

Market Value Assessment in Saskatchewan Handbook

Hotel / Motel

Valuation Guide



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Hotel/Motel Valuation Guide

Market Value Based Assessment Legislation in Saskatchewan

Saskatchewan has different assessment legislation¹ than other jurisdictions in Canada that must be taken into account when valuing properties for assessment and taxation purposes. There are specific definitions in Saskatchewan for “base date”, “market value”, “Market Valuation Standard” and “mass appraisal”. It is important to understand how these definitions relate to one another and the requirement for market value based assessments to be determined in accordance with the Market Valuation Standard.

Base Date is defined as “...the date established by the agency for determining the value of land and improvements for the purpose of establishing assessment rolls for the year in which the valuation is to be effective and for each subsequent year in which the next revaluation is to be effective;” (Refer to the Preface for specific base dates.)

Market Value is defined as the “...amount that a property should be expected to realize if the estate in fee simple in the property is sold in a competitive and open market by a willing seller to a willing buyer, each acting prudently and knowledgeably, and assuming that the amount is not affected by undue stimuli;”.

Market Valuation Standard means the “standard achieved when the assessed value of property:

- (i) is prepared using mass appraisal;
- (ii) is an estimate of the market value of the estate in fee simple in the property;
- (iii) reflects typical market conditions for similar properties; and
- (iv) meets quality assurance standards established by order of the agency;”

Mass appraisal is defined as “...the process of preparing assessments for a group of properties as of the base date using standard appraisal methods, employing common data and allowing for statistical testing;”.

Assessment legislation in Saskatchewan requires that non-regulated property assessments be determined pursuant to the Market Valuation Standard. Throughout this Handbook the term “market value based assessments” is used to refer to non-regulated property assessments. Unlike single property appraisals, market value based assessments must be prepared using mass appraisal and “...shall not be varied on appeal using single property appraisal techniques”. All Handbook references to market value are subject to the requirements of the Market Valuation Standard.

¹ The following Acts provide the statutory basis for property assessment in Saskatchewan:

- *The Assessment Management Agency Act*
- *The Interpretation Act, 1995*
- *The Cities Act*
- *The Municipalities Act*
- *The Northern Municipalities Act, 2010*

For more details on how to access this information refer to Appendix 2: Resources - Section 2a (Queen’s Printer).

1.0 Introduction

In this Valuation Guide the term “hotel” will be used throughout to refer to both hotel and motel properties. Hotels are properties that return revenues to their owner(s) in the form of income. They are typically purchased for investment purposes; thus a property’s ability to earn income is the critical element affecting its value from a market point of view. The potential income from a hotel is affected by many factors, including economic conditions, location and competition. Any condition that affects potential income or how the market views a hotel property may affect its market value based assessment.

1.1 Hotels Covered in this Valuation Guide

The valuation methods described in this valuation guide are designed to suit various types of hotels ranging from small motels with few or no services to large full service luxury resort hotels.

The valuation procedures in this Valuation Guide will work with gallonage hotels (tavern hotels) provided that the appropriate information can be obtained. However, additional valuation procedures have been recommended for gallonage hotels in *Section 3.12*.

The methods presented are not applicable to properties such as bed and breakfast or other home lodging arrangements.

1.2 Scope of Valuation Guide

- This valuation guide is designed as an aid for the valuation of hotel properties for assessment purposes.
- It sets out a procedure to follow to derive market value based assessments for hotels using the income approach.
- The valuation guide provides a practical tool to evaluate and determine the market value based assessments.
- Valuation parameters provide the guidelines that establish statistically sound market value based assessments for hotels as of the base date.
- The valuation guide is designed as a tool to aid the assessor in deriving market value based assessments; it is not intended to replace the assessor’s judgement in the valuation process.
- The method presented in this valuation guide is aimed at deriving assessment values for a number of different groups of hotels.

Hypothetical data and analysis are provided throughout this Valuation Guide in the narrative and in various examples, tables and forms. These examples are provided for illustrative purposes only. The exact form of the market value based assessment analysis is up to the discretion of the assessor subject to the Market Valuation Standard and other relevant legislation.

2.0 Analysis of Valuation Approaches

2.1 Approaches to Value

Sales Comparison Approach

A sale is generally a good indicator of market value; however, the price paid for a hotel may reflect the value of the entire hotel enterprise including real estate, business, management and personal property. Since the market value of the real estate component must be separated from the sale price, analysis is required to determine appropriate hotel real estate values from market sales evidence.

Furthermore, in many situations sales data is limited and such data that exists is often difficult to compare between one hotel and another due to factors such as location, amenities and condition of the property.

Therefore, where adequate sales information is available, the sales comparison approach may be considered.

Income Approach

Hotels are income-producing properties. The majority of hotels are bought and sold based on their ability to generate income. Therefore, when adequate sales and income information is available, hotel properties are most appropriately valued by use of the income approach to value.

Cost Approach

The cost approach can provide good results when valuing a property as new. However, as a property ages and the value changes, the cost approach becomes a less trustworthy measure to establish the amount that would be paid between a willing seller and a willing buyer. In order for a cost approach to work well in the hotel environment, it would be necessary to make appropriate adjustments to the depreciation, obsolescence and land value of the property. Therefore, the cost approach is not generally recommended for the valuation of hotel properties.

