case study

# Nigel's Choice: A hotel appraiser's decision-making issues when interests conflict

*By Chris Gibbs and Gail Cook-Johnson*

## Introduction to Client Pressure in Hotel Appraisals

Hotel appraisals are used as a decision-making tool for hotel investment stakeholders, which include lenders, investors, developers, owners, asset managers, operators and governement agencies (Roubi, 2014). To get an appraisal of a hotel's investment value, it is usually the hotel's owner or asset manager who will engage the appraiser. The appraiser is an individual who is certified by a governing body designating his/her expertise to provide an independent unbiased assessment of a hotel's financial value. An appraisal is used by potential investors or banks to assess the investment risk for a hotel. A higher than expected valuation for a hotel reduces the investment risk and leads to more investment or decreased lending costs levied by banks. A lower than expected valuation increases the investment risk and can lead to less investment or increased lending costs levied by banks or other lenders.

An appraisal is meant to be un-biased professional advice that can by relied on by lenders and professionals (Rushmore, 1993). The results of an appraisal can represent significant positive or negative financial impact to hotel owners. Due to the financial significance of the appraisal, owners and asset managers sometimes exert pressure on appraisers to alter their values. The pressure can be subtle comments like, "Let's work on this one, I have many projects coming down the line" or more direct comments like "You did not give me the value I needed so I will not pay your fee" (Rushmore, 1993). Even with subtle comments, an appraiser is presented with a dilemma. While in the short-term, a simple change in the assumptions could make their client happy, in the long-term, changing the assumptions in the appraisal could challenge their professional code of ethics, indepencence and reputation for their professional advice.

Client pressure in the commercial appraisal industry is a common issue, but seldom researched. In one of the studies completed, however, a behavioural experiment with 953 subjects reported that 41 per cent of commercial appraisers revised their valuation estimates without having supporting documentation when requested by the client (Kinnard, Lenk & Worzala, 1997). This is problematic because lenders and investors depend upon the appraiser to be credible, objective and unbiased.

Client pressure is a form of conflict of interest. Conflict of interest happens when a situation undermines the impartiality of a person because of a self-interest that could compromise their professional commitments. In cases where the client pressures the appraiser, the appraiser must decide between making the client happy in order to get future work and their duty to the appraisal profession. Cases of conflict of interest are never easy and rarely have simple black and white answers. Future managers must not only be aware of potential conflicts, but, most importantly, prepare and practice what to do when they happen. The case study to follow represents a situation based on a real account from a hotel appraiser and is designed to make students aware of how a conflict of interest situation comes about and gives them an opportunity to practice a professional response.

## Client Pressure Phone Call

"Good morning, Nigel. Ed calling from Smithson Development."

"How are you, Ed?" asked Nigel.

"Well, a little concerned, actually. We have just reviewed your draft appraisal report for The Apollo Hotel. Are you kidding, Nigel? Do you seriously think the value of this property has diminished this much?"

"Well, you saw we used a number of approaches to evaluate The Apollo in order to give it the highest possible, yet probable, value. In this regard, you saw that the Discounted Cash Flow Method[1] gives a higher, and, in my opinion, more accurate valuation. This, of course, is not as high as the valuation I did when oil prices were high. You can't ignore, Ed, how the reversals of fortune in the oil industry will impact a hotel located in a town known for its dependence on oil."

"Sure, Nigel, there may be a short-term hit, but your points of comparisons to other hotel properties are very limited and geographically confined. You overemphasize the negatives in the marketplace; you fail to account for the growth in tourism with the devaluation of the Canadian dollar; your projections of interest rates are way off base; and you don't fully take account of the fact that this is a quality product under a well-known global luxury brand with the competence and established experience to expand the reach of this property to other markets. We are counting on you, Nigel. You know this property, and you know what its leadership can do. You need to rethink your appraisal of The Apollo. I can find another appraiser who will give me the right number!"

