

Business Value Allocation in Lodging Valuation

by Eric E. Belfrage, MAI

This article incorporates two separate concepts dealing with the business value of hotels. The presentation of a matched pairs case study will prove the existence of business value in hotels. This is a controversial topic, and a clear consensus does not currently exist on its presence or measurement among lodging consultants. A methodology is also presented in this article to provide a “common sense” approach and a starting point or platform of agreement for this issue.

Business value in a hotel is inherent in the ongoing operation. It is created and maintained by three factors:

- Chain affiliation
- Management expertise
- Service (labor)

All components are labor intensive and require time and reputation to cultivate. Hotel chains create value by consistency, market perception, product support, reservation systems, traveler programs, advertising, etc. Once a critical mass is reached and a chain has an excellent reputation in these areas (i.e., Hampton Inns, Residence Inns, etc.), maximum business value is achieved.

Business rights are “lent” to hotel owners for a “maintenance charge,” commonly known as franchise and management fees. Business value however, still resides in the capitalized value of net income after deduction of these fees. This is much like the reserve expense. The deduction of a reserve for the replacement of furniture, fixtures & equipment (FF&E) accounts is for the replacement of furnishings when they wear out. This represents the return of the personal property component. The actual value of existing FF&E still resides in the value of capitalized net income.

This theory is contrary to the conclusions of Stephen Rushmore’s book, *Hotels and Motels*.¹ This text suggests that total property value is the capitalized net income before deduction of management and franchise fees. However, in practice, appraisers do deduct both franchise and management fees to determine market value. It is generally considered that going concern value is inher-

abstract

The business value component of hotel real estate is elusive to quantify, but is generally assumed to exist. Through consistent tracking of two physically similar hotel chains, we have conducted a matched pairs analysis. Using the industry performance unit of comparison revenue per available room (Rev Par) for six locations containing both chains, we were able to measure the contributory revenue associated with affiliation, management, and service—all primary components of business value.

1. Stephen Rushmore, *Hotels and Motels: A Guide to Market Analysis, Investment Analysis, and Valuations*. (Chicago: Appraisal Institute, 1992): 247.

“Business value in a hotel can be determined by a matched pair’s analysis.”

ent in the resulting conclusion. Business contribution exists despite deduction of management and franchise fees.

When an operating hotel sells, the acquisition represents the ongoing business operation, which includes:

- Real estate
- FF&E
- Business

The FF&E portion is easily allocated based on its depreciated cost. Business value is more elusive and generally perceived to be “in there somewhere.” However, in ad valorem tax cases, a real estate only allocation should be determined. A methodology for allocation is crucial to ensure hotel owners are not paying real estate tax on non-realty items. One of the challenges for an appropriate application is to present a straightforward and understandable methodology that can be easily communicated and grasped in litigation cases.

In *Hotels and Motels*, Rushmore states “Chain hotels generally out perform independents, the additional value created by increased profits is exclusively business related.”²

Obviously, anyone with or without hotel experience could locate a site and construct a hotel. The creation of going concern value, however, includes selecting the appropriate affiliation, management team, marketing plan services, and even employee attitudes. How often has a patron selected an alternative property because of disorganization, uncleanliness, or an unfriendly employee attitude? These situations can be detrimental to property value (i.e., occupancy and rate) despite payment by the ownership of franchise and management fees.

Matched Pairs Analysis

An appropriate verification of the existence of business value can be quantified by comparing a hotel lacking management, franchise, and service components to a similar property possessing these components. An analysis of the two competitors’ performance will re-

veal the difference in revenue. The value difference between these two facilities is the business contribution. Consider the following case study.

Case Study

Business value in a hotel can be determined by a matched pair’s analysis. If two groups of hotels can be identified that possess similar physical characteristics—where the first hotel chain has little business value and the second hotel chain has a definite business value component—the contribution of business value can be isolated. Three components create business value: chain affiliation, management expertise, and service. Comparing the lack of these components to the presence of these components will isolate business value in hotel property. While no operating hotel could be completely lacking in management or service components, we did locate a chain of properties (Chain A) that were not affiliated with a franchise nor had traditional hotel management expertise. They did, however, offer good service in the area of room cleanliness and physical plant maintenance. A direct competitor (Chain B) was then located at identical interchange locations that possessed national chain recognition and hotel management expertise.

