Valuation of Casinos: Risky Business

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Abstract

Traditional commercial real estate is usually valued directly by capitalizing real estate rent, comparing sales of real estate, or applying a cost approach. Valuing just the real property being used as a casino is not so easy. This is because casinos are never built speculatively, and then sold or rented. As a result, an appraiser tasked with valuing just the real property must begin with sales and revenues associated with the total assets of the casino business, and then extract the contribution of the tangible and intangible personal property. This article describes the appraisal problem and presents suggestions about how that problem can be solved.

Introduction

Casinos are high risk, business-intensive operations. They represent a bundle of assets that comprises tangible real and personal property and, most importantly, very valuable intangibles. Among the obvious intangible assets are the assembled workforce and the value of the license or management contract to operate a casino business. The influence of these intangible assets must be left out of the equation when a real estate appraiser is asked to value just the real property component. Reasons such an appraisal might be requested include condemnation and real estate tax assessment.

In a condemnation appraisal in the context of federal acquisitions, the Uniform Appraisal Standards for Federal Land Acquisitions (UASFLA) notes, "The Supreme Court has instructed that 'separation…must be made in any case, between the value of the property and the value of the claimant's own business skill….'"[1] The UASFLA continues, "As a result, in determining the market value of the property, only income generated by the *real estate* itself—typically rental or royalty income—can be considered and capitalized. In contrast, the income generated by *business* conducted on the property (such as a farming operation) is not considered."[2] In other words, in the valuation of real property for federal land acquisitions, rental income for the real estate might be estimated on the basis of a percentage of the business revenue, but the business itself must be excluded.

The individual states may have different rules, although most share the common themes of the UASFLA, with intangibles excluded in the valuation of real estate for tax assessment purposes. As an example, in California intangible assets and rights are not subject to taxation. This is commonly true in other jurisdictions as well.[3] The Revised Code of Washington also exempts intangible property from ad valorem taxation, noting in particular personal property such as "trademarks, trade names, brand names, copyrights, trade secrets, franchise agreements, licenses, permits…favorable contracts," etc.[4] An example related to the discussion here is a provi-

1. Interagency Land Acquisition Conference, "Income to be Considered," Sec. 4.4.4.2 in *Uniform Appraisal Standards for Federal Land Acquisitions*, 2016 ed., 140.
2. Ibid. Emphasis in original.
3. Although California tax assessment regulation recognizes the necessity, in certain situations, for the appraiser to "assume the presence of any intangible assets or rights necessary to the beneficial or productive use of the property being valued," most other states do not. California State Board of Equalization, "Advanced Appraisal," Sec. 502 in *Assessor's Handbook* (December 1998), 150.
4. State of Washington, RCW 84.36.070, "Intangible personal property—Appraisal."

sion in the Kansas Expanded Lottery Act, which specifically states, "A management contract shall not constitute property." [5]

Jurisdictions have different methods of granting the right to game. Typically, the right to game is granted via a gaming license or a management agreement/contract, depending on the specific jurisdiction. In this article, the phrase "right to game" is used to describe the ability to conduct gaming operations typically granted by the award of a gaming license or management agreement/contract.

When market value is sought in a valuation assignment, the appraiser must answer the question, what would the real property rights (usually the fee simple interest) have sold for on the open market assuming a knowledgeable and willing buyer and seller and a typical exposure period?[6] It is important to understand that market value is not a stand-alone concept. It refers to specifically defined rights and assets. *Real property* is "an interest or interests in real estate."[7] In other words, you cannot estimate market value as how much a willing seller would sell to a willing buyer without first clearly identifying what rights and assets are being sold.

The problem in valuation of casinos is that a casino usually would not be sold as is, without the right to game and operate the business in hand. Rather, the buyer would likely option the property, subject to acquiring the right to operate; and the option would not be exercised if that right is not obtained. This is very similar, *in concept*, to a real estate investor buying land that is potentially contaminated. Rarely would the land be purchased as is, with the risk of the unknown cost to remediate assumed by the buyer. Instead, most would be bought subject to learning the costs involved. Unfortunately for the real estate appraiser, the property must be valued as is, which means absent an option. In the case of a casino, this means absent the right to operate the casino business.[8]

After a brief review of literature published on the topic of casinos, this article will provide industry background and a discussion of trends in the casino business, and then discuss the appraisal problem in more detail and the appropriate application of the three approaches to value to answer that problem.

