

Business Enterprise Value in Hotels – The Reality vs. the Shell Game¹

Jan A. deRoos, Ph.D.

The *Appraisal of Real Estate* states:

The existence of a residual intangible personal property component in certain properties has been widely recognized for years. Among the many terms used to describe this phenomenon, *business enterprise value* (BEV) is the most widely used. The issue has attracted attention primarily through assessment, condemnation, and damage claim assignments, which require that an estimate of the value of the real estate component be separated from the market value of the total assets of the business.²

Much of the motivation for the determination that BEV exists comes from the fact that personal property (tangible or intangible) is not subject to property taxes. If some portion of the market value of the total assets (MVTAB) of a building can be shown to be tangible or intangible personal property, that portion can be eliminated from the property tax rolls. There is an obvious incentive to determine that large portions of a given building's MVTAB are BEV in the absence of mitigating factors. To say that the concept of BEV is controversial is an understatement. The deep divide was underscored in a recent debate³ which concluded with no clear consensus and the recognition that appraisers are split between those who believe that BEV is a large component of value and those who believe that BEV is a small component of value.

A hotel example can be used to get a sense of the debate: what is controversial and what is not. In lodging valuation, it is not controversial to deduct management fees, brand fees, franchise fees, and a furnishings, fitting and equipment (FF&E) reserve from the cash flow that is capitalized to estimate the market value of the going concern. In addition, no controversy surrounds deducting the value of the existing stock of FF&E from the going concern value.

On the other hand, it is controversial to say that because brand manager X (with brand Y) achieves supra-normal average rents (called RevPAR in the hotel industry), and hence a supra-normal cash flow, these entrepreneurial efforts produce value above and beyond the value of the real estate. Supporters of this argument say that entrepreneur-

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ial value is not real estate but is intangible personal property, or BEV. The counter argument is that the supra-normal RevPAR/Cash Flow is due to a superior location and hence properly considered real estate income. Because of the difficulty in definitively answering the question of who has the residual claim to the supra-normal flows, the entrepreneurial managers through their skill, or the real estate due to its superior location, the topic remains controversial.

The Economic Foundations of BEV

The two poles of the BEV debate rest on differing interpretations of economic theory. Both sides use the classic “Factors of Production” model as the basis for their arguments. The fundamental fault line is the determination of which factor of production is the residual claimant.

One side posits the classic three factors of production model; land, labor and capital. Adherents argue that it is the monopoly power of the locational advantage of real estate that results in land being the residual claimant.⁴ Advocates of this stance argue that the production of real estate services is required to insure that property is used at its highest and best use, and that the production of real estate services simply a factor of production. They argue that BEV exists only in very limited circumstances. Using a hotel example, Miller, Jones, and Roulac provide a succinct overview of the reasons why BEV, if it exists, is transitory, not permanent. It comes from a temporary ability of the real estate owner to extract excess profits. Paraphrasing their argument, BEV exists if some hotels are able to achieve excess profits due to the superior efforts of the hotel manager, and the manager does not completely capture the excess profits, but rather passes them on to the owner, who is fortunate enough to have negotiated such a deal with the manager. They argue that entrepreneurship is a simply a specialized form of labor that should receive fair compensation for its services, but that entrepreneurs do not possess the monopoly locational power that resides in the land, and hence have no economic claim on the residual. The key argument is that any rights that are transferable with the real estate should be valued as part of the real estate. Only those rights that can be transferred independently from the real estate can be considered BEV. Vandell (1999) takes an even more restrictive view of BEV.⁵

The other side posits a four factor of production model; land, labor, capital, entrepreneurship. Adherents claim that economic theorists have shown that any factor of production can be the residual claimant.⁶ Further, this side argues that the entrepreneur is the ultimate risk taker, who receives the residual income and residual gain from development and sale of a property after all other factors of production have been accommodated through competitive market rates of return. Any return to a business enterprise or investment in excess of a competitive rate of return is the entrepreneur’s surplus. The residual factor of production is not land (or real estate) but entrepreneurship. The entrepreneur buys land, employs capital to

construct improvements, and employs labor to produce real estate services. It is the entrepreneur's skill in properly orchestrating this mix that creates additional value beyond the market value of the other components. Thus, any value in excess of market return to the land and improvements will accrue to the entrepreneur. This excess is intangible personal property; it is not real estate and hence cannot be subject to a 'property' tax.

