Appraising Commercial Recreation Properties

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The appraisal of commercial recreation properties requires industry knowledge, and entails consideration of numerous factors and issues not common among the appraisal of conventional real estate assets. Commercial recreation properties—income generating enterprises which have an entertainment and/or recreational component—cover a broad range of property types and uses ranging from commercial baseball batting cages to destination theme parks. Water parks, golf courses, casinos, cultural attractions, concert venues, fairgrounds, swap meets, amusement parks and major theme parks represent common commercial recreation properties, but there are many other forms of commercial recreation attractions and businesses. For the most part, commercial recreation properties are “going concerns” which represent a blend of real and business property, and often incorporate a significant intangible component of value. Hotel and golf course properties are examples of going concerns, but commercial recreation properties often have value which extends beyond the normal benefits associated with entrepreneurial know-how and effective management.

This paper identifies a series of issues, challenges and considerations that influence the valuation approach and appropriate methodologies employed in appraising commercial recreation properties. While the basic analytical principles in evaluating value do not vary from other types of property, a solid understanding of the basic economics of commercial recreation enterprises is essential in determining supportable value.

Motivations for Developing Commercial Recreation

There are multiple reasons for developing commercial recreation properties. Many uses are developed as free-standing, profit-maximizing enterprises which represent the highest and best use of the real property. In these cases, the expected net operating income is sufficient to fully amortize the cost of the improvements and create positive underlying land value. However, in many instances, development of a commercial recreation property is motivated by other considerations. Development of the recreational element may be desirable or required in achieving government-granted entitlements for other associated, more valuable land uses. Also, the recreation use might serve as an amenity in support of other land uses within a multi-use development project. In this context, the recreation use may create substantial peripheral land value enhancement, not unlike the anchor tenant in a regional shopping center, or a golf course within a residential community.

Often, recreational uses do not represent the long-term highest and best use of the property, but rather are developed as interim uses as part of a land banking strategy. Some types of recreational uses are very land intensive, but require only modest capital improvements. Amortization of the improvements, therefore, can be achieved in a relatively short period, with much of the value related to anticipated rapid appreciation of underlying land value.

Purpose and Use of the Appraisal

There are several principal purposes of a commercial recreation property appraisal, each which may involve specific issues not common to all appraisals.

- Project Feasibility
- Development or Purchase Money Financing
- Determination of Acquisition or Sales Price
- Mark-to-Market Asset Valuation
- Property Tax Assessment
- Ground Lease Market Value
It is critical to clearly state the purpose of the appraisal and the definition of “value.” Real property “market value” meets a more exacting standard, often representing only a fraction of total value. This includes personal and intangible property which frequently accounts for a substantial component of overall value. The concept of “investment value” -- the value attributed to a property based on a specific party’s distinct investment criteria -- may be more meaningful.

### Market Value Appraisal Approaches

Appraising commercial recreation properties typically involves the three traditional approaches to value -- **Cost, Market,** and **Income**. Application of these standard methodologies, however, may be more difficult for commercial recreation properties than conventional real estate.

#### Cost Approach

The cost approach estimates the value of the asset based upon the reproduction or replacement cost (new) of the improvements, less accrued depreciation from physical, functional, locational and economic obsolescence, if any. Added to this amount is the market value of the site, which is typically estimated at its highest and best use. The cost approach to value is based upon the **Principle of Substitution.** This is a valuation principle that states a prudent purchaser would pay no more for physical property than the cost of acquiring an equally desirable substitute on the open market. The Principle of Substitution presumes that the purchaser will consider the alternatives available, will act rationally or prudently on the basis of the available information about these alternatives, and that time is not a significant factor. Substitution may assume the form of the purchase of an existing property with the same utility, or the acquiring of vacant land and constructing improvements upon that land having the same general utility as the property being appraised.

For newly-built projects, the cost approach may provide a reasonable indication of real property value. But recreational land uses rarely support “highest and best use” land value--a land value “write down” is often necessary to attract or justify recreational development. Moreover, the cost approach requires estimates of personal and intangible property, which again may be very significant in the development of commercial recreation uses.

Estimating the replacement cost of improvements is particularly difficult because of the unconventional type of improvements and absence of “cost standards” which exist for other more conventional uses. Further, most commercial recreation uses incorporate theming, which generally adds cost to the constructed improvements. Units of measure vary considerably by type of property, but in many of the commercial recreation uses, a “per annual attendee” factor is a useful indicator. For example, the capital cost of a project (or investment level) may be depicted as cost or value per annual attendee.
<table>
<thead>
<tr>
<th>Property Type</th>
<th>Typical Investment (millions)</th>
<th>Typical Annual Attendance/Utilization</th>
<th>Investment Per Attendee/User</th>
</tr>
</thead>
<tbody>
<tr>
<td>Family Entertainment Centers</td>
<td>$15.0</td>
<td>250,000 visitor days</td>
<td>$60</td>
</tr>
<tr>
<td>Amusement Parks</td>
<td>300.0</td>
<td>2,000,000 visitor days</td>
<td>150</td>
</tr>
<tr>
<td>Destination Theme Park</td>
<td>1,500.0</td>
<td>7,500,000 visitor days</td>
<td>200</td>
</tr>
<tr>
<td>Water Parks</td>
<td>15.0</td>
<td>200,000 visitor days</td>
<td>75</td>
</tr>
<tr>
<td>Athletic Clubs/Fitness Centers</td>
<td>12.0</td>
<td>2,500 members</td>
<td>4,800</td>
</tr>
<tr>
<td>Golf Courses</td>
<td>10.0</td>
<td>40,000 rounds</td>
<td>250</td>
</tr>
<tr>
<td>Ski Mountains</td>
<td>90.0</td>
<td>550,000 skier days</td>
<td>164</td>
</tr>
</tbody>
</table>

