

EXHIBIT A

TENNESSEE STATE BOARD OF EQUALIZATION
BEFORE THE ADMINISTRATIVE JUDGE

In Re: Essex House Condo Corporation)
a/k/a Marriot Courtyard Airport) Shelby County
Ward 60, Block 222, Parcel 345)
Commercial Property)
Tax Years 2001 and 2002)

INITIAL DECISION AND ORDER

Statement of the Case

For the 2001 tax year, the assessor originally valued the subject property at \$7,234,600. The value was appealed to the Shelby County Board of Equalization which set the following value:

<u>LAND VALUE</u>	<u>IMPROVEMENT VALUE</u>	<u>TOTAL VALUE</u>	<u>ASSESSMENT</u>
\$1,107,500	\$5,193,500	\$6,301,000	\$2,520,400

For the 2002 tax year, the assessor originally valued the subject at \$7,234,600. The value was appealed to the Shelby County Board of Equalization which set the following value:

<u>LAND VALUE</u>	<u>IMPROVEMENT VALUE</u>	<u>TOTAL VALUE</u>	<u>ASSESSMENT</u>
\$1,107,500	\$5,193,500	\$6,301,000	\$2,520,400

Appeals have been filed with the State Board of Equalization. This matter was reviewed by the administrative judge pursuant to Tenn. Code Ann. Section 67-5-1412, 67-5-1501 and 67-5-1505. The administrative judge conducted a hearing in this matter on July 16, 2003. The taxpayer was represented by David C. Scruggs and A. Kent Gieselmann, Jr. of Stokes Bartholomew Evans & Petree, P.A. The assessor of property was represented by staff member Larry Bankston, T.C.A.

Findings of Fact and Conclusions of Law

Subject property consists of a three-level hotel built in 1987 containing 145 rooms situated on a 5.0829 acre site at 1780 Nonconnah Boulevard, Memphis, Shelby County, Tennessee. Subject building has a gross building area of 76,946 square feet.

The taxpayer contended that the subject property should be valued at \$4,200,000 for tax year 2001 and \$3,750,000 for tax year 2002. In support of its contention, the taxpayer introduced appraisal reports for tax years 2001 and 2002 prepared by David C. Lennhoff, MAI, CRE. Mr. Lennhoff testified at the hearing regarding his appraisal reports.

The assessor contended that the property should be valued the same for tax years 2001 and 2002, at \$6,301,000. In support of his position, Mr. Bankston relied on the income approach.

Since the taxpayer is appealing from the determination of the Shelby County Board of Equalization, the burden of proof is on the taxpayer. See State Board of Equalization Rule 0600-7-.11(1) and *Big Fork Mining Co. v. Tenn. Water Quality Control Bd.*, 620 S.W.2d 515 (Tenn. Ct. App. 1981).

After having reviewed all of the evidence in the case, the administrative judge finds subject property should be valued as contended by the taxpayer. As will be discussed below, the administrative judge finds that Mr. Lennhoff's appraisal report and testimony should receive greatest weight for two reasons. First, the administrative judge finds that Mr. Lennhoff considered all three approaches to value whereas Mr. Bankston relied solely on the income approach. Second, the administrative judge finds Mr. Lennhoff's analysis constitutes the most thorough and best substantiated evidence in the record. In particular, the administrative judge finds that Mr. Lennhoff properly separated the value of the real property from the value of the tangible and intangible personal property whereas Mr. Bankston did not.

The basis of valuation as stated in Tennessee Code Annotated Section 67-5-601(a) is that "[t]he value of all property shall be ascertained from the evidence of its sound, intrinsic and immediate value, for purposes of a sale between a willing seller and a willing buyer without consideration of speculative values . . ."

I. Application of Three Approaches to Value

General appraisal principles require that the market, cost and income approaches to value be used whenever possible. Appraisal Institute, *The Appraisal of Real Estate* at 50 and 62 (12th ed. 2001). However, certain approaches to value may be more meaningful than others with respect to a specific type of property and such is noted in the correlation of value indicators to determine the final value estimate. The value indicators must be judged in three categories: (1) the amount and reliability of the data collected in each approach; (2) the inherent strengths and weaknesses of each approach; and (3) the relevance of each approach to the subject of the appraisal. *Id.* at 597-603.