In practice, BEV is estimated by partitioning the value of the going concern into real estate, tangible personal property and intangible personal property. There are many methodological articles providing guidance the details of the BEV estimate.⁷ Some articles have demonstrated that BEV is over 30% of the going concern value of a hotel (Kinnard, et. al. 2001) and over 60% in a regional mall (Eppli, 1998). These estimates have clearly raised eyebrows in the property tax assessor community, as these large estimates of BEV contravene years of established practice.

Implications of the Theoretical Foundations

If one subscribes to the notion that the residuals flow to the land and hence real estate is the residual claim, the value of the going concert is the value of the real estate, with appropriate deductions for personal property and resale of products/services to tenants. The fact that one has to use some entrepreneurial skill to produce real estate services runs with the real estate, it is not a separable from the real estate. If all factors of production other than the real estate are paid their marginal product, or market rate of return, then the true value of the real estate must be the residual cash flow after paying for the factors of production. Entrepreneurship is simply a specialized form of labor. The value of the real estate includes both the current flows, plus the option to move the land to its highest and best use over time. Adherents of this argument do not preclude the existence of BEV, but view through this lens any BEV created by managers as transitory, not permanent, because in the long run, someone will pay the value of the real estate in its highest and best use and thus the value falls to the real estate not the entrepreneur.

The transferability argument is the crux of the reasoning for those advocating that residuals fall to the entrepreneur. Since entrepreneurship is transferable, it can be priced distinctly from the factors of production. Reilly and Schweich (1999) propose a test for intangible assets. The overriding condition is that the BEV is a specific bundle of legal property rights:

1. Specific identification/recognizable description
2. Legal existence and protection
3. Private ownership that is legally transferable
4. Tangible manifestation such as:
 - a. Contract or license

- b. Customer list or CD-ROM
 - c. Set of financial statements
5. Created or comes into existence at an identifiable time or as a result of an identifiable event
6. Subject to destruction or termination at an identifiable time or as a result of an identifiable event

Given this definition for an intangible asset, it is clear that BEV in real estate, if it exists, must be valued by valuing the property rights. If there are no property rights, it is difficult to argue that something exists without any legal manifestation of the economic benefit. If the benefit is tied to the real estate and cannot be separated, the benefits flow to the real estate. If the benefits can be separated, then BEV is created. The typical estimate of BEV proceeds in the following manner:

- Estimate Supra-Normal Cash Flow Before Debt Service and Capitalize to Obtain Going Concern value
- Estimate "Normal" Cash Flow Before Debt Service and Capitalize to Obtain the Real Estate value
- Subtract the second number from the first to obtain an estimate of the BEV.

This methodology assumes that the BEV is a long-term flow and can be capitalized; further, it assumes that BEV simply exists without any identifying legal property rights, a point sharply at odds with the transferability doctrine. In general, valuing BEV requires appraisers to precisely identify the rights being valued and the time over which these rights exist.

Using a hotel analogy to illustrate, imagine that property owner LaSalle Hotel Properties hires property manager, Starwood Hotels and Resorts, to manage one of LaSalle's Westin hotels. Further, imagine that the manager does a superior job managing the property and supra-normal cash flows to the property are created. This implies that Starwood has mispriced their services to the benefit of LaSalle.

