MUNICIPAL PROPERTY ASSESSMENT CORPORATION

METHODOLOGY GUIDE

VALUING CASINOS IN ONTARIO

Valuation Date: January 1, 2016

AUGUST 2016

MUNICIPAL PROPERTY ASSESSMENT CORPORATION

August 22, 2016

The Municipal Property Assessment Corporation (MPAC) is responsible for accurately assessing and classifying property in Ontario for the purposes of municipal and education taxes.

In Ontario's assessment system, MPAC assesses your property value every four years. This year, MPAC is updating the value of every property in the province to reflect the legislated valuation date of January 1, 2016.

MPAC is committed to provide Ontario property owners, municipalities and all its stakeholders with the best possible service through transparency, predictability and accuracy in values. As part of this commitment, MPAC has defined three levels of disclosure of information in support of its delivery of this year's assessment update. This Methodology Guide is the first level of information disclosure.

This guide provides an overview of the valuation methodology undertaken by MPAC when assessing casino properties for this year's update ensuring the methodology for valuing these properties is well documented and in alignment with industry standards.

Property owners can access additional information about their own properties through aboutmyproperty.ca. Login information for aboutmyproperty.ca is provided on each Property Assessment Notice mailed this year. Additional information about MPAC can be accessed at mpac.ca.

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President and Chief Administrative Officer

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Chief Operating Officer

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1.0 Introduction

The Municipal Property Assessment Corporation (MPAC) – mpac.ca – is responsible for accurately assessing and classifying property in Ontario for the purposes of municipal and education taxation.

In Ontario, property assessments are updated on the basis of a four-year assessment cycle. In 2016, MPAC will update the assessments of Ontario's nearly five million properties to reflect the legislated valuation date of January 1, 2016. Assessments updated for the 2016 base year are in effect for the 2017–2020 property tax years.

The last Assessment Update was based on a January 1, 2012 valuation date. Increases between the 2012 assessed value and the 2016 assessed value are phased in over a four-year period. Any decreases in assessment are applied immediately.

It is important to ensure that the valuation methodology applied is capable of providing a realistic estimate of current value at the relevant valuation date, which, in turn, enables all stakeholders to understand the valuation process and have confidence in the fairness and consistency of its outcome.

This Methodology Guide has been prepared for the benefit of MPAC assessors, property owners and their representatives, municipalities and their representatives, Assessment Review Board members, provincial officials, and the general public.

This guide outlines the valuation process to be followed by an assessor, including steps that require appraisal judgment. It is incumbent upon the assessor to make informed decisions throughout the valuation process when arriving at estimates in current value.

1.1 Properties Covered by This Methodology Guide

This Methodology Guide applies to casinos in Ontario. There are different types of casinos, including:

- freestanding casinos
- resort casinos
- riverboat/cruise casinos

This guide deals with freestanding and resort casinos. There are currently no riverboat/cruise casinos in Ontario. This guide is not intended for slot facilities at horse racetracks.

The following MPAC property code is used to categorize the various types of casinos in Ontario:

- 713 Casinos

It should be noted that these are general guidelines that vary depending on the specific circumstances of a particular property.

An assessor may also make reference to additional Methodology Guides for properties that do not fall precisely within the description of one of the property codes listed above.

1.2 Legislation

The main legislation governing the assessment of properties in Ontario for property tax purposes is contained in the Assessment Act.[1]

The Act contains important definitions and states that all property in Ontario is liable to assessment and taxation, subject to some exemptions. Section 19(1) of the Act requires that land be assessed at current value, which is defined to mean, in relation to land, "the amount of money the fee simple, if unencumbered, would realize if sold at arm's length by a willing seller to a willing buyer."

The Ontario Lottery and Gaming Corporation (OLG) is a crown corporation of the Government of Ontario as defined in Section 2(3) of the Ontario Lottery and Gaming Corporation Act, 1999.[2] As such, casinos that are owned and operated directly by the OLG are subject to a payment in lieu of taxes at the commercial general rate. Section 4(2) of the Municipal Tax Assistance Act provides that land owned or occupied by a Crown agency is subject to a payment in lieu of taxes, as follows:

"Every Crown agency, in respect of provincial property owned or occupied by it, may pay in each year to the municipality in which the property is situate an amount equal to the tax for municipal purposes that would be payable if the property were taxable."[3]

The Minister of Finance filed Ontario Regulation 430/15 on December 18, 2015, which added additional rules affecting the valuation and classification of properties on which a third-party sign (billboard) is located. To comply with the regulation, the income attributable to a third-party sign will not be included in the valuation of any property for assessment purposes.