Literature Review

Although much has been written on gambling and the casino business,[9] there is little available dealing specifically with real estate appraisal issues. A very good article discussing the industry and its trends did appear in *The Appraisal Journal*, but it did not get into the valuation of the real estate.[10] There is also a very informative chapter on valuing the total assets of a casino business in the textbook, *Financial Valuation: Businesses and Business Interests*.[11] It does not, however, include anything of help to the real estate appraiser tasked with valuing just the real property.

Casino Industry Background and Trends

In his book *Gambling and the Law*, I. Nelson Rose notes that gambling in the United States is in its "third wave." The first wave, which occurred from the colonial period to the Civil War, featured lotteries brought about by the influence of the printing press. The second wave began after

5. Kansas Expanded Lottery Act, 74.8734(m).

6. Some states mandate a hybrid of market value called "market value in use," although most do not. In these situations, when the highest and best use is the existing use, no significant difference in value occurs.

7. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015), s.v. "real property."

8. This is quite different from valuing absent other contractual items that are associated with police power. "Examples of police power include zoning ordinances, use restrictions, building codes, air and land traffic regulations, health codes, and environmental regulations." Appraisal Institute, *The Appraisal of Real Estate*, 14th ed. (Chicago: Appraisal Institute, 2013), 6. Other examples of appropriate inclusions are building and occupancy permits.

9. See, for example, the website of the University of Nevada, Las Vegas, Center for Gaming Research, "Occasional Paper Series," http://gaming.unlv.edu/papers.html.

10. Howard C. Gelbtuch, "The Casino Industry," *The Appraisal Journal* (April 1991): 179–190.

11. Richard C. May and Loren B. Garutto, *Financial Valuation: Businesses and Business Interests*, 2000 Update with Cumulative Index (New York: WG&L/RIA Group, 2000): U16B1-U16B-46.

the Civil War, as the South's instrument to raise money to rebuild. The third wave started with the Great Depression, when Nevada relegalized gambling in 1931. By 2015 twenty-two states had legalized commercial casino gaming, generating revenue of $38.3 billion.[12] This growth has been primarily driven by the states' motivations to raise additional tax revenue, coupled with the attempt to compete with Native American tribal casino gaming.

The US gaming industry can be divided into four categories: commercial casino gaming, iGaming (or online gaming), limited stakes (gaming machines in taverns, restaurants, etc.), and tribal gaming (Native American casinos).[13] While commercial casino revenues have been increasing every year since 2009, continued success is not guaranteed.[14] Growth in the industry depends on the casinos' ability to increase tourism as well as the tax structures levied on casino owners and operators, and the overall legislative restrictions applied across the industry.[15] According to industry reports, more than one-third (34%) of Americans visited a casino in the past twelve months, while 32% of Americans say they gambled at a casino in the past twelve months. Young adults (age 21–35) had the highest rate of casino visitation, as nearly two out of five (39%) visited a casino. In addition to visiting casinos at a higher rate than other age groups, young adults are more likely to come back.[16]

The challenges faced by the commercial gaming segment include increased competition and an aging entertainment offering.[17] According to a panel of gaming industry executives, the gaming industry has reached saturation.[18] One example of the effect of market saturation can be seen in Deadwood, South Dakota, where an estimated 60% of the casinos became unprofitable and an additional 20% became marginal after legalization of gaming in Colorado in the early 1990s. During this same period, two riverboat casinos in Iowa pulled up anchor to travel to points on the lower Mississippi that were less subject to competition from Illinois.[19] Increased competition also was evidenced in 2014 through 2016 by the closures of five casinos in Atlantic City, New Jersey (Showboat Casino, Revel Casino, Trump Plaza Hotel and Casino, the Atlantic Club Casino, and Trump Taj Mahal).

