Case Study: Hotels and "Business Enterprise Value"

Acknowledgement

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Executive Summary

There is an ongoing debate in the property valuation community about the applicability of business enterprise valuation methodology in real estate appraisal, particularly for property assessment and taxation purposes. The debate centers on the correct way to identify and extract business enterprise value from realty value for high-profile properties such as full-service upper-tier hotels, regional shopping centers, and care homes.

The application of various methods can lead to extreme and unpredictable reductions in assessed value estimates, ranging from 5-50%. When this level of uncertainty is applied to the assessment of a $100 million hotel with a corresponding risk to property taxes, local government politicians and assessors take notice.

The irony of this debate is that valuators may find themselves arguing for multiple values; a low or residual value with all forms of BEV extracted for property assessment and taxation purposes, and total assets of the business value for financing, portfolio management, or exposure of property to the marketplace.

This case provides a synopsis of the key arguments advanced by proponents of various BEV approaches applied to real estate appraisal, including strengths and weaknesses, and the developing body of related assessment case law.

Introduction

The goal of this case is to illustrate the application of business valuation methodology in the valuation of a hotel property for assessment purposes. The case involves an appeal of a fictitious property in the City of Victoria. Assessment practices described in this case are not intended to reflect contemporary practices of a specific assessment jurisdiction but are intended provide students with a broad range of approaches which have been advanced by all parties in recent years in various jurisdictions in Canada.

Different approaches to business value theory and practice taken by property owners, assessors, and the courts will be summarized in the case as the parties attempt to determine:

- whether there are components of the hotel Business Enterprise Value (BEV) or Going Concern Value which must be identified and excluded from the assessed value; and
- the appropriate approach for measuring the non-assessable BEV.

Non-realty value is the term used in this case study to refer to all sources of non-assessable BEV.
To tackle this issue, it is necessary to understand the legislation and related case law which provides direction on the valuation of real estate for assessment purposes, as well the various methodologies which been developed in the valuation community for dealing with non-realty value.

**Assessment Legislation and Case Law**

In British Columbia, section 19(4) of the *Assessment Act, R.S.B.C. 1996, c.20*, states that the assessment roll must include the Actual value\(^1\) or Market value of the land and improvements of a going concern. The courts have interpreted this section of the Act to mean the assessed value of the property:

- excludes the value of equipment, furnishing, fixtures, and other personal property not fixed to the land;
- includes all interests in land (e.g. both the landlord and tenant)\(^2\); and
- must be determined as if the property is occupied and operated at economic or typical market levels.\(^3\)

The above principles are generally embodied in assessment legislation and case-law in other jurisdictions in Canada and the USA, where market value assessments are undertaken.

In recent years a small number of high profile assessment appeals have been filed in B.C., Ontario, and Alberta, contesting the inclusion of non-realty value in the assessed value. Appellants have attempted to prove that for certain types of real estate, such as hotels and care homes, there are assets which contribute to the value of the business rather than the value of the land and improvements or the real estate package.

The methodologies used to identify and quantify non-realty value generally fall into the three categories:

- The Rushmore Approach
- Residual or Segregated Value Approach
- Non-Realty Decision Tree

There is a fourth category of valuation academics who believe that any attempt to measure business value as a separate component of the total business enterprise value cannot be supported by economic theory or market practice. These proponents believe that any excess value becomes “wedded” to the land.\(^4\) However, for the sake of this case study, it will be assumed that non-realty value exists and can be quantified under certain circumstances.

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\(^1\) The term Actual value in the *Assessment Act* has been interpreted by courts as equivalent to Market value.


\(^3\) *West Coast Transmission v. Assessor of Area 09* (1987), Stated Case 235.

Rushmore Approach

Stephen Rushmore, an internationally recognized hotel valuation expert, argues that a deduction for management and franchise (hotel flag) fees will account for any intangible non-realty or business value. The premise is that any income attributable to the business has been taken by the managing agent in the form of a management fee. The same principle applies to the franchise or chain affiliation.

The other feature of this approach is the use of a weighted cost of capital (Band of Investment Method) in the income capitalization approach.