[1] Assessment Act, R.S.O 1990, c A.31: https://www.ontario.ca/laws/statute/90a31.
[2] Ontario Lottery and Gaming Corporation Act, 1999, S.O. 1999, c. 12, Sched. L: https://www.ontario.ca/laws/statute/99o12.
[3] Municipal Tax Assistance Act, R.S.O. 1990, c. M.59: https://www.ontario.ca/laws/statute/90m59.

1.3 Classification

MPAC's role is to accurately assess and classify all properties in Ontario in accordance with the Assessment Act and its associated regulations established by the Government of Ontario. The classification of a property will determine which tax rate will be applied by the municipality or taxing authority. All properties are classified according to their use, and Ontario Regulation 282/98 of the Assessment Act sets out how various property uses are classified.

Casinos are included in the Commercial Property Class in accordance with Section 5(1)1 of Ontario Regulation 282/98 as "land and vacant land that is not included in any other property class."[4]

If a portion of the property is used for other purposes, it may be necessary to partition the current value of the property to reflect the various uses. This is to ensure that the appropriate tax rate is applied to the relevant part of the property.

1.4 The Use of This Methodology Guide

This Methodology Guide is intended to:

- Ensure MPAC's assessed values for these properties are fair, accurate, predictable and transparent.
- Provide direction to assessors and clear explanations to municipalities, taxpayers and Assessment Review Board members.
- Ensure that MPAC's methodology for valuing these properties is well documented and aligns with industry standards.
- Explain the thought process/decision-making process that an assessor should undertake to apply the valuation methodology.
- Ensure a consistent approach to valuing these property types.
- Support MPAC assessors in conducting their due diligence in:
    - Applying Ontario's legislation and regulations
    - Adhering to industry standards for market valuation in a mass appraisal environment

[4] Ontario Regulation 282/98, GENERAL: https://www.ontario.ca/laws/regulation/980282.

It should be noted that this Methodology Guide is not intended to be a substitute for an assessor's judgment in arriving at a market value–based assessment (i.e., current value) for a particular property. However, given that the Methodology Guide explains industry standards for property assessment, conforms to valuation industry norms, and adheres to provincial legislation and regulation, MPAC assessors are expected to follow the procedures in the Methodology Guide and be able to clearly and satisfactorily justify any deviations from it.

1.5 Consultation and Disclosure

MPAC is committed to providing municipalities, taxpayers and all its stakeholders with the best possible service through transparency, predictability and accuracy. In support of this commitment, MPAC has defined three levels of disclosure as part of its delivery of the 2016 province-wide Assessment Update:

- **Level 1** – Methodology Guides explaining how MPAC approached the valuation of particular types of property
- **Level 2** – Market Valuation Reports explaining how the methodology outlined in Level 1 has been applied at the sector level for the purposes of each assessment
- **Level 3** – Property Specific Valuation Information available to property taxpayers, their representatives and municipalities

Residential property owners can access detailed information about their assessment through aboutmyproperty.ca. Login information is provided on every 2016 Property Assessment Notice mailed.

2.0 The Valuation Process

The valuation process always begins with a determination of the highest and best use of the subject property.

Any reliance upon this guide is made only after the assessor has determined that the highest and best use of the subject property is that of a casino.

Assessors determine the value of a property using one of three different approaches to value:

- the direct (sales) comparison approach
- the income approach
- the cost approach

2.1 Outline

In the **direct (sales) comparison approach**, value is indicated by recent sales of comparable properties in the market. In considering any sales evidence, it is critical to ensure that the property sold has a similar or identical highest and best use as the property to be valued.

In the **income approach**, value is indicated by a property's earnings or cash flow–generating potential. This method requires a detailed analysis of both income and expenditure, both for the property being valued and other similar properties that may have been sold, in order to ascertain the anticipated revenue and expenses, along with the relevant discount and capitalization rates. There are two main income methods, capitalization of earnings or cash flow approach and discounted cash flow approach.

In the **cost approach**, value is estimated as the current cost of reproducing or replacing the improvements of the land (including buildings, structures and other taxable components), less any loss in value resulting from depreciation. The market value of the land is then added.

MPAC predominantly uses the income approach to value casinos.

A casino that does not realize a sufficient rate of return on its invested capital may not be a suitable property to be valued using the income approach. This guide outlines the use of the income approach specifically.

MPAC uses the discounted cash flow method of the income approach to establish current value assessments of casinos in a mass appraisal context.