2.2 Recommendation

Because hotels are developed, bought and sold on the basis of expected income, the income approach to value reflects the manner in which the market views these properties. The theory behind the income approach to value is that a property's value reflects the present worth of anticipated or forecasted future benefits from the real estate. As such, the income approach analyses the income from a hotel attributable to the real estate and converts it into an estimate of current value. Since the income approach applies well in a mass appraisal environment, the following recommendation is made:

The income approach is recommended for the valuation of hotel properties for assessment purposes.

2.3 Application of the Income Approach

Income Approach Methods

In general, there are two methods available to convert future income into a present value:

- Direct capitalization; and
- Yield capitalization (discounted cash flow analysis).

The direct capitalization method is most applicable to the valuation of income-producing properties in a mass appraisal environment. It requires the least amount of data to apply, reflects typical rents and market conditions, and is best suited to the use of statistical analysis. The yield capitalization method is not suitable for use in mass appraisal valuations in Saskatchewan due to its consideration of individual investor preferences (reflects personal versus typical market conditions), its need for more market data and numerous estimates of rents, holding periods and projected reversions, and its lack of suitability for statistical analysis. For these reasons the yield capitalization method will not be further detailed in this Guide.

Overview of the Direct Capitalization Method

The analysis in this section presents a direct capitalization method that is suited for mass appraisal applications.

Direct capitalization converts or “capitalizes” the expected level of potential net income into a market value-based assessment using an overall capitalization rate. The conversion factor or capitalization rate is a reflection of all of the investor’s relative and comparative feelings and aspirations about the property in light of the investment characteristics offered by the asset and in comparison to other investment opportunities on the market.

In its most basic form, the direct capitalization method is an elementary mathematical ratio involving the estimation of net operating income (NOI) as of a valuation date, which is then capitalized into value to produce a market value based assessment.

The Direct Capitalization Method

Market Value	=	$\frac{\text{Net Annual Operating Income}}{\text{Capitalization Rate}}$	V	=	$\frac{\text{NOI}}{\text{R}}$
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For example

$$\begin{aligned} \text{NOI} &= \$100,000 \\ \text{Capitalization Rate (R)} &= 10\% \\ \text{Market Value} &= \$100,000 \div 0.10 = \$1,000,000 \end{aligned}$$

Although there are other methods of converting expected future income into an estimate of current value (e.g., discounted cash flow), the direct capitalization method lends itself to mass appraisal applications. It is possible to develop market value based assessments under this formula through proper evaluation of the potential net income and through the selection of an appropriate capitalization rate.

In establishing market value based assessments using the income approach, the objective is to evaluate the typical income generated by the real estate. For hotels this task is complicated by the fact that the revenues raised from guests and other sources is attributable to a range of interests including real estate, personal property and management.

2.4 Using the Income Approach to Value Hotels

Hotel Values Rely Upon Performance

Perhaps more than any other income producing property, the value of hotel real estate relates to its performance. While there are many hotels of similar nature, often they do not have the same type of attributes, room mix, room finishes, restaurants, franchise affiliations, labour arrangements, etc. Therefore, in this valuation procedure, actual income and expenses form the starting point in the process.

However, collecting and tabulating such data also enables the assessor to distinguish between the typical value of real estate components and the actual performance of a specific property. A market value based assessment determined through mass appraisal methods demands the application of a property's typical performance in the marketplace, not its actual performance. As noted in the Valuation Parameters Guide, this requirement is established in the Market Valuation Standard mandated in legislation in Saskatchewan's municipal Acts.

Hotel Values are Sensitive to Market Changes

The market value of a hotel is sensitive to changes in the marketplace. Unlike shopping centres or office buildings, which are subject to longer-term leases, the revenue generated from a hotel relies upon short-term stays. As such, a drop or rise in occupancy produces an immediate and corresponding drop or rise in income.

In order to stabilize short-term fluctuations and to provide stability in the assessment system, it is recommended that stabilized income and expenses be used in the valuation of hotels. Three years of income and expense data is typically collected for this purpose.

Segregation of the Hotel Real Estate Component

Hotels may have a number of sources of revenue, for example rooms and restaurants, which generate income and support the value of the entire hotel enterprise. This income arises and is made possible as a result of both tangible assets such as land, buildings and personal property, and intangible assets such as hotel management. Therefore, the valuation of a hotel for assessment purposes requires that the real estate portion be separated from the value of the other component parts.

Component Parts of a Hotel

- Land and buildings.
- Business interests, management, goodwill, labour and operational expertise, licences, trademarks.
- Furniture, fixtures and equipment (FF&E) such as room furnishings, beds, carpets and televisions.
- Working capital such as cash, accounts, supplies, uniforms, tableware, food and liquor.

Division of Income

The income derived from the operation of a hotel may be attributable in some fashion to all of these component parts. Since an assessment is a reflection of the value of the real estate, the valuation process must in some way differentiate between the real estate value and these other values.

2.5 Practical Valuation Process

In this valuation guide, the direct capitalization method has been developed into a practical valuation tool with guidelines on:

- Collecting data;
- Analysing information;
- Developing valuation parameters;
- Determining market value based assessments; and
- Testing the quality of assessment values. (Refer to the Valuation Parameters Guide for a general discussion on statistical testing.)