A comparison of Chain A’s performance to Chain B was made. Business value, of course, was created by revenue differences attributable to Chain B’s name recognition and management abilities. The unit of comparison utilized by hotel companies includes both average daily rate and occupancy. Both were combined in a single category known as “revenue per available room” (Rev Par). A Rev Par comparison of the two chains was made.

For the Rev Par analysis to be accurate, both properties or groups of properties need to be nearly identical physically, and in location, in order to isolate the contributory value to franchise and management expertise. Specific physical data is shown in Table 1 for comparison purposes.

The physical considerations for these two chains are nearly identical. Chain A possesses six locations in common with Chain B in a major Metropolitan area. These are suburban interchange locations and are in many cases literally next door to each other. In all cases, these two properties have the identical competitors. A performance comparison that isolated business components was therefore accomplished. We have cited the 1997–2000 Rev Par for each property. In Table 2 the change column reflects Chain B’s relative increase in Rev Par in the same market.

2. Ibid.

Table 1 Physical Comparison Chart: Identical Locations in the Same Major Midwest Metropolitan City

Characteristics	Local Chain A*	National Chain B*
No. of properties	24	300+
Age	1984 to 1987	1973 to 1986
No. of stories	2–3	2–3
Entry type	Exterior corridor	Exterior corridor
Pool	Yes	Some
Locations	Suburban	Suburban
Price	Economy-limited service	Economy-limited service
Ownership structure	Company owned	Company owned/franchised
Amenities	Cable TV, local calls, & coffee	Cable TV, local calls, & coffee

* Cannot divulge identity due to confidentiality of performance statistics.

Table 2 Rev Par Comparison

Location	Chain A				Chain B				Change			
	1997	1998	1999	2000	1997	1998	1999	2000	1997	1998	1999	2000
A) West	\$24.14	\$24.79	\$23.45	\$22.15	\$36.53	\$36.68	\$38.39	\$34.01	51%	48%	64%	54%
B) East	\$27.48	\$27.02	\$23.23	\$20.15	\$33.62	\$36.71	\$37.87	\$37.61	22%	36%	63%	87%
C) Northwest	\$27.22	\$28.03	\$22.65	\$21.09	\$36.53	\$37.59	\$34.41	\$32.56	34%	34%	52%	54%
D) North	\$21.88	\$22.41	\$20.73	\$21.24	\$29.81	\$30.93	\$31.87	\$31.88	36%	38%	54%	50%
E) University	\$28.54	\$29.66	\$31.36	\$35.53	\$34.41	\$35.74	\$35.22	\$38.44	21%	20%	12%	8%
F) South	\$27.79	\$26.60	\$26.59	\$25.11	\$30.32	\$33.54	\$32.29	\$30.19	9%	26%	22%	20%
Average	\$26.41	\$26.42	\$24.66	\$24.18	\$33.54	\$35.20	\$35.01	\$34.19	27%	33%	42%	41%

Note: Location within same Midwest City.

Table 3 Comparative Value Analysis

Characteristics	Chain A	Chain B	Change
Property size	100 Rooms	100 Rooms	
Revenue per available room (Rev Par) ¹	\$25.50	\$34.50	
Sales per year	\$930,750	\$1,259,250	35%
Net income (35%)	\$325,763	\$440,738	
Value (OAR 12%)	\$2,714,688	\$3,672,813	
Rounded	\$2,700,000	\$3,700,000	37%
Value difference ²		\$1,000,000	
% of total value ³			27%

1. Rounded average years 1997–2000.

2. Attributable to business.

3. Business contribution.

For Chain A the average Rev Par was \$26.41 in 1997, \$26.42 in 1998, \$24.66 in 1999, and \$24.18 in 2000, compared to \$33.54 in 1997, \$35.20 in 1998, \$35.01 in 1999, and \$34.19 in 2000 for Chain B. This indicates a 27% to 42% increase in revenue directly attributable to chain affiliation and management expertise. Increased Rev Par can directly be translated into value contribution in Table 3.