Discounted Cash Flow Method

For the discounted cash flow method, future unlevered free cash flows are projected and discounted over the estimated holding period of the casino. A reversion value is then added to the sum of the discounted cash flows based on the estimated value of the casino at the end of the investment holding period. Business plans and projections provided by the owners are reviewed as part of the projection process.

The eight main steps of the valuation process for casinos used by MPAC's assessors are outlined below.

1) Determine if the casino property is a going concern.

    a. Review and evaluate previous years audited income and expense statements for the property.

    b. Determine if the cash flow is positive or negative.

    c. Determine the length of time it has been positive or negative.

    d. Determine whether or not the situation is likely to change over the next few years.

2) Project annual revenues, operating expenses, capital expenditures and net changes in working capital requirements of the casino over the projected holding period to estimate unlevered free cash flows.

    a. Review and evaluate the previous years' audited income statements to identify trends or patterns in revenues and expenditures.

    b. Review all business plans.

    c. Review Bank of Canada and other reports for economic outlooks.

    d. Calculate revenues, operating expenses, capital expenditures and working capital requirements over the projected holding period to estimate annual unlevered free cash flows

3) Determine an appropriate weighted average cost of capital rate (i.e., the discount rate).

    a. Review security exchange filings for publicly traded casino properties.

b. Review betas, bonds rates, etc.

c. Calculate the weighted average cost of capital.

4) Discount the annual unlevered free cash flows projected over the holding period.

    a. Discount cash flows at mid-term.

5) Calculate the reversion value.

6) Add the sum of the discounted cash flows to the reversion value.

7) Determine the proper adjustments for chattels (furniture, fixtures and equipment (FF&E)).

8) Validate the result of the above process.

MPAC assessors will apply checks to ensure that there has been no double-counting of adjustments and that the final valuation is consistent and accurate.

2.2 Approach

There are three main phases in the process used by MPAC:

- data collection
- analysis of the data collected
- valuation

2.3 Data Collection

Data collection includes the following types of data:

General Casino Data

- collecting casino statistics for annual numbers of slots and gaming tables
- obtaining building and site improvement plans, as well as site plans, for the subject property

Casino Financial Data

- collecting income and expense statements from the casino for at least three years

- tabulating casino revenues and expenses and other income valuation parameters

Casino Improvement Data

- inspecting, measuring and quantifying casino improvements
- identifying improvement ages and function of casino improvements

Confidentiality

As outlined above, it is important to be aware that, in order to enable MPAC to produce an accurate valuation of the property concerned, information needs to be obtained from a variety of sources.

This will include information from MPAC's records, from the owner or operator of the property, from the municipality in which the property is located, from the assessor's visit to the property, and from other sources.

All stakeholders in the property tax system have an interest in ensuring that the current value provided by MPAC is correct; in order to achieve this, it is necessary for all parties to cooperate in the provision of information.

It is appreciated that some of the information outlined above may be of a commercially sensitive nature. MPAC recognizes the need to ensure that any information provided to it is properly safeguarded and only used for the purpose for which it is supplied. Assessors must appreciate the nature of this undertaking and ensure data is treated accordingly.

If, after an appeal has been filed, MPAC receives a request for the release of actual income and expense information, or other sensitive commercial proprietary information, the usual practice is to require the person seeking the information to bring a motion before the Assessment Review Board (ARB), with notice to the third parties, requesting that the ARB order production of the requested information. The release of such information is at the discretion of the ARB and commonly accompanied by a requirement for confidentiality.

The Assessment Act outlines in Section 53(2) that disclosed information may be released in limited circumstances "(a) to the assessment corporation or any authorized employee of the corporation; or (b) by any person being examined as a witness in an assessment appeal or in a proceeding in court involving an assessment matter."

2.4 Data Analysis

Having carried out the data collection outlined previously, the assessor needs to analyze it and reach a conclusion regarding the appropriate valuation method to use and how it should be applied.

At casinos, there is an attempt to maximize the income produced. It follows that the income streams attributable to the real estate can be analyzed to determine property assessments. Such analysis entails the segregation of income into amounts attributable to the real estate and other forms of income (for example, the income attributable to management and chattels).

Given the appropriate financial information, MPAC assessors are able to analyze the expected income to determine the present worth of the casino properties.

2.5 Valuation

Having undertaken the necessary steps outlined above, the assessor should now be in a position to apply the appropriate valuation model.