The value to be determined in the present case is market value. A generally accepted definition of market value for ad valorem tax purposes is that it is the most probable price expressed in terms of money that a property would bring if exposed to sale in the open market in an arm's length transaction between a willing seller and a willing buyer, both of whom are knowledgeable concerning all the uses to which it is adapted and for which it is capable of being used. *Id.* at 21-22.

The administrative judge finds that the need to at least consider all three approaches to value was addressed by Mr. Lennhoff on pages 27 and 28 of his appraisal report in pertinent part as follows:

The USPAP and Appraisal Institute recognize three basic approaches to value – sales comparison, cost, and income capitalization – and require a complete appraisal to *consider* application of all three. An explanation is necessary if a particular approach is not considered applicable and therefore not applied. . . .

* * *

. . . Typical hotel investor acquisition motivation is income oriented and not cost based, and purchasers of this investment property type rarely rely on cost. [footnote omitted] Considering the value sought (real property component of a going concern), however, a cost approach would seem at least potentially useful. . . . Despite [the] limitations [of the cost approach in this case], we will apply a cost approach, if only to test the reasonableness of the far more reliable and meaningful income capitalization approach conclusion.

* * *

. . . hotels typically trade as going concerns [unless distressed], because there is virtually no market for their individual component parts sold separately (real property, and tangible and intangible personal property). Therefore, sales comparison is not an especially valid methodology for hotels when the value sought is only the real property component – or any other ‘slice’ – of the going concern. Although sales comparison is seldom given substantial weight in a hotel appraisal, it can be used to bracket a value or check the value derived by the income capitalization approach. However, this role as a test of income capitalization illustrates value as a *going concern*, and thus shows only what the real property cannot possibly be worth. . . .

The income capitalization approach recognizes that an investment property’s value is a function of its income-producing potential. Of the three approaches to value, the income approach is usually preferred for analysis of income-producing, investment property such as the subject. This approach also allows for market-supported deductions of non-realty items, making it particularly useful for this assignment. . . .

[Emphasis in original]

As previously indicated, although Mr. Lennhoff placed greatest weight on the income approach, he did at least consider the cost and sales comparison approaches in accordance with generally accepted appraisal practices. In contrast, Mr. Bankston considered only the income approach.

The administrative judge has appended to this initial decision and order a summary of Messrs. Lennhoff's and Bankston's income approaches which was introduced into evidence as exhibit C. The administrative judge finds that Mr. Lennhoff actually assumed a *higher* net operating income and *lower* capitalization rate than did Mr. Bankston. Thus, the real dispute in this case concerns the methodology utilized by Mr. Lennhoff to separate the value of the real property from the value of the intangible and tangible personal property. Mr. Bankston stated that in the event the methodology employed by Mr. Lennhoff is found to be proper, he does not dispute the calculations.

II. Methodology

The administrative judge finds that when valuing the real property of a hotel for Tennessee *ad valorem* property tax purposes, the value of tangible and intangible personal property is not assessable and must be separated from the real property value. See O.L.H., L.P., Initial Decision and Order at 8-9 (Davidson Co., Tax Year 1997). See also *Morristown Medical Investors, et al.* (Hamblen Co., Tax Year 1994) wherein the Assessment Appeals Commission held that appraisals must reflect the need for an adjustment to account for the "going concern." Final Decision and Order at 2.

The administrative judge finds that the foregoing decisions addressed what the appraisal literature currently refers to as "business enterprise value" and "total assets of the business." The administrative judge finds that the 12th edition of the Appraisal Institute's *The Appraisal of Real Estate* summarizes these concepts at pages 641-42 as follows:

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 (MVTAB).

These assignments necessarily involve an allocation among the component parts of real property and tangible and intangible personalty. The latter can include what has traditionally been called *business enterprise value* but more recently has become known as *capitalized economic profit* (CEP). CEP is defined as the present worth of an entrepreneur's economic (pure) profit expectation. In other words, CEP is the value of a residual claim that is subordinate to the opportunity cost claims of all agents of production employed by the business (e.g., land, labor, and/or capital). . . .