3.0 Hotel Valuation Process

3.1 Overview of the Procedure

- 1) Collect appropriate information.
- 2) Analyse data and establish hotel classes and valuation parameters.
- 3) Stabilize hotel income and expense information to determine typical income and expenses.
- 4) Deduct typical expenses from typical revenues to establish net income (NOI).
- 5) Deduct income attributable to management and business interests and FF&E (unless deducting as a lump sum value).
- 6) Capitalize typical NOI into value.
- 7) Add/deduct value of any ancillary income and/or other value (such as FF&E if not completed in Step 5) to determine a market value based assessment of the property.
- 8) Test results.

3.2 Collect the Appropriate Data

More than any other factor, the type and quality of information that is available dictates the methods that can be used to value properties. The effort put in at the information collection stage will determine the quality of the final analysis.

Supporting Information

Sources of supporting information include: hotel building owners/managers, real estate consultants and brokers, hotel guides and directories, real estate publications and industry associations.

Property Information

To compare, classify, and develop valuation parameters for hotels, it is necessary to obtain pertinent physical and descriptive information. Typical information that can be collected for a property and entered into the assessor's valuation system is shown on the Hotel Data Entry Example. (*Refer to Figure 1.*)

To collect the appropriate financial data, the assessor could send a Request for Information Form to the hotel property owner (or the designated contact person). (*Refer to Section 6.0 - Appendix B and C for examples.*) If possible, request the following information:

- Actual income and expense statements over a period of time (i.e. typically three years);
- Information on room rates and occupancy rates;
- Information regarding FF&E;
 - Inspection data
 - Property records:
 - land area;
 - number of rooms;

amenities, etc.; and

- Information on sales of hotels.

Property Inspection

To keep records up to date, all assessed properties are generally inspected from time to time. Along with the physical measurements the following types of items may be noted when inspecting a hotel:

- Quality and category (class) of building;
- Nature and quality of common facilities, amenities and finishes;
- Room styles and quality of finishes;
- Additional amenities such as pools, spas, etc.;
- Parking; and
- Surplus or excess land (if any).

An analysis of the above information will enable the assessor to arrive at conclusions about:

- The characteristics and nature of the hotel property market in the jurisdiction and/or market area;
- Typical occupancy rates;
- Typical management and operating expenses; and
- Typical market incomes for various types of hotel properties and various types of space (office, retail, etc.).

Information on sales of hotel properties in the market must also be collected to assist in the development of appropriate capitalization rates.

Figure 1: Hotel Data Entry Example

Hotel name		Base date	
Address		Measurements in	feet
Municipality		Land	
Assessment Roll #		Site area sf	
Hotel description		\$ per sf	
Type of hotel		Land Value	\$ -
Class of hotel			
No. of rooms			
Building area sf			
Year built			
Last bldg. Renovation (yr)			
Last FF&E upgrade (yr)			
Cost of last FF&E upgrade			
Facilities			
Dining room sales			
Lounge area sf.			
Banquet are sf.			
Conference area sf.			
No. Of parking spaces			
Pool			
Exercise/Health Club			
Other			
Inspection notes			
Inspection date			
Hotel quality			
Building condition			
Extra features			
Location comment 1			
Other comment 1			

Issues to Consider in the Collection of Data

Limited or No Information Provided by Property Owner

Some owners may not comply with such information requests or provide appropriate information.

Where no or limited income and expense information is provided, the valuation of the property can be based on the valuation parameters for that class of hotel.

Non-standardized Income and Expense Statements

Though many hotels follow the Uniform System of Accounts recommended by the American Hotel and Motel Association, not all operators report income and expenses in this fashion and not all owners return the information in the same format. (*Refer to Section 6.0 - Appendix A.*) In these situations, the task of the assessor is to analyse all revenues and consider all applicable expenses to derive the net income attributable to the real estate. This process is explained more fully in *Section 3.7* through *Section 3.9*.

3.3 Analyse Data, Establish Class of Hotel and Valuation Parameters

By their nature, mass appraisal programs are designed to value large numbers of properties in comparison with properties of similar nature and function. Efficiencies can be gained in this process by establishing common points of comparison among various properties. Accordingly, once all hotel data is collected and analysed, valuation parameters can be established for each class of hotel.

Since the assessment of property is based upon the value of real estate, such value should be separated from the added value of factors such as management or furniture. Moreover, in order to provide an equitable basis for taxation, the assessed values of similar properties should relate to each other. Due to the wide variety of attributes and characteristics of hotels, it is difficult to make direct comparisons of overall hotel performance even though they may serve similar needs in the market. However, there are certain performance standards typically exhibited in the market place, for example, revenue per available room (RevPAR), the ratio of room operating costs to room revenues and other departmental and operating expense ratios. These factors should be similar for similar classes and types of hotels. (*Refer to Section 3.6 for a detailed discussion.*)

3.4 Classify Hotel

Types of Hotels

Hotels range from small motels with few or no services to large full service luxury resort hotels. The range of services provided in a hotel - conference centres, health clubs and exercise facilities, dining rooms and dinner theatres, retail stores, etc. - may affect the potential revenues and operating costs of a property. In addition to the costs of operation, the expertise demanded of management may also vary with the size and complexity of a property. The differences in revenues and expenses associated with the various types and sizes of hotels may also produce differences in the degrees of risk associated with these properties.

