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# HOW TO VALUE COMMERCIAL IMPROVEMENTS IN A NATIONAL PARK

by Maurice Robinson, CRE, David Dornbusch, Jason Bass & Blaine Chase, CRE

Recently, we were engaged by the National Park Service (NPS) to appraise the structures and other improvements that have been constructed by commercial vendors or "concessionaires" operating hotels, restaurants, and other hospitality services in National Parks. The results of these appraisals are being used to determine the compensation due concessionaires for their in-park investment in fixed improvements upon expiration of the contracts conveying them the right to do business within parks.

The distinctive setting of a National Park, the myriad of statutory rules governing concession contracting, the historic nature of many park improvements, and the numerous benefits and controls that the government provides and imposes, respectively, on park concession operations combine to make the appraisal of commercial facilities in a National Park uniquely challenging. While we cannot, for reasons of confidentiality, divulge any of the specific elements of our completed or ongoing appraisal assignments, we can discuss portions of what we believe to be the appropriate methods for appraisal in a National Park. Accordingly, the purpose of this manuscript is to summarize some of these methods and hopefully, initiate some professional discussion as to their merit.

## BACKGROUND

Thanks to visionaries like John Muir and Teddy Roosevelt, certain federal lands within the United States, containing great natural beauty or historic significance, have been preserved as National Parks for future generations to enjoy. The country's first National Park, Yellowstone, was founded in 1887. Though several other National

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Parks were also established before the end of the 19<sup>th</sup> century, it was not until 1916 that the federal government created a separate agency, the National Park Service (NPS), to administer the growing National Park system. Even then, it was an additional 17 years, 1933, before the NPS actually assumed management of many of the country's National Parks from other federal agencies such as the National Forest Service and Department of Defense.

Since its inception, the NPS has sought not only to fulfill its explicit mandate to protect park natural and cultural resources for the benefit of future generations, but also to provide the current generation of park visitors with adequate access to those resources and on-site amenities to facilitate their enjoyment. Specifically to address visitor needs, the NPS has often sought private sector assistance. In fact, even before the NPS was established, the government frequently partnered with vendors in an effort to make remote, and in many cases inhospitable, park locations more accessible and convenient to the public. From the beginning, most of this collaboration took form as concession contracts. Under these contracts, the government granted vendors, or concessionaires, the right to provide park visitors with specific commercial hospitality services while inside parks (e.g., lodging, food & beverage, retail, transportation services, etc.).

These contracts were not distributed through competitive bidding, but instead negotiated with selected vendors who, for the most part, were at the time already providing some unsupervised visitor services within and adjacent to the parks. The goal, and in some cases, requirement, of these contracts was that concessionaires would pay for the development of many of the facilities necessary to access and operate their concessions. To maximize their incentive to invest in parks, concessionaires were usually given extremely long contract terms and guaranteed exclusive operating rights during those terms. In addition, concessionaire payments to the government for the rights and privileges conveyed by the contracts, called "franchise fees," were fixed at nominal levels.

When the NPS gained full control of the nation's parks in the 1930s, it also assumed oversight responsibility for the parks' private concession operations. Presumably in an effort to solidify and codify its control of these concessions, the NPS entered into new operating contracts with each of the park concessionaires. The majority of these new

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In 1965, Congress passed Public Law 89-249, generally referred to as the NPS Concession Policy Act of 1965 (the Law). The Law's primary purpose was to provide clear legal direction for future NPS concession contracting. Congress anticipated that many concession contracts might change hands following their expiration. Accordingly, the Law set forth guidelines for the transfer of concession assets between an outgoing and incoming concessionaire, making it very clear that concessionaires had a right to receive compensation for the value of their investment in fixed structures and other improvements at the end of their contract term. Since the government holds title to all improvements within the parks, the Law refers to this property right as the concessionaire's "possessory interest" in improvements.

The determination of the value of concessionaires' possessory interest is now a central component of the National Park concession contracting process. An estimate of the possessory interest value must be reported within the contract prospectuses issued by the NPS since the buyout of possessory interest represents the primary cost to prospective new concessionaires to acquire the subject contract. If the incumbent concessionaire does not agree with the government's valuation of its possessory interest, then disputes are to be resolved through arbitration.