For existing projects, the cost approach often substantially overstates the value of commercial recreation properties for a variety of reasons. In addition to development motivations other than purely economic, the nature of commercial recreation properties sometimes results in extreme functional obsolescence related to rapidly changing market preferences, as well as physical depreciation.

**Market Approach**

The market, or sales comparison, approach to value estimates the subject’s enterprise or going-concern value by direct comparison with similar properties which have been purchased or which are offered for sale. It also is based upon the Principle of Substitution by recognizing the availability of substitute properties in the market. Comparable sales are selected, analyzed and adjusted for factors that affect the value. A significant limitation of this approach in appraising commercial recreation properties is encountered when attempting to uncover all the factors which a prudent buyer considers important toward determining investment in a property.

A further limitation associated with using the market approach is the relatively small number of transactions of similar properties, and even smaller number, or complete absence, of such properties within the same market region. Furthermore, the unconventional nature of the commercial recreation properties generally results in transactions which are often convoluted and complex--every transaction has its own story, which may not be readily apparent to the analyst.

**Income Approach**

The income approach to value relates a property’s value to its income earning potential. That is, the value of an asset is dependent upon the investment income produced, and application of the investment criteria observed in the marketplace. The income approach to value generally is regarded as the most reliable in valuing commercial recreation properties. The value of properties which are operating efficiently and at stabilized attendance or utilization levels typically is determined by capitalizing current annual net operating income at an appropriate rate. In such cases, applying a direct capitalization rate yields an indication of the value of the property.
For commercial recreation properties, or other income properties, which expect a “ramp-up” period before stabilizing, the value is determined through a discounted present value approach. This approach considers the potential future income generated by the property to the point where it stabilizes at an efficient level. The present value is determined by applying an appropriate discount rate to the projected income stream, including the future value of the asset at or after a point of stabilization.

The income approach, while clearly the most reliable, has many challenges in valuing commercial recreation properties. Estimating revenue accurately requires a rigorous market support analysis, particularly for properties without a track record. The absence of truly comparable properties in terms of type of recreation, scale, branding, market characteristics and depth, and other property features demands an understanding of market potential for the subject property which can only be gained by an informed analyst. For example, in valuing a theme park, the analyst must make a judgement about the marketability of the overall concept, define the appropriate primary, secondary and tertiary market areas, determine whether the park’s content is sufficient to achieve satisfactory average length of stay, estimate market penetration rates, and quantify the impact of branding. Often, these determinations are highly judgmental.

Estimating operating expenses also is challenging, particularly for properties performing below efficient or stabilized levels. Most analysts employ expense-to-revenue ratios, an approach which is reasonable for many types of real estate land uses and may be appropriate for efficiently operated commercial recreation properties. However, most types of commercial recreation properties are characterized as fixed-cost businesses -- staffing, maintenance, utilities, management and most other costs do not vary significantly as revenue changes. Thus, the ability to estimate the discrete line-item unit cost is necessary.

A common issue in valuing many types of income properties, and particularly problematic in regard to commercial recreation, is determining appropriate operating expense items to include. Generally it is appropriate to include a provision for a professional management fee since the performance of these types of properties is so dependent on management expertise. Management fees typically are structured with a base fee plus incentive compensation, with the total fee generally ranging from 3-5% of gross revenue.

The use of Intellectual Property (IP) may also present an expense issue. Continuing usage royalties to any IP owners need to be included as an expense item. In certain cases where a project was developed by the owner, there may not be a line item breakout of the expense.

For commercial recreation properties, it is essential to recognize the importance and reliance on property reinvestment. If there is not a full recognition of reinvestment in estimating operating income, the capitalization and discount rates need to be adjusted accordingly.

Lastly, selection of appropriate capitalization and present value discount rates is critically important in converting projected net operating income to value. The rates vary considerably by type of property, as discussed below.
Reinvestment

Perhaps the most distinguishing characteristic of the commercial recreation industry is the requirement for significant ongoing capital reinvestment. Commercial recreation projects need to “refresh” their offering in order to maintain attendance, utilization levels, and market share in the highly competitive entertainment industry. For many entertainment-oriented land uses, such as theme parks, an annual reinvestment reserve equal to between 6 and 10 percent of total annual gross operating revenue is needed. This level is typically higher than the physical depreciation of existing assets, and often represents up to one-third of the annual pre-tax cash flow. The need for reinvestment is particularly acute for properties highly dependent on repeat visitation. Attendance patterns at “stagnant” attractions have an all-too-familiar signature of steadily declining attendance following the first year or two of opening, after which the novelty of the experience erodes and repeat visitation becomes increasingly important.

