Tax assessments in flux in new market

The hotel market was booming during the past three years. Purchase prices broke records and set historically low capitalization rates. Across this period, investors in more traditional real estate holdings moved into the hospitality segment, seeking to maximize the anticipated bounce following the post 9/11 downturn. While market conditions were great for investors, both asset managers and property tax professionals faced uphill battles at local assessment offices.

In response to the market upswing, assessors lowered cap rates in their valuation models to match those implied from sales prices. Now, with the crisis in the credit markets prompting a market downturn, taxpayers must ensure that their assessments reflect current economic conditions, which indicate relatively flat income projections. The key to fair property tax assessments lies in deriving a proper cap rate—one that does not assume significant upside potential.

Cap rates and upside potential

Generally a lag exists between hotel assessments and current market conditions. The lag is caused by valuation methods that focus on trailing income and expense as well as the use of cap rates from prior-year sales surveys. These factors provide great benefits for owners when the market is going up, but do not bode well for them when the market peaks and starts to turn down.

With a market in transition, assessors commonly err by using cap rates implied from prior sales in the rising market to capitalize current income streams, which show no upside potential. The math is best understood through an example. To keep the example simple, no intangibles are removed from the sale (but they should always be excluded in a proper assessment). Assume a hotel, which was on the market in early 2007, had a prior-year net income of $1 million and sold for $15 million. By dividing the income by the sales price, the transaction implies a low cap rate of 6.6%. At the time of the sale, however, the buyer estimated that the net income would increase by 30% over the following year to $1.3 million. Thus, the cap rate of 6.6% would be adjusted up to the "real" cap rate of 8.6% once the buyer's anticipated upside is taken into consideration.

Utilizing the stabilized cap rate

Now assume the same property is being assessed for tax year 2008. The assessor knows of the prior sale and has calculated the 6.6% cap rate, which he intends to use to value the property. Over the course of 2007, the buyer's expectations were exceeded and the property's net income grew to $1.4 million. The assessor plugs the income information into his valuation model and calculates a whopping $21.2 million for the hotel ($1.4 million divided by .066).

As a result of the changing market conditions, however, the income projections are flat. If the lack of upside potential reflected in the market is considered, the assessor should have used the stabilized 8.6% cap rate, which would have resulted in a value of $16.3 million, approximately a $5-million difference in assessed value.

Losses from subprime mortgage holdings have profoundly affected the availability of commercial credit. Lenders with holdings tied to subprime mortgages are now scrambling for cash, as investors flee to other sectors of the market. This lack of cash has restricted funds for commercial lending and changed the playing field for hotel transactions. Greater underwriting scrutiny and more risk recognition in interest rates have increased the cost of capital, making deals more difficult to justify.

money talks

Mark Hutcheson
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Unreliability of market extraction

The impact of the current credit crisis is abundantly evident in the market. For example, the share price for one large independent commercial lender dropped from more than $61 last June to around $10 in March, and the lender recently announced it will sell assets to address concerns about a cash shortage.

When interest rates increase because of the lack of commercial credit and with tighter underwriting standards, cap rates must go up to reflect these market conditions. Evidence of this increase, however, may be difficult to establish. Assessors typically use the "market extraction" method, which derives cap rates by dividing net income by the sales prices of transactions in the local market. When the volume of sales transactions declines, the market extraction method becomes less reliable because there are fewer transactions from which to develop an appropriate market cap rate. One alternative is to build up the cap rate through a band-of-investment analysis, wherein a return of and on the debt and equity components can be independently established. This analysis requires greater knowledge of valuation principles, but may be the best alternative during a time of market transition.

Ensure the assessment matches market

During times of market transition, especially from an up market to a down one, taxpayers should spend extra time to carefully analyze their tax assessments. The underlying valuation methodology and the cap rate applied may not reflect current market conditions concerning income growth and the availability and cost of capital. As the market continues its cycle, the tax dollar saved today will pay dividends tomorrow.

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Supplement to Hotel Business®
Hotel Journal™

SEPTEMBER 2008

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