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1 *See Glossary of Terms*

## The Apollo Hotel, Calgary, Alberta, Canada

The Apollo Hotel is managed by one of the premier international-luxury hotel brands and is located in Calgary, Alberta Canada. Calgary is a city of more than 1,000,000 people; the livelihood of many of its citizens and the economic health of the city are dependent on the fortunes of its primary industry: oil. When the price for a barrel of oil is high, hotel room rates and occupancies are also high and hotel owners are happy making a profit. Consequently when the price for a barrel of oil falls precipitously, hotel room rates and occupancies decrease and hotel owners are unhappy. For many years while the price of a barrel of oil was high, Calgary hotels witnessed the highest RevPAR[1] growth within Canada.

The Apollo hotel was developed by Smithson Development to capitalize on the booming Alberta, Canada economy, driven by high oil prices. The Apollo opened to great fanfare. With 144 exquisitely appointed rooms and suites, an Oyster Bar, Roof Terrace, fitness club and spa, as well as elegant, yet technologically advanced, conference rooms and event spaces, The Apollo quickly became the place to stay, the place to meet and be seen, the place to make deals, and the place to celebrate. After the first year, average occupancy was over 75%; the RevPAR[1] index comparing The Apollo to its luxury competitors in the area was 115%, and the average room rate had grown by 25%. The early successes of The Apollo gave both Smithson Development and the bank, which financed most of the development of The Apollo, a satisfying level of confidence. They believed that The Apollo would continue to be a stellar investment. However, as oil prices fell, the economic outlook for Alberta was becoming a source of concern, signalling a reversal in fortunes.

## The Dilemma for Ed and Smithson Development

With the crash in oil prices, the prominent Canadian economist Terence Corcoran had declared, "The dream of Canada becoming an energy-exporting superpower is now all but dead." Calgary, Alberta was already witnessing a significant outflow from top-tier commercial office space as companies cut back and either postponed or cancelled projects. The bank, feeling nervous and overexposed in the Alberta market, activated a clause in their mortgage agreement with Smithson Development, demanding that Smithson have The Apollo reappraised by a certified appraiser in the event of a change in economic circumstances. If neither the bank nor Smithson could accept the value set by the appraiser, the case would go to arbitration.

Smithson Development is anxious to show the highest possible valuation in order to secure continued financing through the bank on favorable terms. If the value of the property is shown to have fallen significantly, the bank will likely make a margin call and want Smithson to pay down a large part of the principal. The bank could also call into question other aspects of the loan covenant if occupancy and revenue projections fall too much below original expectations, thereby triggering a right to renegotiate rates. A lot is also at risk for Ed personally. His credibility is on the line: he had convinced his partners to develop The Apollo, despite the fact that the more senior partners in the firm had argued that standard hotel investments have generally become too risky, given that hotel revenues are less predictable and more variable than other kinds of commercial arrangements, which rely on long-term leases or shared ownership.

## The Conflict for Nigel Darwani, The Appraiser

Nigel Darwani was chosen by Smithson Development as the appraiser. Now 49 years old, Nigel has worked hard to establish his reputation as a thorough and ethical appraiser, with special expertise in hotel valuation in Western Canada markets like Calgary, Edmonton, and Vancouver. He has a Bachelor of Commerce from Ryerson University, a MBA from Cornell, with a focus in Hospitality, and has earned an AACI Designation[1] while working for various real estate firms and pension fund managers. He is now a key member of the appraisal team for the King Real Estate Group, located in Vancouver, British Columbia, Canada.

Smithson Development has been a client of Nigel's for many years. Annually, the work that Smithson provides to Nigel accounts for a significant percentage of his income, and Nigel currently has proposals submitted to Smithson for other work. As part of his work for Smithson, Nigel had, in fact, completed a previous appraisal of The Apollo. Smithson had used Nigel's previous appraisal to negotiate very favorable terms with the bank.