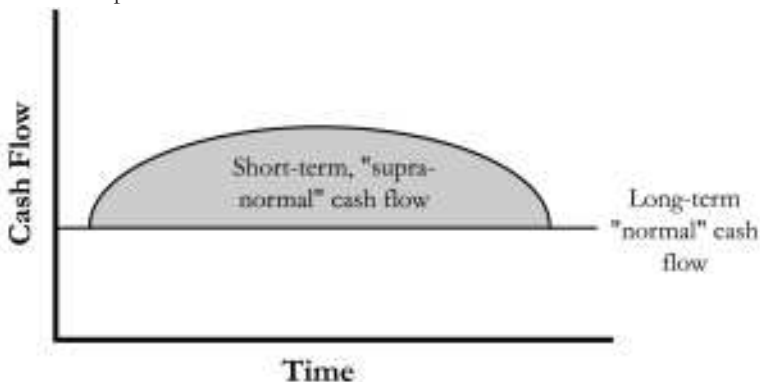


Figure 1: Cash Flows over Time

Is this advantage transferable with the real estate, or is the advantage part of LaSalle's entrepreneurial efforts? If it is the former, then the benefit flows to the real estate. If it is the latter, then the benefit will dissipate upon sale of the asset; the new owner will not possess superior entrepreneurial skills, or the manager will correctly price the management services upon transfer. Either way, the BEV is transitory. If LaSalle will own the property for the long term, the additional value can be capitalized only if one believes that the manager will continue to misprice their management services to the owner's benefit.

Thus, proper valuation of BEV calls for a discounted cash flow technique, not a capitalization technique. The valuer must specifically identify the excess cash flows, identify the defined time horizon over which the excess cash flows occur and discount them at an appropriate rate of return. Graphically, the BEV valuation model seeks to estimate the value of the excess cash flows in the shaded area below the curve via a DCF model, while the Real Estate value can be estimated by capitalizing the long-term "normal" cash flow.

Conclusion

The BEV debate may continue for many years. This article seeks to found the debate in the economic foundations and then enumerate the implications of taking one of two dominant positions. In the end, the "correct" approach depends on the values and philosophy of individuals, but the implications of the approach taken cannot be ignored. We advocate a model that requires appraisers to use a discounted cash flow technique to estimate BEV. The capitalization models proposed ignore important economic principles, specifically the identification of the rights being valued.

Endnotes

² Appraisal Institute. 2001. *The Appraisal of Real Estate, 12th ed.* Chicago: Appraisal Institute, page 641.

³ See Lenhoff. "The Business Enterprise Value Debate: Still a Long Way to Reconciliation". *The Appraisal Journal*. October 1999.

⁴ See Miller, Jones and Roulac. "In Defense of the Land Residual Theory and the Absence of a Business Value Component for Retail Property" *Journal of Real Estate Research*. 10:2, 1995. and Vandell, "Business vs. Real Estate Value in Shopping Center Valuation: A Critical Examination" Presentation for the 1999 Summer Appraisal Institute Conference, Orlando Florida.

⁵ Vandell (1999) states that the only sources of BEV are a return to tangible personal property employed (FF&E) and for the resale of products to tenants, such as the sale of utilities if the landlord buys at wholesale prices and sells at retail prices.

⁶ See Fisher and Kinnard . "The Business Enterprise Value Component of Operating Properties". *Journal of Property Tax Management*" October 1990, 19-27; Karvel and Patchkin. "The Business Value of Super-Regional Shopping Centers and Malls", *Appraisal Journal*. October 1992, 453-462; and Lenhoff, op. cit. for a good summary.

⁷ A short list for lodging includes Rushmore and Rubin. "The Valuation of Hotels and Motels for Assessment Purposes" *Appraisal Journal*. April 1984, 270-288; Lesser and Rubin "Understand the Unique Aspects of Hotel Property Tax Valuation", *Appraisal Journal*. January 1993, 9-27 is highly cited; Hennessey, "Myths about Hotel Business and Personality Values" *Appraisal Journal*. October 1993 rebuts Lesser and Rubin; Kinnard, Worzala, and Swango "Intangible Assets in an Operating First-Class Downtown Hotel" *Appraisal Journal* January 2001, 68-83. Other important articles relate to shopping center allocations of value. See Ramsland and Kinnard, "Quantifying Business Enterprise Value for Malls". *Appraisal Journal*. April 1999 and Eppli. "Value Allocation in Regional Shopping Centers". *Appraisal Journal*. April 1998.