3.0 The Valuation

3.1 Discounted Cash Flow Method

The discounted cash flow method uses future projected net cash flows and discounts them based on the appropriate discount rate to arrive at the current value estimate. Therefore, this method can incorporate changes in expected net cash flows to reflect a typical gaming property's performance. This method is accepted in the gaming industry and the capital markets.

The discounted cash flow method for casino properties is comprised of the following steps:

1) Forecast gaming and non-gaming revenues for a period of 10 years.

2) Forecast operating expenses, excluding interest expense on interest-bearing debt, also for a period of 10 years.

3) Deduct forecasted operating expenses from forecasted revenues to calculate expected earnings before interest and taxes ("EBIT") for each year within the 10-year forecast period.

4) Deduct corporate income tax based on the combined federal and provincial corporate tax for Ontario to arrive at unlevered net income.

5) To the unlevered net income, add depreciation and amortization and deduct the estimated annual sustaining capital expenditures required to maintain operations to calculate unlevered free cash flows before adjusting for net changes in working capital.

6) Adjust unlevered free cash flows above to account for changes in non-cash working capital requirements, if sales revenue growth has been forecasted. (The assumption is that changes in working capital requirements are proportional to revenue growth.)

7) Discount the annual unlevered free cash flows by the discount rate determined based on the gaming WACC study (see Section 3.2 below), and then sum the discounted values over the 10-year forecast period to determine the present value of the forecasted unlevered free cash flows.

8) Add the reversion value calculated at the end of the 10-year forecast period to the present value of the unlevered free cash flows to determine the current operating value.

9) Deduct reserve for chattels (FF&E) to determine the current value assessment.

3.2 Discount Rate (WACC)

The discount rate for casinos is based on the gaming industry weighted average cost of capital (WACC) and then converts the 10-year forecasted unlevered free cash flows into value.

The WACC Formula

The WACC may appear complicated, but it is in common use in the valuation of income-producing properties such as casinos.

WACC is derived from the following formula:

$$\mathbf{WACC = Re \times E/V + Rd \times (1 - Tc) \times D/V}$$

Where:

- Re = cost of equity
- Rd = cost of debt
- E = market value of the firm's equity
- D = market value of the firm's debt
- V = E + D
- E/V = percentage of financing that is equity
- D/V = percentage of financing that is debt
- Tc = corporate tax rate

Whereas cost of debt is relatively easy to calculate (e.g., the blended rate the company pays on its various debt instruments), the cost of equity is less precise. To estimate the cost of equity for each of the casinos, it is necessary to use a capital asset pricing model (CAPM). In this model, the cost of equity (Re) is calculated as:

$$\mathbf{Re = Rf + B\ (Rm - Rf)}$$

Where:

- Rf = risk-free rate. This is the rate obtained by investing in securities considered free from credit risk, such as government bonds. It is possible to use the prevailing interest rate of US Treasury Bills as a proxy for the risk-free rate.

- B = beta. This is a measure of the volatility of a company's securities in contrast to the market as a whole. If a beta is in excess of one, this indicates that the security is more volatile than the overall market; less than one indicates that the security is less volatile than the overall market. A beta of one indicates that the price of the company's securities moves in sync with the overall market.

- (Rm – Rf) = equity market risk premium. The equity market risk premium represents the rate of return added to the risk-free rate to reflect the additional risk of investing in equity instruments over risk-free investments (i.e., the additional return investors expect in order to compensate them for taking on extra risk).

Unlevered free cash flows are discounted at mid-year to take into account that the flow of cash is distributed throughout the year so as not to overstate or understate the present value of the operations.

A reversion value is added to the present value of the unlevered free cash flows to determine the total value of the casino operations. This is a lump-sum benefit that an investor receives or expects to receive at the termination of an investment.[5]

3.3 Casino Financials

The income approach converts the income attributable to real estate into an estimate of value. This procedure works best when income and expense data can be analyzed over a period of years and when information on capital improvement expenditures is available from a number of casinos.

To account for all aspects of real estate value, MPAC analyzes the annual revenues for the following elements of a casino (by class of property):

- gaming revenue (slots and gaming tables)

- non-gaming revenue

  - accommodation
  - food and beverage
  - entertainment
  - retail operations
  - other

[5] *The Dictionary of Real Estate Appraisal, 4th Edition* (Appraisal Institute, 2002): 249.

Casino Revenues

MPAC establishes casino revenues by type of casino and projects it out 10 years.

In particular, MPAC analyzes:

- gaming revenues (slots and gaming tables)
- trends
- competition
- retail tenants
- food and beverage
- other non-casino operations

MPAC adds casino revenues to determine gross potential income for each year.