Nigel is in a difficult position on the reappraisal. If Nigel pays no attention to Ed's feedback about the revaluation of the property, he risks losing Smithson as a client and puts in jeopardy his annual bonus, which he counts on as the sole source of income for a family of four. Ed will likely ask one of Nigel's competitors at one of the larger firms or in private practice to do the appraisal, and with this new relationship established, he may never get Smithson back as one of his more reliable, high-volume clients. Nigel also knows that there are appraisers out there who have fewer scruples than he has about what goes into their valuations, and indeed there are a lot of educated "guesses" when making projections. Yet, professionally, Nigel understands that to be swayed by Ed is the wrong thing to do unless he really believes a more optimistic valuation of The Apollo is plausible.[2] Ultimately, he also has to consider the bank's position. If they perceive that he is just following Ed's and Smithson's bidding, his hard-fought reputation for integrity will be damaged to the point it will be almost impossible to recover.

*2 According to CUSPAP (Canadian Uniform Standards of Professional Appraisal Practice) article 5.11, relating to a conflict of interest, AACI-certified members must "pledge to develop, support and communicate each analysis, opinion and conclusion without regard to any personal interest." See Appraisal Institute of Canada (2014:19).*

## The Appraisal of The Apollo and Nigel's Choice

In his usual fashion, Nigel's approach to his reappraisal of The Apollo is comprehensive. Given the abruptness of the drop in oil prices, Nigel feels it is inappropriate to use the Direct Capitalization Method (DCM)[1] alone, as it overemphasizes the immediate economic hit of the current situation. Nonetheless, he is uncomfortable with the tenuous nature of forecasting implied by the Discounted Cash Flow Method (DCF)[1]. Consequently, to bolster his forecast assumptions, he carefully researched other markets that had experienced precipitous downturns for various reasons, as well as examined what "normal" looked like for full-service luxury properties in markets that had become less heated.

Nigel's detailed analysis shows that most properties take immediate and significant hits when faced with something like a collapse in their major business sector and that many never fully recover to their former glory. While his research did find some properties that were successful in re-establishing themselves after a market collapse, these properties were always located in major cities like New York. Properties in more secondary natural-resource-dependent markets never recovered fully until the price of commodities bounced back. Didn't Calgary become a more secondary market if the price of oil remains depressed? Certainly Smithson argues that this is not the case. While The Apollo is a very well-managed luxury property, is it poor judgement to assume that the hotel will attract sufficient business unrelated to the oil business? Nigel summarized his current findings as follows in the Table 1:

Nigel can well understand why Ed is upset. The previous valuation of The Apollo was 19%-32% higher than Nigel is now estimating! The bank will certainly be challenging their agreement with Smithson on this project.

Ed is most critical of the comparables and economic forecast that Nigel used. Ed argues that Nigel should include in his analysis the tourist properties located in the Canadian Rockies since those travelling to the Rockies are high-spending tourists who will likely stay a night or two in Calgary on their way to and from other Alberta destinations. Ed also thinks that that Nigel's economic forecasting assumptions do not adequately account for the positive impact the lower Canadian dollar will have on Alberta's economy.

In the aftermath of the call from Smithson, Nigel is faced with a choice: he can leave his appraisal as is, and/or he can re-examine his use of comparables and his economic forecasting assumptions. He wonders which of his options will be in line with the spirit of CUSPAP[1] standards. He also wonders if he should prepare and add to his analysis a second Discounted Cash Flow (DCF) appraisal projection that better supports the assumptions proposed by Ed, and let Smithson argue it out with the bank. What is the right thing to do?

## Ethics Case Study Analysis Questions

- What are the relevant facts and industry issues of the case?
- What individuals or groups have an important stake in this case? Do some have a greater stake because of a special need or obligation?
- What are Nigel's options?
- Which option is the right or best thing for Nigel to do? Why is it the best option?

