Decision and Order

IN THE MATTER OF AN APPEAL PURSUANT TO S. 50 OF THE *ASSESSMENT ACT*

CONCERNING:

Fairmont Hotels & Resorts

APPELLANT

AND

Assessor Of Area #01 - Capital

RESPONDENT

Appeal Nos.:	2001-01-00028; 2002-01-00021
Refer to as:	Fairmont Hotels v. Area 01 (2005 PAABBC 20040267)
Date of Decision:	April 14, 2005
Property:	01-61-234-01-031-001 700 Douglas Street, City of Victoria
Heard:	May 12, 13, 14, & 17, 2004, July 7, 2004 at Richmond and Written Submissions and evidence received November 5 and 19, 2004 ; December 14, 2004; January 26 and 31, 2005; and April 5, 12, and 13, 2005
Panels:	Cheryl Vickers, Panel Chair John Warren, Panel Member
Appearances:	W Graham Allen, Barrister and Solicitor, for the Appellant John H. Shevchuk, Barrister and Solicitor, for the Respondent

INTRODUCTION

[1] The Fairmont Empress Hotel (Empress) is a luxury full-service hotel located in the scenic inner harbour of Victoria. Designed by Francis Rattenbury for the CPR in an "imaginative Elizabethan, Jacobean and Gothic variation on the CPR's Franco-Scottish theme", the hotel has become a landmark in the City and focal point in the inner harbour since its opening as a CPR hotel in 1908.

[2] Fairmont appealed the 2001 and 2002 assessed values of the Empress submitting the assessed value includes the value of non-assessables. The parties agree that in valuing the hotel using an income approach, the resulting value is the value of the going concern, or the Total Assets of the Business (TAB), and includes the value of real property, tangible personal property, and intangible personal property. As the *Assessment Act* only requires the valuation of realty, that is land and improvements, to the extent the going concern value includes the value of personal property, whether tangible or intangible, the value of the personal property must be deducted from the value of the going concern to arrive at a value for assessment purposes.

[3] In *Fairmont Hotels v. Area 1* (2003 PAABBC 20039104) the Board determined a method for extracting the contributory value of the furniture, fixtures and equipment (FF&E) from the value of the going concern. In this phase of the appeal, we are concerned with identifying and allocating value to intangible personal property.

[4] The Appellant submits that deductions from the value of the going concern or TAB must be made for brand/goodwill, working capital, assembled work force, pre-opening sales and marketing, and initial start-up losses. The Appellant values these intangible assets at $29,931,215, of which $20,600,000 is attributed to brand/goodwill.

[5] The Assessor submits that the only intangible asset to be deducted from the value of the going concern or TAB is brand/goodwill. The Assessor quantifies this deduction at $750,000. The Assessor says if any of the other items exist, they can be accounted for in separate adjustments made between vendor and purchaser once the going concern value is negotiated or, alternatively, the items can be traced to the revenue and expenses making up the net income or Earnings Before Interest, Depreciation, Taxes and Amortization (EBITDA).

ISSUE

[6] The Board must determine:

i. Which intangible assets are properly deductible from the value of the going concern or TAB?
ii. How should the value of those intangible assets be determined?
iii. What is the value of the intangible assets to be deducted?

[7] This is the first time these issues have been presented for adjudication in this jurisdiction.

TERMINOLOGY

[8] The terms "going concern value" and "total assets of the business" or TAB may be used interchangeably. A going concern is an established and operating business with an indefinite future life. The value of the going concern includes value attributed to both realty and non-realty, and tangible and intangible assets. Likewise, the TAB includes the value of all assets including real and personal, and tangible and intangible property. While the *Appraisal of Real Estate*, 12th edition, suggests the term "going concern" has been replaced with TAB, the *Assessment Act* still employs the terminology of the going concern, requiring, where a business enterprise is carried on, the land and improvements to be "valued as the property of a going concern" (section 19(4)). In this decision we will use the term going concern value to represent the value of all of the assets of the going concern.

EVIDENCE

[9] The Board heard evidence and received expert reports from Dr. James Vernor Ph.D., MAI, Joel Rosen, CMC, and Ed Cheung, AACI. All were called as experts in the appraisal of hotels.

[10] Dr. Vernor, a Ph.D. in Real Estate and Urban Land Economics, is the Chair Emeritus of the Real Estate Department at Georgia State University. He was a member of the development team constituted by the Appraisal Institute's Curriculum Committee to develop Course 800: Separating Real and Personal Property from Intangible Business Assets, published in 2001, and instructs the course. Dr. Vernor's expertise brought an academic or theoretical perspective to the issues. He did not attempt to value the various intangible components, only to identify them and rationalize the need to separate their value.

[11] Mr. Rosen is Chairman and CEO of a consulting firm specializing in strategic marketing, hotel, resort and golf course development and management, feasibility studies, valuations, property tax appeals and franchising. Mr. Rosen has extensive practical experience in the valuation of hotels from an operational and professional perspective. He provided the valuation evidence for the Appellant and estimated value of the various intangible components identified by Dr. Vernor.

[12] Mr. Cheung is a senior supervisory appraiser with BC Assessment with extensive experience in the valuation of hotels for assessment purposes. He was a member of a BC Assessment working group tasked with developing a method to identify the non-realty assets in a going concern. His evidence spoke both to whether particular intangible assets should be allowed for and the valuation of the one he considered appropriate, namely goodwill.

[13] In addition to the testimony of these three witnesses, the Board received numerous academic articles and text extracts relevant to the issues in these appeals.