## THE APPRAISAL PROBLEM

From a general real estate standpoint, National Parks can be thought of as magnets for visitor demand. Depending on the park, large numbers, in some cases millions, of visitors are attracted every year to enjoy the beauty of the parks. Therefore, it is no surprise that often private property located in proximity to parks has realized significant increases in value, particularly lands that support visitor services, such as hotels, restaurants, and gift shops. An even greater potential for generating visitor-related revenues and profits lies within the parks themselves. Therefore, many parks have significant commercial value.

The value of revenue-producing activities within a National Park is derived from a number of sources. Certainly, the attractiveness of the park itself, as well as the quality of the visitor services and facilities, is important. However, the value can also be attributed to the rights granted by the NPS to the operator of those commercial services. For example, concession contracts limit the number of enterprises that may operate commercial facilities inside a park. As a result, many concessionaires operate in a monopoly-like setting, in that only one concessionaire typically has the right to provide a certain type of service in each park — such as lodging, food and beverage, retail sales, or a combination of those services. Certainly, this exclusive right to operate visitor-serving facilities inside a National Park has value.

But who “owns” this value—the concessionaire or the government? Historically it has not been necessary to answer this question, since few concessions have changed hands following expiration of a concession contract. However, it is evident that to properly appraise a concessionaire’s possessory interest, this question must be answered. Specifically, it is necessary to identify and then quantify the value contributed to the concession enterprise by the government from that contributed and belonging to the concessionaire. In the unique setting of a National Park, we must recognize that the concessionaire is essentially acting as a service provider; though in most cases, the concessionaire also pays for some or all of the improvements used in its operation. So, in answering the question of who owns the value inherent in a National Park concession, we must make distinctions between the various components of the concession’s overall enterprise value, including the:

1. Concession facilities (possessory interest) and

personal property funded by the concessionaire;

2. Management provided by the concessionaire;
3. Concession facilities funded by the government;
4. National Park land used for concession purposes; and
5. Commercial operating rights and privileges provided by the government through the concession contract.

In particular, the last three value components need to be isolated from the first two, recognizing that only the first two are “owned” by the concessionaire. In other words, the concessionaire contributes their improvements and personal property, as well as their management expertise, but the government contributes the other components of value.

## THE LEGAL FRAMEWORK GOVERNING THE APPRAISAL ASSIGNMENT

As stated previously, in appraising a concessionaire’s possessory interest, it is incumbent upon the appraisers to follow the provisions of the Law. It is also the appraisers’ responsibility to evaluate and assess the specific provisions of the contract between the concessionaire and the NPS, though these provisions generally mirror the Law.

The Law specifies the concessionaire’s protection against lost values, as follows:

*The Secretary may include in contracts for the providing of facilities and services such terms and conditions as, in his judgement, are required to assure the concessioner of adequate protection against loss of investment in structures, fixtures, improvements, equipment, supplies, and other tangible property provided by him for the purposes of the contract, but not against loss of anticipated profits.*

The Law limits possessory interest to structures, fixtures, and improvements, as follows:

*A concessionaire who has heretofore acquired or constructed or who hereafter acquires or constructs, pursuant to a contract and with the approval of the Secretary, any structure, fixture, or improvement upon land owned by the United States within an area administered by the NPS shall have a possessory interest therein, which shall consist of all incidents of ownership except legal title, and except as hereafter provided, which title shall be vested in the United States.*

The Law specifies the method for valuing possessory interest to be “reconstruction cost less depreciation,

but not to exceed fair market value," as follows:

*The said possessory interest shall not be extinguished by the expiration or other termination of the contract and may not be taken for public use without just compensation. The said possessory interest may be assigned, transferred, encumbered, or relinquished. Unless otherwise provided by agreement of the parties, just compensation shall be an amount equal to the sound value of such structure, fixture, or improvements at the time of taking by the United States determined upon the basis of reconstruction cost less depreciation evidenced by its condition and prospective serviceability in comparison with a new unit of like kind, but not to exceed fair market value.*