The gaming segment is also confronted with technological advancement, as the slot-machine as a gaming device is quickly becoming an aging form of entertainment.[20] The Nevada state senate recently passed a bill requiring the Nevada Gaming Commission "to adopt regulations which encourage manufacturers to develop and deploy gaming devices, associated equipment and various gaming support systems that incorporate innovative, alternative and advanced technology."

All of these developments factor into the valuation of casino real property, as they represent the elements that create both functional and external obsolescence, which must be accounted for in each of the three valuation methods discussed next.

The Appraisal Problem

Solving the appraisal problem presented when an assignment is to just value the real property component of a casino going concern requires an understanding of all the concepts and principles related to separating real property, personal property and intangible business assets. These concepts are presented and discussed in the Appraisal Institute course, *Fundamentals of Separating Real Property, Personal Property, and Intangible Business*

12. RubinBrown, *Gaming Statistics '16*, 3, available at www.rubinbrown.com/Gaming_Stats.pdf.

13. Ibid.

14. David G. Schwartz, *United States Commercial Casino Revenues* (Las Vegas: Center for Gaming Research, University Libraries, University of Nevada Las Vegas, 2016).

15. University of Nevada Las Vegas, *The Gaming Industry Introduction and Perspectives* (New York: John Wiley & Sons, Inc., 1996), 55.

16. American Gaming Association, *State of the States—The AGA Survey of Casino Entertainment* (2013).

17. RubinBrown, comp. *Gaming Statistics '15*. Publication. RubinBrown LLP. 7.

18. Richard N. Velotta, "Gaming Execs Say Casino Industry Has Reached Saturation Point," *Vegas INC* (September 2013).

19. Adam Rose, *The Regional Economic Impacts of Casino Gambling: Assessment of the Literature and Establishment of a Research Agenda* (State College, PA: Adam Rose and Associates, 1998).

20. Ibid., 7.

Assets.[21] Of particular importance are the principles of return on investment and opportunity cost. In the text *Valuation of Intellectual Property and Intangible Assets*, Smith and Parr state that with regard to return on investment, "We cannot emphasize enough the importance of the relationship of value and earnings. The raison d'être of business assets is to provide a return on the investment required to obtain them."[22] *The Dictionary of Real Estate Appraisal* defines *opportunity cost* as "the payment needed to attract productive resources from the next most rewarding alternative use."[23] This explains why both a return "on" and "of" investment have to be accounted for in removing an intangible asset from the real property valuation equation.

Other appraisal concepts also come into play in the valuation of just the real property component of a casino going concern. These include differentiating investment value from market value, and properly measuring functional and external obsolescence; however, the most critical is separating the value of the intangibles from the tangible property.

Highest and Best Use

In market value situations—that is, in situations other than those with the hybrid market value in use requirement—highest and best use is a critical conclusion upon which the valuation will be based. As such, it will require a careful and thorough marketability study. In some jurisdictions (New Jersey, for example) it is quite possible the highest and best use conclusion will be an alternative use or even demolition. In situations where the casino improvements already exist and the market is sufficient to support one, however, it is likely the highest and best use *of the real estate* will be *to pursue* the casino license, recognizing that the right to game is not a part of the real estate. With this highest and best use conclusion, the real property is valued as is; that is, without the right to game. Under such an assumption the appraiser is contending with a situation similar in concept to a rezoning conclusion, it terms of the way it is to be handled. Even when a zoning change is reasonably probable, the property is never valued as if the event had already occurred. The same is true when valuing a property with a reasonable probability of securing the right to game from a sanctioning body. If a buyer would pay more for a casino property for which there is a high likelihood of obtaining the right to gamble, that increment would be factored into the as is value; however, the property would not be valued as if that right to gamble were already in hand.[24]

The Three Approaches to Value

All three of the traditional valuation approaches are potentially useful in the valuation of casino real property. However, all three approaches also involve obstacles that must be carefully negotiated if the appraiser is to end up with the correct answer to the assignment's question. The appraiser will initially try to apply the approaches that would be used with conventional real estate problems. This would involve finding leased buildings housing casinos, sales of buildings that were put to use as casinos, and cost new less depreciation of buildings suitable for casino use. Unfortunately, as will be quickly revealed, casino buildings are rarely built speculatively and then put on the market for lease or sale. There are some exceptions but too few to allow development of value in a more conventional model. One such transaction took place in 2016, when Gaming and Leisure Properties (GLP) purchased the Meadows Racetrack and Casino located in Washington, PA. GLP concurrently closed on the sale of the gaming licenses and operating assets to Pinnacle Entertainment, while retaining the real property. Pinnacle entered into a triple net lease with GLP to operate the casino.[25] These types of transactions are rare; however, if they become more common in the industry, reliable indications of market value and market rent may become more easily accessible.