Identification of intangible components - Conceptual Frameworks

[14] Dr. Vernor divided the concept of TAB into tangible property, consisting of personal and real property, and intangible property consisting of cash, workforce, contracts, name, patents, copyrights and Capitalized Economic Profit (CEP) and other Residual Intangible Assets (RIA). He said intangible assets are those assets you can’t sense by merely touching them. Tangible assets are soil, brick and mortar, furniture and inventories, whereas intangible assets tend to be more representational. His evidence was that in the case of the Empress Hotel, there are numerous assets which contribute to the profitability of the going concern but which in themselves are non-realty assets and need to be separated. These intangible assets include:

- working capital;
- a trained workforce;
- name, reputation and goodwill; and
- pre-opening marketing expenditures and other losses during the initial period of operations

[15] Dr. Vernor identified the intangible assets that he says have value and distinguished them conceptually from ongoing expenses using a time line. His evidence was that before a hotel gets to stabilized operating levels investments are required for initial marketing and the hiring and training of staff. These expenditures occur before the hotel opens. These expenses allow the property to operate and therefore, according to Dr. Vernor, have value. Similarly, before the hotel reaches stabilized operations, it will suffer some early period losses. These losses represent an investment towards the stabilized operation, and have value. If one values the total assets of the business at any given point in time after the operation has stabilized, those assets include, in Dr. Vernor’s view, value for the initial investments that enable the operation to get to stabilized levels including pre-opening marketing expenses, the cost of assembling a workforce, and initial start-up losses. His evidence was that these expenses are distinguishable from ongoing expenses for marketing or the hiring and training of staff because of the time in which they occur. They are, in his opinion, an investment no different from the investment in land, constructing the improvements or purchasing the FF&E and have value.

[16] This approach to dealing with intangible assets was developed by Dr. Vernor and others into Course 800, a course offered by the Appraisal Institute entitled Separating Real and Personal Property from Intangible Business Assets of which more will be said later. The Appellant relied extensively on Course 800 as providing the framework and support for their approach to the valuation of intangibles.

[17] Mr. Cheung presented a different conceptual framework for identifying intangible assets in the form of a "BC Assessment Non-Realty Decision Tree". One identifies the components of value for a going concern and asks: "Are the components part of the real property?" The answer to this question depends, according to the BCA Decision Tree, on whether the component falls within the broad "bundle of rights" comprising fee simple ownership, and whether it transfers with the land and improvements. If they are not, the Decision Tree asks: "Are the Non-Realty Component’s Values Measurable?" The reader is instructed that non-realty value components

cannot be measured if there is no market information by which to measure them, there is no acceptable appraisal method to measure the component, or it is impossible to measure the component in a mass appraisal context. In Mr. Cheung's opinion, therefore, in order to make a deduction for the non-realty value that may be found in a going concern, it must satisfy the following requirements:

- it must be identifiable as discreet from the real estate;
- it must be measurable from reliable market data; and
- it must not transfer with the real estate upon the sale of the real estate.

[18] Applying his three criteria to Dr. Vernor's list of intangible assets, it was Mr. Cheung's opinion that only name, reputation and goodwill, or as Mr. Cheung called it, brand/personal (business) goodwill qualified as a discreet intangible that could be measured. In Mr. Cheung's view, "if revenues fall within the broad "bundle of rights" conveyed in fee simple ownership and the benefit of the revenue sources are transferred with the real estate, the revenue sources are components of the overall value of the real estate." In Dr. Vernor's view all of the intangible assets on his list could be measured and had value discreet from the value of the land and improvements.

[19] One of the significant differences between the evidence of Dr. Vernor and Mr. Cheung was that, in Dr. Vernor's view, intangible assets were always personal property and could never be part of the real estate. In Mr. Cheung's view, intangible assets could add value to the real estate and be part of the real estate.

[20] Dr. Vernor canvassed several potential methods of separating the values of personalty and realty. The simplest is where the value of the personalty is known, or can be estimated, and can be deducted from the value of the going concern. Alternatively, the income to the personalty is imputed and subtracted from the income to the going concern before capitalizing the income to the real estate. Dr. Vernor suggested that sometimes a paired data sales approach will reveal the value of an asset component as the difference in sales prices for two otherwise equivalent properties. Sometimes a cost of replacement approach may provide a value indication for individual asset components. For example, Dr. Vernor suggested the value of an assembled and trained workforce is the cost to recruit and train the same talent.

[21] Dr. Vernor said name, reputation and goodwill derived from an affiliation with a well-known hotel operating company can add substantially to the value of the going concern. He was critical of the method generally accepted in the industry until the development of Course 800 and attributed to Stephen Rushmore, a leading authority in hotel appraisal, of deducting a management or franchise fee as a percentage of revenue to account for this value. He suggested an alternative approach, intended to account for business value attributable to brand, flag or franchise is to capitalize the marginal revenues to a subject over and above the average to all competitors in a sub-market at an intangibles capitalization rate to indicate the marginal value of a particular flag over the average value of other flags

in the submarket. This is the method used in Course 800 for attributing value to brand/goodwill.

[22] The Board received evidence of the "Rushmore Approach" in the form of an article by Stephen Rushmore entitled *In Defence of the "Rushmore Approach" for Valuing the Real Property Component of a Hotel*. Mr. Rushmore, a recognized expert in the appraisal of hotels and author of several texts on the subject, was not called to testify and, consequently, could not be cross-examined. In this article, Mr. Rushmore is critical of the business enterprise approach. In Mr. Rushmore's view, any business value is captured and separated from the realty value by the deduction of management and franchise fees from the income stream. These fees, in Mr. Rushmore's view, represent the portion of the income stream attributable to the business. Once removed, capitalization of the remaining income stream does not include intangible business value. Dr. Vernor testified and provided a written response entitled *Comments on the Rushmore Article*, in turn critical of Mr. Rushmore's approach and commentary on the business enterprise approach.