***Table 1***

### The Apollo Hotel Appraisal Summary

| Appraisal: Timing / Method | Estimated Value ($ million) | Stabilized Annual Net Income ($ million) | Overall Cap Rate[1] (%) |
|---|---|---|---|
| Previous / Direct Capitalization Method (DCM) | 112.9 | .9 | 7.00 |
| Current / Direct Capitalization Method (DCM) | 85.5 | 6.2 | 7.25 |
| Current / Discounted Cash Flow Method (DCF) | 94.7 | 9.0 | |

## Glossary of Terms

- **AACI Designation** stands for Accredited Appraiser Canadian Institute. Those with an AACI designation have fulfilled the educational and professional requirements set out by the Appraisal Institute of Canada. The designation signifies that the individual is qualified to offer valuation, consulting services, and expertise for all types of real estate, both commercial and residential. Depending on an individual's education, it takes four to six years to become certified. See also [http://www.ai-canada.ca/the-appraisal-institute-of-canada/.](http://www.ai-canada.ca/the-appraisal-institute-of-canada/)
- **Cap Rate (Capitalization Rate)** is Net Operating Income (NOI; see definition below) / Current Market Value.
- **CUSPAP** stands for the Canadian Uniform Standards of Professional Appraisal Practice introduced in January 2001 by the Appraisal Institute of Canada. Established in 1938, the Appraisal Institute of Canada (AIC) is a self-regulating association that aims to ensure a high level of professionalism and confidence in real estate valuation practices. See the definition above for AACI Designation.
- **Direct Capitalization Method (DCM)** is one of two income approaches used to appraise hotel properties (see the definition for the Discounted Cash Flow Method below for a description of the other alternative). DCM looks at a property's income potential based on historical and current financial information, as well as industry norms, in order to stabilize the income for a one-year period. DCM is most appropriate for properties with a normalized or long-established, and therefore predictable, income flow. This method is considered less reliable when income is compromised by significant changes, such as those brought about by changes in the competitive landscape or micro- and macroeconomic factors.
- **Discounted Cash Flow Method (DCF)** is one of the two income approaches used to appraise hotel properties (see the definition for the Direct Capitalization Method above for a description of the other alternative). To calculate a Discounted Cash Flow, the appraiser forecasts revenue and expenses over a number of years (usually five to ten years). A discount rate is applied to the NOI projections to provide an estimate of present value. Since hotel properties are often subject to market fluctuations for a variety of reasons, the DCF method is often the preferred method of valuation for hotel properties. The quality of the valuation, however, is greatly impacted by the assumptions made about key factors affecting occupancy, room rates, other revenue streams, and expenses.
- **The Income Approach of appraisals** involves a conversion of anticipated future net income derived from the ownership of property into a value estimate through a capitalization process. Within this approach, there are two methods of valuation: the Discounted Cash Flow Method (DCF) and Direct Capitalization Method (DCM). The former makes assessments based on assumptions about cash flow in coming years, and the latter bases assessments on historical and current-year data to establish the present value.
- **Net Income (NOI)** is the property income minus operating costs.
- **RevPAR (Revenue Per Available Room)** is calculated by dividing guest room revenue by the number of rooms and taking into consideration the number of days in the period being measured.

# teaching note

*Nigel's Choice: A hotel appraiser's decision-making issues when interests conflict*

## Summary

This case presents a dilemma for a hotel appraiser who is being asked to change the valuation assumptions of an appraisal in order to satisfy the client. The case and teaching methods have been based on the values-driven leadership methods from Giving Voice to Values (Gentile, 2010). The conflict demonstrated in the case and teaching methods allow the student to practice the skills required to recognize, speak to, and act on his/her values in difficult situations. The case tells the student not what is right or wrong but how to think logically about a decision and act on that decision once the right course of action has been identified.

