RRI ACQUISITION COMPANY, INC.	*	IN THE
	*	
vs.	*	MARYLAND TAX COURT
SUPERVISOR OF ASSESSMENTS OF HOWARD COUNTY	*	No. 03-RP-**HO**-0055
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MEMORANDUM AND ORDER

Petitioner, RRI Acquisition Company, Inc., owns the Red Roof Inn Jessup located at 8000 Washington Boulevard in Jessup, Maryland. The subject property is comprised of a 1.8279 acre improved site with a three story limited service hotel containing 108 rooms and 117 parking spaces. As of January, 2002, the Respondent, Supervisor of Assessments for Howard County, valued the property at $6,830,400.

After an appeal to the Property Tax Assessments Appeal Board for Howard County, the value of the property was retroactively reduced to $6,300,000 on January 3, 2003. In appealing to the Maryland Tax Court, Petitioner contends that the present assessment should be reduced to $4,800,000 because the State's valuation included tangible and intangible personal property. The Petitioner relies upon the testimony of David C. Lennhoff, an expert who has given expert appraisal testimony in hotel valuation cases before tax tribunals in several states.

The subject property is assessed for real estate Ad Valorem tax purposes pursuant to Sections 8-102, 8-103 and 8-105 of the Maryland Tax-Property Article of the Annotated Code. The assessment of real property equals its value on the date of finality,

and since the subject property produces income, the income capitalization approach ("income approach") may be used to determine its value. Generally accepted appraisal practices recommend consideration of the income approach as well as the sales comparison and cost approaches to value income generating property.

The critical question for the Court to determine is how to distinguish the tangible and intangible personal property value from the real estate value of the subject property hotel. Petitioner argues that a hotel is a business enterprise and is comprised of many assets, which in their totality equate to the total value of the business. In an effort to insure that the real estate only is taxed for assessment purposes, it is necessary to separate the real estate value from all other assets. The Petitioner suggests that the income approach may be utilized to separate or distinguish the real estate from other assets by distinguishing the revenue derived from the tangible and intangible personal property of the business enterprise from that attributed to the real estate.

The Petitioner further contends that it is well established Maryland law to exclude business value and other personal property when valuing real property for Ad Valorem tax purposes, see Whitestake Assoc. vs. Supervisor of Assessments of Anne Arundel County, MTC Case No. 728 (1990); see also Inner Harbor Marina of Baltimore, Inc. vs. Supervisor of Assessments of Baltimore City, 1 HTC 533, 534 (1991). The Court ruled in Whitestake that ". . . care must be taken to avoid an analysis of the business rather than the real estate on which it is operated." In Inner Harbor, the Court cited the Whitestake holding and stated that ". . . we must carefully distinguish real estate income from business income and real estate expenses from business expenses."

Courts in Tennessee, Arizona, and Virginia have found that non-real estate value should be separated from real estate value when assessing hotels and other facilities. See Potomac Hotel Limited Partnership vs. Maricopa County, A.T.C. No. 2001-000531 (2004); see In Re: Essex House, a/k/a Marriott Courtyard Airport, Tennessee State Board of Equalization (2004); see WXII/Oxford-DTC Real Estate, LLC vs. Board of Supervisors of Loudoun County, Virginia, CL No. 29368 (2004). In determining market value for real estate purposes, assessing authorities were required to segregate the value of the real estate from the value of the going concern.

The process of separating the income attributable to the use of the real estate out of the total income generated by the operation of the business before capitalization of the real estate income is generally treated in the discussions of the going concern value and business enterprise value in The Appraisal of Real Estate, 12th Edition, The Appraisal Institute (2001). This well respected treatise notes that income is derived from the total assets of the business, which can include real property, tangible personalty, and intangible elements. Necessarily, in the income capitalization approach, because the capitalized income stream will most likely reflect income to all of the assets of the business, all components of net operating income not attributable to the real estate must be removed.

The Respondent relies upon the Rushmore method. Stephen Rushmore is the author of Hotels, Motels, and Restaurants: Valuations and Market Studies (1983). Mr. Rushmore has established a national reputation in hotel valuation.