21. Appraisal Institute, *Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets* (Chicago: Appraisal Institute, 2011), http://bit.ly/FundamentalsOfSeparating.

22. Gordon V. Smith and Russell L. Parr, *Valuation of Intellectual Property and Intangible Assets*, 3rd ed. (New York: John Wiley & Sons, Inc.), 66.

23. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "opportunity cost payment."

24. J. D. Eaton, *Real Estate Valuation in Litigation*, 2nd ed. (Chicago: Appraisal Institute, 1995), 142–149.

25. Paul J. Gough, "Meadows License, Gaming Assets Sold for $138M," *Pittsburgh Business Times* (March 2016).

Presently, there are very few rent comparables from which to develop a direct indication of market rent for the real property alone, and virtually no sales of buildings that subsequently were put to use as casinos.[26] As a result, an income capitalization approach must begin with revenues to the total assets and a sales comparison approach with sales of the total assets. The cost approach would seem to be the most direct method to get at just the real property value, but it too has difficult issues relating to land value and depreciation, which will be discussed in the following section. Ultimately, in most situations, the best way to answer the appraisal question is to begin with the value of the total assets of the casino business, then allocate the portion of that that would represent the value of the real property.

The Cost Approach

The cost approach is based on the premise that a property's market value may be established by its cost new—land plus construction (hard and soft costs)—less accumulated depreciation from all sources. The approach comprises three main parts: site value as if vacant, improvement cost new, and depreciation. There is market evidence that suggests gaming/casino facilities can suffer from acute external and functional obsolescence, absent their right to conduct gaming operations. However, the depreciation—absent the right to game—becomes very difficult to estimate with significant accuracy, and the method's reliability can be dramatically diminished as a result. The cost approach will not indicate the value of just the real estate unless special steps are taken to recognize the impact of the right to game on the market value of the total assets of the business, and to capture any functional and external obsolescence emerging from the industry trends outlined earlier. Notwithstanding these obstacles, a cost approach might be useful at least as a check on the other methods used. After all, if the depreciation can be properly accounted for—probably best through either market extraction or even feasibility rent analysis—it, and it alone, allows a direct indication of the real property value without having to parse the tangible and intangible personal property.

Site Value. The first step of the cost approach is to estimate the value of the site as though vacant and available to be developed to its highest and best use.[27] Care must be taken in identifying land sales that have not been influenced by a speculative award of the right to game, or to adjust any that are included that have been influenced by speculation. As noted by the United States Supreme Court, "Elements affecting value that depend upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable, should be excluded from consideration."[28] Furthermore, even if the appraiser concludes there is a reasonable probability of obtaining the right to game, the property may not be valued as if this right is in hand. The property must be valued only in light of the probability of obtaining the right to game. Typically, in order to be considered for an award of a right to game, a potential candidate-developer has to have a site in hand or an option agreement in place. As a result, a potential developer would option but not outright purchase candidate sites. If awarded a right to game, the option is exercised and the sale goes through. If not awarded a right to game, the option is not exercised and the sale does not go through. As such, the option price typically reflects value as if a right to game is in hand. As noted in the UASFLA, "An option to purchase is a form of an offer; it is an offer that is irrevocable for the period stipulated….even if consideration has been paid for it, an unexercised option—like an unaccepted offer—is inadmissible to establish market value."[29] If option sales are utilized as an indication of site value, the appraiser must adjust the price to reflect their superior economic standing (price was contingent, in this example, on securing the right to game), as of the date of closing.[30]

26. There are sales of casinos, especially in New Jersey, where casinos were purchased and put to an alternative use, such as a school or an office building. These situations, however, are usually distress sales involving a different highest and best use and do not make good comparisons.