After examining the Law, specific concession contracts and other documents setting forth the legal framework for concession contracting, we concluded that a concessionaire's possessory interest must be appraised applying two separate valuation approaches. First, we must appraise the cost to reproduce the subject buildings and infrastructure funded by the concessionaire, less accrued depreciation from all causes. Second, we must estimate the fair market value of those same buildings and improvements, considering each of the three primary fair market valuation methods: the Cost Approach, Income Approach, and Sales Comparison Approach. We believe that in this instance of fair market valuation, application of the Cost Approach requires the use of a replacement cost rather than a reproduction cost analysis. In addition, only secondary consideration can be given to the Sales Comparison Approach, since no direct comparables for National Parks exist.

#### **"RECONSTRUCTION" COST**

A review of early editions of *The Appraisal of Real Estate* textbooks in use when the Law was written suggests that the term "reconstruction cost" had the equivalent meaning of reproduction cost. Accordingly, we feel it is appropriate to use a reproduction cost approach to comply with the first valuation method stipulated in the Law.

During their tenure, many concessionaires have built structures and associated site and infrastructure improvements. Some of the structures are award-winning, unique buildings, and have been named to the National Register of Historic Places, while many others are simple wooden structures used for operation support such as employee housing and storage. For the Reproduction Cost portion of the appraisal, we measure every building that the

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We also must assess the relative amount of depreciation and deferred maintenance, if any, present in each structure. Since many buildings in National Parks are on the National Register of Historic Places, items of both curable and incurable functional obsolescence, in addition to economic obsolescence, need to be carefully evaluated.

Though complex, estimation of the "reconstruction cost less depreciation" is not the most difficult appraisal approach utilized within a National Park setting. The Law states that the possessory interest value is "not to exceed fair market value." Thus, to comply with the Law, we must also employ the traditional approaches to estimate fair market value, the most interesting element of which, the income approach, is addressed in some detail here.

#### **THE INCOME APPROACH**

To apply the income approach to assess the value of a National Park concessionaire's possessory interest, we first analyze the concession operation itself.

Since concessionaires must report the financial details of their operation to the NPS, we typically have access to a long historical record of a concession's annual receipts and operating and capital expenditures. In addition, the NPS carefully tracks visitation to its Parks. Therefore, the levels and trends in both the financial performance of a concession and park visitation can be carefully examined to project a concession's future anticipated income stream. When this income stream is determined to be stable, the direct capitalization method of the Income Approach can be used to derive the capitalized value of the overall concession operation. Specifically, we can apply a market capitalization rate to the operation's stabilized net operating income (NOI) to estimate the fee simple value of the entire property that is the concession.

Since the income stream of a concession cannot be attributed solely to the concessionaire's possessory interest, this capitalization analysis alone does not provide an estimate of the fair market value of that possessory interest. Specifically, the government often funds some of the improvements used by the concession, certainly provides all of the in-park land used by the concession, and conveys a variety of additional rights and privileges to the concessionaire through its concession contract. All of these tangible and intangible assets contribute to the income stream of the concession, and therefore, its capitalized value.

Normally, and as previously noted, concessionaires pay the government some form of rent or "franchise fee" to compensate for the use of land and other rights and privileges conveyed by a concession contract. Lacking additional information, one might presume that this franchise fee accounts for the return to the land and other rights and privileges of the concession contract. If this were true, then the estimated stabilized income of the concession would arguably represent the return to the concessionaire's possessory interest. However, according to the Law, the assignment is to determine the fair market value of a concessionaire's possessory interest. Since the income-based valuation analysis starts with a determination of the fair market value of the entire concession contract, to derive the fair market value of a concessionaire's possessory interest from this overall concession value, we must remove the fair market value of the other contributing assets.

Unfortunately, historical franchise fees of recently expired and soon to expire concession contracts

were negotiated by concessionaires and the NPS and rarely determined through fair market competitions for the subject concession contracts. Accordingly, while we do not necessarily presume it to be the case, we do not accept, out of hand, that historical franchise fees provide an accurate measure of the fair market rent for the use of land and other rights and privileges of individual concession contracts. Therefore, we calculate the concession's stabilized income without any account of franchise fees. As such, the stabilized concession income that we start our analysis with represents a return to both the concession's and government's contribution of assets to the operation. It is then incumbent on us to determine the fair market value of the government's contribution to this income, which is implicitly the fair market franchise fee.