The case is based on an actual hotel in a resource-driven economy and a valuation performed during a significant economic downturn. However, due to reasons of privacy and the sensitive nature of the topic, all identities of the actual individuals and organizations involved have been removed.

## Target Audience

This case may be applied to hotel management, real estate management, or management ethics courses. The case would be appropriate for upper-year undergraduate students or masters students. Students participating in the case will gain an understanding of the role of real estate valuation and conflicts of interest in a professional setting.

## Learning Outcomes

The purpose of this case is to improve decision-making and leadership skills. Upon completion of this case students will:

- Recognize reasons for and rationalizations about a difficult decision.
- Analyze the impacts on stakeholders in a decision.
- Identify arguments that could influence others who may disagree with their plan of action.
- Practice making a difficult decision and supporting it with a plan of action.

## Case Assignment

Recognizing that hotel valuation is a very specialized field, additional reading may need to be assigned along with the case study. Depending upon the class and level of knowledge, one or more additional readings may need to be assigned. Since every school has different levels of access to journal sources, two different levels of readings have been identified, the full references for which are provided in the references that follow.

## Introductory Readings

For undergraduate students in hospitality or ethics courses who have limited knowledge of hotel valuation, two readings are recommended:

"Hotel valuation" (Roubi, 2016)

In chapter 14 of The Routledge Handbook of Hospitality Management, Roubi introduces the strategic role of hotel valuation. The chapter is good for students who have limited knowledge of the hotel industry or valuation.

"Ethics in hotel appraising" (Rushmore, 1993)

Appraisers are exposed to pressure from clients all of the time. This article gives the reader an understanding of the different kinds of pressures to which the appraiser is exposed.

## More Advanced Readings

For graduate students or students studying real estate or hotel asset management, two academic papers are suggested for reading:

"Client pressure in the commercial appraisal industry: how prevalent is it?" (Kinnard et al. 1997)

This research paper used an experimental methodology to provide evidence of whether appraisers react to client pressure.

"The influence of clients on valuations" (Levy and Cschuck, 1999)

Many non-methodological factors affect the valuation of real estate. The results from this research highlight many different factors that impact the valuation of real estate.

## Teaching Plan/Case Discussion

Considering that many students will not have any real estate background, it is important that they read the case and the readings in advance of class. To achieve the optimal learning from this case, we propose a three-staged approach based on Erskine, Leenders, and Mauffett-Leenders (2011).

## Individual Preparation (In Advance of Class)

Assign the student the reading of the case and two of the readings. Have them submit answers to four questions in advance of class to be evaluated for a grade. This evaluation will ensure that the students complete the work in advance and are prepared for the discussion. Answers may be provided in simple table format rather than in essay form in order for students to focus on the content and not on the process of writing an essay.

1. What are the relevant facts and industry issues in the case?
2. What individuals or groups have an important stake in this

case? Do some have a greater stake because of a special need or obligation?

3. What are Nigel's options?
4. Which option is the right or best thing for Nigel to do? Why is it the best option?

## Initial Class Discussion (Small Group) - 15 Minutes

Once the class starts, break students into small groups of 3-5 students. While in their groups, have them review their answers again with each other. This process of group review will teach them that other students in the group may have different perspectives. The purpose of the small group discussion is for the students to reach general agreement on the answers to the questions amongst themselves.

Before the groups are ready to move on to the large group discussion, first they must all agree on an answer to question 4.

## Class Discussion (Large Group) - 20 Minutes

Now that your students have prepared for the case in small groups, have a group volunteer to share their answer to a question. After the initial question is answered by one of the groups, have other groups feed into the discussion. To encourage feedback and discussion, write the answers to the question on the board so that the students understand that you are listening and that they can feed into the discussion. Proceed to the other questions in a similar fashion.

