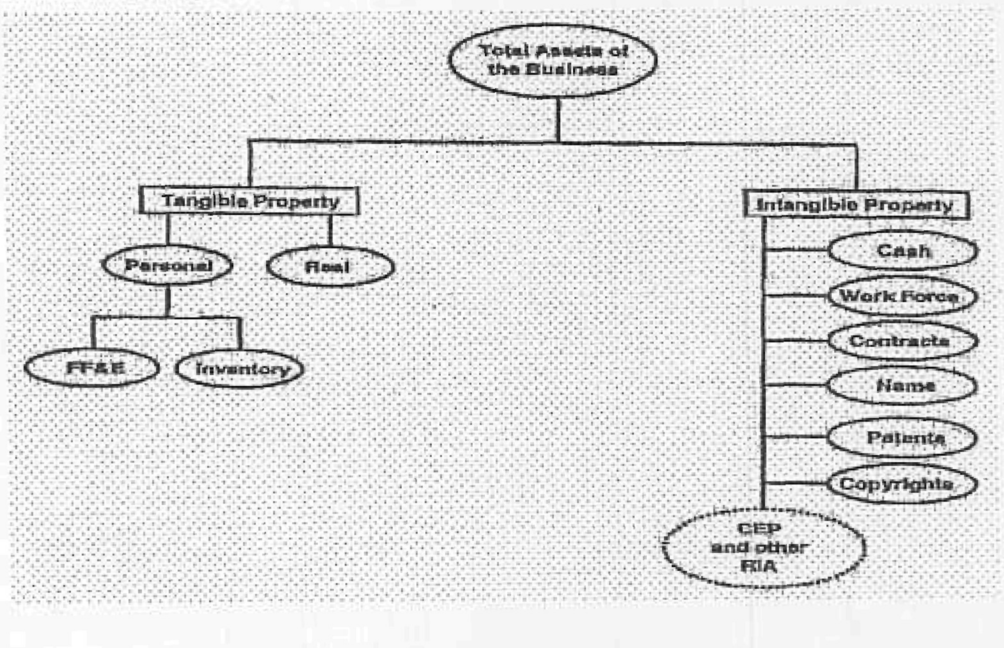
The intangibles are made up of

- Contracts
- Name
- Patents
- Copyrights
- An assembled work force
- Cash
- Other residual intangibles

CEP is included in the residual intangible category.

[Emphasis in original]

The administrative judge finds Mr. Lennhoff's methodology assumes that the components of a going concern or business are as follows:



The administrative judge finds that Mr. Lennhoff's methodology begins with the calculation of the NOI of the going concern (total assets of a business), which must then be adjusted to reach the NOI for the *real property*. In order to accomplish this, all tangible and intangible personal property that can be quantified, such as furniture, fixtures and equipment

(FF&E), business start-up costs and subject brand-specific residual intangibles, must be removed. Also, other non-realty items that are not as easily quantified, such as market-typical residual intangibles, are accounted for by adjusting the capitalization rate upward to reflect their inclusion in the NOI.

Mr. Lennhoff's 2001 income approach leads to an NOI of the going concern of $984,667. In order to account for the tangible personal property, Mr. Lennhoff first removes the FF&E by amortizing it over an economic life of approximately eight years, using a chattel mortgage rate of 10.65%. This calculation produces a deduction for return of and return on FF&E of $73,268.

Next, he removes the business start-up costs which include, among other things, assembled and trained work force, management and administration team, regulatory compliance, accounting and other business systems, pre-opening marketing, etc. These costs were adjusted to the tax year 2001 and amortized over a twenty-five year estimated economic life of the real estate, resulting in a deduction for return of and return on business start-up costs of $131,616.

Finally, the residual intangibles – the remaining intangible personal property – must be removed from NOI. According to Mr. Lennhoff, this category contains two components: i) market-typical intangibles, or those common to all hotels, and ii) brand-specific intangibles to the extent they exceed or are less than market-typical intangibles. The Revenue Per Available Room (RevPAR) is the most appropriate measure of brand-specific intangibles, to the degree that it exceeds or fails to exceed the market norm. Mr. Lennhoff determined that 20% of the RevPAR is attributable to the Marriot brand name. This portion of the residual intangibles that is attributable to the Marriot affiliation is reflected in a 20% deduction based on projected NOI, resulting in a $196,933 deduction from NOI. After these deductions, the NOI of the real property is $582,850.

