MUNICIPAL
PROPERTY
ASSESSMENT
CORPORATION

METHODOLOGY GUIDE

VALUING HOTELS IN ONTARIO

Valuation Date: January 1, 2016

AUGUST 2016

MUNICIPAL PROPERTY ASSESSMENT CORPORATION

August 22, 2016

The Municipal Property Assessment Corporation (MPAC) is responsible for accurately assessing and classifying property in Ontario for the purposes of municipal and education taxes.

In Ontario's assessment system, MPAC assesses your property value every four years. This year, MPAC is updating the value of every property in the province to reflect the legislated valuation date of January 1, 2016.

MPAC is committed to provide Ontario property owners, municipalities and all its stakeholders with the best possible service through transparency, predictability and accuracy in values. As part of this commitment, MPAC has defined three levels of disclosure of information in support of its delivery of this year's assessment update. This Methodology Guide is the first level of information disclosure.

This guide provides an overview of the valuation methodology undertaken by MPAC when assessing hotel properties for this year's update ensuring the methodology for valuing these properties is well documented and in alignment with industry standards.

Property owners can access additional information about their own properties through aboutmyproperty.ca. Login information for aboutmyproperty.ca is provided on each Property Assessment Notice mailed this year. Additional information about MPAC can be accessed at mpac.ca.

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1.0 Introduction

The Municipal Property Assessment Corporation (MPAC) – mpac.ca – is responsible for accurately assessing and classifying property in Ontario for the purposes of municipal and education taxation.

In Ontario, property assessments are updated on the basis of a four-year assessment cycle. In 2016, MPAC will update the assessments of Ontario's nearly five million properties to reflect the legislated valuation date of January 1, 2016. Assessments updated for the 2016 base year are in effect for the 2017–2020 property tax years.

The last Assessment Update was based on a January 1, 2012, valuation date. Increases are phased in over a four-year period. Any decreases in assessment are applied immediately.

It is important to ensure that the valuation methodology applied is capable of providing a realistic estimate of current value at the relevant valuation date, which, in turn, enables all stakeholders to understand the valuation process and have confidence in the fairness and consistency of its outcome.

This Methodology Guide has been prepared for the benefit of MPAC assessors, property owners and their representatives, municipalities and their representatives, Assessment Review Board members, provincial officials, and the general public.

This guide outlines the valuation process to be followed by an assessor, including steps that require appraisal judgment. It is incumbent upon the assessor to make informed decisions throughout the valuation process when arriving at estimates in current value.

1.1 Properties Covered by This Methodology Guide

This methodology guide applies to hotels in Ontario. Hotels vary from small budget hotels to very large convention hotels, luxury hotels and resort hotels. The following MPAC property codes are used to categorize the various types of hotels in Ontario:

- 444 Full service hotel
- 445 Limited service hotel

It should be noted that these are general guidelines that vary depending on the specific circumstances of a particular property.

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An assessor may also make reference to additional methodology guides for properties that do not fall precisely within the description of one of the property codes listed above.

1.2 Legislation

The main legislation governing the assessment of properties in Ontario for property tax purposes is contained in the Assessment Act.

The Act contains important definitions and states what property is taxable and how it should be valued. Section 19(1) of the Act requires that land be assessed at current value, which is defined to mean, in relation to land, "the amount of money the fee simple, if unencumbered, would realize if sold at arm's length by a willing seller to a willing buyer."[1]

In determining the current value of hotels, Section 45.3 of Ontario Regulation 282/98 provides that if the land is assessed using the *pro form* income capitalization approach, the amounts deductible for management fees and personal property for a year shall not exceed 5% and 15% respectively.[2]

1.3 Classification

MPAC's role is to accurately assess and classify all properties in Ontario in accordance with the Assessment Act and its associated regulations established by the Government of Ontario. The classification of a property will determine which tax rate will be applied by the municipality or taxing authority. All properties are classified according to their use, and Ontario Regulation 282/98 of the Assessment Act sets out how various property uses are classified.

The classification of hotels is covered in Section 17(1) of Ontario Regulation 282/98. This section of the regulation provides that hotels are included in the "commercial property class and not in any other property class." Hotels include land that would otherwise be in the multi-residential or new multi-residential property class that meets the requirements set out in the legislation or hotel as defined in the Hotel Registration of Guests Act.