The following is a list of examples of different types of hotels. However, it is up to the assessor to determine how hotels should be grouped (stratified) for determining valuation parameters:

- Motels with limited amenities, generally catering to drive-by traffic.
- Limited service hotels with only some of the amenities found in full service properties.
- Full service hotels that provide a wide variety of facilities and amenities including food and beverage service, recreational facilities and meeting rooms.
- Select service hotels offer the fundamentals of limited service hotels together with a selection of the services and amenities characteristic of full service hotels.
- Suite hotels that have separate (not necessarily physically divided) sleeping and living areas.
- Extended-stay hotels designed for longer term stays typically with kitchen and laundry facilities.
- Resort hotels usually located in non-urban locations with special recreational facilities to attract guests.
- Gallonage hotels or tavern hotels (*Refer to Section 3.12*).

Hotel Quality Classification

Along with the type of hotel, each property may be classified according to its quality. Ranking each hotel by quality class can further refine the comparison process.

For example, if most of the attributes of a hotel are superior and fall within Class 1, the hotel should be classified as Class 1. If the property is superior in some respects and less than average in others, it should be classified as average or Class 2, etc.

3.5 Revenue and Expense Data

Revenues

The revenues generated by a hotel property may include room revenue, food and beverage revenue, and other revenues (e.g., convention centre, laundry, money exchange, parking, golf course or health club fees, etc.).

Expenses

The expense of running each department is typically included under “departmental expenses.” Typical hotel departments are rooms, food and beverage, and telephones, etc. Departmental expenses not listed should be sub-totaled under “other departments.” All other expenses associated with the hotel in general are included under “undistributed operating expense.” For example, expenses associated with the commercial retail space in a hotel should be included under the various expense categories contained in undistributed operating expenses.

Other Income

Ancillary income is typically included in the revenues under one of the following categories that best describes the type of income:

- Other departments.
- Rental income.
- Other.

Income Attributable to Management and Business

Analysis of the income attributable to management may be completed by studying hotel management contracts (if any) and referring to other data available from industry sources. (*Refer to Section 3.8 for additional details.*)

Income Attributable to FF&E

Part of the revenue generated in a hotel is attributable to FF&E. (*Refer to Section 3.9 for additional details.*)

Revenue from Video Lottery Terminals (VLTs)

Commission on Revenue from VLTs

Hotels provide an environment for the use of video lottery terminals (VLTs). A VLT does not require a large space but it typically generates a significant amount of income. The VLT site contractor receives remuneration for its services solely by way of commission on revenues received from the playing of a VLT, in accordance with a fixed percentage as established by the Saskatchewan Liquor and Gaming Authority. VLT income is typically considered business income; therefore, VLT income to the hotel owner should not be included in the valuation process for determining the value of the real estate under the income approach.

Income from Provision of Space for VLTs

If not already included as part of the rental revenues the value added to the real estate from the provision of space for VLTs may be included under ancillary income. This is different than the business income generated by VLT commissions.

Other Commercial Components

If the hotel property contains other commercial components (for example, an office building or retail), these parts of the property could be valued separately. These other commercial components may be valued using procedures found in other valuation guides (e.g. Shopping Centre and Office Valuation Guides). The totals of all such values would then be added together to form the total property value.

Stabilizing Income and Expense Figures

Since all income properties are purchased on the basis of expected future income, and since the hotel business has a tendency to fluctuate from year to year, it is recommended that hotel values be established on the basis of typical stabilized incomes and expenses. This procedure follows the steps that a prudent purchaser would take in considering the value of a hotel.

It is recommended that the assessment appraiser collect and analyse three years of income and expense statements from the hotel property owner.

Stabilizing the Data

The assessor determines the appropriate weighting factor to be applied to each year to stabilize the data. For example, if the property owner supplies information for the applicable three-year period and the assessor decides that each year is equally important in stabilizing the data to reflect the base date, the assessor would apply equal weight (33.3 percent) for each year to calculate typical stabilized data. However, if the income is expected to be more closely related to the base date (or any other) year, a higher weight can be assigned to this year (e.g., 30 percent, 30 percent and 40 percent). The assessor may also use data solely from the year closest to the base date if it is considered to reflect the typical income for the base date.

3.6 Compare Income and Expense Ratios to Valuation Parameters

Once the data has been collected, and stabilized revenues and expenses are entered into the assessor's valuation system, valuation parameters can be determined. The next step is to compare the actual performance of a hotel to the valuation parameters.

Mass appraisal is intended to value large groups of properties using statistical analysis. As noted in the Valuation Parameters Guide, part of the process is to identify elements of comparison common to the various properties within a group of similar properties. Once identified, these elements can be analysed and modelled to produce assessment values for the properties within the identified group.