Net Operating Income to Real Property

Net Operating Income to Going Concern (Excluding R.E. Tax)	$984,667
Less: Return on/of FF&E	$ 73,268
Less: Return on/of Start-Up Costs	$131,616
Less: Marriott/Subject-Specific Residual Intangibles	$196,933
Net Operating Income to Real Property*	$582,850

*Includes market-typical residual intangibles.

The final step in Mr. Lennhoff's process is to determine the capitalization rate. For tax year 2001, he determined that a tax rate loaded capitalization rate of 13.5582% is appropriate. For tax year 2002, he determined that the tax rate loaded capitalization rate should be 14.0582%. The assessor did not dispute either of these capitalization rates and in fact utilized a higher rate in his calculation.

For tax year 2001, Mr. Lennhoff concluded a value of $4,200,000. Regarding tax year 2002, Mr. Lennhoff employed the same methodology and concluded a value of $3,750,000. Mr. Lennhoff did show a decline in revenue for 2002. He explained that the market softened in 2001, and this condition was exacerbated by the economic recession in the United States and by the effects of the September 11, 2001 tragedy, which impacted both business and personal travel.

On cross-examination by Mr. Bankston, Mr. Lennhoff admitted that this method is not used by every appraiser. However, he also testified that this methodology has evolved over time, and is currently endorsed by the Appraisal Institute as evidenced by the previously quoted language from the 12th Edition of *The Appraisal of Real Estate* and by the Appraisal Institute's Course 800 (Separating Real and Personal Property from Intangible Business Assets). Even though the 12th Edition was not published until 2001, Mr. Lennhoff testified that the methodology should not come as a surprise to any expert in hotel valuation. He indicated that an informed appraiser who is current with education in terms of reading articles and properly utilizing continuing education would know of this evolution of the methodology of determining the value of the real estate component. He also testified this methodology is not a "new" concept; rather, it began as early as 1986.

The administrative judge finds that although Mr. Lennhoff's methodology may not be universally accepted, it is in accord with the position of the Appraisal Institute and the previously cited administrative decisions. The administrative judge finds that the assessor did not introduce any legal precedent or appraisal literature in support of an alternative method for separating the value of the real property from the value of the tangible and intangible personal property. The administrative judge finds the cross-examination of Mr. Bankston established that he has not taken Appraisal Institute Course 800 (or the equivalent) and was only partially familiar with many of the articles introduced relating to the methodology used by Mr. Lennhoff. Respectfully, the administrative judge finds unconvincing Mr. Bankston's assertion that he isolated the value of the real property by simply allowing for a management fee, franchise fee, reserves and a deduction for the reported value of the tangible personal property.

Based upon the foregoing, the administrative judge finds that subject real property should be valued at $4,200,000 and $3,750,000 for tax years 2001 and 2002 respectively.

ORDER

It is therefore ORDERED that the following values and assessments be adopted for subject property for the indicated tax years:

2001

LAND VALUE	IMPROVEMENT VALUE	TOTAL VALUE	ASSESSMENT
$1,107,500	$3,092,500	$4,200,000	$1,680,000

2002

LAND VALUE	IMPROVEMENT VALUE	TOTAL VALUE	ASSESSMENT
$1,107,500	$2,642,500	$3,750,000	$1,500,000

Pursuant to the Uniform Administrative Procedures Act, Tenn. Code Ann. §§ 4-5-301—325, Tenn. Code Ann. § 67-5-1501, and the Rules of Contested Case Procedure of the State Board of Equalization, the parties are advised of the following remedies:

1. A party may appeal this decision and order to the Assessment Appeals Commission pursuant to Tenn. Code Ann. § 67-5-1501 and Rule 0600-1-.12 of the Contested Case Procedures of the State Board of Equalization. Tennessee Code Annotated § 67-5-1501(c) provides that an appeal **"must be filed within thirty (30) days from the date the initial decision is sent."** Rule 0600-1-.12 of the Contested Case Procedures of the State Board of Equalization provides that the appeal be filed with the Executive Secretary of the State Board and that the appeal **"identify the allegedly erroneous finding(s) of fact and/or conclusion(s) of law in the initial order"**; or
2. A party may petition for reconsideration of this decision and order pursuant to Tenn. Code Ann. § 4-5-317 within fifteen (15) days of the entry of the order. The petition for reconsideration must state the specific grounds upon which relief is requested. The filing of a petition for reconsideration is not a prerequisite for seeking administrative or judicial review; or
3. A party may petition for a stay of effectiveness of this decision and order pursuant to Tenn. Code Ann. § 4-5-316 within seven (7) days of the entry of the order.