If a portion of the property is used for other purposes, it may be necessary to value those components separately and sum the component values to achieve the correct total current value. It may also be necessary to apportion the total value of the property between the various uses to ensure that the appropriate tax rate is applied to the relevant parts of the property.

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[1] Assessment Act, R.S.O 1990, c A.31: https://www.ontario.ca/laws/statute/90a31.
[2] Ontario Regulation 282/98, GENERAL: https://www.ontario.ca/laws/regulation/980282.

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1.4 The Use of This Methodology Guide

This Methodology Guide is intended to:

- Ensure MPAC's assessed values for these properties are fair, accurate, predictable and transparent.
- Provide direction to assessors and clear explanations to municipalities, taxpayers and Assessment Review Board members.
- Ensure that MPAC's methodology for valuing these properties is well documented and aligns with industry standards.
- Explain the thought process/decision-making process that an assessor should undertake to apply the valuation methodology.
- Ensure a consistent approach to valuing these property types.
- Support MPAC assessors in conducting their due diligence in:
    - applying Ontario's legislation and regulations
    - adhering to industry standards for market valuation in a mass appraisal environment

It should be noted that this Methodology Guide is not intended to be a substitute for an assessor's judgment in arriving at a market value–based assessment (i.e., current value) for a particular property. However, given that the Methodology Guide explains industry standards for property assessment, conforms to valuation industry norms, and adheres to provincial legislation and regulation, MPAC assessors are expected to follow the procedures in the Methodology Guide and be able to clearly and satisfactorily justify any deviations from it.

1.5 Consultation and Disclosure

MPAC is committed to providing municipalities, taxpayers and all its stakeholders with the best possible service through transparency, predictability and accuracy. In support of this commitment, MPAC has defined three levels of disclosure as part of its delivery of the 2016 province-wide Assessment Update:

- **Level 1** – Methodology Guides explaining how MPAC approached the valuation of particular types of property

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- **Level 2** – Market Valuation Reports explaining how the methodology outlined in Level 1 has been applied at the sector level for the purposes of each assessment

- **Level 3** – Property Specific Valuation Information available to property taxpayers, their representatives and municipalities

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2.0 The Valuation Process

The valuation process always begins with a determination of the highest and best use of the subject property.

Any reliance upon this guide is made only after the assessor has determined that the highest and best use of the subject property is that of a hotel.

Assessors determine the value of a property using one of three different approaches:

- the direct (sales) comparison approach
- the income approach
- the cost approach

2.1 Outline

In the **direct (sales) comparison approach**, value is indicated by recent sales of comparable properties in the market. In considering any sales evidence, it is critical to ensure that the property sold has a similar or identical highest and best use as the property to be valued.

In the **income approach** (or, more accurately, the income capitalization approach), value is indicated by a property's revenue-earning power, based on the capitalization of income. This method requires a detailed analysis of both income and expenditure, both for the property being valued and other similar properties that may have been sold, in order to ascertain the anticipated revenue and expenses, along with the relevant capitalization rate.

In the **cost approach**, value is estimated as the current cost of reproducing or replacing improvements of the land (including buildings, structures and other taxable components), less any loss in value resulting from depreciation. The market value of the land is then added.

MPAC predominantly uses the income approach to value hotels. The value of an income-producing property such as a hotel is based on the present worth of anticipated future income. The income approach is accepted by market participants as an appropriate way of estimating the value of income-producing properties, including hotels.

MPAC uses the direct capitalization method to establish current value assessments in a mass appraisal context.

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This method estimates the stabilized annual revenue that can be generated by the hotel, deducts the annual expenditure reasonably incurred, and then applies a capitalization rate to the net income to arrive at a value for the hotel.

The direct capitalization method includes the following steps:

1) Determine stabilized room and hotel departmental revenues.

2) Determine stabilized expenses for the hotel.

3) Determine net operating income (NOI) or earnings before interest, taxes, depreciation, and amortization (EBITDA).

4) Capitalize NOI into value.

5) Deduct the personal property allowance.

6) Determine the current value assessment.

The income received and the capitalization rate used in the process of valuation are established by MPAC through the analysis of property specific and market data.