<u>Course 800</u>

[23] Dr. Vernor was involved in the research and development of the course and is one of its instructors. The development of the course started in 1991 when Dr. William Kinnard presented an academic paper to meetings of the Appraisal Institute with respect to the business enterprise value in shopping centres. Dr. Kinnard's paper stirred great interest, and a sub-committee of the Appraisal Institute's Curriculum Committee was formed and charged with determining whether the Appraisal Institute needed to have a course on the concept of business enterprise value in going concerns. Dr. Vernor headed this committee which included six or seven other appraisers including Mr. David Lennhoff. The sub-committee did some research and reported back to the Curriculum Committee recommending there be a course. The Curriculum Committee constituted a development team to create the course on which Dr. Kinnard, Mr. Lennhoff and Dr. Vernor served with several other appraisers. The development team worked for two years developing the course, which was launched in 2001.

[24] The purpose of Course 800 is to provide a theoretical and analytical framework for separating the intangible assets of operating properties. The two day course discusses the need to separate intangibles, lays down the economic theory of production, provides examples of the treatment of intangibles, and uses a hotel case study.

[25] The disclaimer at the front of the Course 800 Handbook (marked as Exhibit 20 in these proceedings) reads:

> The opinions and statements set forth herein reflect the viewpoint of the Appraisal Institute at the time of publication but do not necessarily reflect the viewpoint of each individual member.

[26] On cross-examination, Dr. Vernor acknowledged that Course 800 is not referenced in either the American or Canadian most recent editions of *The Appraisal of Real Estate*, the profession's most authoritative text. Dr. Vernor agreed the course dealt with issues that were evolving and that there are a

number of people within the Appraisal Institute that do not adopt the Course 800 material, including Stephen Rushmore. Mr. Rushmore was not consulted in the development of Course 800.

[27] We subsequently received further evidence by way of affidavit that Course 800 was being reviewed and would not be offered in 2005 until the review was completed. Sometime during 2004, the disclaimer to Course 800 was amended to read:

> The material presented in this text has been reviewed by members of the Appraisal Institute; however, the opinions and views expressed herein are the author's views and opinions and are not necessarily endorsed or approved by the Appraisal Institute as Appraisal Institute policy.

[28] According to the Appraisal Institute, one of the purposes of Course 800 is to present varying viewpoints on issues that are both advanced and unsettled. While initially developed under the auspices of the Appraisal Institute, the Appraisal Institute has a position of impartiality and does not formally recommend or endorse a single methodology for separating real and personal property from intangible business assets. According to the Appraisal Institute, no methodology appearing in Course 800 constitutes official Appraisal Institute policy.

Components of Intangible Personal Property

Brand/Goodwill

[29] The experts agreed that value from brand and business goodwill is an intangible asset that ought to be deducted from the going concern value. The experts agreed that there was value in the Fairmont brand and business goodwill included in the going concern value of the Empress Hotel and that this value could be measured and extracted. Both experts lumped brand and goodwill together.

[30] Both Mr. Rosen and Mr. Cheung valued brand/goodwill from an analysis of the annual Revenue Per Available Room (RevPAR) differential enjoyed by the Empress over other hotels. Mr. Rosen wrote: "The annual premium or revenue differential between a hotel and its primary competitors represents the marginal income attributable to Brand." Mr. Cheung wrote: "When a hotel achieves a RevPAR perceivably higher than those in the competitive set, it may be an indication that the marketplace is showing a preference to one hotel over another."

[31] Mr. Rosen used the method, espoused in Course 800, of comparing room revenue at the Empress to that of its primary competitive market to measure the value of brand/goodwill. He compared the Empress with eight competitors and determined that the Empress achieved a revenue per available room index of 39.1% to 41.4% above its primary competitors in 2001 and 2002. The hotels were selected based on the hotel's competitive market share – those hotels that the Empress itself considers to be in its competitive tracking.

[32] Using such factors as site and location; improvements - physical condition; and furniture fixtures and equipment - physical condition, he ranked the factors from 1 to 5, with 5 being the highest. The benchmark Empress was ranked 5 across the board, with the competitive set ranked in comparison. He concludes that the differential of the Empress over the market represents the difference between the market average RevPAR and that of the subject that is attributable to tangibles. The balance is attributable to intangibles.

[33] Mr. Rosen's rankings result in a market average of 9.78, compared to the perfect score of 15 for the Empress making the Empress 153.4% above the market average. From this he opines that 53.4% of the difference between the market average RevPAR and that of the subject hotel is attributable to tangibles and 46.6% attributable to intangibles.

[34] Mr. Cheung used a similar ranking model but to the three categories used by Mr. Rosen of Land, Physical Plant, and FF&E, Mr. Cheung added a fourth category for Amenities and Services. Similar to Mr. Rosen, Mr. Cheung ranks the identified factors on a scale of 1 – 5, with five points assigned to the most desirable or best feature and one point for the least desirable. Mr. Cheung included the same eight hotels in the competitive set.

[35] Based on his ranking of the individual categories, Mr. Cheung arrives at a market average of 10.78 with the Empress being 185.6% of the market average. In similar fashion to Mr. Rosen, Mr. Cheung concludes that 85.6% of the RevPAR differential is attributable to tangibles and 14.4% of the RevPAR differential can be considered the contribution from goodwill.

[36] Mr. Cheung concludes that the RevPAR differential is $40.26, or $6,994,772 for a year. He deducts the 80% overall expense ratio (from agreed EBITDA) and multiplies the resulting amount by 14.4% to arrive at the Net Income Differential Attributable to Intangibles. Mr. Cheung capitalizes the Net Income Differential by 25% to 30% to arrive at a value range of $671,497 to $805,796. He concludes a value of $750,000 for the Brand/Goodwill of the Empress.

[37] Mr. Cheung provides no support for cap rate selections of 25% to 30% other than to say he assumes it should be higher than the 18% cap rate established for FF&E.

[38] Mr. Rosen calculates the contribution of the Brand Value/Goodwill by taking the average of the revenue differential in 2001 and 2002 of $7,130,484, extracts the tangibles at 53.4%, and capitalizes the resultant amount at 15.8%, for a total Brand Value of $20,600,000.