27. Appraisal Institute. *The Appraisal of Real Estate*, 14th ed., 568.

28. *Olson v. United States*, 292 U.S. 246, 257 (1934).

29. Interagency Land Acquisition Conference, "Offers, Listings, Contracts, and Options" Sec. 4.4.2.4.6 in *UASFLA*, 2016 ed., 130.

30. Eaton, *Real Estate Valuation in Litigation*, 2nd ed., 134.

Improvement Cost New. The cost to construct an improvement on the effective appraisal date may be developed as either the estimated reproduction cost or estimated replacement cost of the improvement.[31] In the end, distinguishing between replacement and reproduction cost is not as important as appropriately concluding functional and external obsolescence associated with removing the subject's right to game. (Both result in the same indicated value, assuming functional obsolescence-super adequacy is correctly accounted for.) Within the context of a functioning casino business, which is predicated on the retention of the right to game, the excessive costs associated with building a casino are financially feasible in the context of the casino business. If the right to game is extracted, the cost of the improvements is not financially feasible. The valuation question that needs to be answered is, "what is the market value in fee of the property, absent any contribution from tangible or intangible personalty." This does not mean the property would not sell with the buyer then attempting to secure a right to game for the casino, just that the value must reflect only the fact that a right to game will be pursued rather than the value as if that right were in hand.

The appraiser must also be aware of specific regulatory requirements that can be attached to the award of the right to game. In certain areas of Kansas, for example, as a requirement of the right to game (which in Kansas would mean the award of a management contract), a minimum capital investment of $225 million must be made to build a gaming facility. This amount can far exceed what would be built if the requirement were not in place. These required investment benchmarks create the potential for significant functional obsolescence via super adequacy of the improvements. A real-world example of functional obsolescence via super adequacy tied to required investment thresholds is illustrated by the Kansas Star Casino in Mulvane, Kansas. A 162,622-square-foot, very basic and far from ornate auditorium/arena building was built in 2012 to accommodate 7,200 people. It served as a temporary casino while the actual casino was under construction. In 2013, the main casino floor opened and the arena building transitioned back to an area used to host special events/concerts, etc. Revenues at the casino spiked in 2013, when the main casino floor opened; however, after stabilization in 2014 and 2015, revenues fell to levels at or even slightly below what was achieved in the arena/auditorium building. Due to the required investment of $225 million, the casino owner is now left with a super adequate building that far exceeds the size of an ideal improvement. Furthermore, the arena has become not much more than a loss leader.

Depreciation. Depreciation is simply the difference between the contributory value of an improvement and its cost at the time of appraisal.[32] Depreciation accrues from three sources: physical deterioration, functional obsolescence, and external obsolescence. Physical deterioration is the breakdown of physical components usually caused by age. Functional obsolescence refers to a flaw in the structure, materials, or design (in the case of casino buildings, low-ceilinged, maze-like designs, or super-adequate design for which the market is not willing to pay). "In contrast to functional obsolescence, external obsolescence occurs *outside* the subject property. It is caused by something beyond the control of the real estate owner."[33] An example in the casino industry could include the proliferation of internet gambling and its effects on brick-and-mortar casinos.

The three methods of measuring depreciation are the economic age-life method, the market extraction method, and the breakdown method. The economic age-life method is a simple method to extract depreciation, but it is only as accurate as the appraiser's estimate of effective age and total economic life. Appraisers must be careful to understand that effective age can often diverge from chronological age, and total economic life and physical life have very different meanings. Rarely is this method acceptable if the cost approach is to be given significant weight. The formula for calculating depreciation via the age life method is as follows:

31. Appraisal Institute, *The Appraisal of Real Estate*, 14th ed., 569.

32. Ibid., 576.

33. E. Nelson Bowes, *In Defense of the Cost Approach* (Chicago: Appraisal Institute, 2011), 85.

$$\frac{\text{Effective Age}}{\text{Total Economic Life}} \times \text{Total Cost} = \text{Depreciation}$$

The breakdown method is the most comprehensive of the three methods, and it accounts for all of the components (physical, functional, and external) separately. Given the regulatory environment, changing economic conditions, and complexity of most casino structures, the breakdown method is not a simple exercise. Due to the lack of overall practicality of the method as it relates to a casino project, no further discussion is necessary.