The direct capitalization formula can be expressed as:

Market Value (MV) = Net Operating Income (NOI) / Capitalization Rate (R)

For example, given that the stabilized NOI of a particular hotel is $100,000 and the capitalization rate (R) is 8.00%, the value of the property is:

$100,000 / 8.00% = $1,250,000

From this value, the value of personal property is deducted at 15.00%:

$1,250,000 X 15.00% = $187,500

Therefore, the assessed value of the example property is:

$1,250,000 – $187,500 = $1,062,500

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2.2 Approach

There are three main phases in the valuation process used by MPAC:

- data collection
- analysis of the data collected
- valuation

2.3 Data Collection

The data required for hotel valuations come from a number of sources:

- MPAC conducts periodic inspections of hotels.
- Property owners are required to provide MPAC with details including actual income and expenses.
- MPAC also collects information about sales and transfers of hotels.
- There are a number of guides and other published information about hotels.

MPAC generally collects the following types of data for hotels:

- general data (number of rooms, restaurants, meeting rooms, convention space, amenities, parking, etc.)
- financial data
- property description
- sales data
- space and concession data
- hotel improvement data
- land valuation data
- commercial rental data
- condominium data (hotel versus residential condominium units)
- fixtures, furnishings and equipment data (FF&E)

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Financial Data

A hotel owner or operator is the main source of a hotel's financial data. A written request for the pertinent financial information is made to each hotel owner. A copy of the previous year's operating statement, including revenue and expenses, is required annually.

Income and expense information includes:

- occupancy levels
- average room rate
- food and beverage (F&B) outlet income
- other income (meeting room rentals, parking, etc.)
- departmental operating expenses
- other operating expenses broken down by type of expense
- management contract details
- fixed expenses, including property tax and insurance
- record of expenditures on FF&E
- record of capital expenditures
- reserves for replacement
- record of property owner's personal property

Hotel Sales Data

MPAC collects data relating to the sale of hotels to analyse the price paid in relation to the net operating income in order to determine the capitalization rate.

It is important for MPAC to ascertain as much information as possible regarding each sale, including local market factors. Hotel sales may include non-assessable items such as inventory, FF&E and intangibles.

MPAC analyses sales from a broad geographical area to determine appropriate capitalization rates and, ultimately, values. MPAC analyses local market conditions to reconcile sale prices.

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Confidentiality

As outlined above, it is important to be aware that, in order to enable MPAC to produce an accurate valuation of the property concerned, information needs to be obtained from a variety of sources.

This will include information from MPAC's records, from the owner or operator of the property, from the municipality in which the property is located, from the assessor's visit to the property, and from other sources.

All stakeholders in the property tax system have an interest in ensuring that the current value provided by MPAC is correct; in order to achieve this, it is necessary for all parties to cooperate in the provision of information.

It is appreciated that some of the information outlined above may be of a commercially sensitive nature. MPAC recognizes the need to ensure that any information provided to it is properly safeguarded and only used for the purpose for which it is supplied. Assessors must appreciate the nature of this undertaking and ensure data is treated accordingly.

If, after an appeal has been filed, MPAC receives a request for the release of actual income and expense information, or other sensitive commercial proprietary information, the usual practice is to require the person seeking the information to bring a motion before the Assessment Review Board (ARB), with notice to the third parties, requesting that the ARB order production of the requested information. The release of such information is at the discretion of the ARB and commonly accompanied by a requirement for confidentiality.

The Assessment Act outlines in section 53(2) that disclosed information may be released in limited circumstances "(a) to the assessment corporation or any authorized employee of the corporation; or (b) by any person being examined as a witness in an assessment appeal or in a proceeding in court involving an assessment matter."

2.4 Data Analysis

Having carried out the data collection outlined previously, the assessor needs to analyze the data and reach a conclusion regarding the appropriate valuation method to use and how it should be applied.

Analysis Process

The analysis process involves several steps. The first task is to qualify the data (i.e., check for accuracy) before it is used to establish the rates and factors that will be used to value the properties. The second step is to enter the data into MPAC's database so that one or a number

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of different properties can be analyzed and compared. Next, MPAC classifies the data so that it can be sorted into appropriate groups that reflect conditions where data comparisons can be made and conclusions drawn. Finally, MPAC develops certain valuation parameters to be used in the valuation of hotels.

Industry Performance Standards

Due to the wide variety of hotel attributes and characteristics, direct comparison of their overall performance should be made very carefully, even if the hotels serve similar needs in the market. However, there are certain performance metrics typically compared, such as revenue per available room (REVPAR), the ratio of room operating costs to room revenues, as well as other departmental and operating expense ratios. Overall, these factors should be similar for similar hotels.

To achieve an equitable assessment base, industry revenue and expense norms need to be reviewed by MPAC. These norms can then be compared to the actual operating and expense performances of the various types of hotels.