Assessment practice normally requires the exclusion from assessed value of hotel tangible personal property such as furniture, fixtures, and equipment (FF&E). These capital items tend to have a short effective life (6-12 years) and are normally replaced on an on-going basis.

Rushmore believes it is necessary to account for the return on and the return of FF&E assets. In this method, the capital expenditure representing the return of FF&E is annualized as an expense on the re-constructed statement of hotel income and expenses. The return on FF&E is required since it represents a return on the original investment in hotel FF&E. The return is determined by first estimating the depreciated value of the FF&E in place and then using a Capital Assets Pricing Model (CAPM, adjusted risk-free rate plus risk on asset class) to develop a percentage rate of return. The rate of return will be built-up from a base rate reflect commercial mortgage rates with an additional amount for risk associated with short-lived assets.

The combination of the annual return of FF&E and the return on FF&E are then summed and deducted from the stabilized net operating income.

Residual Approach

In recent years, some members of the academic and appraisal community have advocated use of business valuation methodology to identify and quantify BEV. This approach is based on an examination of each tangible and intangible component of value contributing to the total value of the business to identify the residual value remaining to the real estate.

The essential elements of this approach are as follows:

- Business Enterprise Value exists and can be quantified for all going-concern or operating properties.
- An investment approach, rather than an empirical approach, is necessary since hotels are very unique and insufficient comparable market information is available.

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6 Rushmore, Stephen, and Eric Baum, Hotel and Motels: Valuations and Market Studies, Appraisal Institute, Chicago, p.361.
Each source of income for the property will have associated business income which must be identified and eliminated from the valuation. The total of all sources of “non-realty” income (tangible and intangible) may be capitalized at a business capitalization rate to provide an estimate of BEV. The difference between the total business value or value of the going-concern and the sum of all non-realty value components represents the residual value of real estate.

This approach, similar to conventional real estate appraisal, relies on capitalization of earnings before interests and taxes or direct capitalization. Consistent with business value theory, the capitalization rate is developed through a CAPM approach rather than analysis of hotel property sales.

This methodology can be summarized as follows:

Going Concern Value of the Hotel
Less:
   Value of Tangible Personal Assets (e.g. FF&E)
   Value of Intangible Assets
Equals Residual value of land and improvements

In their 2001 Appraisal Journal paper, proponents of this method, Kinnard, Worzola, and Swango\(^8\) provide examples of specific intangible non-realty components of value for a hotel property, including:

- start-up costs including a trained and mobilized work force
- working capital
- property reputation or brand (e.g. affiliation with a known hotel chain)
- licences (e.g., liquor licence) and permits
- business activities not related to rental of real estate (e.g. room rental) such as food & beverage sales, telephone income, laundry and concierge services, fitness club sales
- entrepreneurial goodwill

Non-Realty Decision Tree

The assessment community has responded to the evolving debate on identification and quantification of non-realty value by adopting some aspects of the Rushmore approach, and in the case of BC Assessment, developing a unique decision methodology.

This methodology tackles the issue of BEV by posing a sequence of questions about the nature of the income stream for the going-concern. In marked contrast to the Residual Method, there is no presumption that the going concern will always contain components of BEV. The decision process is outlined in the following steps:

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1. The starting point is the assumption that the property is to be valued for assessment purposes as a going concern\(^9\) and is operated at typical or economic levels.

2. First determine if the highest and best use of the property is limited rental of land and improvements. If so, no further investigation is required. However, in the case properties such as a hotel, there are generally additional income sources and further investigation is required.

3. Identify and analyze the non-realty components of value. Are they measurable? Are they inextricably linked to the real estate?

4. If the non-realty components can be measured and are not inextricably linked to the real estate they should be quantified and excluded from the assessed value.

**Real Estate Valuation Standards**

Both the Appraisal Institute (USA) and the Appraisal Institute of Canada recognize the existence of personal intangible value for certain properties associated with assets such as contracts, branding, entrepreneurial skill, etc. In common with all approaches, both valuation associations support the notion that personal intangible value can be identified for some properties, such as hotels, care homes, and retail properties, apart from the total assets of the business. This residual intangible value has been labeled Business Enterprise Value or BEV.