This order does not become final until an official certificate is issued by the Assessment Appeals Commission. Official certificates are normally issued seventy-five (75) days after the entry of the initial decision and order if no party has appealed.

ENTERED this 26th day of August 2003.

MARK J. MINSKY
ADMINISTRATIVE JUDGE
STATE BOARD OF EQUALIZATION

c: Mr. David C. Scruggs, Esq.
Ms. Tameaka Stanton-Riley, Appeals Manager

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Contents

Features

* *Editor's Note: The theories and methodologies for hotel valuation, long a subject of controversy, has become a hotly-debated issue in the appraisal community in recent months as new challenges to hotel values are being tested in court. The three articles appearing in this issue are explorations of various aspects of one side of this debate. An articulation of the opposing viewpoint, "Hotel Asset Allocation: Separating the Tangible Personalty" by Heather J. Reichardt and David C. Lennhoff, MAI, was published in the Winter 2003 issue of IAAO's* Assessment Journal.

IPTI and IAAO would like to acknowledge the editorial services of Sandra Patterson and the design services of Don Bapst in the production of *Journal of Property Tax Assessment and Administration.*

Editorial Policy

The *Journal of Property Tax Assessment and Administration* (the Journal) provides an international forum for the dissemination of theoretical and practice-based research in the fields of property tax assessment and administration. It aims to develop theory and practice, to compare experiences internationally, and to place policies, methods, techniques and practice in their fiscal, political and economic context. The Journal seeks to encompass an increasing range of skills and disciplines which have an influence on property tax issues, including economics, public administration, mass appraising, geographic and land information systems, law, valuation and computer systems. In addition to the manuscripts submitted by academics and practitioners, the Journal also publishes invited papers by selected authors on a topic of special interest. All papers submitted for publication are subject to a system of blind refereeing.

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"Total Assets of the Business" and Lodging Facilities: What Should be the Final Chapter

BY DANIEL H. LESSER, MAI, CRE, CHA

During the past two decades, much has been written relative to what is commonly referred to today as "Total Assets of the Business" and how the concept relates to lodging facilities. Unfortunately, most of what has been posited has been unsubstantiated by "the market" and has been put forth, for the most part, by generalist professionals who have no hotel educational background; little, if any, hands on hotel operational experience; and little, if any, hotel investment expertise. Essentially, these theories and methodologies are merely hypothetical academic constructs without any market foundation which have been developed by advocates for advocates for the purpose of reducing hotel property tax burdens. Analysis of the actions of hotel investors, however, indicates that the purchase of a hotel property reflects the acquisition of real and personal property only. Hotel investors account for income attributable to the business through the expense deduction of management and franchise fees. An investor purchasing a hotel "unencumbered" by a management agreement will not pay for a seller's assembled work force, business name, patents, copyrights, working capital and cash, or operating procedures and manuals. A passive investment in a first class hotel "encumbered" by a long-term hotel management agreement is riskier, but no different than a passive investment in a class A office building occupied by a long-term creditworthy tenant. Either passive investment yields a risk-adjusted return on property and not a business.

In the Forward section of *A Business Enterprise Value Anthology* edited by David Lennhoff, MAI, and published by the Appraisal Institute, Brian A. Glanville, the 2001 Appraisal Institute President, wrote that the text is "a collection of articles that chronicles the evolving theory of business enterprise value and illuminates the issues involved in valuing an operating business"(Appraisal Institute