For each question, there are some important items that need to be discussed. Below is a summary of the questions and the key learnings to be expected from the class discussion:

**1. What are the relevant facts and industry issues in the case?**

There are multiple facts in the case. Students will present some that are relevant and some that are not. The most relevant key facts include:

- Resource industry is having a negative impact on the business of hotels in the market.
- The value of The Apollo Hotel will drop significantly.
- The drop in value will trigger a reaction from the bank, with financial consequences for Smithson and a negative impact on Ed's credibility.
- Smithson has been a significant client of Nigel's for many years.
- Nigel needs to follow CUSPAP standards, which state that he should provide valuations based on his professional judgment, without regard for personal interests.

**2. What individuals or groups have an important stake in this case? Do some have a greater stake because of a special need or obligation?**

- Smithson Development. Lower valuation can trigger higher costs for lending, as well as a margin call, and/or lower value when selling the property.
- Ed. His credibility was attacked as he fought for the development of The Apollo, despite opposition from more senior partners.
- Nigel. At stake for Nigel is the business revenue he receives from Smithson and his reputation as a real estate valuator.
- Bank. The bank is a stakeholder indirectly. It has an interest in managing the risk on its loan to Smithson Development.

**3. What are Nigel's options?**

Students can forward multiple options to address the case. At the most basic level there are three options: 1) keep the valuation the same, 2) re-do the valuation and change assumptions, or 3) create a third valuation forecast using a more optimistic forecast and/or wider range of comparable assumptions. For a more advanced class that has detailed knowledge of hotel real estate, options related to the changing of the assumptions for the valuation may come into play.

**4. Which option is the right or best thing for Nigel to do? Why is it the best option?**

Depending upon the options that the students develop, there is no one right answer to this question. Based on the standards set out by CUSPAP, Nigel must be able to stand behind his valuations. This obligation must supersede any obligation that he may have to his client or to his future business revenues because it is his legal obligation.

During this stage of the case, the instructor must get the class to decide on the one option that the entire class should pursue, so that one last question related to the right course of action may be assigned. Once the class has made the decision, they should be asked to work in small groups again.

## Implementing the Decision (30 Minutes)

With all questions now answered and discussed in the large group, post the final question for discussion:

**5. Implement the decision. Outline the steps your group would take to implement the decision in chronological order.**

Ideally this question will be discussed during the same classroom time, or it may be done in a second class. Each group must come up with a list of action items, in chronological order, of how they would approach their client to inform them of their decision.

After ten minutes of small group discussion, the groups are then asked to present their action plan. Have the first group write their action plan in chronological order on the board. Now that an initial action plan has been established, go around the room to different groups and have each group contribute a new idea or revise an existing action. As the changes are discussed, write them on the white board at the front of class. This iterative process of having groups add/delete content from an action list is paramount to the learning activity. Initially, the first group may have a five-step action plan that is only partially well thought out. However, after an around-the-room discussion, this action plan will grow to include more items, and the items will also be more specific. The final product of the large-group discussion will lead to a comprehensive action plan that a student can use to deal with a difficult decision. This focus on the actions required in difficult situations is based on the Giving Voice to Values (Gentile, 2010) approach to ethical decision making.

Typically, what happens through this process is that students start with a rather simple action plan, but after discussion with the large group and the adding/deleting of items, the action plan becomes more detailed and complete. The students learn from each other and develop a more comprehensive plan to deal with a difficult decision.

## Pilot Test Results

This case was tested twice (Winter 2015 and 2016) in a class of 30+ hospitality students enrolled in a Hospitality and Tourism Ethics course. After each testing of the case, feedback was solicited from students to help improve the case. Overall, the case stimulated discussion and made students aware of the role of hotel valuation and the ethical dilemmas faced by appraisers. The process used to analyze and discuss the case resulted from the amalgamation of different case-study teaching methods for ethics and business cases. The variety of questions and discussion methods used demonstrated to the students the value of in-group decision making and that their initial instincts for decision making can be improved by soliciting input from others. Most importantly, it demonstrated a process for making and implementing difficult decisions.

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