Casino Expenses

MPAC identifies expenses and establishes typical operating costs, projecting it out 10 years, for:

- gaming expenses
- non-gaming expenses
- maintenance and operation expenses
- management, marketing and administration expense
- capital expenses

MPAC also establishes operating costs for:

- water supply
- heat and utilities
- security
- insurance
- other costs

3.4 Casino Unlevered Free Cash Flows

MPAC deducts operating expenses excluding interest on interest-bearing debt from the total casino revenue to determine unlevered free cash flow.

The next stage is for MPAC to deduct income attributable to non-real estate items (e.g., reserves for casino improvements, and other intangibles) to produce unlevered free cash flow attributable to the real estate.

3.5 Current Value Assessment

The final step in the process is to consolidate a current value assessment for the property. Once the determination of value by the income approach has been completed, MPAC's assessor will consider whether there is any other value in the real estate that has not been captured by the analysis of income.

Excess Land

One source of additional value may be excess land, which is land in excess of the requirements of the casino buildings and parking. Such land is generally held in anticipation of expansion.

To determine excess land values, MPAC's assessor will analyze local zoning bylaws, current development of the property and market sales of similar parcels.

3.6 Quality Control

The individual casino values developed using the income approach are reviewed by MPAC assessors for reasonableness and checked to ensure no errors have been made. The outcome of the valuation is also reviewed to confirm that the value is in line with the valuation of other similar casinos.

A simplified example of a discounted cash flow valuation of a casino is shown in Appendix A.

3.7 Conclusion

This guide sets out how MPAC assessors approach the valuation of casinos for property assessment purposes.

Although it outlines the general approach adopted, it does not replace the assessor's judgment and there may be some cases where the assessor adopts a different approach for justifiable reasons.

For further information about MPAC's role, please visit mpac.ca.

Appendix A – Simplified Example of a Casino Valuation Using Discounted Cash Flow

	Forecast											Reversion Value
Year	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**		
Earnings before interest and taxes	$17,615,036	$17,865,364	$18,118,946	$18,334,136	$18,593,583	$18,813,343	$19,078,792	$19,303,228	$19,574,817	$19,849,936		19,849,936
Deduct: corporate income taxes @ 26.5%	(4,667,985)	(4,734,321)	(4,801,521)	(4,858,546)	(4,927,300)	(4,985,536)	(5,055,880)	(5,115,355)	(5,187,326)	(5,260,233)		(5,260,233)
Unlevered net income	12,947,051	13,131,043	13,317,425	13,475,590	13,666,283	13,827,807	14,022,912	14,187,873	14,387,491	14,589,703		14,589,703
Add: Depreciation and amortization	3,400,000	3,400,000	3,400,000	3,400,000	3,400,000	3,400,000	3,400,000	3,400,000	3,400,000	3,400,000		3,400,000
Deduct : Annual sustaining capex	(2,000,000)	(2,000,000)	(2,000,000)	(2,000,000)	(2,000,000)	(2,000,000)	(2,000,000)	(2,000,000)	(2,000,000)	(2,000,000)		(2,000,000)
Adjust: Change in net working capital												
Unlevered free cash flow	14,347,051	14,531,043	14,717,425	14,875,590	15,066,283	15,227,807	15,422,912	15,587,873	15,787,491	15,989,703	*A*	15,989,703
Discount rate	8.50%	8.50%	8.50%	8.50%	8.50%	8.50%	8.50%	8.50%	8.50%	8.50%		8.50%
Deduct perpetuity growth rate												-1.0%
Capitalization rate											*B*	7.50%
Reversion value before disposition costs											*A/B*	215,327,996
Less disposition costs @ 5%												(10,766,400)
Reversion value												204,561,596
Mid-year discount Period	0.5	1.5	2.5	3.5	4.5	5.5	6.5	7.5	8.5	9.5		10.0
Discount Factor	0.9600	0.8848	0.8155	0.7516	0.6927	0.6385	0.5884	0.5423	0.4999	0.4607		0.4423
PV of unlevered free cash flow	**$13,773,610**	**$12,857,371**	**$12,002,107**	**$11,180,729**	**$10,436,919**	**$9,722,407**	**$9,075,553**	**$8,454,031**	**$7,891,514**	**$7,366,444**		**$90,474,610**

Output	
Present value of unlevered free cash flow	$102,760,684
Present value of reversion value	90,474,610
Operating value (rounded)	**$193,200,000**
Less Chattels @ 25%	(48,300,000)
2016 CVA (rounded)	**$145,000,000**