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Daniel H. Lesser, MAI, CRE, CHA, *serves as the Senior Managing Director-Industry Leader of the Hospitality and Gaming Group of Cushman & Wakefield, Inc. During the past twenty-four years, Mr. Lesser has specialized in real estate appraisals, economic feasibility evaluations, investment counseling, and transactional services for hotel, casino, and timeshare properties on a worldwide basis. Previously, Mr. Lesser held operational and administrative positions with Hilton Hotels Corporation and Eurotels-Switzerland. Mr. Lesser is a member of the American Society of Real Estate Counselors and the Appraisal Institute and served as a founding member of the Lodging Industry Investment Council (LIIC), an industry think tank.*

2001a). Lennhoff's Preface in the same text states "the articles in this anthology trace the emerging theory, appraisal methodology, and related controversy on the subject and are presented in five sections: general issues, hotels/motels, health care facilities/senior housing, shopping centers, and miscellaneous properties"(Appraisal Institute 2001). While the text is an excellent reference document, that lodging (hotel/motel) facilities are matter of factly compared and considered with other real estate property types is erroneous.

Few would dispute that lodging facilities are unique forms of real estate, in that in addition to real estate, they inherently contain a significant "business" and "personal property" component. Problems occur, however, when one considers lodging facilities in the same breath as other real estate properties that contain one or both of these components. Retail, healthcare, bowling alleys, theme parks, and race tracks are but a few examples. Hotels, because they are unique forms of real estate, cannot be considered theoretically as just any other "business enterprise."

The valuation of lodging facilities is a highly specialized art based upon a solid hospitality educational, operational, and real estate investment background. It is not an exact science based on theories and methodologies that may be applicable to other property types.

An Historical Perspective

To better understand the current conflict between the opposing methodologies for segregating hotel income attributable to real estate, it is helpful to summarize and trace the evolution of published literature chronologically relative to the myriad of theories and opinions surrounding what has been a very controversial topic.

The monograph "The Valuation of Hotels and Motels" by Stephen Rushmore, MAI, which was published by the American Institute of Real Estate Appraisers in1978, posited the first accepted methodology for separating income attributable to business and income attributable to personal property from the entire income stream of a lodging facility. Stephen Rushmore, MAI, and Karen E. Rubin further clarified the methodology in the article, "The Valuation of Hotels and Motels for Assessment Purposes," which was published in the April 1984 issue of the *Appraisal Journal.* Essentially, Rushmore's methodology isolates income attributable to the business in the form of a deduction from income of management and franchise fees. Income attributable to personal property or furniture, fixtures, and equipment (FF&E) is accounted for in the form of a deduction from income for a return on and a return of personal property. The resultant net income after these deductions is deemed income attributable to the real estate.

Anthony Reynolds, MAI, challenged Rushmore's methodology in his October 1986 *Appraisal Journal* article, "Attributing Hotel Income to Real Estate and to Personalty," by claiming that income attributable to goodwill and working capital was mistakenly retained in the residual attributable to real estate. Reynolds, however, offered no explicit alternative methodology. The April 1988 *Appraisal Journal* manuscript, "Hotel Enterprise Valuation," by Roland D. Nelson, MAI; Jay L. Messer, MAI; and Laurence G. Allen, MAI, challenged the Rushmore methodology even further by claiming the need to further deduct from a hotel's income stream the total value of a liquor license, for organization (the cost of assembling, training, and coordinating staff and management), and of inventories.

The January 1993 *Appraisal Journal* manuscript, "Understanding the Unique Aspects of Hotel Property Tax Valuation," which I co-authored with Karen E. Rubin updated, refined, and validated the original Rushmore methodology for separating income attributable to business and personal property from a hotel's income stream. Sean Hennessey challenged this article in his October 1993 *Appraisal Journal* piece, "Myths about Hotel Business and Personalty Values," but offered no plausible alternative ideas, approaches, or methodologies. My rebuttal of Hennessey appeared in an October 1994 *Appraisal Journal* article entitled "Hotel Property Tax Valuation Issues." This article reinforced the position that through acceptance by a variety of hotel owners, municipalities, and courts of law throughout the nation, the original Rushmore methodology was sound. In the interim, the *Appraisal Journal* published in July 1993 "The Determination of Hotel Value Components for Ad Valorem Tax Assessment" by Stephen J. Matonis, MAI, and Daniel DeRango, MAI, which refined the Nelson/Messer/Allen theory of organization costs by deducting for the amortization of "one time initial start-up costs associated with the property, including initial losses from the business which must be captured by an owner/investor" (Matronis and DeRango 1993).