The comparative analysis indicates that the 35% increase in sales (assuming comparable net income ratios and overall capitalization rates) result in a value difference of about \$1 million or approximately 27% of property value. Stated another way, about 25% of

the value of a Chain B hotel is attributed to the business component. This estimate is considered to be conservative as the service component of business value—i.e., guest care, cleanliness, etc.—exists in Chain A and therefore is not included in the above number. Obviously, refined capitalization could consider differing net income ratio and overall for the two income streams. These, however, would likely be canceling. In our opinion, the allocation of business value for a successful well-run chain type limited-service hotel is quantified up to 25%. This case study compares a very successful well-known chain to a physically comparable, but localized chain, where maximum business value is

measured. Under the theoretical “competent or typical management” scenario, a range in business value allocation of 15% to 20% appears reasonable.

Application of Methodology

The case study quantifies that a reasonable range of business value between 15% and 20% generally exists in hotel properties. Obviously the business value contribution can be more or less, depending on the quality of franchise affiliation, management, or service level. Integra Lorms & Belfrage has interviewed several hotel owners, brokers, and management companies who unanimously disagree with the philosophy that deduction of management and franchise fees remove all the business value component. In fact, we have completed consulting assignments for owners who have changed their affiliation, as the original franchise was not generating revenues in excess of fees. In other words, 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. In fact, it is a common practice for hoteliers to track the percentage of room nights sold or revenue generated by the reservation system. If the reservation system generates, for instance, 18% and the total franchise costs are 9%, the annual revenue contribution to the business would be 18% (minus 9%) or 9%, assuming the room rate is consistent.

A similar quantification to the above is applicable for management fees. Most owners or employers would expect a contribution to income in excess of management fees. In marketing his firm for management services, one of our respondents specifically stated that their management company will provide additional net income equal to the annual management fee.

In order to determine an appropriate methodology to allocate the business value contribution to a specific hotel property, *it appears reasonable to utilize the capitalized value of the annual net income contribution made by affiliation and management expertise.* It does not appear possible to quantify the contribution of the service component. However, management and franchise fees are more “leadership” related and can be identified by the contribution discussed previously. These revenues clearly relate to business income as opposed to income associated with the real estate only. In the comparative value analysis of Chain B (shown

Table 4 Affiliated Hotel Business Revenue Allocation

Revenue	\$1,259,250
Generated by affiliation	
Total revenue from affiliation at 18%	\$226,665
Previously deducted in cash flow at 9%	(113,333)
Balance of revenue remaining in gross income	\$113,333
Generated by management	
Total (double 4% fee) attributed to management	\$100,740
Previously deducted in cash flow 4%	(50,370)
Balance of revenue remaining in gross income	\$ 50,370
Total business revenue remaining in gross income	\$163,703

in Table 3), the successful hotel generated room revenue of \$1,259,250. This chain charges 9% total franchise fees. The average contribution to room sales for this chain is 18%. Therefore the revenue contribution is the difference, or 9%. Of course the chain affiliation may have an impact on the rate a hotel can charge. If the successful going concern became an independent, the rate may fall and would have an even greater impact on revenue. Conversely, if quality and condition is maintained, this impact may be minimized. An average management fee of 4%, contributing double its cost, indicates a total business revenue contribution (including affiliation) of 13% (9% franchise contribution plus 4% management).

The business revenue remaining in the cash flow after the deduction of franchise and management fees is demonstrated in Table 4.

The total remaining business revenue of \$163,703 is indicated. Value contribution can be determined by capitalizing the net business revenue. We have utilized the 35% net income ratio as in Table 3 (NOI ratio may vary by property). This indicates net revenue of \$57,296. By utilizing the overall capitalization rate of 12% from Table 3, the value contribution is processed as follows:

Net revenue to business	\$57,296
÷ Overall rate	12%
Value	\$477,467
Rounded	\$500,000

Certainly an argument could be made that the net income could be higher due to some fixed expenses already considered in the NOI ratio. Con-

versely, the argument could also be made that a capitalization rate that is slightly higher than the overall rate should be used, given the business revenue risk. This is considered canceling.