[39] To derive the capitalization rate, Mr. Rosen used the Capital Asset Pricing Model (CAPM). He said he looked at other methods including multiples of share prices and the weighted average cost of capital, both of which are mentioned in Course 800.

[40] Mr. Rosen's CAPM formula is: KE = RFR + B(ER), where KE is the unlevered discount rate or the cost of equity, RFR is the risk free rate (10-year U.S. Treasury Yield at December 31, 2001), ER is the equity risk

premium or the expected rate of return for the market (historical return on the S&P 500 from 1926-2001), and B is the adjusted Beta, which is a measure of the stock price volatility relative to the overall market.

[41] Mr. Rosen writes "There is no difference between a discount rate and a capitalization rate when future income is not expected to grow. Where growth in future income is expected, the capitalization rate equals the discount rate less the growth rate." To determine the growth rate for the Empress, Mr. Rosen reviewed the growth in total revenue, departmental profit and gross operating profit from 2000 to 2002. He presented the data in table form and concluded, "although gross operating profit declined over this period, I assumed a growth rate of 1.0% as being a reasonable expectation of future growth."

[42] Applying the above formula, Mr. Rosen concludes a cap rate of 15.8%. He says the method isn't perfect, but in the absence of a better method is "an excellent approach and resembles a reasonable proxy for determining a cap rate." He says the CAPM method is widely used and accepted by business valuators.

Working Capital

[43] According to Dr. Vernor, working capital includes cash, receivables and inventory, is part of the TAB, and is not realty.

[44] Mr. Cheung's evidence is that working capital is more in the nature of a cash float rather than the generally accepted accounting concept, and that in the case of an asset transfer of a hotel, the cash float does not usually form part of the sale price. Since the cash float is not conveyed with the selling price of the going concern, no further adjustment for it would be necessary.

[45] Mr. Cheung further adds "In the event that the owner has to temporarily fund the cash float or secure a short-term loan – and the float is repaid or returned to the owner as the revenues come in from the business – it is the opportunity cost or the interest cost that needs to be considered.

[46] Mr. Cheung states that the cash float is identifiable as discrete from the real estate; the opportunity cost of the cash float can be quantified and usually accounted for in the hotel's operating expense statement; and the cash float is not conveyed with the real estate upon the sale of the hotel property. He further writes that the opportunity cost of the cash float has been accounted for as part of the operating expenses and concludes that no deduction for the cash float as a non-realty component of a going concern is considered necessary.

[47] Dr. Vernor agreed the inventory and cash sometimes does not transfer on a sale but they are part of the total assets of the business, so when valuing the TAB or going concern, they need to be extracted. He also agreed that a hotel would typically have an operating line of credit at the bank, that they would be paying interest on the operating line, and that the interest is an expense deducted out in an operating statement.

[48] Mr. Rosen says working capital needs are dependent on the revenue mix, size and type of property. He classifies the Empress as a seasonal resort property that receives approximately 46% to 48% of room revenue from transient business and leisure travel. He stated that Fairmont Management indicate that in general, receivables at the subject hotel are carried for 30 to 60 days, which he says is consistent with interviews with representatives of the major hotel companies.

[49] Mr. Rosen then took the mid point of the range, 45 days, and applied it to the operating expenses of the hotel for the years 2001 and 2002. Total operating expenses varied from $32,421,000 to $34,082,000, or $89,000 to $93,000 per day. Over 45 days, Rosen estimated that the amount of working capital required to sustain operations at the Empress ranged from $3.9 million to $4.2 million. He concluded that a value of $4.1 million should be deducted from the Total Assets of the Business.

<u>Assembled Workforce</u>

[50] According to Dr. Vernor, "the difference between a going concern and mere completed construction (real property) includes a trained workforce". His opinion was that a fair estimate of the value of an assembled workforce is the cost to replace it.

[51] Mr. Rosen used this method to estimate the value of the assembled workforce at the Empress. His evidence was that the number of days required to assemble the workforce taken as a percentage of the hotel's total payroll would represent the value of the workforce.

[52] Mr. Rosen uses the Fairmont Vancouver Airport Hotel as an example. This hotel has 392 rooms and was built in 1999. He reports that this hotel had a pre-opening payroll cost of approximately $776,000, including benefits, recruitment and training costs. Based on the average number of weeks of recruiting and training of 5.26 weeks, this represented about 10.1% of the total annual payroll. Applying this approach to the Empress resulted in a total cost for the assembled workforce of approximately $1.4 million.

[53] In a second approach, Mr. Rosen takes the actual cost per employee of the assembled workforce for the Fairmont Vancouver Airport and applies that to the Empress. This results in a value of $1.9 million for the Empress, which has 207 more employees than the Fairmont Vancouver Airport. He estimates the value of the assembled workforce to be in the order of $1.4 million to $1.9 million, with the resulting value at the mid point of the range, or $1.65 million. This amount, he concludes, should be deducted from the Total Assets of the Business to arrive at the assessable real estate value of the hotel.

[54] In Mr. Rosen's view, the value of the assembled workforce represents not having to recruit, hire and train a workforce every year.

[55] While Mr. Cheung recognizes that the recruitment, hiring, and training of staff is an expense associated with setting up an enterprise, in his opinion, when valuing the going concern, because staff turnover is

anticipated in the normal course of business, the costs of recruiting staff is fully recognized when stabilized expenses are deducted in the determination of EBITDA. In his view, no deduction for the value of the assembled workforce is appropriate.

Pre-opening Sales and Marketing Expense

[56] In estimating value of pre-opening sales and marketing expenses, Mr. Rosen again uses the Fairmont Vancouver Airport Hotel as an example. He says sales and marketing expenses commence with the hiring of personnel for this purpose. The average recruiting and hiring period for these personnel at the Fairmont Vancouver Airport Hotel was 28.5 weeks, or about half a year (54.8%) prior to opening. Mr. Rosen applies a representative value of 54.8% to the total annual sales and marketing costs at the Empress for the years 2001 and 2002 to arrive at pre-opening costs between $859,000 and $972,000 with an average of $915,000. He concludes $915,000 should be deducted from the TAB.