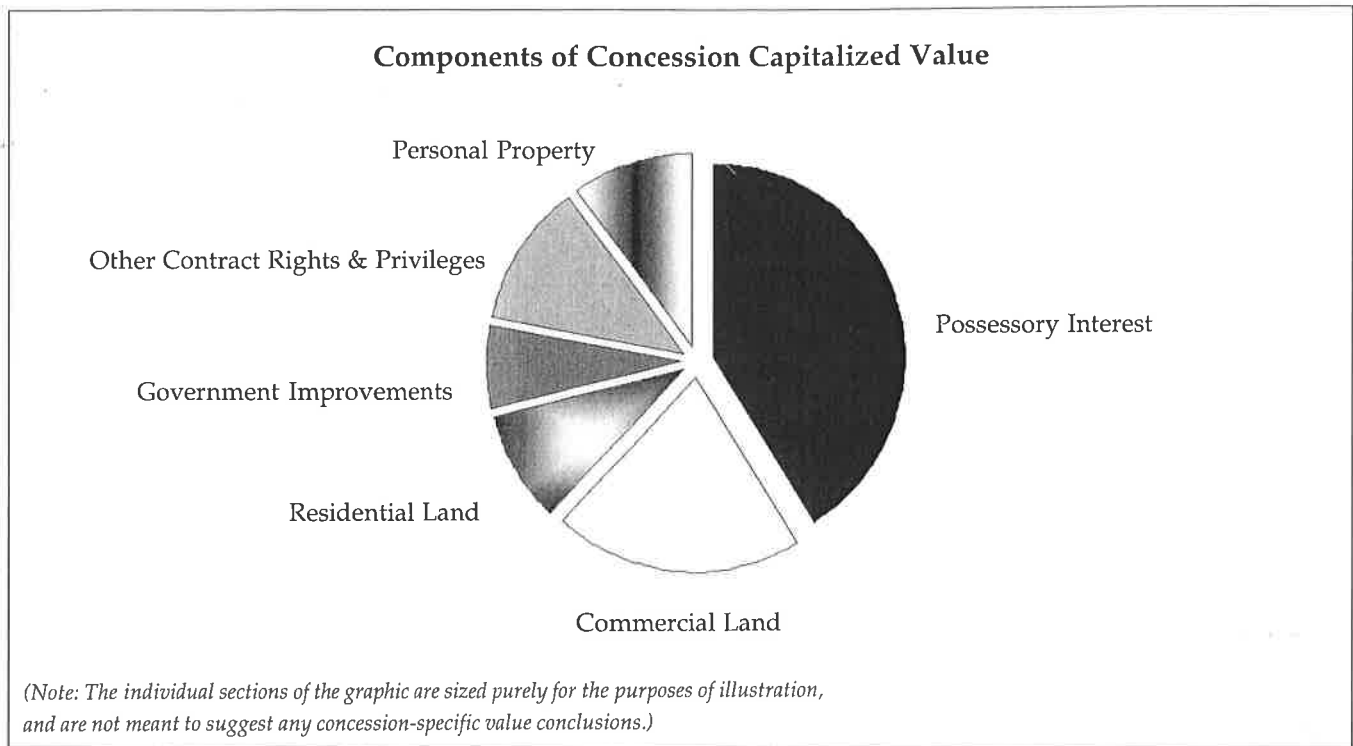
Clearly, the value of the government contribution should not be included within the concessionaire's possessory interest. So in many ways, the contracts resemble a ground lease. And since the goal of the appraisal is to estimate the value of only the concessionaire's improvements, it is logical to use a Building Residual valuation methodology. To perform an accurate Building Residual appraisal, we need to isolate each of the elements of the capitalized value of the income stream and allocate them between the concessionaire and the government. In essence, we need to identify the elements of value that are attributable to the government's contribution and then subtract the value of those contributions from the fee simple value of the entire concession. The residual value represents the value of the concessionaire's investment in the concession, including its possessory interest exclusively in the improvements that it funded.