"Hotel Investment Analysis: In Search of Business Value" by Bernice T. Dowell was published in the March/April 1997 issue of IAAO's *Assessment Journal*. Utilizing a Cash Flow Allocation Model, Dowell posits that Cash Flow to the Owner (net operating income after fixed charges including FF&E reserve) less:

A) "Cash needed to support tangible personal property (value of tangible personal property in place multiplied by hurdle rate), less

B) Cash needed to support investment in business, i.e., working capital (investment in going concern multiplied by hurdle rate), less

C) Cash needed to support real estate (value of real estate multiplied by hurdle rate)" yields

residual cash which "measures the owner's expected entrepreneurial profit, which is used to value the owner's intangibles or business value" (Dowell 1997). The article summarizes by describing results of this analysis utilizing confidential year-end 1994 operating data for 470 full-service hotels. "Of the 470 observations, 197 or 41.92 percent were achieving positive entrepreneurial profits, as measured by the allocation model; however 273 observations, or 58.08 percent, were achieving "negative" entrepreneurial profits" (Dowell 1997). Dowell, who at the time of authorship was Director, Real Estate Tax and Valuation, for Host Marriott Corporation, Bethesda, Maryland (a major hotel owner), concluded "this negative cash flow could be used to measure obsolescence, or loss in value, to be applied to the real assets. Not only was the operation not earning enough to compensate the owner(s) for the risk bearing, but also the losses are reducing the value of the real assets. This is an important concept for owners to understand, especially in controlling real estate taxes. Not only is the intangible business value not to be taxed as real estate, but in the event that negative profits exist, the value of the real assets is diminished" (Dowell 1997).

"Hotel Valuation: Splitting the Hospitality Business From the Real Estate Assets" by Peter Gloodt, MAI, ISHC, appeared in the July/August 1998 issue of *The Journal of Multistate Taxation and Incentives*. Gloodt posits, "The component asset allocation valuation program is based on accepted appraisal procedures used to estimate the value of properties that are components of interrelated and interdependent operating business systems. This methodology first estimates the value of the entire operating enterprise and then apportions the value between the business component assets, including real estate, tangible personal property, and intangible assets. Under this "residual" appraisal methodology, the value of real estate is determined by identifying and deducting the value of all non-real-estate property components from the total value of the business enterprise as a going concern" (Gloodt 1998).

"Hotel Real Estate Tax Valuation: Current Issues" by Karen E. Rubin, CRE, CHA, MAI, which was published in the Fall 1998 issue of *Real Estate Finance* correctly concludes that: "two of the distinguishing characteristics of hotel investments—the relative volatility of value over time and the accepted inclusion of intangible assets in a hotel asset—renders the valuation of lodging facilities complex in comparison to their commercial real estate cousins (such as office and retail buildings). Of the four components that create a hotel's revenue-generating capacity—land, improvements, personal property, and intangibles—both the personal property and the intangibles values must be specifically excluded from consideration. Segregating the value of a hotel's intangible assets from its tangible ones is a particularly controversial issue at this time" (Rubin 1998).

"Intangible Assets in an Operating First-Class Downtown Hotel—A Comparison of Sources of Information in a Profit Center Approach to Valuation" by William N. Kinnard, Jr., MAI, CRE, PhD; Elaine M. Worzala, PhD; and Dan L. Swango, MAI, CRE, PhD, appeared in the January 2001 issue of the *Appraisal Journal*. The Summary and Conclusion of the article states: "The result of deducting total operating expenses from total operating revenues is net income from hotel operations, which is capitalized to going concern value. Then the value of the tangible personal property (FF&E) and the intangible assets (including the value of the hotel name and affiliation with TAG [The A Group-international group of affiliated hotels and resorts], as well as working capital and assembled/trained workforce) must be deducted from going concern value before the market value of the real property may be properly and supportably estimated. Additionally, the NOI of identifiable profit centers (adjusted to reflect proxy rent for the space they occupy) must be capitalized at an appropriate business capitalization rate to derive the value attributable to this part of the investment. The profit center values are also deducted from going concern value less FF&E and other intangible asset value. The final remainder is the indicated market value of the real property of the hotel" (Kinnard, Worzala, and Swango 2001). The problem with this type of analysis is that it does not occur in the marketplace and is, therefore, not reflective of the actions of typical hotel investors. The authors further state: "This finding has been developed by following, in particular, the precepts and guidance of the late, great James A. Graaskamp, as provided in his writings. Graaskamp notes that 'since Ricardo, a major premise and concern of urban land economists has been the proper attribution of net income (or) economic surplus to the instruments of production.' He defines the allocation of productivity for the purchase of the going concern of a business (e.g., an operating hotel) as 'land, structure, personalty, and intangible assets and goodwill plus artifactual profit centers for management'" (Kinnard, Worzala, and Swango 2001).