Rushmore suggests that all payments to the entity that manage and operates the hotel constitute business income generated by the exercise of management and entrepreneurship. Under the Rushmore method, these payments are excluded in the

computation of realty income subject to capitalization. In addition, a portion of the overall income realized by the employment of furniture, fixtures, and equipment ("FF&E") is also excluded from realty income. Separate adjustments are made to provide for the periodic replacement of the personal property (the return of FF&E) and also for a yield on the investment in personal property (the return on FF&E). This method has been employed by experts in other hotel valuation cases and has been generally accepted in the market.

The Petitioner relies on the Lennhoff approach. David C. Lennhoff is the editor of a collection of articles entitled A Business Enterprise Value Anthology (The Appraisal Institute, 2001), and is one of the developers of the Appraisal Institute Course 800: "Separating Real and Personal Property from Intangible Business Assets." Applying the theories he has developed to hotel valuation, Lennhoff concludes that, in addition to the adjustments of the Rushmore method, several additional adjustments must be made to arrive at an accurate valuation for the real property used in a hotel operation.

The additional adjustments that Lennhoff supports are designed to deal with value attributable to: (a) personal property; (b) the hotel franchise or "flag" ; (c) various residual intangibles, including goodwill and business and credit relationships; and (d) developmental and start-up outlays associated with the initiation of the hotel business.

Mr. Lennhoff first determines the net operating income to the going concern from which he subtracts a return on/of furniture, fixtures, and equipment (FF&E), a return on/of business start-up costs, and a return on/of brand-specific intangibles. Lennhoff asserts that the return on/of FF&E, return on/of business start-up costs, and return on/of brand-specific intangibles are all non-realty items excluded from net operating income. The resulting NOI is ultimately capitalized into real estate value using a cap rate, which is

increased to account for market specific residual intangibles, according to Petitioner's approach.

The Petitioner further argues that the incremental value added to tangible and intangible personal property makes a hotel an economically viable business enterprise that is expected to continue. If a hotel investor was interested in buying or selling a hotel property, he might use the sales comparison method as a reference point to compare the sale price of the subject property against other similar properties. The sale price would reflect the value of the total assets of the business: the real property, tangible, and intangible personal property. The income capitalization method is preferred for hotels in order to properly deduct the tangible and intangible property, thereby isolating the real property component.

Lennhoff testified that a return on and of FF&E, as well as a replacement allowance are both necessary deductions in order to completely remove the value of FF&E from the capitalized stream of net income. The return on FF&E reflects the level of profit that an investor would anticipate on a limited service hotel such as the subject property. This return on is considered an intangible, because it reflects profit earned on tangible items. Lennhoff also takes a return of FF&E to recover the money actually invested in FF&E. Lennhoff accomplishes this by amortizing the "as is" value of FF&E over eight years using an average hotel mortgage rate adjusted upwards by 250 basis points to reflect the higher rate of return on personal property.

A replacement allowance provides for the periodic replacement of building components that wear out more rapidly than the building itself and must be replaced periodically during the building's useful life. Petitioner's expert utilizes a replacement

allowance consistent with the replacement allowance taken by other similar limited service hotels. Mr. Lennhoff then increases the allowance to reflect the subject's higher occupancy penetration rate premium over other limited service hotels within the same geographic area.

The Petitioner also contends that the start-up costs benefit the going concern over the economic life of the hotel, and, therefore, must be amortized over the period of time that should realistically reflect a typical management agreement as well as the time period before which a thorough "renovation and re-orientation" is needed. The Appraisal of the Petitioner capitalizes the business start-up costs from the Subject Property's Franchise Offering Circular over the subject's estimated economic life of twenty years.

Mr. Lennhoff's methodology further evaluates brand specific intangibles by measuring the extent to which the subject property out-performs other hotels within its competitive set. The competitive set is a group of properties in the same geographical area whose real property is generally equivalent. Because the competitive set, as adjusted, equalizes the value of the real property, any superior performance by the subject property relative to its competitors is business related as opposed to income related to the real estate. Mr. Lennhoff measures this degree of superior performance using a formula calculated by multiplying the average daily room rate by occupancy in order to determine the revenue per available room. The RevPAR penetration rate index suggests that the subject property out-performs the market by about 20%. Lennhoff accounts for the 20% above market performance by deducting 20% of the projected 2002 net operating income.