Hotel properties exhibit certain unique characteristics or performance ratios that can be used to make comparisons for valuation purposes. The market typically refers to these unique characteristics as industry norms and can include local, regional and national data. The industry norms most prominent in the hotel market are the following:

- Average rate per occupied room
- Average daily rate (ADR)
- Occupancy
- Revenue per available room (RevPAR)

Each type and class of hotel property typically reflects a range of performance ratios or measures based on revenue and expense performance. For mass appraisal purposes, the assessor analyses the data received from hotel property owners and reviews the above measures to determine typical valuation parameters for a given class of hotel. This analysis process can indicate where a particular hotel property may be performing either above or below the valuation parameters established for its class, leading the assessor to further investigate the data associated with that property to determine if the reported data is reported correctly or to understand why that property is performing outside of the valuation parameters.

The assessment of property is based on the mass appraisal of the fee simple interest in real estate pursuant to the market valuation standard. Under assessment jurisprudence, it is assumed that all properties should achieve a performance comparable to the valuation parameters and are valued on that basis. Performance that is above or below the valuation parameters is generally attributed to superior or inferior management practices. The fee simple interest of real estate requires the reflection of typical or normal management practices and hence typical valuation parameters.

3.7 Deduct Expenses from Revenues to Arrive at Net Income

Total Revenue
- Departmental Expense
= <u>Gross Operating Income</u>
- Undistributed Operating Expense
- Total Fixed Expense
= Net Income

Departmental Expenses

Departmental expenses refer to the expenses of operating the various departments in the hotel; i.e., rooms, food and beverage, and telephones.

Undistributed Operating Expenses

Undistributed operating expenses are those expenses not directly attributable to a single department but more properly assignable to the operation of the entire hotel. Therefore, these expenses include such items as administration, maintenance, marketing, heat and light.

Fixed Expenses

Fixed expenses typically refer to expenses that occur whether the hotel operates or not. Therefore, from a property valuation point of view, they include items such as property taxes and insurance. For valuation purposes, fixed expenses do not include depreciation, debt service, mortgage payments or interest payments.

Issues to Consider With Expenses

Franchise Fees

Hotel ownership and operations range from independently owned and operated facilities to centrally owned groups of hotels run by a franchise management group, and every combination in between. In general, franchise hotels have some economies of scale and administrative reservation advantages over independent hotels. Therefore, franchise hotels may perform somewhat better than independent hotels. However, franchised locations (e.g., Holiday Inns) also incur additional costs such as franchise fees.

As there are a number of different types of franchise arrangements, franchise fees are reported in many different ways. For example:

- As part of the administrative and general expense;
- As part of advertising and marketing expense;
- As part of the management fee (under the management contract); or
- As a separate item.

Ideally, franchising costs should be entered as a separate item. Where franchise fees are included as part of the marketing, general administration or management budgets, they may distort that expense item.

In these situations, the assessor will either have to make an allowance for the distorted expense item or separate out the franchise fees from the affected expense item.

Management Fees

Similarly, there is a whole range of possible management arrangements, ranging from a percentage of gross revenues to structured fees for each department. *(Refer to Section 3.8 for a detailed discussion.)*

Expenses not to be deducted from Revenues

In the process of deriving the market value standard assessment, the following expenses are not to be deducted:

- Depreciation;
- Debt service or loan interest payments;
- Mortgage payments; and
- Owner's business expenses.

3.8 Deduct Income Attributable to Management and Business Interests

Once the net income has been established, it must be apportioned among the components that comprise a hotel:

- Management, business and other intangibles
- FF&E
- Real estate

Income Attributable to Management

A number of hotels are owned by investors and operated under contract by management companies. Local assessors may complete studies to track the appropriate range of management fees that are expensed for various hotel types.

Income Attributable to Business

There are two aspects of business value to consider when establishing the value of a hotel:

- The business value associated with the management function; and
- The business value associated with the investment in FF&E.

Business Value of Management

The business portion of the hotel management function is taken into account as part of the deduction for the management fee.

Business Value of FF&E

The business value associated with FF&E is part of the deduction made for FF&E. (*Refer to Section 3.9.*)

Hotels also have a certain portion of their value attributable to intangibles such as liquor licences. A portion of the income also relates to the investment value attributable to the business. Local assessors may complete studies to track the various business expenses to account for these intangible and business values. For the most part, the owner has expensed these items.

3.9 Deduct Income Attributable to FF&E

A portion of the revenue generated by a hotel is attributable to and goes to support FF&E. There are two issues to consider in establishing the value of such items:

- A hotel makes significant periodic investments in FF&E (the life expectancy of FF&E varies significantly in years depending upon individual circumstances).
- The amount invested relates directly to the quality and type of hotel. The higher the quality of the hotel, the higher the investment in FF&E and the higher the expected room rate and revenue generated. Therefore, income and investment attributable to FF&E is directly related to the income generated by the hotel.

There are up to three types of value to be considered when valuing the FF&E portion of the hotel:

- The depreciated cost of the FF&E;
- The reserve for the replacement of FF&E; and
- The business value of the investment in FF&E.

As FF&E gets older, its market value falls and the need for funds to replace FF&E grows. Therefore, the amount of income attributable to FF&E remains fairly constant.

For example, it can cost a significant amount of money to refurbish a 200-room full-service hotel, resulting in a significant investment required in FF&E. If a hotel operator or owner is going to invest this amount of money, there will be the expectation of a return of business value associated with the investment. This business value factor is included in the deduction made for FF&E.