Eric Belfrage, MAI, authored "Business Value Allocation in Lodging Valuation" which appeared in the July 2001 *Appraisal Journal*. Belfrage suggests, "If total franchise fees approximate 9%, operators believe that a franchise relationship ought to contribute in excess of 9% of revenue. Successful chain affiliations generate between 15% and 25% of room nights sold to their franchisee. Interviewees indicated that for a franchise affiliation to be considered successful it ought to generate approximately double its cost. A similar quantification is applicable to management fees" (Belfrage 2001). Belfrage posits that "total business remaining in gross income" is one times the management and franchise fees that are already deducted on a hotel's income statement. He further suggests capitalizing the "net revenue to the business" (total business revenue remaining in gross income multiplied by an applicable net income ratio) results in a business value allocation in relation to a hotel's going concern value which already includes a deduction for management and franchise fees (Belfrage 2001).

Between the end of 2001 and the end of 2002, three articles with essentially the same message appeared in different real estate publications. These articles were all authored by real estate tax attorneys, whose firms are members of the American Property Tax Counsel (APTC)—The National Affiliation of Property Tax Attorneys. The APTC Web site states that it "is the only organization of law firms providing major portfolio owners with a single source for all their property tax reporting and tax reduction needs." The articles are: "Hotel Owner Jolted by New Method Used to Determine Real Estate Value" by Jim Popp (2001), "New Appraisal Theories Will Reduce Hotel Assessments" by John Garippa (2002), and "Methods Exist to Reduce Hotel Taxes" by William D. Siegel (2002).

Popp's article states, "In contrast to the traditional approach, the new refined methodology advocating a higher business deduction in hotel appraisal has been supported by such appraisers as David Lennhoff of Delta Associates and Peter Gloodt of Chicago Hospitality Consulting Services, and by property tax lawyers" (Popp 2001).

Garippa states in his article: "Opponents have argued that significant elements of business value remain in the income stream when this valuation formula (Rushmore/Lesser/Rubin method) is utilized. The Appraisal Institute has not only recognized the problem, but has provided guidance in how to remove these non-realty components. In the most recent edition of its textbook, *The Appraisal of Real Estate*," (Appraisal Institute 2001b) the institute spells out its position by replacing the terminology "going concern" which means an active, operating business, with the terminology "total assets of the business" (TAB). TAB includes real property, tangible personal property and intangible personal property. The personal property is broken down into FF&E and inventory. The intangibles are made up of contracts, business name, patents, copyrights, work force and cash. This change in terminology is important. Intangible assets are recognized as contributing to value" (Garippa 2002). Garippa further states, "Now, under evolving theory supported by the Appraisal Institute, this additional value will also be deducted for tax assessment purposes as a non-real-property component. Over the past 25 years, as significant new research has taken place in the appraisal industry, it was inevitable that new appraisal theories developed. If this were the automobile industry, some of those locked in the past would still be using the Model T. But time has passed. Just as we recognize the need to drive modern cars, we must also recognize the change in modern appraisal thinking" (Garippa 2002).

Siegel's article states, "A proper analysis for a hotel interested in reducing its property taxes should consider the following methods:

- Determine the revenue generated by the franchise flag over and above the typical hotel. One method of adjustment is a reduction in the actual income stream to a market income stream.

- Determine the revenue generated by the intangible elements common to all hotels such as assembled work force, working capital, typical management skills, contracts, leases, licenses and operating agreements. One method of adjustment is to estimate the difference in cash flow associated with a stabilized hotel compared to a start-up lodging.