While this may sound simple, quantifying the various elements necessary for the analysis is not. The elements include:

- The value of the government-funded improvements used by the concessionaire;
- An overall capitalization rate (OAR) for National Park concession contracts;
- The value of commercial and residential land used by concession facilities;
- The value of other rights and privileges provided by the government to the concessionaire during the term of the contract.

*Figure 1* provides a graphic representation of the capitalized value of a hypothetical concession and its individual value components. (*Note:* The

Figure 1



individual sections of the graphic are sized purely for the purposes of illustration, and are not meant to suggest any concession-specific value conclusions.)<sup>1</sup>

#### GOVERNMENT-OWNED IMPROVEMENTS

The value of the structures and infrastructure funded by the government, but assigned for use by a concessionaire to support its operation, can be determined by applying the Replacement Cost method, less accrued depreciation from all causes. We use a Replacement Cost method instead of the Reconstruction Cost method because in many cases the government's buildings in National Parks are overimproved relative to their current use, or suffer from elements of functional obsolescence. The Replacement Cost method values only the portion of the structures that the concessionaire uses, and according to its actual use. Since this value is deducted from the capitalized value of the entire concession operation, the concessionaire is not penalized for any unused potential value in government-funded buildings occupied by the concession operation.

#### THE OVERALL CAPITALIZATION RATE (OAR)

Fortunately, there is a market, however limited, for National Park concession contracts. In fact, there were two sales of such contracts in early 1999. Additionally, there were two other transfers of

large concession contracts during the past decade, for which enough information was available to calculate implied overall capitalization rates (OARs).

We have interviewed executives from the buyers and sellers of each sale and transfer of National Park concession contracts in the past 10 years to understand their valuation approaches, motivations, desired rates of return, and implied OARs.

We also have done an extensive analysis of OARs for fee simple and leasehold full-service resort sales, since these properties are operationally similar to many concession operations. However, discussions with the buyers of concession contracts revealed substantial differences, from an investment perspective, between such resort properties and a park concession. These interviews convinced us, based on the relative risk profiles, that it would be incorrect to consider the OARs for such fee simple resort properties to be representative of OARs for a concession contract. So we believe it is appropriate to place greater weight on the sales of comparable concession contracts in determining the OAR for an income valuation analysis of possessory interest.

The OAR is applied to the estimate of a pre-franchise fee stabilized NOI from the existing concession operation to obtain an estimate of the entire concession enterprise value. However, as already discussed, this results in a fee simple value that

includes all buildings, whether owned by the concessionaire or the government, all of the land necessary to support the operation, and other government contributions. In order to isolate the concessionaire's improvements, we still need to deduct certain elements of value from this estimate, as per our Building Residual valuation methodology.

### **VALUING THE LAND**

To estimate the value of the land used by a concession, we must consider its contribution to the value of the operation. Specifically, there are two components of land that the government typically provides to the concessionaire to support its operation: 1). the land under the commercial, revenue-producing portions of the concessionaire's operation; and 2). the land under the concessionaire's employee housing (if any).

For the commercial land component, we can utilize the Ground Lease methodology. We assembled data from a large number of ground leases for full-service hotels and stand-alone retail and restaurant operations across the United States. We analyzed this data on both a percentage of departmental revenue basis and on a percentage of total revenue basis, and discovered remarkably stable tendencies, regardless of size, location, or facility quality.

We use the lease data to estimate a fair market ground lease rental structure for the subject concession operation, as if it were a commercial ground lease. Certain percentages of revenues are identified for the concession's major departments, such as lodging, food and beverage, and retail sales. After considering the particular mix of business at the subject concession and ground lease data referenced above, we can conclude a reasonable estimate of the fair market rental structure for the commercial land, based on a percentage of concession receipts.

Applying this Ground Lease methodology to the estimate of stabilized revenues from the concessionaire's operation, we are able to estimate a stabilized annual fair market ground rental payment, as if the concession were on a typical ground lease in a competitive market environment. By applying a land capitalization rate to the estimated annual rental stream, we can calculate the value of the commercial land supporting the subject operation.