However, neither valuation association has accepted a preferred methodology for identifying and quantifying BEV. In fact, given the controversy over application of business value methods to real estate valuation, the Appraisal Institute withdrew Course 800\(^10\) from its educational curriculum in 2004.

**Background – Hotel Case Study**

A hotel property has been selected for this case study since it provides examples of many of the potential non-realty value arguments which have arisen in assessment appeals.

Hospitality and accommodation related real estate, such as golf courses, care homes, hotels, and resorts are unique in relation to conventional commercial real estate (e.g. office and retail properties) since income is generated from multiple sources in addition to rental or use of real estate. Other unique qualities include the relatively significant amount of personal property associated with hotel properties, as well as specialized management skill required to generate annual cash-flow.

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Hotel terminology used in this case study includes:

- **REVPAR or Revenue Per Available Room** – a measure of annual hotel room rental is commonly used to track a hotel's performance and for consistent comparisons with competing properties. Hotel REVPAR represents the hotel effective gross income or gross income after deduction for vacancy and collection loss.

- **Flag** – a hotel franchise or brand associated with specific hotels or hotel management companies. Hotel flags are generally acquired to improve occupancy, maintain or improve a hotel’s standings, or to target a specific sub-market (e.g., vacation or convention trade). Well known and established hotel flags include Hilton, Marriott, Holiday Inn, and Best Western. Franchise fees are generally based on fixed contract fees with escalation clauses based on hotel performance and will have minimum requirements for hotel operations which must be met.

- **Management Contract** – a contract in which a specialized lodging company operates a hotel on behalf of the owner for a specific fee based on percentage of gross revenue. Hotels are complex real estate enterprises and hotel management contracts are seen as a way to reduce the risk of operations.

### Case Details – Hotel Assessment Appeal

The owners of the Happiness Hotel in Victoria have filed an assessment appeal after an unsuccessful attempt to resolve non-realty issues with the local Assessor prior to the completion of the 2006 assessment roll. While the owners have accepted that the assessment may represent the total assets of the business, further deductions are required for various forms of non-realty value.

The Happiness Hotel is a smaller mid-range or 2-star full-service motor hotel with 90 guest rooms located on the eastern downtown fringe of Victoria. The 4-story wood frame hotel is similar in design to competing properties. The hotel is associated with the Dusty Trail flag and relies on the related central reservation system for a portion of bookings.

The parties to the appeal have agreed on the following:

**Table 1: Summary of Agreed Facts**

<table>
<thead>
<tr>
<th>Item</th>
<th>Specification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highest &amp; Best Use</td>
<td>Motor Hotel Property – no excess land present</td>
</tr>
<tr>
<td>Guest Rooms</td>
<td>90</td>
</tr>
<tr>
<td>Replacement Cost of Hotel FF&amp;E</td>
<td>$12,000 per room (for entire hotel)</td>
</tr>
<tr>
<td></td>
<td>no agreement on FF&amp;E economic life</td>
</tr>
<tr>
<td></td>
<td>• Assessor 11 years</td>
</tr>
<tr>
<td></td>
<td>• Appellant 8 years</td>
</tr>
<tr>
<td>Hotel Management fees</td>
<td>5% of gross revenue</td>
</tr>
<tr>
<td>Hotel Franchise fees</td>
<td>8% of room rental</td>
</tr>
<tr>
<td>Meeting/Banquet area</td>
<td>3,000 ft²</td>
</tr>
<tr>
<td>Food &amp; Beverage area</td>
<td>8,000 ft²</td>
</tr>
</tbody>
</table>
The hotel owners have engaged a team of consultants (collectively referred to as the appellants) to argue that the assessment includes non-realty value associated with the following issues:

Net Operating Income
- The treatment of the Hotel Management Contract for “return on” and “return of” the investment;
- Business income from food and beverage sales, and telephone revenue was improperly included in gross income;

Valuation Method
- The Income Capitalization approach did not account for return of non-realty (e.g. Empirical-Market vs. CAPM approach).

Deductions for Personal Property and Other Intangibles
- The deduction for FF&E was insufficient to account for “return on” and “return of” the investment.
- No deduction was made for hotel intangible assets including start-up costs, hotel brand (flag), and goodwill.