Establishing the Income Required to Support the Value of FF&E

The income to support the value of FF&E can be determined by analysing the amount of money typically spent on FF&E and the timing of this investment. A sample questionnaire to the owner requests such information. (*Refer to Section 6.0 – Appendix B for examples.*)

When this type of information has been collected and analysed, it may be possible to determine the typical value of FF&E per room. Discounting this value by the appropriate capitalization rate produces the amount of income necessary to support the value in FF&E and the return from the investment in FF&E.

The amount of money spent on FF&E typically relates to the type and quality of hotel. (This relationship is determined through the analysis of market evidence.)

3.10 Establish Capitalization Rate and Effective Tax Rate

The value of the income stream is determined by capitalizing the net operating income.

$$\text{Value} = \text{Net Operating Income} \div \text{Capitalization Rate}$$

Establishing Capitalization Rates

Sales of Hotels – Recommended Approach

Turning the equation in the capitalization method around produces the appropriate formula for establishing capitalization rates:

$$\text{Capitalization Rate} = \text{Net Operating Income} \div \text{Value (Sale Price)}$$

In the same manner that income and rents are analysed for property valuation purposes, the income and other data should be analysed for hotels that have sold as of the base date in order to establish the capitalization rates to be applied to hotels.

Other Approaches

If there is insufficient market sales evidence to establish capitalization rates, there are other possible ways such as mortgage-equity or band of investments to derive rates. These other approaches are not suitable for use in mass appraisal valuations in Saskatchewan.

Selection of a Capitalization Rate

Selection of an appropriate capitalization rate is essential for the determination of an equitable market value based assessment for a property. The selection task starts with an analysis of the capitalization rates demonstrated in the sales of similar hotels.

After a review of the available information, appropriate statistical measures (median, mean, range, etc.) can be determined for capitalization rates for each class of hotel. From this the typical capitalization rate can be determined for each group of properties being valued.

Capitalization Rate Guidelines

The income approach is based on the present worth of future benefits. Because of this, and when applying capitalization rates, it is important to recognize the expected future income at the time of the valuation.

There are a number of influences that can affect the capitalization rate to be applied to a hotel. In general, favourable conditions may lower the capitalization rate and raise the value, and negative conditions may raise the capitalization rate and lower the value. Some of the issues to consider when establishing a capitalization rate are:

- Economic conditions;
- Competition and expected changes in competition;
- Location - roads, parking, access;
- Property age and condition; and
- Property design.

Effective Tax Rate

There are two ways to deal with the impact of property taxes when valuing a hotel:

- The first is to deduct the actual property taxes charged as part of the fixed expenses (before the determination of net income). Under this approach, the net income produced is entirely attributable to the value of the various aspects of the hotel and the capitalization rate employed in the valuation process is considered the base rate. The base rate is established as outlined above.
- The second method is to determine the effective tax rate and add this amount to the base capitalization rate.

Effective Tax Rate Calculation

Property taxes	\$300,000
Market value based assessment of property	\$10,000,000
Effective tax rate:	$\$300,000 / \$10,000,000 = 3.0\%$

This effective tax rate of 3.0 percent is added to the base capitalization rate to determine the market value based assessment as presented in the example below:

Direct Capitalization Value Calculation Example

Net income	\$1,589,000
<hr/>	
Base capitalization rate	9.5%
Effective tax rate	3.0%
Total capitalization rate	<u>12.5%</u>
Value	\$12,712,000

3.11 Add / Deduct Other Values

There may be certain properties where the entire value of the property is not completely captured by the foregoing application of a given valuation approach. In these situations a lump sum adjustment may be required. For example, a property may have surplus or excess land which is not developed due to current market conditions. This land may be valued separately and added to the market value based assessment for the entire property. A similar lump sum adjustment may also be applied for improvements if warranted.

3.12 Valuation of Gallonage Hotels

Because a significant portion of the revenues from gallonage hotels or tavern hotels are generated by beverage sales, the revenue and expense information will be somewhat different from other types of hotels. As a result, the analysis and valuation parameters used in the valuation of a gallonage hotel may be different from those generated for other types of hotels.

A special consideration for gallonage hotels is if the property has a history of no longer renting rooms, or the rooms are no longer capable of being rented, the property may be treated as a tavern, restaurant or general commercial property.

As with other hotels, gallonage hotels may be assessed using any of the three approaches to value, subject to adequate underlying income, sales or cost information.

Income Approach

Collect the revenue and expense information, determine the valuation parameters, and apply the valuation process as outlined for other hotels.

Sales Comparison Approach

If the available revenue and expense information proves to be unsuitable for such analysis, it may be possible to determine the values of gallonage hotels from sales transactions. On this basis, points of comparison between hotels are:

- Value per (bar) seat.
- Value per volume of alcohol.
- Value per square foot.

The number of bar seats should be confirmed by inspection and a review of permits. When applying the sales comparison approach, the assessor must still consider the value of FF&E and intangible assets in order to determine the appropriate market value based assessment, although these amounts may differ significantly from other hotels.

Cost Approach

When there is a lack of reliable income and sales data, the cost approach may be used to determine the market value based assessment of gallonage hotels.