* * *

Because of inconsistent definitions of the various terms related to the topic among assessors, business and real estate appraisers, and the courts, a new lexicon has been developed. In discussing business enterprise value, the term going concern, for example, has been replaced with *total assets of the business* (TAB). TAB includes

- Real property
- Tangible personal property
- Intangible personal property

The personal property is broken down into

- Furniture, fixtures, and equipment (FF&E)
- Inventory

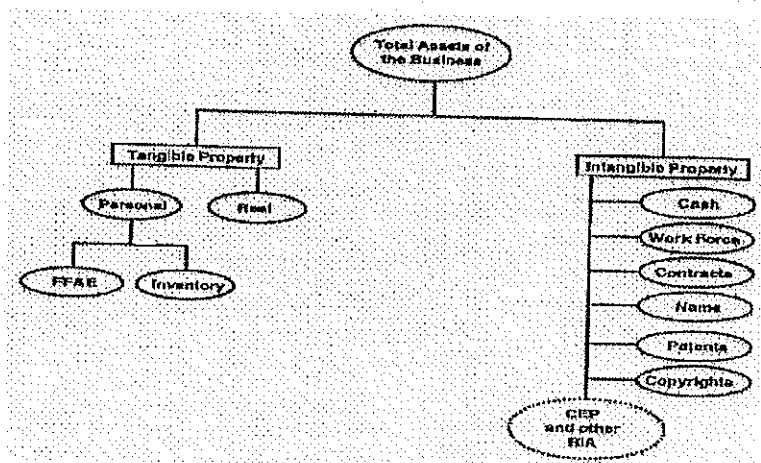
The intangibles are made up of

- Contracts
- Name
- Patents
- Copyrights
- An assembled work force
- Cash
- Other residual intangibles

CEP is included in the residual intangible category.

[Emphasis in original]

The administrative judge finds Mr. Lennhoff's methodology assumes that the components of a going concern or business are as follows:



The administrative judge finds that Mr. Lennhoff's methodology begins with the calculation of the NOI of the going concern (total assets of a business), which must then be adjusted to reach the NOI for the *real property*. In order to accomplish this, all tangible and intangible personal property that can be quantified, such as furniture, fixtures and equipment

(FF&E), business start-up costs and subject brand-specific residual intangibles, must be removed. Also, other non-realty items that are not as easily quantified, such as market-typical residual intangibles, are accounted for by adjusting the capitalization rate upward to reflect their inclusion in the NOI.

Mr. Lennhoff's 2001 income approach leads to an NOI of the going concern of \$984,667. In order to account for the tangible personal property, Mr. Lennhoff first removes the FF&E by amortizing it over an economic life of approximately eight years, using a chattel mortgage rate of 10.65%. This calculation produces a deduction for return of and return on FF&E of \$73,268.

Next, he removes the business start-up costs which include, among other things, assembled and trained work force, management and administration team, regulatory compliance, accounting and other business systems, pre-opening marketing, etc. These costs were adjusted to the tax year 2001 and amortized over a twenty-five year estimated economic life of the real estate, resulting in a deduction for return of and return on business start-up costs of \$131,616.

Finally, the residual intangibles -- the remaining intangible personal property -- must be removed from NOI. According to Mr. Lennhoff, this category contains two components: i) market-typical intangibles, or those common to all hotels, and ii) brand-specific intangibles to the extent they exceed or are less than market-typical intangibles. The Revenue Per Available Room (RevPAR) is the most appropriate measure of brand-specific intangibles, to the degree that it exceeds or fails to exceed the market norm. Mr. Lennhoff determined that 20% of the RevPAR is attributable to the Marriott brand name. This portion of the residual intangibles that is attributable to the Marriott affiliation is reflected in a 20% deduction based on projected NOI, resulting in a \$196,933 deduction from NOI. After these deductions, the NOI of the real property is \$582,850.

Net Operating Income to Real Property

Net Operating Income to Going Concern (Excluding R.E. Tax)	\$984,667
Less: Return on/of FF&E	\$ 73,268
Less: Return on/of Start-Up Costs	\$131,616
Less: Marriott/Subject-Specific Residual Intangibles	<u>\$196,933</u>
Net Operating Income to Real Property*	\$582,850

*Includes market-typical residual intangibles.

The final step in Mr. Lennhoff's process is to determine the capitalization rate. For tax year 2001, he determined that a tax rate loaded capitalization rate of 13.5582% is appropriate. For tax year 2002, he determined that the tax rate loaded capitalization rate

should be 14.0582%. The assessor did not dispute either of these capitalization rates and in fact utilized a higher rate in his calculation.

For tax year 2001, Mr. Lennhoff concluded a value of \$4,200,000. Regarding tax year 2002, Mr. Lennhoff employed the same methodology and concluded a value of \$3,750,000. Mr. Lennhoff did show a decline in revenue for 2002. He explained that the market softened in 2001, and this condition was exacerbated by the economic recession in the United States and by the effects of the September 11, 2001 tragedy, which impacted both business and personal travel.