As a test of reasonableness, we may convert our total estimate of the commercial land value to a

dollar per square foot unit value. We can then utilize the Sales Comparison Approach by gathering comparable sales data for commercial land sales in the gateway and neighboring communities surrounding the park. If the estimate of land value on a per square foot basis in the park is within the range for out-of-park land sales, this would provide support for the reasonableness of the estimate. In fact, such a result usually indicates that the estimate is conservative, since the land inside the park is intuitively more valuable than the land immediately outside of the park.

Next, we estimate the value of the land supporting the concessionaire's residential operation, if one exists. In many parks, the concessionaires build employee housing units for their workers on government-owned land inside the parks. Although the concessionaire is entitled to possessory interest recovery for the residential improvements, it is necessary to deduct the value of the government-owned land from the total enterprise value, since the concessionaire would incur some cost for residential land were it operating outside the Park. Using the Sales Comparison methodology as our primary indicator of value for this land, we search the surrounding communities for recent sales of multi-family-zoned private land. Applying this per square foot estimate to the amount of land allocated to the concessionaire's residential operation yields an estimate for the value of residential land that is being used by the concessionaire, but owned by the government.

The estimated values of commercial and residential land, used by the concessionaire but owned by the government, are subtracted from the estimate of the fee simple value for the entire concession operation.

### **VALUE OF OTHER CONTRACT RIGHTS AND PRIVILEGES**

In addition to land, the NPS contributes some unique benefits to concessionaires through the special rights and privileges it conveys in its concession contracts. Occasionally, these benefits may be offset by costs contractually imposed on a concession operation that a concessionaire would probably not incur in the normal course of doing business absent the concession contract. Accordingly, it is very important to recognize not just the benefits but also the costs derived from the stipulations of the concession contract in determining the fair market value of the government's contribution to a concession operation.

In our effort to quantify the effect of concession contract-related benefits and costs on a concession's income stream and thus overall concession value, we must first identify any potential contract-related influences on the concession operation. These influences may include, but may not be limited to: A). the use of federal land; B). a unique location; C). a monopoly at that location; D). controls on concession prices charged to visitors; and E). minimum repair and maintenance (R&M) spending requirements.

The next step is to examine the concessionaire's income statement to determine how, if at all, these potential influences are expressed in terms of operational receipts and expenses. For example, citing item A above, the concession operation may benefit from the simple fact that it is operated on federal land. Specifically, a concessionaire may pay no property taxes on the in-park land that it uses, although the NPS provides many of the services that would normally be available to such an enterprise operating outside of a park. The opportunity to avoid certain property taxes translates to higher net income for the concessionaire. While this additional income is included in the process of capitalizing the value of the total concession, it is not part of the return to the concessionaire's possessory interest, but effectively part of the return to the government's contribution to the concession. To determine what property tax expense, if any, a concessionaire is avoiding, we estimate the property tax burden on the concessionaire if it were operating on land adjacent to the park, and compare this to what it is actually spending on property taxes. The difference represents the annualized value of this federal land benefit.

Citing items B and C above, some concessionaires may not have to spend a lot on marketing because their unique location attracts visitors to its lodges, restaurants, and retail stores, irrespective of the specific services it is providing. And, the monopoly-like privileges of the concession contract mean that the concessionaire does not have to compete with other enterprises for those visitor dollars. Accordingly, we might examine a concessionaire's spending on advertising/marketing to determine if that spending is in line with industry norms. If not, depending on the circumstances, we might interpret the difference to represent at least a portion of the fair market annual return on the government's contribution to the concession of a unique location and monopoly rights.