[57] In Mr. Cheung's view, pre-opening sales and marketing expenses are input costs to a specific operation in a specific location at the start of the enterprise, and much, if not all of the value of these expenditures are associated with the real estate. While the benefits are vested in both the business and the property they are usually transferred with the sale of the real estate and form part of the value of the real estate. In his view, no deduction for the value of pre-opening sales and marketing expenses is appropriate.

Initial Start-Up Costs

[58] Mr. Rosen states that hotels require a period of time to ramp up to stabilized operations. Using the Fairmont Vancouver Airport Hotel as an example, where he says it took 18 months before a positive cash flow was achieved, Mr. Rosen estimates the operating losses at $9,023 per room. Applying this per room figure to the Empress, Mr. Rosen estimates that the operating losses would be $4.3 million (rounded) and concludes this amount should be deducted from the TAB.

[59] Mr. Cheung suggests that while initial start-up losses are identifiable there is no market data to suggest they have a discreet value independent of the real estate.

ANALYSIS

[60] As indicated earlier, this is the first time these issues have been presented for adjudication in this jurisdiction. We have carefully reviewed and considered all of the evidence, articles, jurisprudence and arguments presented. This decision has been difficult and challenging. We wish to thank both counsel for their thorough and able arguments and their assistance in providing us with as much material that they were aware of on this issue, including case authorities from other jurisdictions.

[61] It is clear from the evidence and the numerous articles and case authorities presented that the identification and valuation of intangible

assets is an extremely controversial subject in appraisal circles. There is no definitive method for dealing with intangibles. Given that the treatment of intangibles is not a settled matter, it seems to us that there are no right or wrong answers to the issues raised in this appeal. This Board is nevertheless charged with making a decision on these issues in the context of this case and on the basis of the evidence and arguments presented to us. We can only hope that our analysis of the evidence and arguments in this case can contribute constructively to the debate as appraisers throughout North America continue to develop theory and practice in this area.

[62] From the evidence before us, it appears that as early as 1983, Stephen Rushmore, writing on the valuation of hotels, recognized that the value of a hotel included the value of intangible personalty and business value that needed to be extracted if the appraisal assignment was for just land and improvements. Rushmore suggested that one "method for separating a hostelry's business value from its property value is to assume the owner enters into a management contract with a hotel company to take over all operating responsibilities of the property". The management fee therefore represents the income attributed to the business. This approach, generally known as the "Rushmore Approach", has been applied in the assessment of hotels in this and other jurisdictions without much debate until recently.

[63] The debate started to heat up in the United States in the late 1980's with concern that the assessment of shopping centres included the value of non-assessable business assets. The business enterprise approach emerged as a method of addressing what was considered a difficult but necessary task of separating and measuring the values of individual components of operating properties. The debate continued through the 1990's. The crux of the debate is whether land or entrepreneurship is the residual factor of production in valuing a going concern. In other words, once all factors of production have been satisfied, whether excess productivity runs with the land or whether it should be considered business value. Application of a business enterprise approach started to be discussed and advocated in the valuation of hotels as well as other going concerns besides shopping centres. By the late 90's interest in the subject prompted the development of Course 800, ultimately published in 2001.

[64] The first judicial test of the business enterprise approach (of the jurisprudence provided to us in any event) was a 1991 decision of the Wisconsin Court of Appeals with respect to the assessment of a shopping mall (*State ex rel. N/S Assoc. Board of Review* (1991) 473 N.W. 2d 554 (Wisc. App.) (QL). The court held that the "key to the analysis is whether the value is appended to the property, and is thus transferable with the property, or whether it is in effect independent of the property so that the value either stays with the seller or dissipates upon sale." The court found that the "mall's raison d'etre – namely the leasing of space to tenants and related activities such as trash disposal, baby stroller rentals, etc. – is a transferable value that is inextricably intertwined with the land" and that it was not possible to separate the mall's "non-transferable income-producing capacity from the elements of real estate". Subsequent decisions respecting the assessed value of shopping malls also rejected that there was any business value that needed to be deducted (*Equitable Life Assur. Soc'y of the United States v. County of Hennepin*, 1995 WL 702527 (Minn. Tax 1995) (QL);

Merle Hay Mall v. City of Des Moines Board, [1997] IA-QL 171 (S.C. Iowa)). In *Merle Hay Mall*, *supra*, the Supreme Court of Iowa found the "business enterprise theory is not a generally recognized appraisal method".

[65] With respect to cases involving the valuation of hotels, acceptance of the business enterprise approach by courts and tribunals has been mixed. In *ABKA Limited Partnership v. Board of Review*, [1999] WI-QL 1521 No. 98-0851 (Wisc. S.C.), the Supreme Court of Wisconsin found that management fees earned by a hotel company for the management of non-owned adjacent condominiums advertised and promoted by the hotel, managed by the hotel and sharing hotel amenities, was not business income to the hotel but income "inextricably intertwined" with the hotel land. The Court held that a "determination of whether business value is assessable involves an inquiry into the income producing capacity of the land. Income that is attributable to the land, rather than personal to the owner, is inextricably intertwined with the land and is thus transferable to future purchasers of the land".

[66] The Course 800 material was adopted by an administrative judge of the Tennessee State Board of Equalization in 2003 and 2004 in three hotel assessment cases: *Essex House Condo Corporation a.k.a. Marriot Courtyard Airport*, Initial Decision and Order, August 26, 2003, Tennessee State Board of Equalization; *HH HPTMI II Properties Trust a.k.a. Springhill Suites*, June 10, 2004, Tennessee State Board of Equalization*; HH HPTMI III Properties LLC a.k.a. Nashville Airport Marriott*, June 10, 2004, Tennessee State Board of Equalization. Mr. Lennhoff, one of the principle authors of Course 800, gave evidence in the three proceedings. Without much in the way of analysis or reasons, the administrative judge found in each case that Mr. Lennhoff had given "the most thorough and best substantiated evidence" and that "Mr. Lennhoff properly separated the value of the real property from the value of the tangible and intangible property".

