

# Chapter 5: Asset Valuation (Real Estate)

**Real estate is often the largest fixed asset on the balance sheet. The two most important items to consider are either the market value of the building (if it is part of the transaction) or the lease (if the building is not part of the transaction).**

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## Introduction

When valuing a family entertainment center and reviewing the real estate component, you need to look at one of three things, depending upon whether the seller owns the facilities or leases:

- (1) The value of the facility (if the seller owns the building/buildings).
- (2) The value and duration of the lease (if the seller does not own the building).
- (3) Some combination of the two (if the facility will be leased by the seller, then the fair rental rate should be determined).

The lease and real estate facilities of a family entertainment center are the most important items to review before valuing or purchasing one. It is critical to know how much land there is, how much building space there is, where it is, whether the property is owned or leased, and whether the valuation is for a market value or a liquidation value. The building and land characteristics of the property, as well as its market supply and demand, which should be accurately determined.

Before reviewing the different techniques of valuing a family entertainment center lot or a building, it is important to understand the various ownership interests in real estate, as well as the critical and unique building and land statistics.

### Ownership Interests

There are four general interests in real estate:

- (1) fee simple
- (2) leased fee
- (3) leasehold
- (4) partial interest

Fee simple interests are the most common, meaning that the property is not encumbered by any other interest or lease. This interest is most used when valuing an owner user property where there are no tenants, and the owner (seller) also owns both the land and building.

A leased fee interest means an ownership interest held by a landlord, but leased to others; the rights of the lessor (landlord) or the leased fee owner and leased fee are specified by contract terms contained within the lease. This interest is involved mostly when valuing income producing property with leases such as industrial, office buildings or retail centers.

A leasehold interest is defined as the right to use and occupy real estate for a stated term and under certain conditions, conveyed by a lease. This interest is generally involved when valuing a land lease or the lease of a tenant.

Finally, a fractional interest is an interest in either of the three interests seen above but is less than 100%. An example of this would be a house in which three people have one third interests.

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## General Land and Building Analysis

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Before valuing anything, one must know the building and land parcel sizes. First, the site improvements need to be reviewed. The general characteristics for a land parcel can be seen in Table 5-2 on page 99. Critical improvement characteristics are seen in Table 5-1.

**Table 5-1: Important Family Entertainment Building Characteristics**

Item	Comments
Gross Building Area:	Get the correct square footage.
Exterior:	Concrete, wood, stucco?
Foundation:	Is it flat? Reinforced concrete?
Roof:	Do you need a new one? This can be expensive! How old is it?
Air-conditioning/Heating:	Same as the roof.
Plumbing:	Do you need new plumbing? Is there sufficient plumbing for restrooms? Are there plumbing and drains available for multiple concessions stands?
Electrical:	Is the wiring sufficient to run the necessary amperage for all the equipment? Do you need to replace or install additional circuit boxes? Do you need additional transformers?
Fire System:	Will the fire department allow you to operate in the existing facility as a family entertainment center?
Parking:	Critical! Are there enough spaces for the use of the facility?. Is the parking being shared with any other businesses?
Construction:	Are the interior walls strong?
Environmental:	Asbestos, etc.? Are you purchasing an off balance sheet liability?
Age:	Is the building about to fall over, or has it been maintained?

**Table 5-1: Important Family Entertainment Building Characteristics**

Item	Comments
Functional Obsolescence:	Are there problems with the building which impact the operation of the business? For example, if you are to lease or buy a building and there is no air conditioning system, then this is a problem.
Deferred Maintenance:	This is critical. You want to know going into a deal whether you need to pull out your checkbook for a new roof, electrical wiring, earthquake retrofitting, asbestos abatement, plumbing, etc. Get a good structural engineer and contractor when in doubt (even when not in doubt).
Signage:	Are there signage posts with good exposure to traffic? Can the building be clearly seen by the public?
Capital Expenditure:	What is the most recent capital expenditure? Any future expenditures?