The perspective of each party on the specific issues is discussed in the following synopsis of the appeal.

Hotel Management Contract and Chain Affiliation

The Assessor, following the multi-step Non-Realty Decision process, has concluded that the value associated with the management contract and flag cannot be separated and both expenses are required to account for a hotel going-concern. Consistent with Rushmore, it is concluded that non-realty value, if any exists, is accounted for in the following deductions:

Management Fee 5% of Gross Revenue
Franchise Fee 8% of Room Revenue

The appellants agreed with a management and franchise fee deduction as expense items but argued that these contracts represent business income to a 3rd party, the hotel manager, and do not represent a return on or return of the owner’s assets. Therefore, additional deductions are required to account for return on and return of other business related capital expenditures.

The Board accepted the evidence of both parties for the need to deduct stabilized expenses for the hotel management and chain affiliation (franchise) contracts. The appellant’s arguments about the need for further deductions are addressed in the following discussion on additional components of value.

Business Income – Food and Beverage (F&B)/ Telephone
The food, beverage (lounge-pub), and meeting room areas are leased at $13/ft\(^2\) to a food services tenant. The F&B lease includes use of the restaurant equipment.

Applying the Non-Realty Decision methodology, the Assessor has determined that:

- the space rented for F&B sales has been leased at market rates;
- the retail rents are fully net to the landlord (tenants pay all apportioned charges for maintenance, hydro, repairs, taxes, etc);
- the rents represent real estate, rather than business income;
- the telephone income is roughly offset by similar expenses and any residual income is negligible.

The Assessor acknowledges that a non-realty deduction is required for the portion of the F&B lease covering the use of equipment. A review of restaurant leases indicates that a rent of $2/ft\(^2\) can be attributed to restaurant equipment (non-assessable). The adjusted rent is calculated as follows:

<table>
<thead>
<tr>
<th>Area ft(^2)</th>
<th>Rate $/ft(^2)</th>
<th>Total Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>total f&amp;b income</td>
<td>11,000</td>
<td>13.00</td>
</tr>
<tr>
<td>less f&amp;e component</td>
<td>11,000</td>
<td>2.00</td>
</tr>
<tr>
<td>total adjusted income</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The appellants have argued that a considerable portion of the F&B rent was non-realty since:

- they were required under the terms of the franchise agreement to operate the restaurant at extended hours in relation to non-hotel restaurant competitors; and
- the asset associated with sale of food and beverages was a “transferable” asset owned by the restaurant operator, not the hotel owner, and hence was not tied to the real estate.\(^\text{11}\)

The owner’s team argued that the entire or unadjusted F&B rent of $143,000 should be excluded from the net operating income (NOI). It was agreed that since the income associated with the telephone was more or less equivalent to the expense, the net impact on the NOI was nil.

The Board relied on B.C. case law, specifically Standard Life,\(^\text{12}\) to conclude that all interests in real estate must be included in the assessment. The Board accepted the Assessor’s evidence that the F&B rent reflected market rents for similar restaurant operations (after adjusting for rent of chattels). Since the landlord’s interest is reflected in rent, it is appropriate to include the rent in the determination of net operating income. While the restaurant business may be transferable to a 3\(^{rd}\) party, the actual F&B premises were part of the hotel real estate and therefore, would transfer with the real estate.

**Valuation Method**

\(^{11}\) University of B.C. Real Estate Division, Course 452: Lesson 7: Business Enterprise Valuation Part I, p.10.

\(^{12}\) *Standard Life*, supra.
The appellants proposed a business valuation method using CAPM theory to “build-up” an overall capitalization rate through the BEV Investment Approach. Consistent with the approach advocated by Kinnard\textsuperscript{13}, the appellants relied on sources such as The American Council of Life Insurance, the Korpacz Real Estate Investor Survey and the RERC Real Estate Report for data. It was argued that hotels are unique business enterprises and the Empirical approach was unreliable since there are few, if any, reliable hotel sales for this type of property. Secondly, it was argued that this method reflects the private sector approach of measuring investment alternatives based on returns in relation to equity and other markets, adjusted for risk.