Accounting for capital reinvestment is essential in properly determining a stable income stream, but it also creates some confusion in the collection and interpretation of industry data. Typically, the valuation analyst focuses on EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). While accounting depreciation can serve as a proxy, the required cash flow impact needs to be fully incorporated in the analysis. Appropriately, incorporating a capital improvement reserve allowance, and treating it as an annual expense, provides a more accurate depiction of the real commercial recreation business model.

Capitalization and Discount Rates

Establishing market-based capitalization rates for commercial recreation properties is not straightforward for a variety of reasons. One of the most significant factors is that very few properties are sold at a point of stabilized operation. Consequently, the actual capitalization rates observed on transactions tend to be very low, typically in the 3 to 6 percent range when measured against trailing 12-month EBITDA. During soft market periods, it is common to observe even lower capitalization rates -- asset prices may be declining in a soft market, but not as precipitously as trailing net operating income. In cases of properties operating at a break-even level or loss, there is not an observed positive capitalization rate.

Capitalization rates applied to projected income usually are much different than observed rates. In many cases, the capitalization and present value discount rates applied to pro forma income are based on the investment criteria present in the marketplace. Given a property’s expected performance (rather than actual current performance) the analyst must determine what is the investment return expectation of the buyer and seller in the market. The investment criteria can be established through interviews with the investment decision makers. Over the past several years, capitalization and present value discount rates employed in appraising commercial recreation properties are as follows:
The capitalization rates shown above are expressed as "unleveraged" yields, representing the blended rate earned on debt and equity combined. Assuming that the cost of debt is lower than the required expected yield on equity, the equity capitalization rates are substantially higher than the unleveraged yields. There are many factors which influence the capitalization rate, including the following:

- Market and financial risk related to the property
- Potential for improvement to revenue stream/efficiencies in operations (lower expenses)
- Availability and cost of debt
- Alternative investment yields
- Dependency on intangibles such as entrepreneurial skills
- Value of brand/goodwill
- Exit options and market
- Salvage value/alternative uses

### Components of Value

Unlike most other land uses, commercial recreation property values typically consist of three elements of value:

- **Real Property** -- and and fixed improvements
- **Personal Property** -- movable property, business property, and equipment.
- **Intangible Property** -- intellectual property, naming rights, trade secrets, and goodwill.

Many land uses consist of real and personal property, but very few possess intangible property which contributes to overall value. Moreover, for some commercial recreation properties, the value of intangible property may not be reflected in the income produced at the property level. Understanding and properly valuing the intangible property is particularly important for commercial recreation projects, particularly depending on the use of the appraisal. For example, appraisal
of a property as the basis for ad valorem property taxes considers only the real and personal property. The intangible property component, in most jurisdictions, is not subject to property tax assessment. Many branded destination theme park attractions such as Disney, Universal Studios, and SeaWorld, have significant intangible assets such as intellectual property and naming rights, etc. that produce or increase income at the attraction, but would not be included in such an appraisal.

While the concept of intangible property is generally accepted, measuring and quantifying its value is a critical task for the appraiser. In theory, analyzing a matched comparative set of properties which compares the income/value produced by a property having intangible assets with one that does not would provide a basis for measuring intangible value. In practice, such a straightforward comparison is not practical, due to the many varied factors influencing property performance. However, it may be possible to establish surrogate measures of intangible value. A number of international theme parks developed in recent years operate under a license agreement with an established, branded theme park company. These agreements allow the licensee to use the name, intellectual properties such as cartoon characters, film, and other branded or copy-righted property, in the operation of the park. Royalty or licensing fees are typically paid to the licensor for the right to use these license properties. The fees paid can serve as a solid basis for estimating the value of the intangible property rights such as intellectual property and good will.

**Conclusions**

While it may be necessary and sometimes informative to employ the cost and market (sales comparison) approaches to value in appraising commercial recreation properties, the bias should be placed on the income approach. The income approach fully reflects the specific characteristics of a property, including the market environment in which it operates, the property’s locational attributes, and other special circumstances or conditions affecting the property performance.

Establishing potential net operating income for a commercial recreation property, however, requires the expertise of an analyst with knowledge and experience with these unique types of properties, particularly given the absence of established operating standards, unique business models, and the variance of observed capitalization and discount rates.

Understanding the various components of value is a critical challenge faced by the analyst, with intangible property often representing a substantial percentage of total value. Considering the unconventional nature of most commercial recreation properties, absence of substantial standardized data bases, and overall market dynamics, appraising these properties requires subject expertise in addition to traditional valuation skills.
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