- Determine the revenue created by non-realty service profit centers such as food and beverage, health club, telephone, parking, laundry, etc. Profits may be capitalized at a business capitalization rate and separately allocated" (Siegel 2002).

"Hotel Asset Allocation: Separating the Tangible Personalty" by Heather J. Reichardt (a director of lodging property tax for Marriott International Inc.) and David C. Lennhoff, MAI, appeared in the Winter 2003 issue of IAAO's *Assessment Journal.* The summary of the article states, "Most appraisers recognize that a hotel going concern is comprised of real property and tangible and intangible personal property. Properly recognizing the intangibles causes the bulk of the controversy. Methods for allocation of the tangible personalty, however, are deficient, too, usually for one of the following reasons: First, the replacement allowance is confused with providing a return 'of' deduction. As a result, an expense for 'reserves' is made, but the return 'of' is not captured. In this instance, even if a return 'on' is deducted, the result is a value estimate that is purportedly only real property, but actually includes tangible personal property too. The situation is exacerbated by assuming only FF&E is included in the allowance, thereby failing to provide sufficient monies even to cover just the replacement allowance for the short lived items. Replacement allowances for realty related components, such as the roof or paving, are not addressed. Second, the value of the tangible personal property is deducted from the bottom line, but no other deduction is made. This results in an overstatement of the real property, as the return 'on' the personalty has not been captured" (Reichardt and Lennhoff 2003).

Reflections of the Market

Transactions of lodging facilities, which occur in the fluid hotel real estate market, provide the true market evidence to support appropriate conclusions relative to the appropriate methodology for segregating hotel income attributable to real estate. When analyzing opportunities, one of the first things sophisticated investors in first class hotels want to know is, if the asset is "encumbered" or "unencumbered" by management. All things being equal, it is a fact well-known to sophisticated hotel investors, that the market typically will pay a premium for an "unencumbered" hotel over one that is "encumbered" by a long-term management contract. It is not that one is better than the other, but rather a wider arena of prospective buyers typically exists for "unencumbered" hotel assets versus "encumbered" properties, the competition for which tends to drive prices higher.

Investors that purchase "encumbered" hotels such as pension funds, private equity funds, or hotel REITs (e.g., Strategic Hotel Capital, Host Marriott, CNL Hospitality Properties, LaSalle Hotel Properties, and FelCor Lodging Trust) are clearly passive investors who are looking for pure real estate returns, albeit higher ones when compared with alternative real estate investments such as office buildings and retail centers which are perceived as less risky due to the long-term contractual leases in place that produce a more stable stream of income. Investors that purchase "unencumbered" hotels are typically hotel companies aligned with capital sources or ones using their own sources of funds (e.g., Starwood Hotels & Resorts Worldwide, Hyatt Hotel & Resorts, and Hilton Hotel Corporation) who seek to purchase not just the real and personal property, but the opportunity to brand the asset with one of their owned identities (e.g., Starwood brands include St. Regis, Westin, Sheraton, and Four Points). Furthermore, these investors are seeking opportunities to implement their own business operating standards and procedures to reposition hotel assets and create upside. For the past twenty years, the name of the game in the hotel industry has been the creation of widespread guest distribution channels and critical mass. The worst scenario for a worldwide hotel company such as Marriott International (which owns the following brands: Ritz-Carlton, JW Marriott, Marriott Hotels & Resorts, Courtyard, Fairfield Inn, Springhill Suites, and Residence Inn) is for a loyal Marriott "Rewards" (Frequent Traveler Program) member to travel to a location where Marriott does not have representation but a competitive firm does. Furthermore, worldwide hotel companies maintain significant corporate investments in such assets as trademark brand name(s), reservation systems, assembled work forces, accounting systems, and standardized operational policies, procedures, and manuals. One of the ways these companies profit from these investments is by leveraging off them, thereby growing and expanding their critical mass.

When an "unencumbered" hotel property is purchased, the buyer is paying for the real estate and the personal property only. For example, if Hilton Hotels Corporation agreed to purchase an "unencumbered" 400-room hotel from Hyatt Hotels Corporation for $80 million and Hyatt bargained for an additional sum of money for Hyatt's assembled work force, business name, patents, copyrights, working capital and cash, operating procedures and manuals, and such, it would not realize any additional proceeds. Hilton Hotels Corporation, a worldwide hotel company that has its own assembled work force, business name, patents, copyrights, working capital and cash, and operating procedures and manuals, would not pay another worldwide hotel company for intangible assets that it already possesses. When Hilton, as a worldwide hotel company, obtains another hotel for its system, it accomplishes the previously mentioned objectives, namely widening its guest distribution channel and leveraging its corporate-owned intangible assets thereby expanding critical mass.