3.13 Market Value Based Assessment of Property

In summary, a market value based assessment is determined by establishing the typical net operating income generated through the foregoing analysis and applying to this the appropriate typical capitalization rate. Then, if required, any additional value is added to this total to determine an overall market value based assessment for the property.

An example of a hotel valuation is presented in *Section 5.0*.

4.0 Validation of Results

The strength of an assessment system rests on two tenets: (1) its ability to produce appropriate market value based assessments; and (2) its treatment of similar properties in a fair and consistent manner.

In order to accomplish these ends, the valuation process should reflect the views and methods used in the marketplace. The process is applicable to all properties.

There are two areas where the quality of the results can be ensured quickly and efficiently:

- Valuation parameters; and
- Check against sales values.

Valuation Parameters

The assessor's valuation system has valuation parameters that have been researched, collected and analysed by local assessors. Appropriate statistical measures (median, mean, range, etc.) can be determined for each valuation parameter. When the assessor applies these valuation parameters to all similar properties, then the market value based assessments will be fair and consistent.

Check against Sales Values

To ensure that the market value based assessments developed are in line with the local market, the assessment values will typically be checked against any sales of similar properties that took place. Such sales also have inferences for values of similar properties.

5.0 Hotel Valuation Example

The following three pages present a hypothetical example of a market value based assessment analysis of a hotel.

Figure 2: Hotel Data Entry - Example

Example of typical pertinent physical and descriptive data about the property.

Figure 3: Valuation Proforma Analysis - Example

Example for determination of the appropriate net income from the hotel.

Figure 4: Hotel Valuation Summary - Example

Example of summary data that would enable the assessor to calculate the appropriate market value based assessment for the property.

Figure 2: Hotel Data Entry - Example

Hotel name	
Address	
Municipality	
Assessment Roll #	

Base date	
------------------	--

Measurements in	Square feet
-----------------	-------------

Hotel description	
Type of hotel	Full Service
Class of hotel	2
No. of rooms	250
Building area sf	364,000
Year built	1983
Last bldg. Renovation (yr)	
Last FF&E upgrade (yr)	1992
Cost of last FF&E upgrade	\$2,400,000

Land	
Site area sf	58,100
\$ per sf	
Land Value	\$ -

Facilities	
Dining room seats	85
Lounge area sf.	3,400
Banquet are sf.	
Conference area sf.	7,000
No. Of parking spaces	150
Pool	Indoor
Exercise/Health Club	2,000
Other	

Inspection notes	
Inspection date	
Hotel quality	average room finishes, higher class public areas - class 2
Building condition	good
Extra features	n/a
Location comment 1	downtown, poor automobile access and exposure
Location comment 2	
Other comment 1	caters to business traffic
Other comment 2	insufficient parking - overflow in lot across street

Figure 3: Valuation Proforma Analysis - Example

Hotel _____	Type : <u>Full Service</u>				Stabilized Data	% of Total Revenue
Address _____	Class : <u>2</u>					
Assessment Roll # _____					Weighted Average	
Fiscal year	20__	20__	20__	20__		
Weight (for averaging)	30.00%	30.00%	40.00%	100.00%		
Days open	365	365	365	365		
Number of rooms	250	250	250	250		
Occupancy rate	63.10%	68.00%	73.00%	68.50%		
Average room rate (POR)	\$86.21	\$86.18	\$88.42	\$87.09		
Average room rate (PAR)	\$54.40	\$58.60	\$64.55	\$59.72		
Revenue						
Rooms	\$4,963,800	\$5,347,200	\$5,890,200	\$5,449,380	62.90%	
Food	\$1,784,100	\$1,856,500	\$2,060,000	\$1,916,180	22.10%	
Beverage	\$810,000	\$801,000	\$849,000	\$822,900	9.50%	
Telephone	\$198,700	\$202,600	\$219,000	\$207,990	2.40%	
Other departments	\$167,000	\$189,000	\$221,000	\$195,200	2.30%	
Rental income	\$48,000	\$51,000	\$55,000	\$51,700	0.60%	
Other	\$8,000	\$21,000	\$13,000	\$13,900	0.20%	
Total revenue	\$7,979,600	\$8,468,300	\$9,307,200	\$8,657,250	100.00%	
Departmental expense					% of Dept.	
Rooms	\$1,529,000	\$1,583,000	\$1,649,256	\$1,593,302	29.20%	
Food & beverage	\$1,998,300	\$2,089,700	\$2,194,290	\$2,104,116	76.80%	
Telephone	\$81,600	\$86,000	\$88,540	\$85,696	41.20%	
Other departments	\$152,100	\$159,900	\$187,850	\$168,740	86.40%	
Total departmental expense	\$3,761,000	\$3,918,600	\$4,119,936	\$3,951,854	45.60%	
Gross operating income	\$4,218,600	\$4,549,700	\$5,187,264	\$4,705,396	54.40%	
Undistributed operating expenses						
Administration & general	\$317,995	\$313,031	\$302,277	\$311,191	3.60%	
Management	\$334,345	\$355,669	\$372,288	\$354,947	4.10%	
Marketing	\$487,560	\$525,880	\$529,652	\$515,893	6.00%	
Property operation & maintenance	\$352,100	\$361,800	\$359,768	\$358,077	4.10%	
Heat light & power	\$329,000	\$330,100	\$322,000	\$326,530	3.80%	
Other	\$15,000	\$12,700	\$10,000	\$12,310	0.10%	
Franchise fees	\$287,000	\$295,000	\$300,000	\$294,600	3.40%	
Total undistributed operating expenses	\$2,123,000	\$2,194,180	\$2,195,985	\$2,173,548	25.10%	
Fixed expenses						
Insurance	\$26,500	\$26,300	\$26,900	\$26,600	0.30%	
Property taxes				\$0	0.00%	
Total fixed expense	\$26,500	\$26,300	\$26,900	\$26,600	0.30%	
Net income	\$2,069,100	\$2,329,220	\$2,964,379	\$2,505,248	28.90%	