The market extraction method, which relies on the availability of comparable sales, reflects reality as long as similar sales are arm's-length and recent. Herein lies the major challenge of applying the market extraction method: (1) Unless distressed, casinos almost always trade as the total assets of the business, including the right to game; and (2) The number of casinos in the United States is quite limited when compared to other property use/types. As of March 2016, there were only 580 casinos in the United States.[34] Thus the pool of available comparable sales is extremely limited. There is market-based evidence that, absent the right to game, functional/external obsolescence is severe. This is not unique to casinos and may be found in other types of special-purpose properties. As noted by Lovell,

> many successful businesses are structured around highly specialized improvements for which there is very limited market if the particular business was discontinued.… While the operator of such facilities can justify the cost of its specialized design components based on their contributory value to an operating business, a typical purchaser of the real estate will generally not pay for the cost of such components. Specialized design elements generally do not add value to the real estate because they derive their worth from the business entity associated with them. If the business entity is viable, their worth is related to the production of business income and they are components of the going concern value of the business.[35]

Recent examples of casino transfers absent the right to game, or repurposed to alternative uses can be found in Atlantic City, New Jersey. These transfers are significant because in each case the properties were casino-hotel properties prior to their sale, with buyers repurposing or reusing the properties for substantially non-casino uses. For example, The Revel Casino opened April 2, 2012, at a cost to build of $2.4 billion dollars. The casino closed September 2, 2014, due to financial troubles. The Revel has been subsequently purchased by investor Glenn Straub for $82 million dollars.[36] Thus, the property sold for 3.4% of the original cost to complete, indicating the existence of substantial functional and external obsolescence. While this may be an atypical example, it demonstrates that costs expended in relation to a business enterprise may not reflect actual real property value. To date, plans have not been finalized for the Revel property, and Straub has indicated that a casino use, if any, would be only a minor part of the redevelopment.

Sales Comparison Approach

The sales comparison approach analyzes the actions of buyers and sellers of similar properties, whose interaction reflects the fundamental principle of supply and demand. Central to this approach is the principle of substitution, which holds up well for properties where an active market of comparable product is traded but falters when characteristics of a product are perceived by the market to be unique. *The Appraisal of Real Estate*, fourteenth edition, cautions that "[t]he demand generated for such products may result in unique pricing….In those situations, the appraiser may have to research substitute properties in a broader market or employ analytical techniques appropriate for limited-market properties."[37]

Most casino properties fit the description of a unique property without an active market and a limited pool of buyers.[38] Although there are ample sales of casino going concerns, there is

34. RubinBrown, *Gaming Statistics '16*, 3.

35. Douglas D. Lovell, "Does Your Client Really Need a Market Value Estimate?" *The Real Estate Appraiser* (May 1991): 3–11.

36. Reuben Kramer, "Revel Casino Hotel Sold to Straub's Company," *Press of Atlantic City*, April 8, 2015.

37. Appraisal Institute, *The Appraisal of Real Estate*, 14th ed., 31.

38. It is important to note that "[t]he lack of market participants does not translate into a use being intrinsically valuable simply because a use is rare or unique." Lovell, "Does Your Client Really Need a Market Value Estimate?" 11.

limited data involving sales of just the real property component. (As previously noted in regard to the Meadows Racetrack, if these sales become more prevalent, they might very well be used in a stand-alone approach.) As a result, to properly employ the sales comparison approach in valuing just the real property component of a casino going concern, it is necessary to either widen the scope to include the sales of other kinds of entertainment facilities and noncasino properties, or use sales of casino going concerns, which are readily available, then allocate (adjust) the sales for the tangible and intangible personalty components. In either case, the role of such an analysis is understandably limited in this situation as a discrete appraisal methodology. The sales comparison approach is best used in combination with an allocation of the real property. In this model, the appraiser extracts a multiplier for earnings before interest, taxes, depreciation, and amortization (EBITDA) from the sale of casino going concerns, applies that multiplier to the net income to total assets to develop an indication of the market value of the total assets, and then applies a market-extracted allocation percentage to quantify the contribution of the real property to the total assets. Sources of published EBITDA multiples include IBISWorld, BizComps, Pratt's Stats, and Mergerstat Review. In addition, certain jurisdictions publish gaming financials as a matter of public record, such as the Nevada Gaming Abstract Report. This method will be illustrated and further explained in the following Income Approach section.

