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SEPTEMBER 2020

PROPERTY TAXES POST COVID-19

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Following waves of asset of appreciation, the pendulum has swung, and many hotels will be facing significant value declines in the current economic climate. As owners look for every way to reduce operating expenses, they should remain vigilant to pending fluctuations in real property assessment levels and proactive on appealing their assessments, if warranted.

After realizing record-high RevPAR levels with over 100 consecutive months of growth, the lodging industry continued to strengthen through 2019, albeit at a significantly more tempered rate. Then, in the first quarter of 2020, COVID-19 struck. The unimaginable pandemic erased years of RevPAR gains virtually overnight, leaving owners and operators scrambling to strategize the forthcoming steps. While logistics pertaining to reopening hotels, new sanitation standards, and controlling variable operational expenses are on the forefront of hoteliers' minds, fixed expenses, particularly an asset's property tax burden, are also key factors that hotel owners should keep on the horizon. With eroded net operating incomes (NOIs) and, ultimately, declining values, hotel property assessments should fall somewhat proportionally.

The Challenges with Hotel Tax Assessments

When valuing commercial assets, the income capitalization approach is most often the preferred and appropriate valuation method for both appraisers and property tax assessors alike. At the crux of this methodology, a property's market value is estimated by the asset's ability to generate cash flow. Although straightforward in theory, real-world application of this approach is subject to numerous property-specific intricacies and nuances that require expert analysis. In addition to analyzing a subject hotel's numerous daily guestroom leases and, oftentimes, myriad additional revenue-generating departments (e.g., restaurants, spas, health clubs, valet operations, etc.), a specialized hotel appraiser must peel through the various layers of non-realty components, such as franchise and management contracts, personal property, business value, and goodwill, in order to arrive at a market value opinion that is reflective of only the tangible real estate. Assessors often utilize generalized general commercial real estate knowledge and valuation techniques; moreover, they are neither well versed in the intricacies of hotel valuation nor do they have the data and tools necessary to generate a well-substantiated assessment. Accordingly, property assessments may be inflated and incorrectly include non-realty, intangible components. Ultimately, however, a hotel's property tax burden should be based on its land and physical improvements/buildings, and nothing else; thus, it is critical that the appropriate income capitalization methodology be employed.

The Rushmore Approach

As noted earlier, it is essential that appraisers and assessors utilize the appropriate valuation methodology when valuing hotel real estate in order to isolate any intangible components. When hotels are appraised, typical operating expenses include a management fee, as well as franchise fees if the property is branded. These expenses are deducted in all hotel appraisals, whether they are being prepared for mortgage loan purposes, estate taxes, or an assessment appeal. Making these expense reductions in the context of an appraisal for assessment purposes has come to be called The Rushmore Approach, based on HVS founder Steve Rushmore's use and presentation of this methodology in property tax appeal cases. This methodology reflects the thinking of hotel investors that make up the universe of potential buyers and sellers, and can be applied universally for all purposes and users; application of the Rushmore Approach is consistent and thus highly defensible. The following summarizes how the income to the real property is defined for valuation purposes in this realty-based methodology:

Net Income to Real Property Excludes:

1. **<u>Income Attributable to Intangible Business Component</u>**
   - Franchise Fee
   - Management Fee
   - Adjustment for Residual Intangibles

2. **<u>Income Attributable to Personal Property Component</u>**
   - Reserve for Replacement
   - Value of FF&E in Place *or* Return on Personal Property

In many cases, the income attributable to the intangible business component does not have to be removed, as it is not present; franchise and management fees are paid to hotel branding and management companies as operating expenses, and the remaining EBITDA reflects the income attributable to the real and personal property only.

However, an adjustment to a hotel's financial performance may be necessary if the property is benefiting from some intangible factor that does not reflect typical property and market conditions; this would be considered an adjustment for residual intangibles. An example of such an adjustment is if there were evidence of super-competent management, in which instance a hotel's expenses are registering at levels far below typical benchmarks, and/or revenues are substantially higher than those of its competitors, with the premium not being attributable to location, condition, facility offering, etc. Conversely, it may be necessary for the inverse, adjusting expenses down and revenues up, if the asset is significantly underperforming. Examples of other potential intangible factors can include income ascribed to leases in excess of market rent (above-market rent), as well as branded/themed products or services that can command extraordinary profit premiums.