The formula\textsuperscript{14} used to determine the capitalization rate using CAPM approach is as follows:

\[ K_e = R_f + \beta (R_p) \]

- \( R_f \) is the risk free rate for similar investments
- \( \beta \) is the beta coefficient which relates a specific industry’s risk to the average market risk
- \( R_p \) is the equity risk premium which reflects market expectations of return on investment, less the risk-free return

\[ K_e = 5\% + 1.25(7\%) = 13.75\% \]

The Assessor argued that the CAPM approach did not reflect market behaviour and the assumptions required to establish the risk component of the capitalization rate could not be substantiated. The Assessor, using an Empirical or Market approach, submitted an analysis of hotel sales over the past few years which indicated, after the NOI stabilization process, an overall capitalization rate of 11%.

The Board reviewed relevant case-law from Canada and US jurisdictions and found no impediment to use of either method for determining the capitalization rate. Since the market evidence was very dated and subject to considerable adjustment, the Board preferred the Investment or CAPM approach. The Board relied on Fairmont Hotels vs. Area 01 (PAAB 2005) to support this decision.

**Deduction for FF&E**

Both parties accepted the business value theory of return on and return of the investment. The Assessor argued that the value of FF&E should be treated as a capital deduction rather than an expense, since there is evidence of the depreciated value of personal property recorded in hotel transactions. It was argued that this amount reflects the return of capital to the investor at the end of the investment cycle. The Assessor determined that amount required to reflect the return on investment, by first applying an investment rate to depreciated value of FF&E to determine the annual return of value and then capitalizing this amount to determine the overall amount.

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\textsuperscript{13} Kinnard, supra.
Return of capital invested
- FF&E Replacement Cost New is $12,000 per room or total of $1,080,000 for the hotel
- assume on average, at any one time, the FF&E in the hotel is 50% depreciated or at its mid-life.

Return of FF&E = ($1,080,000)(50%) or $540,000

Return on capital invested
- assume a safe re-investment rate of 6%
- assume a chattel capitalization rate of 16%

Return on capital invested in FF&E = ($540,000)(6%)/16% = $32,400/.16 = $202,500

Total value of FF&E deducted = Return of FF&E + Return on FF&E
= $540,000 + $202,500 = $742,500

The Assessor argued that a further deduction for the annual replacement of FF&E in Income Statement (reserves for replacement) would be double accounting.

The appellants argued that the following components were required to properly account for personal property:

Reserves for replacement of FF&E (i.e., capital is treated as an expense item)
- 8 year replacement cycle with consistent amount of 12.5% replaced per year
- $12,000 per room or total of $1,080,000 for hotel

Annual Replacement = $1,080,000 x 12.5% or $135,000

Return on capital invested (treated as expense item)
- assume chattel mortgage rates of 14% (reflects higher risk for short-lived items)

Total Income attributable to FF&E = $1,080,000 x 14% = $151,200

Return of invested capital (treated as bottom line deduction)
- it is assumed that the investor would obtain 100% return of capital at the end of the investment in the hotel or $1,080,000.

The appellants argued that it was necessary to account for FF&E reserves for replacement in addition to return on invested capital since:

- hotel industry practice is to treat annual capital expenditures on FF&E as reserves (e.g. as expense item) in the valuation of the going-concern
- business valuation theory requires valuators to separate out the income related to the real estate alone – this means deductions for return of and return on FF&E,
- it is necessary to account for the owner’s recovery of invested capital to meet the 
  Assessment Act requirement to exclude chattels.

The Board relied on the recent BC Supreme Court case British Columbia Assessor Area 
01 v. Fairmont Hotels (BCSC 468) in analyzing the evidence. The Board agreed with 
both parties that regular replacement of FF&E is necessary to maintain a hotel as a 
going concern but preferred the evidence of the appellants that it is common practice to 
allow for a specific reserve for replacement of FF&E, in addition to other short-lived 
components of the real estate. This approach is required to value the hotel as a going- 
concern, as required by section 19(4) of the Assessment Act. The Board concluded that 
the reserve for replacements did not remove income associated with the FF&E in place 
and separate deductions were required.