Figure 4: Hotel Valuation Summary - Example

Hotel		Type :	Full Service	Assessment Roll #	
Address		Class :	2	FF &E upgrade	1992

	Stabilized Data Weighted Average	% of Total Revenue	
Fiscal year	20__		
Number of rooms	250		
Occupancy rate	68.5%		
Average rate (POR)	\$ 87.09		
Average rate (PAR) actual	\$ 59.72		
Average rate (PAR) applied	\$ 59.72		
Total revenue	\$8,657,250	100.0%	
Total departmental expense	\$3,951,854	45.60%	
Gross operating income	\$4,705,396	54.4%	
Undistributed operating expense	\$2,173,548	25.1%	
Total fixed expense	\$26,600	0.3%	
Net income	\$2,505,248	28.9%	
Less income to management	\$259,718	3.0%	% of Total Revenue
Less net income to FF & E	\$512,462	20.5%	% of Net income
Less income to intangibles	\$42,705	1.76%	% of Net income
Income to real estate	\$1,690,363	19.5%	% of Total Revenue
Capitalization rate			
Base Capitalization Rate	8.50%		
Effective Tax Rate	5.00%		
Final capitalization rate	13.50%		
Value sub-total	\$12,521,207		
Other	\$0		
Market Value Based Assessment	\$12,521,000		

6.0 Appendices

A. Uniform System of Accounts

The information found in most hotel financial statements is tabulated according to the *Uniform System of Accounts for Hotels*. This system is recommended by the American Hotel and Motel Association and is in general use throughout the Canadian hotel industry. The income and expense information found in this valuation guide conforms to these standards. Under this system, only direct operating expenses are charged to operating departments of the hotel. General overhead items such as administration, marketing and maintenance, which are applicable to the operations as a whole, are classified as undistributed operating expenses.

Revenue

Rooms
Food and Beverage
Other Operated Departments
Rentals and Other Income

Total Revenue

Departmental Expenses

Rooms
Food and Beverage
Other Operated Departments

Total Departmental Expenses

Total Departmental Income

Undistributed Operating Expenses

Administrative and General
Sales and Marketing
Property Operations and Maintenance
Utilities

Total Undistributed Expenses

Gross Operating Profit

Management Fees

Income before fixed charges

Fixed Charges

Rent
Property and Other Taxes
Insurance

Fixed Charges

Net Operating Income

Less: Replacement Reserves

Adjusted Net Operating Income

B. Request for Information Form Example

As part of the ongoing assessment process, the Assessment Department requires certain income and expense information pertaining to the property identified as:

Building name	
Address	
City	
Assessment Roll #	

Any information received will be treated in a confidential manner.

Failure to provide information has potential consequences.

Information Required

- * Income and expense statements including departmental breakdowns covering the past three years.
- * Financial statements indicating major expenditures on FF&E and building renovations over the past three years.

Information Format

Information can be submitted in either electronic format, paper format, or by filling in the enclosed forms.

Information can be submitted in the format used by the property owner but at a minimum the following information should be provided:

Minimum Information Requirement from Income and Expense Statement

- * Income totals (all forms of rent)
- * Other income
- * Occupancy rate
- * Average room rate per occupied room
- * Number of rooms in hotel or motel

Other Information Required

- * Date of last major building renovation
- * Date of last FF&E upgrade

C. Income and Expense Information – Request Form Example

THE INFORMATION REQUESTED ON THIS FORM CAN BE SENT IN YOUR OWN FORMAT (HARD COPY).
ALTERNATIVELY, THIS FORM IS TO BE FILLED OUT.

Name:
Address:

	20__	20__	20__
Days open			
Occupancy rate			

REVENUES

ROOM			
FOOD			
BEVERAGE			
TELEPHONE			
OTHER DEPARTMENTS			
RENTAL			
OTHER INCOME			
TOTAL REVENUE			

DEPARTMENTAL EXPENSES

ROOMS			
FOOD & BEVERAGE			
TELEPHONE			
OTHER DEPARTMENTS			
TOTAL DEPARTMENTAL EXPENSE			

OPERATING EXPENSES

ADMINISTRATION & GENERAL			
MARKETING			
OPERATION & MAINTENANCE			
HEAT, LIGHT, POWER			
OTHER EXPENSE			
FRANCHISE FEES			
TOTAL OPERATING EXPENSE			

FIXED CHARGES

INSURANCE			
PROPERTY TAXES			
TOTAL FIXED EXPENSE			

NET OPERATING INCOME			
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CAPITAL EXPENSES			
Expenditure on:			

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