[67] More recently, the same administrative judge rejected Mr. Lennhoff's approach in *Wolfchase Galleria Ltd. Partnership*, March 16, 2005, Tennessee State Board of Equalization, with respect to the assessment of a shopping mall, again where Mr. Lennhoff gave evidence with respect to the business enterprise approach. The administrative judge refers to the debate over the business value approach of which he says he was not aware when he issued his earlier decisions, quotes from several detractors of the business enterprise value theory, and concludes that "even if Mr. Lennhoff's methodology was generally accepted in the appraisal community, it does not necessarily constitute an acceptable approach for Tennessee property tax purposes".

[68] With respect to other types of going concerns, business value has been recognized, including intangible value for an assembled work force, permits and licences, working capital, and goodwill by the Superior Court of the State of California in proceedings respecting the determination of the fair market value of gas-fired power plants (*County of Los Angeles, et al v. Edison International et al*, Superior Court of the State of California (County of Los Angeles), March 22, 2002). With respect to the assessment of landfill sites, courts in Wisconsin and Ohio have rejected that intangible business value could be separated from the value of the land and improvements (*Waste Management v. Kenosha County Bd. of Review*, [1994] WI-QL 210

(Wisc. S.C.); *East Liverpool Landfill v. Columbiana County Board of Revision* (1997), 117 Ohio App. 3d 606 (QL)).

[69] We were provided with two decisions from other Canadian jurisdictions. The first was a decision of the Ontario Assessment Review Board with respect to the assessment of a retirement home (*1285328 Ontario Limited v. The Municipal Property Assessment Corporation, Region No. 3 and the City of Ottawa*, December 12, 2002, Ontario Assessment Review Board, Decision No. 1648323). Mr. Rosen gave expert evidence in those proceedings providing the opinion that deductions from the total value of the going concern should be made for intangible assets. The Board found that the Assessor’s methodology did not "properly recognize and remove the value of tangible and intangible property" and that Mr. Rosen’s method was correct. The Board accepted that the value of tangible and intangible personal property represented a measurable and separate portion of total property value and must be extracted. The Board accepted the deduction put forward by Mr. Rosen for working capital and the value of an assembled workforce but rejected the deduction put forward for the cost of pre-opening sales and marketing.

[70] The second was a decision of the Alberta Municipal Government Board with respect to the assessment of the Jasper Park Lodge, a Fairmont hotel. Dr. Vernor and Mr. Rosen gave evidence in that proceeding. From the decision, it appears their evidence with respect to theory and methodology for the valuation of intangibles was similar to the evidence given in these proceedings. The Board reduced the assessed value to that advocated by the Appellant on grounds of equity, but indicated it had evidentiary and theoretical concerns with the Appellant’s income approach. The Board was unable to accept the deductions put forward for brand/goodwill, assembled workforce, working capital and pre-opening losses.

[71] It is clear from a review of the academic and jurisprudential authorities that the business enterprise approach to the identification and valuation of intangible assets is not universally accepted. There continues to be debate amongst appraisers on the subject as is evident from the various publications and the divergent evidence presented before courts and tribunals across North America where the issue of separating the value of intangible personal property from the value of real property is raised. The majority of the decisions referred to us reject the theory and methodology of the business enterprise approach. Those decisions that accept it provide little in the way of reasons or analysis.

[72] Clearly, the valuation of intangible personal property is an evolving area of thought and practice. Course 800 is part of the evolving theory on the separation of tangible and intangible assets within a going concern but is far from authoritative or generally accepted. The business enterprise approach, the conceptual framework advanced by Dr. Vernor and the methodology employed by Mr. Rosen for the separation and valuation of intangible assets in a going concern remains controversial and cannot be said to constitute generally accepted appraisal theory.

[73] The Appellant argued that Course 800 represented the views of the Appraisal Institute before it adopted a policy of neutrality. We find that while Course 800 was developed under the auspices of the Appraisal institute, it

was never intended to recommend a particular practice. Dr. Vernor agreed that the methodology put forward in Course 800 was controversial. The Appellant did not suggest that Course 800 represented definitive methodology, but agreed it represented evolving thought.

[74] Despite the original disclaimer indicating the opinions and statements in the coursebook reflected the views of the Appraisal Institute, the bulk of the evidence suggests that the business value approach has always been controversial and has not been widely accepted. When the Board received the new evidence that the disclaimer had been amended and that the Course had been suspended and was being reviewed, the Appellant argued that "nothing had changed with the introduction of the new evidence". We agree. The bulk of the evidence already demonstrated that Course 800 did not represent settled thought.

[75] The Appellant submitted that this Board should await the Appraisal Institute's review of Course 800 before rendering our decision in this appeal. Given the evidence that the Appraisal institute has never formally recommended, endorsed or adopted a single methodology that constitutes official Appraisal Institute policy, it is unlikely that awaiting the review will assist. Even if the Appraisal Institute decides to continue the Course without changes, given the nature and extent of the debate over the business value approach to date, it seems unlikely that the controversy will evaporate overnight. Over time, it may be that Course 800 and the business value approach gains wider acceptance, but it seems unlikely that acceptance will be immediately universal. We will still be faced with the dilemma of deciding the issues in this appeal without the benefit of generally accepted appraisal practice in this area, and on the basis of our consideration of the evidence before us.