Comparing the business indication to the overall value offers a percentage of going concern attributed to business value as shown in Table 5.

The contribution of business value at \$500,000 indicates a percentage business value allocation of 13.5%. This is lower than the comparative value analysis in the case study (Table 3), indicating a value contribution by Chain B of \$1 million over Chain A or 27% of Chain B's value. This is due largely to the difference in the rate that Chain B is able to charge for a room when compared to Chain A.

In the case study, an 11% lower occupancy was noted by Chain A when compared to Chain B, but a 26% downward impact on total sales occurred (see Table 6).

This is a 1 to 2.4 relationship. In other words, for every percent of occupancy impact, a 2.4% impact is felt in the Rev Par. The Rev Par impact based on the 9% occupancy contribution from affiliation (above fees) is 22%.

For this reason, the application methodology may be somewhat understated. However, clearly a business component of between 15% and 25% is reasonable in this case. Extraction of every dollar of contribution is obviously difficult as business value is so intermingled with real estate. Perhaps, as improved tracking of hotel statistics continue, addi-

tional development of this concept can evolve. For instance, the area of service contribution involves cleanliness and guest treatment, as well as employee attitudes, etc. The quantification of this component is not currently possible. The management and affiliation components provide "leadership" and, if not present, they could possibly negate good service. Continued study in this area is needed.

Conclusion

The above methodology inherently considers variables including the quality of franchise affiliation and management. This is because higher quality affiliation and management costs are generally charged at a higher percentage of revenue. The franchise revenue contribution is the difference between revenue generated by the specific affiliation and franchise costs. This method will therefore measure varying levels of value contribution, depending upon the success of the individual hotel.

At this time, there is no clear consensus on the issue of measuring the business value component for lodging property. The previous methodology serves as an easily quantifiable starting point to a platform of agreement in lodging valuation as to the contribution of the business component. This "common sense" and simple approach can be expressed and comprehended easily in litigation situations to those not involved daily with such concerns. This method is especially helpful in ad valorem tax situations where the real estate component must be isolated.

Table 5 Affiliated Hotel

Going Concern Value

Revenue	\$1,259,250
Net income ratio	35%
Net income	440,738
Overall rate	12%
Value indication	\$3,672,813
Rounded	\$3,700,000
Business value allocation	\$500,000
% Business contribution	13.5%

Table 6 Sales Impact Ratio

	Chain B	Chain A	Difference
Average occupancy*	70%	62%	-11%
Average Rev Par	\$34.50	\$25.50	-26%
Occupancy to Rev Par impact			1 to 2.4

* Average for each chain for 1997-2000.

Eric E. Belfrage, MAI, ISHC, is the managing director for Integra Lorms & Belfrage of Columbus, Ohio. His background includes twenty five years of independent fee appraisal and consulting experience.

Mr. Belfrage has largely focused on consulting, evaluating, and appraising lodging property. He holds a bachelor's degree in Business Administration from Franklin University, Columbus, Ohio. **Contact:**

(614) 451-3211; fax (614) 451-9599; email:

ebelfrage@irr.com.

References

- Appraisal Institute. *The Appraisal of Real Estate*, 11th Ed.: 414.
- Egan, Patrick J. "Mixed Business and Real Estate Components in Hotel Valuation," *The Appraisal Journal* (July 1996): 246-251.
- Hennessey, Sean F. "Myths About Hotel Business and Personality Values," *The Appraisal Journal* (October 1993): 608-611.
- Lenhoff, David C. "Business Enterprise Value Debate: Still a Long Way to Reconciliation," *The Appraisal Journal* (October 1999): 422-428.
- Lesser, Daniel H. and Karen E. Ruben. "Understanding the Unique Aspects of Hotel Property Tax Valuation," *The Appraisal Journal* (January 1993): 9-27.
- Matonis, Stephen J. and Daniel R. DeRango. "The Determination of Hotel Value Components for Ad Valorem Tax Assessment," *The Appraisal Journal* (July 1993): 342-347.
- Rushmore, Stephen. "Hotel Business Value and Working Capital: A Clarification," *The Appraisal Journal* (January 1987): 144-147.