The Income Approach

The Appraisal Institute's course *Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets* discusses three methods used by business valuers to value the total assets of a business or going concern: the market approach; the income approach, presented as a discounted cash flow analysis; and the asset approach, or adjusted book value approach.[39] The latter is considered least reliable and will not be discussed further.

The Market Approach. The market approach, also known as the comparable companies approach, includes two applications: the guideline publicly traded company method and the private transaction comparison method. In the guideline publicly traded company approach, capitalization rates or market multiples are applied to earnings figures to develop the value. (Although called the market approach, this is really just direct capitalization.) The earnings before interest, income taxes, depreciation, and amortization multiple (EBITDA multiplier) and earnings before interest and taxes multiple (EBIT multiplier) are observed most frequently. The second market approach—the private transaction comparison method—is similar to a real estate appraiser's sales comparison; however, "a business appraiser generally does not have an adequate amount of information about a sufficient number of sales to treat individual transactions as if they were sales comparisons."[40] As a result, a business valuer will usually rely on the published transactional databases discussed earlier (e.g., BizComps, Mergerstat, and Pratt's Stats).

The Income Approach. A business valuer's income approach is quite similar to a real property appraiser's discounted cash flow analysis and usually includes a weighted average cost of capital method (WACC) to develop a discount rate. This approach is best suited for determining the value of a single property but often requires, or at least benefits from, the involvement of a business valuer in order to reliably forecast the cash flows of the enterprise over the projection period.

For the purposes of illustrating how an income approach might be used to develop the value of the real property component of a casino going concern, this article will use a market comparison approach with an EBITDA (debt-free) multiplier, and then apply an allocation based on a percent of the total represented by the real property contribution.[41]

As with direct capitalization with a more traditional property, the revenue to which the EBITDA multiple is applied must mirror the

39. Appraisal Institute, "Valuing the Total Assets of the Business," part 7 in *Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets*, 113–132.

40. Ibid.

41. An excellent discussion of this market comparison approach for a casino business is presented in the text by May and Garutto, *Financial Valuation: Businesses and Business Interests*, 16B-15-19.

revenue that was represented by the source for the multiple. In other words, the multiple must be extracted or developed in the same way it is to be applied. Also, the multiple should be developed from companies of similar size, with similar risk and preferably in a similar jurisdiction.

Using actual company performance in the industry in conjunction with the published EBITDA multiples previously cited, total revenue can be converted to EBITDA as follows:

Total Annual Revenue	$100,000,000
EBITDA (Profit Margin of 20%)	$20,000,000

Using an EBITDA multiplier, the EBITDA can be converted to market value of the total assets of the business (MVTAB). Market multiples, such as price-to-earnings ratios or EBITDA and EBIT multipliers, are commonly used in business valuations. Real property appraisers are more accustomed to using capitalization rates, although real estate appraisers are also taught about gross rent multipliers and effective gross income multipliers. The simplistic example used here will illustrate what casino business valuers would do, but recognizes an EBITDA multiplier is more or less simply the reciprocal of an overall capitalization rate.

EBITDA	$20,000,000
	Multiplied by 7.5 (from published data bases previously cited)
MVTAB	$150,000,000

Next, the appraiser needs to identify what percentage of the total assets is represented by the real property. A casino company's annual US Securities and Exchange Commission Form 10-K can be consulted, as often these reports specifically quantify the percentage of the sale price that was allocated to real estate; but, particular attention should be paid to how the allocations shown there were developed. It is emphasized, that great care must be taken in the verification process to determine if the real property allocation is accurate. This allocation percentage should be cross-checked with other more general sources, such as published studies,[42] and with other different but similar business investments, such as racetracks. Although racetracks might seem quite dissimilar, they actually perform in much the same way, and the relationship of real property value to total assets value is remarkably similar.