Components of Intangible Value

[76] Typically, where these issues have been adjudicated by a court or tribunal, the debate is between the business enterprise approach, as articulated by Lennhoff or Vernor, advanced by the property owner or taxpayer, and the "Rushmore Approach" advanced by the Assessor. In this case, the taxpayer has advanced the business enterprise approach, of which the Assessor is critical. But as an alternative, the Assessor does not advocate the Rushmore Approach but what amounts to a hybrid approach. The Assessor accepts Rushmore to the extent he disagrees there should to be deductions for intangible assets such as working capital, assembled workforce and start-up losses, but does not accept, at least in the valuation of this hotel, that the deduction of the management fee sufficiently accounts for intangible value associated with brand and business goodwill.

[77] With respect to the conceptual frameworks put forward by Dr. Vernor and Mr. Cheung both parties were critical of the other for the same reasons: that there was inadequate consultation in its development and that consultation did not include key people. As an analytical framework, we find that Mr. Cheung's approach of inquiring whether a particular component falls within the broad bundle of rights comprising fee simple ownership is more in line with the weight of authority that asks whether the value is appended to the property, and is thus transferable with the property, or whether it is independent of the property so that it either stays with the seller

or dissipates upon sale. In other words, is the value inextricably intertwined with the realty?

[78] While Dr. Vernor is able to identify intangible components of value conceptually and theoretically, there is no market evidence that these components actually have value that can be identified and separated from the value of the going concern, or that can be separated from the value of the realty.

[79] We accept that it is the object of the operator of any going concern to bring the factors of production, including land, improvements, equipment, labour, and entrepreneurship together to generate income sufficient to compensate those factors and make a profit. But there is no evidence to suggest, either generally, or specifically with respect to this going concern, that the investment in any particular factor of production will necessarily be satisfied or recovered in the sale of the going concern, or that the current cost of any factor of production (to the extent it can be measured by cost) necessarily equates to its value.

[80] The *Assessment Act*, requires that the land and improvements used by a commercial undertaking or business "be valued as the property of a going concern" (section 19(4)). A going concern would not be a going concern without all of the factors of production working together to generate revenue. The value of land in a going concern will be what it is, to a certain extent, because of all of the factors of production working together.

[81] We do not accept the evidence of Dr. Vernor that intangible value can only ever be associated with personal property and not real property. The value of real estate may be enhanced or diminished by intangibles such as zoning, development potential, location, competition and stigma. These are not things that can be held or touched, to use Dr. Vernor’s definition of tangible, but they are things that contribute positive or negative value to real estate. Such value is in our view intangible, but it is value that is part of the realty and not personal property. Dr. Vernor gave the example of historical icon value attributed to the lighthouse on the last hole of the Hilton Head South Carolina golf course. In our view, this is an example of intangible value associated with and transferable with the real estate – not of separate intangible personal property.

[82] That intangibles can contribute to the real estate is also illustrated in the following passage from Mr. Rosen’s evidence:

> The Empress was designed in Canadian Pacific’s signature "quasi-medieval architecture" style to serve as an attraction in and of itself, but more importantly to create a sense of history and luxury. The Fairmont Empress, as it is now known, has been a landmark in the City of Victoria for the past 95 years. It enjoys an enviable location, with excellent views of Victoria’s inner harbour.

[83] The factors of location, architecture, history, and prestige all contribute to the experience that is the Empress Hotel. Certainly there is value in these things. Some of that value may be intangible personal property, but some of

it will be intangible value that attaches to, and is inextricably intertwined with the realty.

Brand/Goodwill

[84] The Assessor uses methodology similar, but not identical, to that used by Mr. Rosen and put forward in Course 800 to value brand/goodwill. We have said the Course 800 methodology does not constitute generally accepted appraisal practice and the Assessor's methodology for the valuation of brand/goodwill cannot be said to constitute generally accepted appraisal practice either.

[85] However, given that both parties accept that the going concern value of the Empress Hotel includes intangible value for brand/goodwill, and accept that the deduction of a management fee is insufficient in this case to capture that value, the Board finds, on the evidence in this case, that intangible value for brand/goodwill exists in the going concern value of the Empress Hotel, and that it must be estimated and deducted. While we do not have difficulty accepting that there is intangible value to the Fairmont Brand or business goodwill value as part of the going concern of the Empress Hotel, we do have some difficulties with the evidence of how to determine that value.

[86] Both Mr. Rosen and Mr. Cheung provide a model that ranks factors contributing to RevPAR at the Empress with other hotels. Both use the same eight hotels as the competitive set: Chateau Victoria, Harbour Towers, Executive House, Grand Pacific, Coast Harbourside, Delta Ocean Pointe Resort, Magnolia, and Laurel Point Inn. Mr. Rosen ranked the hotels in three categories: Site and Location, Improvements – physical condition, and FF&E – physical condition. To these three categories (called Land, Physical Plant and FF&E by Mr. Cheung), Mr. Cheung added a fourth category called Amenities and Services.

[87] The Appellant argued that the fourth category was unnecessary, that it was hard to conceive of anything in Amenities and Services that would not already be covered in the other three categories. For example, separate check-in desk and private lounge could be considered under the improvement category, and access to the Victoria Conference Centre could be included under site and location. The Assessor says the number of categories does not matter, what matters is that the process fully capture the magnitude of the difference between the subject and the competitive set. We agree that the fourth category probably is a duplication, but we also agree that the number of categories probably does not matter. Given that Mr. Cheung was a bit unsure as to what he was including in the fourth category, and given that he did not inspect the properties for the purpose of doing the ranking, we accept Mr. Rosen's evidence of three categories.

[88] Our first concern with the model is the selection of the competitive set. Mr. Rosen's evidence was that the eight hotels were the eight hotels that the Empress themselves considered to be their competitors. The Empress may compete with these hotels to sell rooms in the Victoria market, but it is evident from the rankings given by both appraisers to some of these hotels that they are not very comparable to the Empress. For example, the rankings by both appraisers in all categories for the Chateau Victoria,

Harbour Towers and Executive House were low compared to the rankings for the Empress (1 or 2 compared to 5). It is probable, given these differences, that those three hotels and the Empress do not compete for the same clientele. As both appraisers accepted the competitive set, however, we accept it as well despite these reservations.