**Table 5-2: Important Land Characteristics**

Item	Description/Comments
Location:	Get the address (look at title report/tax bill)
Assessor's Parcel Number:	Needed to establish basic tax identification and other statistics. Generally found on the tax bill.
Size and Shape:	There are 43,560 sq ft in one acre. This is a critical factor since you need to know if there is enough room for expansion, if your parking is less than the overall market, if the turning radius for freight delivery is inadequate, or if there is excess land which is an additional asset for the balance sheet.
Ingress/Egress and Exposure:	If you cannot access the property or are subject to a short term easement, then the value is much lower.
Adjacent Properties:	Is the property next to a toxic dump or gas station?
Topography:	Are there problems here? A hard rain or earthquake may make a building slide down a hill. Some buildings gradually shift down a slope.
Drainage and Storm Water Control:	Will the building float away? You may need flood insurance.
Hazards:	What was the building previously used for? Is it on top of a fault line (earthquake)? Is it contaminated by toxins (lead, methane)?
Easements, Restrictions, and Encroachments:	Does the title report flag any issues? The seller may not even know about these, such as the right of a neighbor to drive across your property.
Utilities:	Will you have to dig a ditch for sewage, water, or electricity, and pay for two miles of digging and engineering to make the building operational?
Zoning Provisions:	This factor is critical. It is absolutely critical to find the existing zoning code. If your building burns down, can you re-build the same structure? In most cases you can't. If you currently run a manufacturing business and the zoning has been changed to retail, then this may be a problem. Check to see if you need a conditional use permit (CUP) for your business.
CC&Rs/Private Restrictions, Governing Use:	Nail these down. These usually appear in the title policy and show any restrictions on the use of the property.
Tax and Assessment Data:	Are you being over assessed or under assessed? Also, you want to find out when the next assessment is for the county. Your taxes may double.

## Different Types of Family Entertainment Centers

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Family entertainment centers vary widely in both the size of the real estate and the respective size of the buildings. Typically speaking, the size of the building is significantly smaller relative to the total square footage of the land. In our subject company, the building only takes up 3% of the total land area.

Building size is usually determined by the type of offerings the facility has, with arcades and indoor play centers needing the largest buildings (5,000 to 15,000 square feet). Operations with only miniature golf or primarily outside activities can get away with buildings less than 500 square feet in size. Indoor facilities are the exception.

The goal with most family entertainment centers is to employ a minimum building size so as to maximize the utility of the real estate. The exception, however, would be those facilities operating in colder climates. If the operator chooses to operate year around, it would be in his or her best interest to maximize the size of the building and bring as many attractions indoors as possible.

### Market Analysis

The appraiser should then determine the vacancy rates in the area, the amount of space which is being built or planned, and whether vacancy rates and rental rates are decreasing or increasing as a result of supply and demand imbalances. This information may be obtained from real estate brokers or from appraisers. Also, contact the city planning department for additional information on future development. One should not get into a long term lease, only to learn that better and new space is about to be built, or a competitor is about to locate next to you.

You can get much of this information on-line from three commercial real estate brokerage companies. These companies and their respective web sites can be seen in Table 5-3.

**Table 5-3: Market Analysis Sources**

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Commercial Real Estate Company	Web Site
CB Richard Ellis	<a href="http://www.cbrichardellis.com">http://www.cbrichardellis.com</a>
Cushman & Wakefield	<a href="http://www.cushmanwakefield.com">http://www.cushmanwakefield.com</a>
Grubb & Ellis	<a href="http://www.grubb-ellis.com">http://www.grubb-ellis.com</a>

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### Market Analysis Example

If the total amount of retail space in a given market is 4,200,000 sq. ft., with the vacant space being 252,000 square feet the vacancy rate is 6.0%. It therefore seems like a healthy market and may indicate stable values. On the other hand, the market may have greater demand than supply, indicating that you may be paying top dollar for the facility.

## Example Valuation of Real Estate Assets

The best way to understand real estate valuation is through the use of an example. Throughout this chapter, we will present a quick valuation of a family entertainment center's real estate portion. This analysis will assist the reader in understanding how this asset fits into the overall business valuation. Many steps have been skipped, but the issues and analysis will give a buyer/seller or analyst a good "back of the envelope" indication. The most important specifics of this building can be seen in Table 5-1.

### Valuation Example

**Table 5-1: Land/Improvement Statistics of an Example Family Entertainment Center**

Item	Statistic
Location	Southern California
Interest Valued:	Fee simple interest (company owns building and does not lease)
Land Size and Shape:	7.0 acres / 304,920 sq. ft.
Zoning	C1
Tax and Assessment Data	1.358300% of assessed value, plus \$1059.64 in special assessments
Gross Building Area:	10,000 square feet
Year Built	1970
Construction Type:	Good, Class C Construction See Table 5-6 on page 106 for Codes
Parking	Estimated 45,000 square feet

## Valuation Approaches

After gathering basic statistics on the building and land which is being appraised, the appraiser may then apply different approaches to valuing the property or properties. There are three basic valuation approaches: (1) the Cost Approach; (2) the Direct Comparison Approach; and, (3) the Income Approach. These approaches are more comprehensively described in Figure 5-1 on page 102.

The Cost Approach calculates either the reproduction cost estimate of the subject property improvements (maintaining comparable quality and utility) or the replacement cost. Losses in value are then subtracted from this value. Losses are from depreciation, age, wear and tear, functionally obsolete features, and economic factors affecting the property. The net value (cost less depreciation) is then added to the estimated land value to provide a total value estimate.