When an "encumbered" hotel property is purchased, the buyer is paying for the real estate and personal property only. For example, if CNL Hospitality Properties, a private REIT, purchases a 400-room hotel "encumbered" by a long-term Marriott International management contract, CNL's investment would be "passive," with Marriott retaining complete control of the operation and management of the property. CNL's ownership interest would include real estate that contains a significant amount of personal property. Returns on that ownership interest are dependant upon a business operation over which CNL has little, if any, control. CNL would receive a return on its investment in the real and personal property of the hotel, albeit a theoretically higher return than a real estate asset such as a class A office building occupied by a long-term creditworthy tenant.

Since a minor with no investment knowledge could theoretically own an income-producing passive interest in a class A office building that would require no knowledge or expertise in the management or operation of the building, the same minor could also theoretically own an income-producing passive interest in a first class hotel that would require no knowledge or expertise in the management or operation of that hotel. Clearly, a minor's investment advisor would require a higher return for a hotel investment compared with an office building, but in either case the return is on property and not the business.

Conclusion

During the past two decades, much has been written relative to what is commonly referred to today as "Total Assets of the Business," and how the concept relates to lodging facilities. However, most of what has been posited has been unsubstantiated by "the market." Essentially, these theories and methodologies are merely contrived academic constructs which have been developed to reduce hotel property tax burdens. Analysis of the actions of hotel investors proves that the purchase of a hotel property reflects the acquisition of real and personal property only. Hotel investors account for income attributable to the business through the expense deduction of management and, in some cases, franchise fees. An investor purchasing a hotel "unencumbered" by a management agreement will not pay for a seller's assembled work force, business name, patents, copyrights, working capital and cash, operating procedures and manuals, and such. A passive investment in a first class hotel "encumbered" by a long-term hotel management agreement is riskier, but no different than a passive investment in a class A office building occupied by a long-term creditworthy tenant. Either passive investment yields a risk-adjusted return on property and not a business.

Richard Marchitelli, MAI, could not have said it better than in his July 1996 *Appraisal Journal* Letter to the Editor, "How Should Appraisers View Business Enterprise Value?" Marchitelli wrote, "I continue to be astounded by the creative rationalizations of business enterprise value (BEV) posited by a handful of appraisers and other consultants. In my view, the answer is, and always has been, quite clear. The business value, if any, of malls is reflected in the deduction of a management fee as an operating expense. It works for hotels, apartments, office buildings, and any other property" (Marchitelli 1996).

Marchitelli continued, "The real and most compelling proof, however, is not a matter of personal opinion. Market participants reflect it every day. Buyers and sellers of regional malls do not acknowledge the existence of business enterprise value. Most are unfamiliar with the concept altogether. Other than a deduction for management, this factor is not reflected in their analysis, negotiations, or in any other thinking. Why all the fuss? Proponents of BEV are a very small, but highly vocal, minority of appraisers, who are involved regularly in tax appeal cases, usually on the side of the property owner. The issue of BEV provides their clients with another argument for a tax reduction. The vast majority of appraisers do not write on the subject because, until recently, it had been a non-issue and explanation is so simple that it can be articulated in just three or four sentences. I fear, however, the proponents of BEV are papering academic journals with articles on the subject to create the impression that theirs is a widely held belief when it is not. For their part, such journals are being intellectually responsible by providing a forum to discuss ideas—new, sometimes controversial, but not necessarily correct or widely accepted. The act of publication does not validate a real estate hypothesis. The market does. Unless and until the marketplace embraces BEV and incorporates it in the decision making process, business enterprise value will remain an abstract theory, the product of either wishful thinking or of consultants with too much time on their hands." (Marchitelli 1996)

This manuscript should now conclude "What Should be the Final Chapter," and hopefully close the book on *"Total Assets of the Business" and Lodging Facilities* until that day when the market says otherwise.

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