Industry Norms – Points of Comparison Between Hotels

Each type of hotel has a standard range of revenue and expense ratios, which a reasonably run establishment would be expected to fall within. Although any part of a hotel's performance can be compared to the performance of similar hotels, the differences in the types of data reported and the different characteristics of the various hotels narrow the points of comparison to the following:

- revenue standards
- expenses standards

More details of each of these standards are shown below.

While there are many hotels of a similar nature, they have different locations and often have different attributes, room mix, room finishes, restaurants, franchise affiliations, labour arrangements, market focus, etc. Therefore, in the valuation process, actual income and expenses form the starting point in the process. This data is then compared to the performances of other comparable hotels and adjusted as appropriate in order to establish the correct assessment value.

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Sensitivity to Change

The revenue generated by a hotel relies upon short-term stays and is sensitive to changes in the market. As such, the average daily rate (ADR) and occupancy a hotel is able to achieve is highly correlated to its income and, therefore, to its value. A change in either ADR or occupancy may produce an immediate and corresponding fall or rise in income. The hotel industry is cyclical in nature; therefore, values can also be anticipated to rise and fall over time and as new supply comes on stream or older properties renovate or convert to different uses.

In order to deal with short-term or anomalous fluctuations, stabilized income and expenses are used by MPAC in the valuation of hotels.

Revenue Standards

Hotels have a number of sources of revenue – rooms, meeting space, food and beverage outlets, leisure facilities, space rental – which support the value of the entire hotel enterprise. A hotel's revenue arises as a result of both physical assets, such as land, buildings, and FF&E, and as a result of intangible and tangible personal property. The income derived from the operation of a hotel is attributable to all these component parts. The assessment of a hotel for property tax purposes requires that the real estate portion be separated from the value of the personal property, as only the real estate is subject to property tax.

The revenue data required for the assessment may include the following:

- revenue per room
- stratified by hotel type, size, age, amenities, location
- room revenue per available room (REVPAR), which is calculated as follows:

Number of Rooms x Number of Days Open = Total Room Revenue

Expense Standards

The expense data required for the assessment may include the following:

- expenses per room
- stratified by hotel type, size, age, amenities, location
- room expenses as a percentage of room revenue
- food and beverage expenses as a percentage of food and beverage revenue

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- administration and general expenses as a percentage of total revenue
- marketing expenses as a percentage of total revenue
- property operation and maintenance as a percentage of total revenue
- heat, light and power as a percentage of total revenue
- other operating expenses as a percentage of total revenue

Stabilizing Income and Expenses

Hotel revenues and expenses can vary significantly from one year to the next. Because the valuation of hotels considers the income achievable in the longer term, it is appropriate to value hotels by excluding any abnormal relation of supply and demand or a transitory or non-recurring condition, which may result in unusual revenues or expenses to the property.

MPAC reviews several years of revenue and expense data to stabilize the revenue and expenses to produce an accurate picture of the hotel's performance that could form the basis of a transaction between vendor and purchaser.

2.5 Other Adjustments

Expense Attributable to Management

In addition to expenses related to the on-site management of a hotel, the pro forma capitalized net income approach assumes a passive owner and inputs a management fee to reflect a contribution of business expertise to the stabilized income. This expense, attributable to asset management of the hotel, forms part of the operating expenses of the hotel and is found in the undistributed expenses group of expenses. This expense can also include costs related to franchise or brand affiliation. In accordance with Ontario Regulation 282/98, the management fee expense is set at 5% of total revenues for a hotel valued using the pro forma income method of the income approach to value.

Reserve for Replacement

Due to the fact that hotels offer transient accommodation and incur high traffic in both their rooms and common areas, there is a need for regular replacement of relatively short-lived furniture, fixtures, furnishings and equipment (FF&E). A reserve for replacement is a deduction from the hotel's operating income, which creates a fund from which to draw on to keep up with the ongoing replacement of short-lived items.

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Typically established under the terms of a property's financing or branding requirements, a reserve for replacement is deducted as a percentage of total revenue. While an owner funds all expenditures – whether for repairs, replacement or large-scale capital improvements – the reserve for replacement is designed to capture all such expenses.

Typically, expenses greater than a threshold are considered capital expenditures and do not appear as an expense line item in an operating statement. Capital expenditures incurred as a result of a large-scale renovation program would affect the capitalization rate, which relates to the risk associated with achieving an anticipated NOI.