Petitioner argues that the Salomon Smith Barney Equity Research Report on Marriott International, Inc. ("SSB Report") indicates that a RevPAR premium benefits hotels with a Marriott flag by increasing property revenue, which allows Marriott to charge higher

fees and secure preferable contract terms from its franchisees. Consequently, according to Lennhoff, a hotel investor would pay more for a Marriott branded hotel because of its future ability to out-perform the market. The subject property is a Red Roof Inn and is similar to Marriott and, thus, out-performs its respective competitive set. A hotel investor likewise would pay a higher price for the total assets of the business related to the subject property since it too would yield higher revenues and occupancy rates. Therefore, since the RevPAR premium directly measures the real estate's ability to sustain higher revenues than other equivalent real estate, Lennhoff argues a 20% deduction from 2002 projected income is justified.

Finally, Lennhoff concludes that the subject property qualifies as second or third tier property, and a cap rate for only the real property would logically be below that of a going concern but above an apartment or office building which enjoy relatively long-term leases as compared to a hotel. Lennhoff suggests that a premium on the cap rate is necessary to reflect this additional risk.

The Respondent argues that the Court should reject Mr. Lennhoff's methodology with respect to the treatment of FF&E and the value of certain business intangibles. The Respondent suggests that the proper method is to deduct an amortization of the current replacement costs of FF&E to remove a return on the personal property from the real property value. The Respondent's Assessor also subtracted the actual corporate expenses to remove the value of the flag affiliation.

According to the Respondent, the method of the Petitioner duplicates the removal of the return of value first as a reserve and then as a return of. Moreover, the

annual amortization of the original start-up costs incurred at the initial opening of a fourteen-year-old hotel is not a recognized analysis in the market place.

The Respondent further contends that the intangible value which Petitioner assigns to the Red Roof Inn affiliation based upon average daily rates and occupancy percentages of the subject with those of a competitive set is fatally flawed because such a comparison does not give proper consideration to the location, market segment, or other differences between the subject and the components of the set. Accordingly to the Respondent, unless all the properties were comparable in all other value impacting characteristics, the differences identified by comparison to the so-called competitive set does not justify an allocation of value based solely on the flag.

The Court agrees with the Respondent's methodology and is skeptical of the adjustments proposed by Lennhoff to the Rushmore method. Lennhoff's proposed adjustments are not persuasive from a theoretical standpoint due to the lack of market data supporting such adjustments. The Court is persuaded that in the case of properties such as hotels, which are sensitive to many intrinsic and extrinsic factors, there may be a wide range of business incomes which could be achieved at different but competent levels of management. Those differences do not necessarily depend on management that is either superior or inferior.

Mr. Lennhoff's deduction for a return on FF&E from income as well as a deduction of the invested capital from value is an impermissible duplication under standard appraisal practice. Once an appropriate allowance of income earned on FF&E is deducted from the income stream to be capitalized, that property is no longer in the capitalized value.

In addition, Mr. Lennhoff's start-up cost adjustment may have some theoretical soundness where the hotel business is actually still benefiting from start-up costs, and the costs can be specifically identified and limited to those that produce business value as opposed to real estate value. However, the subject property is fourteen years old, and there is no data to support such an adjustment.

Roy Sleeman, a statewide Commercial Supervisor, with over thirty years of experience in commercial assessments, provided a persuasive rebuttal to Mr. Lennhoff's approach. Mr. Sleeman suggested that the real estate market simply does not understand or address intangibles in the way Mr. Lennhoff suggests. To accept Mr. Lennhoff's approach would be to in effect turn expenses into intangible assets for the purpose of deducting value from the return of value on real property. Mr. Sleeman also provided a detailed analysis of Mr. Lennhoff's appraisal, which raised theoretical as well as empirical questions regarding the Lennhoff method.

The Court finds that the Lennhoff approach includes impermissible adjustments to the Rushmore approach, which were either duplicative or not supported by the market place. Consequently, the Court must reject Mr. Lennhoff's appraisal as his theories and methodologies are academic constructs unsubstantiated by the market. Respondent's appraisal closely reflects the Rushmore methodology, which is market driven and tested.

For the aforegoing reasons, the Maryland Tax Court, this **10th** day of **February, 2006**, affirms the determination of value by the Property Tax Assessment Appeals Board of Howard County of $6,300,000.

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Judges