The Board was faced with two very different approaches to removal of FF&E from the 
Total Assets of the Business. Another methodology, advocated in the Rushmore 
Approach, was not considered by either party. In the Rushmore approach, the income 
associated with the return of FF&E is judged to be accounted for in the reserves for 
replacement allowance, while the income associated with the return of FF&E is 
converted to an expense at a rate of return taken or derived from the market for chattel 
mortgages.

The Board, relying on Fairmont (BCSC 468) accepted the Assessor’s approach for 
determining return on and return of FF&E. The Board concluded that while the investor 
may seek 100% return of capital, the value of FF&E in place would be determined by the 
market and the assumptions about depreciated value were reasonable.

Hotel Intangible Assets

The Assessor argued further deductions for a trained work-force in place, hotel goodwill 
(brand), and working capital were unnecessary. It was argued that a trained work-force 
and working capital were required to operate the hotel as a going-concern under section 
19(4) and therefore were considered inseparable from the real estate assets.

To review the issue of hotel performance, the Assessor stabilized the income from hotel 
operations over a 3 year period, as follows:

Table 2: Happiness Hotel Operating Performance

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2004</th>
<th>Stabilized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occupancy</td>
<td>62%</td>
<td>65%</td>
<td>75%</td>
<td>72%</td>
</tr>
<tr>
<td>ADR16</td>
<td>$110</td>
<td>$105</td>
<td>$112</td>
<td>$110</td>
</tr>
<tr>
<td>REVPAR17</td>
<td>$68</td>
<td>$68</td>
<td>$84</td>
<td>$79</td>
</tr>
</tbody>
</table>

15 The owner refused to provide the Assessor with income and expense information for the year ending 2003 
citing accounting irregularities associated with adopting a new system. Assessors commonly deal with gaps 
in available property information, particularly financial records.
16 Average Daily Rate – the average rate achieved by room rental over the course of the year – includes 
discounted or promotional rooms sold. Determination of ADR is necessary to determine REVPAR.
17 REVPAR is analogous to Gross Effective Income or Gross Income after deductions for vacancy and 
collection loss.
The stabilized REVPAR for the hotel represents a 15% premium over similar competing hotels in the Victoria core area. All competing hotels have “flags” with similar prestige and have typical levels of hotel management.

Using the Non-Realty Value Decision Tree, the Assessor concluded that the superior performance cannot be allocated to specific tangible assets or intangible assets such as entrepreneurial ability or goodwill. It is likely that the superior performance is due to location and hence the tangible real estate. The Assessor concluded that any intangible values are intrinsically linked to the tangible assets and therefore, no deduction for goodwill (non-realty) was made. The Assessor noted that hotel consultants and franchisors prepared reports for franchisees on occupancy levels and benefits of central reservation systems among flagged hotels. However, these reports only provided evidence of the general performance of one brand vs. another and could not be applied to site-specific scenarios.

The Assessor also argued, citing the Rushmore approach, that if any non-realty value did exist it was accounted for in the deduction for management and hotel franchise fees.

The appellants argued that it was possible, using business valuation techniques, to identify the value of intangible assets, including start-up costs\(^{18}\), working capital, and hotel goodwill, and that these assets should be excluded from the assessment. The following calculations were submitted:

- Trained work-force-marketing $90,000
- Franchise fee (initial cost of franchise) $30,000
- Other business losses (including cost of working capital) $100,000
- Total business start-up capital $220,000

\[ \text{Income attributable to start-up} = (220,000) \times 11.5\% = 25,300 \]

It was argued that this amount should be deducted from the NOI for start-up costs.

The appellants argued that the property has consistently ranked above average in relation to competitors in the Victoria downtown market in terms of REVPAR (revenue per available room) achieved and is close to amenities such as the shopping district, tourism attractions, restaurants and the Victoria Convention center. The owner believes that the superior hotel performance is directly linked to the Dusty Trails flag or brand name and other licencing arrangements, and the difference in REVPAR between the hotel and its competitors represents goodwill. It was also argued that according to business valuation theory, intangible assets, such as goodwill, have value and can be measured if transferable. In this case, the hotel flag contract is linked to the property and owner, and can be assigned with the consent of the franchisor.