This methodology appropriately accounts for the isolation of the necessary intangible components. While opponents of the Rushmore Approach generally employ a theoretical methodology that inappropriately accounts for excessive deductions for intangible components, this practice is biased in favor of the hotel owner's position and has no basis in the universe of actual hotel investments. Although a hotel owner would be elated over a low value for a property tax reduction, the double-edged appraisal also functions as a major disservice for the hotel owner, specifically when it comes to the refinancing or exiting (i.e., selling) stage of the investment's life cycle. Thus, the Rushmore Approach remains the gold standard in hotel valuation, replicating real-world transactional underwriting and due diligence.

It Can Always be an Appealing Time for Reassessment

Although it is most evident during a downturn, there are numerous instances when appealing for a decrease in a hotel's assessment is warranted. The following are example scenarios that hotel owners should be cognizant of when it comes to a hotel's assessment.

- **Decreased Revenues:** In today's current economic environment, virtually all hotels are expected to realize significant decreases in overall revenue relative to 2019 levels. Most notably, full-service assets have experienced the greatest impact given the loss of meeting/group business and commercial corporate-traveler demand, resulting in significant RevPAR reductions. These hotels also offer food and beverage (F&B) outlets, meeting space/event offerings, and other additional profit centers (e.g., spas, health clubs, retail components, etc.) that are either non-operational or no longer profitable. The values/assessments of these hotels should drop significantly in tandem with revenue and profit declines.

- **Required Capital Improvements:** Hotels are capital-intensive properties that necessitate reinvestment; this particularly resonates for franchised properties. Brands require cyclical property improvement plans (PIPs) that may not necessarily be apparent to an assessor. Although a hotel may appear to be in good condition, a significant capital outlay may be on the horizon in order for the current owner (or a new owner) to maintain the flag and/or its current cash flows. Such a capital expenditure should be appropriately reflected in the hotel's market value on a dollar-for-dollar basis.

- **Overimproved Assets:** Logic would seem to suggest that a hotel built of expensive, high-quality construction materials and designed with similar furnishings and finishes should be worth more than a property of inferior overall caliber next door. In the valuation sphere, this is not always the case. With respect to hotel real estate, valuation is largely dependent on what the market can support. A five-diamond, full-service resort hotel may be overimproved relative to the average rate and profitability it can obtain, and thus its market value may be significantly lower than replacement cost.

- **Disproportionate Decrease in NOI to Assessed Value:** If a hotel's NOI increases/decreases, the valuation of the asset should in theory change somewhat proportionately (after removal of personal property value), all other factors being equal. However, if a hotel's assessment level changes by an illogically disproportionate amount (e.g., NOI increases by 10% and the assessment increases by +20%), some unknown factor could potentially be amiss.

- **After the Sale of an Asset**: Several assessing jurisdictions will reassess a hotel upon its sale. In doing so, the assessor might rely on the sale of other comparable hotels as a means of forming the basis for the new assessment level. The concern that lies within this approach is that there may be inconsistencies by which values of the comparable sales are allocated and reported and recorded within the deed records. A hotel, for example, may have been sold as part of a 20-hotel portfolio transaction in which the same value was assigned to each of the 20 hotels. Or the purchase price might reflect tax considerations and not be a realistic allocation. If this sales price is reflected in the deed, the assessor might assess the hotel at a level that is in line with this recorded price; however, unbeknownst to the assessor, this price would not necessarily reflect the market value of an individual hotel transaction.

- **Potential Intangible Components:** As noted earlier, there can be a variety of factors that can result in the creation of intangible value. Common examples of such potential factors that can be attributable to intangible value include super competent management, above-market rent, and themed/branded products or services that can generate extraordinary revenue premiums. Identifying and appropriately handling these intangible components are critical to hotel valuations, as these are non-taxable, non-realty items that should not be accounted for with respect to property tax assessments.

Preliminary Steps Before Proceeding with an Appeal

If you feel that your property tax assessment could potentially be a candidate for a reduction, the following steps outline how you should proceed.