On cross-examination by Mr. Bankston, Mr. Lennhoff admitted that this method is not used by every appraiser. However, he also testified that this methodology has evolved over time, and is currently endorsed by the Appraisal Institute as evidenced by the previously quoted language from the 12th Edition of *The Appraisal of Real Estate* and by the Appraisal Institute's Course 800 (Separating Real and Personal Property from Intangible Business Assets). Even though the 12th Edition was not published until 2001, Mr. Lennhoff testified that the methodology should not come as a surprise to any expert in hotel valuation. He indicated that an informed appraiser who is current with education in terms of reading articles and properly utilizing continuing education would know of this evolution of the methodology of determining the value of the real estate component. He also testified this methodology is not a "new" concept; rather, it began as early as 1986.

The administrative judge finds that although Mr. Lennhoff's methodology may not be universally accepted, it is in accord with the position of the Appraisal Institute and the previously cited administrative decisions. The administrative judge finds that the assessor did not introduce any legal precedent or appraisal literature in support of an alternative method for separating the value of the real property from the value of the tangible and intangible personal property. The administrative judge finds the cross-examination of Mr. Bankston established that he has not taken Appraisal Institute Course 800 (or the equivalent) and was only partially familiar with many of the articles introduced relating to the methodology used by Mr. Lennhoff. Respectfully, the administrative judge finds unconvincing Mr. Bankston's assertion that he isolated the value of the real property by simply allowing for a management fee, franchise fee, reserves and a deduction for the reported value of the tangible personal property.

Based upon the foregoing, the administrative judge finds that subject real property should be valued at \$4,200,000 and \$3,750,000 for tax years 2001 and 2002 respectively.

ORDER

It is therefore ORDERED that the following values and assessments be adopted for subject property for the indicated tax years:

<u>2001</u>			
<u>LAND VALUE</u>	<u>IMPROVEMENT VALUE</u>	<u>TOTAL VALUE</u>	<u>ASSESSMENT</u>
\$1,107,500	\$3,092,500	\$4,200,000	\$1,680,000

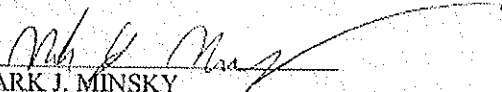
<u>2002</u>			
<u>LAND VALUE</u>	<u>IMPROVEMENT VALUE</u>	<u>TOTAL VALUE</u>	<u>ASSESSMENT</u>
\$1,107,500	\$2,642,500	\$3,750,000	\$1,500,000

Pursuant to the Uniform Administrative Procedures Act, Tenn. Code Ann. §§ 4-5-301—325, Tenn. Code Ann. § 67-5-1501, and the Rules of Contested Case Procedure of the State Board of Equalization, the parties are advised of the following remedies:

1. A party may appeal this decision and order to the Assessment Appeals Commission pursuant to Tenn. Code Ann. § 67-5-1501 and Rule 0600-1-.12 of the Contested Case Procedures of the State Board of Equalization. Tennessee Code Annotated § 67-5-1501(c) provides that an appeal "must be filed within thirty (30) days from the date the initial decision is sent." Rule 0600-1-.12 of the Contested Case Procedures of the State Board of Equalization provides that the appeal be filed with the Executive Secretary of the State Board and that the appeal "identify the allegedly erroneous finding(s) of fact and/or conclusion(s) of law in the initial order"; or
2. A party may petition for reconsideration of this decision and order pursuant to Tenn. Code Ann. § 4-5-317 within fifteen (15) days of the entry of the order. The petition for reconsideration must state the specific grounds upon which relief is requested. The filing of a petition for reconsideration is not a prerequisite for seeking administrative or judicial review; or
3. A party may petition for a stay of effectiveness of this decision and order pursuant to Tenn. Code Ann. § 4-5-316 within seven (7) days of the entry of the order.

This order does not become final until an official certificate is issued by the Assessment Appeals Commission. Official certificates are normally issued seventy-five (75) days after the entry of the initial decision and order if no party has appealed.

ENTERED this 26th day of August 2003.


 MARK J. MINSKY
 ADMINISTRATIVE JUDGE
 STATE BOARD OF EQUALIZATION

c: Mr. David C. Scruggs, Esq.
 Ms. Tameaka Stanton-Riley, Appeals Manager