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Citing item D above, the NPS carefully regulates the prices concessionaires may charge visitors for their goods and services. The NPS determines these rates by conducting fairly extensive annual surveys of prices charged by businesses operating outside of parks that are of similar scope and nature (including historic characteristics) to those inside parks. These surveys are aptly called "comparability studies." It might be argued that in many parks, the concession prices, and thus income, are kept artificially low as a result of this NPS rate-setting. Taking this to its logical end, one might conclude that NPS rate-setting suppresses the income-based value of concessionaire's improvements (possessory interest) below its fair market level. But what characteristics distinguish the businesses included in the comparability study from the subject that might allow above market prices to be charged in the park? We believe that by and large it is not the improvements themselves (since these presumably are already addressed in the comparability study), but instead the unique and special attributes of the park location. Therefore, any costs (or lost receipts) imposed on concessionaires by NPS rate-setting do not represent lost returns to the concessionaire's investment in improvements, but simply unrealized returns of the government's contribution to the concession operation. Accordingly, we need not make any adjustment in the income-based analysis for contract-related NPS controls of concession prices.



Finally, citing example *E*, some concession contracts explicitly require a concessionaire to spend a certain percentage of its receipts on R&M. In such a case, we would examine that spending to determine if it is above levels that would typically be required to maintain the concession's facilities in adequate operating condition. If so, to ignore this negative impact on the concession's income in our analysis would possibly undervalue the income-based fair market value of the concessionaire's possessory interest.

To summarize the Income Approach, we start with the fee simple value of the entire concession operation by capping the stabilized, pre-franchise fee NOI. Then we identify, appraise, and deduct the value of the government's contributions to the value of the concession. We subtract the value of the government-owned improvements and land that the concessionaire uses to support the operation, as well as the value of the extraordinary rights and privileges bestowed by the government to the benefit of the concessionaire. The remaining value in this Building Residual approach belongs to the concessionaire. To avoid double counting, any values that the concessionaire recovers from the sale of its personal property should also be deducted from the residual to isolate the exclusive value of its possessory interest in structures, fixtures, and improvements. One last caveat: if there is deferred maintenance on these structures, whatever amount is needed to improve the buildings to serviceable levels would need to be subtracted as well.

#### **OTHER FAIR MARKET VALUE APPROACHES**

In keeping with our charge to determine the fair market value of the concessionaire's improvements, we also utilize the other two traditional approaches for real property valuation — Sales Comparison and Replacement Cost Approaches — and reconcile any differences.

The Sales Comparison Approach is not able to produce an overall value estimate per se, although elements of it can be used in several aspects of the Income Approach. Specifically, these comparable sales can be used to:

- Derive the appropriate concession OAR (from comparable sales of concession contracts);
- Value the land components (from private land sales for commercial and multifamily residential land located outside of the Park); and
- Estimate the appropriate ground lease rent percentages for the subject operation (from ground

leased properties of other full-service hospitality operations across the U.S.).

We also check the value derived from the Income Approach with the value estimated using the Replacement Cost Approach. Then we reconcile the final fair market value by considering the values derived from the both Income and Replacement Cost Approaches.

#### **RECONCILIATION OF SOUND VALUE**

The final step in the valuation assignment involves the reconciliation of the sound value. As stated above, within this assignment it is incumbent upon the appraiser to first estimate the new reproduction cost less depreciation. The resultant figure is then compared to the value as determined from the analysis of the fair market value, which represents a reconciled estimate of value between the Replacement Cost and the Income Approaches. From these two value conclusions, as per the Law, the lowest figure is adopted as representative of the possessory interest value to be paid to the concessionaire.

#### **CONCLUSION**

This concludes a partial description of the methodology utilized to conduct a most unique appraisal assignment. We hope that we have provided an informative insight into some of the elements of value in the world of National Park concession contracts.<sup>REI25</sup>

#### **NOTES & REFERENCES**

It is important to note that the views expressed in this article are solely those of the authors, and are not represented as those adopted by the National Park Service, Department of the Interior, or any other Government agency. The authors would appreciate feedback from appraisers, hospitality consultants, land economists, and other professionals in their efforts to continually refine the complex process of appraising these concession contracts. (See author e-mail addresses below and on pg. 17)

1. We did not allocate a separate component for Enterprise Value. Since the concessionaires deduct a management fee, in addition to other actual expenses, we have assumed that the deduction for management fee adequately represents the Enterprise Value.

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The Counselors of Real Estate recently named Maurice and Blaine 2000 recipients of its James Felt Creative Counseling Award for their innovative methodology and appraisal of the Grand Canyon National Park concession contract.