Once a conclusion has been reached concerning the percentage, the market value of the real property—as it contributes to the total assets of the business rather than in liquidation—can be calculated by multiplying the MVTAB by the allocation percentage. Please note that this exercise is intended to be a simplistic example of the methodology, and the following percentage is not to be used as a benchmark.

MVTAB	$150,000,000
	Multiplied by 30% (from casino company 10-Ks and secondary sources)
Market Value of Real Property	$45,000,000

The validity of this application, of course, is a function of the care taken to correctly estimate the total revenue, profit margin, EBITDA multiple, and percentage of allocation to real property. However, this is true of any appraisal: in fact, all products are only as good as the ingredients used to make them.

Summary and Conclusions

With traditional real estate, commercial real estate appraisers usually do not have to worry about separating the real property from the tangible and intangible personalty, although it is required in a number of business-intensive real property types, such as hotels, restaurants, malls, and senior housing. Usually appraisers can find rents of just the real property and arrive at a value via the income approach without getting into the business being conducted in it. Also, they can usually find sales of similar real estate that is subsequently put to use by a business but whose sale price reflects only the real property. Much commercial real estate is, in fact, built speculatively, and sold without a particular business in mind. Casinos, however, are never built speculatively.

42. For example, see those reported by William N. Kinnard, Jr., "Identification and Measurement of Intangible Asset Values Associated with Operating Properties" (paper presented at 1998 CPTA Workshop, Halifax, Nova Scotia, 1998), 12–15.

Historically, rents and sales of pure casino real estate are quite rare (although, as evidenced by the Meadows Racetrack example, they may be becoming more prevalent). This lack of sufficient direct evidence of either real estate rents or sale prices could lead one to conclude the cost approach would probably be most reliable for casino real property. However, "Cost is only equal to value if typical purchasers base their pricing decision on the cost of production. If a typical purchaser does not base his pricing decision on the cost of production, it should not be assumed that he would do so."[43] Because of this, depreciation becomes such a significant element that a cost approach rarely can be put forward as a standalone method for valuing casino real estate. As a result of these circumstances, the real estate appraiser must work with sales and revenue derived from the total assets of the business, and then extract from them the value contribution of the real property. A valuation of casino real property is not an easy task, especially for one without knowledge of the business operation. These valuations are risky and must be handled with particular care. Unless the real estate appraiser has the expertise and experience in valuing the total assets of a casino business (or a background in other properties with the same tangible and intangible personalty components, such as hotels or senior housing), involving a business appraiser is a prudent decision. It is hopeful that this article provides some insight into the concepts, principles, and methods that are used to solve this interesting but challenging problem. The examples have been included simply to illustrate the methodology, and the multipliers and ratios used should not be accepted as appropriate absent independent subject-specific research. The hope is to follow this article with a second one that includes a detailed case study of an actual casino assignment in order to move the discussion from principles and issues (what appraisers have to do and why they have to do it) to the specifics of how appraisers would complete a valuation.

About The Authors

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SEE NEXT PAGE FOR ADDITIONAL RESOURCES >

43. Lovell, "Does Your Client Really Need a Market Value Estimate?" 11.

Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

American Gaming Association—Research
https://www.americangaming.org/research

Appraisal Institute

- **Education**
  http://www.myappraisalinstitute.org/education/default.aspx
  - *Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets*
- **Lum Library External Information Sources [Login required**]
  Information Files—Special-purpose properties/sports, recreation, and entertainment

Indian Gaming—National Information Site for American Indian Gaming Industry
http://www.indiangaming.com/home/

New York Times Business Day Markets—Casinos and Gaming
http://markets.on.nytimes.com/research/markets/usmarkets/industry.asp?industry=53313

North American Gaming Regulators Association
http://www.nagra.org

RubinBrown Stat Books—Gaming Statistics
http://www.rubinbrown.com/Resources/stat-books.aspx

Statista—Casino and Gambling Industry: Statistics and Facts
https://www.statista.com/topics/1053/casinos/