[89] The second problem with the model of both appraisers is the subjective nature of the rankings. While the rankings of both appraisers are subjective, we prefer the evidence of Mr. Rosen given that he actually inspected each hotel for this purpose and given his experience in the hotel industry.

[90] Both appraisers total the ranking scores in the various categories for the Empress and the competitive set and conclude that the differential of the Empress over the market represents the difference between the market average RevPAR and that of the Empress that is attributable to tangibles. In Mr. Rosen's opinion 53.4% of the difference between market RevPAR and that of the Empress is attributable to tangibles and the remaining 46.6% is attributable to intangibles. In Mr. Cheung's opinion, 85.6% of the difference between market RevPAR and that of the Empress is attributable to tangibles and the remaining 14.4% is attributable to intangibles.

[91] We have difficulty following the logic of this analysis. It is a huge leap, not substantiated by either appraiser, that the differential from the ranking exercise represents the difference in RevPAR attributable to tangibles. For one thing, it assumes that all the categories ranked contribute equally to RevPAR. There are many reasons why a hotel patron may choose one hotel over another and why they may be willing to pay more for a room in one hotel than in another. Given that the Empress is really in a category of its own in Victoria as a first class heritage hotel and city landmark, the comparison to other hotels ignores that the Empress may itself be a destination attraction that may attract higher RevPAR on its physical and tangible attributes alone. Mr. Rosen agreed that in order for the brand to associate with the Empress, the Empress needs to be at a certain level of quality for the land, the FF&E and the site. So for Fairmont to put its brand on the Empress, it needs a certain quality and character of land and improvements to start with. We question how the appraisers can be sure how much of the RevPAR differential enjoyed by the Empress over the other eight hotels is related to the character and quality of the land and improvements, and how much is related to brand or business goodwill. Could not the differential be attributed to a combination of factors working together?

[92] Despite these reservations, in the absence of other evidence, we accept that such an analysis may indeed isolate value to brand/goodwill. Given that we prefer Mr. Rosen's rankings over Mr. Cheung's, we find that 46.6% of the difference between market RevPAR and that of the Empress is attributable to intangibles. We continue to have concerns over the subjective nature of this analysis and the lack of evidentiary support. While we have accepted the approach as being the best evidence in this case, we do not necessarily endorse the methodology for application in other cases.

[93] Mr. Cheung adjusted the income differential for expenses applying the 80% expense ratio for all departments as, in his view, the additional income did not come without additional expenses. Dr. Vernor agreed that the

income differential should be adjusted for expenses but thought it should be a smaller ratio although he was unable to say what the ratio should be. We agree that if this methodology is to be used, the RevPAR differential must be adjusted for expenses and the net differential converted to a capital value. Just as net income is capitalized to determine the value of the going concern, it should be the net income differential that is capitalized to determine the value of the brand/goodwill component within that value. We find that the 80% overall expense ratio should be applied to the differential RevPAR.

[94] As to capitalization rate, although the Assessor was critical of the CAPM method advanced by Mr. Rosen, we find the CAPM method at least provides some rationale and support for the capitalization rate selected. Mr. Cheung provided no support for his capitalization rate. We find a capitalization rate of 15.8% should be applied to the net income differential attributable to intangibles.

[95] We calculate the value of the brand/goodwill as follows:

Average room differential (2000-2002) = $40.26		
	x 476 rooms x 365 days =	$6,994,772
	Less 80% operating expense	(5,595,818)
	Net income differential =	$1,398,954
Net income differential $1,398,954 x 46.6% =		$651,913
Capitalized at 15.8% =		$4,126,032

Say, **$4.1 million rounded**

[96] We find the value of the brand/goodwill component to be $4.1 million.

<u>Other Intangible Components</u>

[97] With respect to an assembled workforce, while we accept that there must have been an initial investment in hiring and training a workforce, we do not accept that the initial investment necessarily continues to have discreet market value or that its value is separable from the real estate.

[98] The business of the hotel is to generate income through the nightly rental of rooms and the provision of other guest services to support that basic function. All of the factors of production, including labour, are

integrated to create and maintain the going concern. To the extent there is or could be value in an assembled workforce, we find that such value is, necessarily, inextricably intertwined with the realty.

[99] Furthermore, the evidence was that the workforce of a hotel is constantly turning over, which means that a hotel is constantly re-investing in its workforce. It is constantly recruiting, hiring and training, and all of the expenses associated with this activity are already deducted from the income stream. To deduct the cost of replacing the existing workforce and equating that cost to an intangible value for the assembled workforce is in our view double counting. In any event, there is nothing to substantiate the assumption that the current replacement cost of assembling a workforce would necessarily equate to its market value upon the sale of the going concern.

[100] The same is so for pre-opening start up costs and initial losses. While these items can be theoretically identified, there is no evidence that they actually have market value or that any value can be independently appraised. To the extent the investment in opening a hotel does or can have value, we find that such value is inextricably intertwined with the real estate and cannot be separated. There is nothing to substantiate the theory that the present day costs of bringing a hotel to stabilized levels will form part of the purchase price of a going concern, generally, or of this going concern in particular.

[101] As for working capital, the evidence is that cash and receivables are not part of the EBITDA. Consequently, to the extent working capital has value, that value is not part of the value of the going concern determined by capitalization of the EBITDA and need not be extracted. The interest cost of working capital is also already deducted from the income stream.

CONCLUSION

[102] We conclude intangible value for brand/goodwill should be deducted from the going concern value of the Empress. We conclude the intangible value of brand/goodwill at the Empress is $4.1 million.

[103] We conclude that no other deductions for intangible value should be made.