\(^{18}\) The main start-up cost for the hotel was provision of a trained workforce and marketing. Other business losses include costs of permits, licences, inspections, bank interest, working capital.

\(^{19}\) Reflects return on the use of capital of 9% and 2.5% recapture of capital)
Deduction for Brand related goodwill

- assume 15% superior performance relative to competitive set (competing hotels offering similar amenities in the downtown Victoria area)
- assume that 50% of the difference in performance is related to tangibles (e.g. location of real estate) and 50% is related to intangibles such as goodwill, licences and permits.
- NOI after adjustments for FF&E reserves, Start-up, etc. = $550,000

Net income differential = $550,000-[(($550,000)(.925))= $41,250.
- overall capitalization rate (investment method) 13.54%

\[
\text{Capitalized value of goodwill}^{20} = $305,555
\]

The Board reviewed case law from the United States and Canada to determine if a consistent approach had evolved in the treatment of intangible assets. For example, in a 1991 decision involving a shopping mall, the Wisconsin Court of Appeals concluded that it was not possible to separate the income from the rental of real estate from the mall’s other sources of business income. Subsequent decisions in Minnesota and Iowa reinforced the notion that business enterprise valuation is not a recognized real estate appraisal method. However, in Canada, the Ontario Assessment Review Board did accept the notion that deductions from the total value of a care home going-concern should be made for intangible assets.\(^{21}\) In a similar case involving the Jasper Park Lodge, the Alberta Municipal Government Board allowed a deduction on the basis of equity, although it was not convinced that the business value methodology was sound.

Based on the evidence presented, the Board concluded that the intangible values associated with start-up costs were inseparable from the real estate and were required to achieve a hotel going concern. Therefore, no deduction for start-up costs was allowed.

In terms of goodwill, the Board did not accept the appellant’s argument that the premium in value associated in superior hotel performance could be separated into factors for real estate and non-assessable goodwill. The evidence presented on the allocation of value to tangible and intangible assets was not supported by market analysis and was considered highly theoretical. The Board also relied on a very recent case, \textit{Delaware North v. Areas 15 & 16} (PAAB 2005) to conclude that intangible value associated with licences, such as health, liquor and other permits which are appended to the property, are transfereable with the property, and are inextricably linked to the realty.

However, the Board did note that in the case of Fairmont v. Area Assessor-01 (PAAB 2005), the Assessor had argued that it was possible to account for goodwill through methodology similar to the appellants. The differences in the parties’ approaches in the Fairmont case was the selection of the competitive set and the decision by both parties on allocation of the premium in REVPAR between tangible (real estate) and intangible (goodwill) factors. The Board stated that the difficulty with this approach to goodwill is

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\(^{20}\) The business value approach to quantifying goodwill or “blue sky” is less complex and generally relies on use of industry specific earnings multipliers.

the number of assumptions required and the lack of empirical information to support the assumptions.

The Board concluded that it is not bound by previous decisions of the Board and reserved the right to hear evidence on the issue of goodwill in future appeals.

Conclusion

This case study illustrates the very different outcomes possible using empirical and investment approaches to BEV identification and quantification.

In the few available decisions on treatment of BEV, the courts (including assessment tribunals) seem to be prepared to accept parts of competing approaches based on the facts of each case and weight of evidence provided, rather than accept 100% of any party’s methodology.

The most recent decisions in Canada (B.C.) have continued to confirm the acceptance of BEV methodology for real estate valuation in very limited circumstances, including:

- use of CAPM theory to develop overall capitalization rates for thinly traded properties such as higher tier full-service hotels;
- Identification and quantification of the value of personal tangible assets (mainly FF&E); and

Conversely, the courts have also recognized the argument that the value associated with intangible assets is often intertwined with the real estate going concern, and cannot be separately measured or extracted.

It is apparent that the courts are prepared to hear arguments for an expanded use of BEV theory to account for intangible assets such as goodwill in property assessments. However, until advocates of all approaches can support their assumptions and calculations with empirical or market information, the courts are likely to take a conservative approach to BEV and discount the broad applicability of any specific methodology.

All parties can expect more assessment appeals and controversy on BEV issues as the methodology continues to evolve in the court system.