MPAC establishes an appropriate reserve for replacement percentage through its review of financial data and general trends in the market and appraisal practice. This percentage adjustment takes into account a return on and return of investments in short-lived items at a hotel.

2.6 The Capitalization Rate

MPAC analyses hotel market data to determine a range of capitalization rates that can be applied to the different types of hotels in each market.

The capitalization rate is found from the formula:

$$\text{Capitalization Rate (R)} = \frac{\text{Net Operating Income (NOI)}}{\text{Sale Price of Hotel (SP)}}$$

Once the net operating income has been determined, MPAC uses the capitalization rate to convert it into an indication of value.

Effective Tax Rate

An adjustment must be made in the valuation to deal with the payment of property taxes. The way MPAC does this is to disregard property taxes as an expense item, determine the effective tax rate, and add this amount to the base capitalization rate. The effective tax rate imputes the expected tax burden on the property.

The effective tax rate is calculated using the following formula:

Effective Tax Rate = Commercial Tax Rate x (100.00% – Personal Property %)

= Commercial Tax Rate x (100.00% – 15.00%)

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For example, if the base capitalization rate is 9% and the commercial tax rate for the municipality concerned is 0.02897, the calculation is:

$$0.02897 \times 85.00\% = 0.0246 \text{ (or } 2.46\%)$$

Add the base rate of 9%; effective property tax rate = 9% + 2.46% = 11.46%

Value Attributable to Personal Property

Part of the revenue generated in a hotel is attributable to personal property, including elements of FF&E and intangibles. For a hotel valued using the pro forma income methodology, a final deduction of 15% of indicated value is set in accordance with Ontario Regulation 282/98.

2.7 Valuation

Having undertaken the necessary steps outlined above, the assessor should now be in a position to apply the appropriate valuation model.

2.8 Validating the Results

Once the assessor has completed the valuation, it is necessary to carry out a series of checks to ensure that all relevant parts of the property have been included in the valuation, there has been no double-counting of any adjustments made for depreciation, the resulting valuation has been compared with any market evidence that may be available in relation to similar properties, and the final valuation is in line with the valuation of other similar properties in Ontario.

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3.0 The Valuation

3.1 Excess Land

Excess land is land that is distinct and over and above that required to operate according to the property's zoning or other governmental control. The value of this land is not captured by the method described above, as the revenues used in the pro forma valuation relate only to the operation of the hotel. Land that is not required to operate the hotel is excess to current needs. The value of excess land depends on its location within the site and how well it suits future developments.

MPAC investigates the appropriateness of adding the value of excess land using on-site inspection, a municipality's graphic information system (GIS) and zoning information, and the current density and configuration of the property. The rate to be applied to value excess land is typically derived using market sales studies of vacant land sites. Excess land is valued separately and added to the value arrived at for the hotel to determine the total assessed value of the property.

3.2 Sample Valuat on

The following table provides an example of the way in which MPAC values a hotel with 100 rooms and the usual range of amenities for a hotel of its type and location. The figures used are illus-trative only.

Item	Amount	Per room
Number of rooms	100	
Average daily rate	$100.00	
Occupancy	70%	
Total revenue	$2,555,000	$25,550
Less: Departmental expenses	$1,000,000	
Total operated dept. income	$1,555,000	$15,550
Less: Undistributed expenses	$555,000	
Income before fixed charges	$1,000,000	$10,000

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Item	Amount	Per Room
Less: Insurance	$10,000	
Less: Reserve for replacement (4%)	$102,200	
Stabilized net operating income	$887,800	$8,878
Base capitalization rate	8%	
Effective tax rate	2%	
Overall capitalization rate	10%	
Indicated value	$8,878,000	$88,780
Less: Personal property (15%)	$1,331,700	
Hotel value (rounded)	$7,546,000	$75,460

3.3 Quality Control

Having arrived at the value of the hotel through the above process, MPAC will check the outcome of the valuation to ensure no errors have been made and that the value is in line with the valuation of similar hotels. This may involve an evaluation of income and expense projections against industry norms, an evaluation of values against market sales, and/or an evaluation of values against the values of other hotels.

3.4 Conclusion

This guide sets out how MPAC assessors approach the valuation of hotels for property assessment purposes.

Although it outlines the general approach adopted, it does not replace the assessor's judgment and there may be some cases where the assessor adopts a different approach for justifiable reasons.

For further information, please visit mpac.ca.

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