1.) Understand your tax bill and familiarize yourself with appeal deadlines
If your hotel's assessment increased, check to determine if it may have been a function of a change in your municipality's equalization ratio. Some jurisdictions, for instance, use an assessment ratio equivalent to a percentage of fair market value. A municipality that utilizes an assessment ratio of 75%, for example, would reflect an assessment of $7.5 million for a hotel that has a market value of $10 million; this ratio may or may not change annually and be anywhere below market value, at exactly 100% market value, or even above market value (over 100%). Additionally, although it is common for taxing jurisdictions to reevaluate assessments on an annual basis, the depth of analysis in their "appraisal" process can often be rather cursory. Make note of the deadline(s) to appeal taxes to allow for ample time to prepare any necessary paperwork and documentation as needed; in certain municipalities, it is possible to contest prior years' taxes, as well.

2.) Do some quick research
If you conclude that your assessment appears to have unreasonably increased, do a little digging to determine the assessments of comparable hotels in the same taxing jurisdiction. Although this is a very basic approach, this can serve as an initial litmus test, can oftentimes be very effective, and is easy to accomplish (typically by accessing the local assessor's online assessment database or making a call to the assessor's office). Gather the results and put them into a spreadsheet for easy reference, noting any property-specific information you feel might provide additional context (e.g., date of construction, recent renovations, facility offering, etc.).

3.) State your case
Reach out to your local assessing office to inquire about your hotel's assessment and to gain an understanding of the context behind the increase; this can oftentimes be done over the phone. Respectfully present the comparable data you collected as talking points with the assessor. If the assessor seems steadfast on your hotel's assessment, you can request that a formal review be completed by the local board. Make note of the deadlines, paperwork, and supporting documentation that might be requested for the review.

4.) Appeal the decision
After you receive the decision from your local taxing board, you could either be rejoicing over a successful assessment reduction or refueling for another round of rebuttal. If you are in the latter position, it would be prudent to start reaching out to an appraiser, tax consultant, and/or attorney that specializes in the realm of property taxes appeals specifically pertaining to hotel real estate. Having initial conversations with these experts to discuss your case can ultimately help you determine if the appeal process is worth pursuing in terms of time, money, and risk.

5.) Commission a property tax appraisal
In almost all appeal cases, an appraisal will be at the crux of the litigation, providing an unbiased third-party's opinion of market value. It is of utmost importance that the correct expert be retained at this point to furnish a well-supported valuation methodology that is easy for courts to comprehend and is universally accepted and respected by all parties in the hotel real estate sphere.

Closing Thoughts

During these challenging and uncertain times, property tax assessments and burdens are in flux. From a valuation perspective, HVS anticipates that values may decline anywhere between 20% to 35%, and potentially more, varying significantly from market to market and asset class/type, due to the net effects of the COVID-19 pandemic. While this decline should be appropriately captured in the next assessment cycle, if there is a notable disconnect between the relationship in a hotel's decline in NOI and market value, there may be an opportunity for a meaningful tax reduction and appeal. Discerning owners should be watchful of this and take the appropriate actions to appeal any unjustified change in assessment. Retaining an appraiser that is well versed in the Rushmore Approach is a solid initial step that can help facilitate a successful appeal; this methodology is the foremost choice of industry professionals and assessors, as well, and has more importantly established case law and precedent in court systems nationwide. Let our property tax specialists at HVS assist you in navigating through the motions of the appeal process and furnishing a well-supported and defendable appraisal.

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About HVS

HVS is the world's leading consulting and valuation services organization focused on the hotel, restaurant, shared ownership, gaming, and leisure industries. Established in 1980, the company performs more than 2,000 assignments per year for virtually every major industry participant. HVS principals are regarded as the leading professionals in their respective regions of the globe. Through a worldwide network of 30 offices staffed by 400 seasoned industry professionals, HVS provides an unparalleled range of complementary services for the hospitality industry. For further information regarding our expertise and specifics about our services, please visit www.hvs.com.

About the Authors

Brian Bisema, a Managing Director and Partner of HVS Boston, has more than a decade of experience in the hospitality industry. Throughout his career, Brian has been involved in nearly every facet of how hotels are bought, sold, run, and valued. His background extends across hundreds of assignments, from appraisals of existing full-service hotels and resorts, to feasibility studies for proposed new builds. A native of Boston, Brian has honed his expertise in hotel markets across New England. Brian's industry publications include surveys of the Boston hotel and convention market, the effects of economic downturns on hotel lending, and demand segmentation in U.S. markets. Brian earned his bachelor's degree in Hospitality Management from Boston University. He is a state-certified appraiser and has contributed expert testimony in courts of law, specializing in legal matters of hotel property taxes and finance.

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