Chapter 2: Analyzing a Family Entertainment Center's Financial Statements

An analysis of a family entertainment center's operations requires a close at the day to day operations as well as the center's financial history. Usually more emphasis is placed on financial ratio analysis. However, financial statements offer only figures. Many times more insight can be gained by simply walking through the family entertainment center.

Overview

Competition drives profit margins and the returns on investment down to a free market minimum level. In other words, competition translates into lower prices. Therefore, in the long run, the analysis of profit margins (which is a component of return on equity) will depend upon the analysis of a firm's competitive position as well as the competitive position of the industry in which it operates.

Two factors determine the choice of a competitive strategy:

(1) The long-term profit outlook for the family entertainment center industry.

(2) A firm's competitive position within the entertainment industry.

Both are important. A firm can be in a profitable industry and still do poorly because of a poor competitive strategy, or it may have a good competitive strategy and do poorly because the industry is mature.

In order to forecast the profit margin of a company, and its return on equity, one needs to review the basic competitive forces that exist in an industry and assess the strength of each. In any industry, there are five basic competitive forces as put forward by Michael Porter in his book *Competitive strategy: Techniques for Analyzing industries and competitors*:[1]

(1) Ease of entry and exit

(2) Rivalry between existing competitors

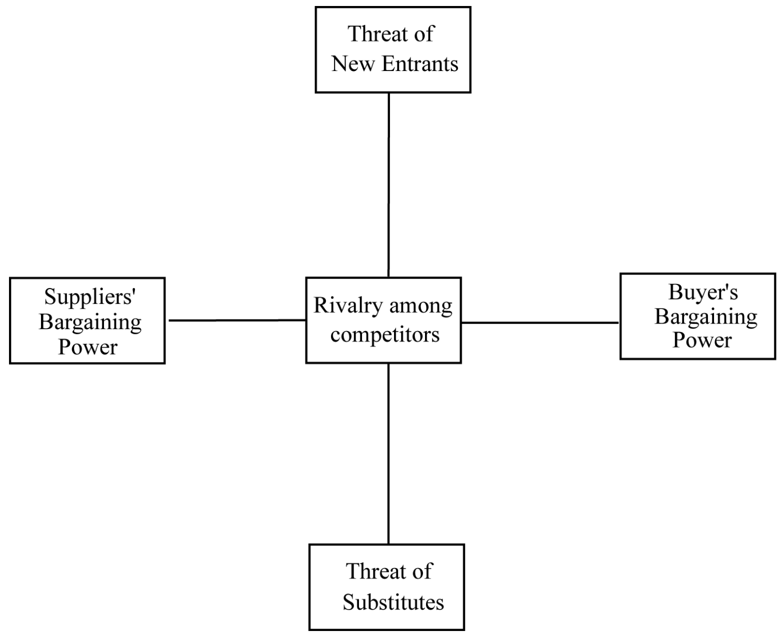
(3) Pressure from substitute products

1. Porter, Michael E. 1980. *Competitive Strategy: Techniques for Analyzing Industries and Competitors*. New York: Free Press.

(4) Bargaining power of buyers
(5) Bargaining power of suppliers

These pressures are presented in Figure 2-1.

Figure 2-1: Five Basic Competitive Forces Facing a Family Entertainment Center



First, with respect to ease of entry, the following factors affect the decision of a family entertainment center to enter a given market: capital requirements, economies of scale, strong brand identification, government policy, and technologically differences.

Second, rivalry between existing competitors involves such variables as the number of competitors, the relative strength of the competitors, the industry growth potential within a given demographic, the amount of fixed costs needed, concession product differences, and the quality and variety of the attractions.

Third, pressure from substitute attractions can devastate the family entertainment center industry. The family entertainment center industry faces competition not only from within, but also from other industries. One needs to focus on providing attractions that are unique to its location or are conveniently placed in a single location so as to make it beneficial for the consumer.

Fourth, with respect to their bargaining power, family entertainment centers may be able to negotiate lower prices on food items and game prizes. Their ability to reduce prices will be contingent upon the size of the facility, frequency of ordering, and relationship with distributors. Furthermore, operators with relationships with numerous distributors have more bargaining power as they can easily switch to another source when their price is not matched.

The bargaining power of suppliers (equipment manufacturers and food item distributors) can also reduce a facility's profit margins by raising costs or reducing quality. Since cost of goods sold is relatively small compared to other expenditures, the concern of suppliers increasing costs is not that high. If a supplier did raise prices, the most significant impact of doing so would be felt by the operator when he or she goes to replace an item in the operation such as arcade equipment, which tends to be turned over frequently.

Lastly, the supply of labor has the greatest impact on the profitability of an operator. Family entertainment centers rely heavily on low wage workers, and a raise in government mandated minimum wage can significantly cut into an operator's already slim margins. There is little an operator can do to prevent minimum wage raises, but the operator can protect itself to a higher degree by negotiating more favorable wage rates across the board.

If economic forces are strong enough to create a competitive market, then they will place downward pressure on rates of return so as to equal the return to assets used plus a business risk premium. If an industry is earning above average returns, then capital will flow into it causing an expansion of supply and therefore placing downward pressure upon margins. If the industry is earning below average returns, then capital will exit and there will be upward pressure upon margins.

It is the degree of competition produced by these competitive forces that determines the ability of family entertainment centers within the industry to generate attractive rates of return. If these five factors are favorable, then many family entertainment centers can earn attractive returns; if they are unfavorable and lead to intense competition, then few family entertainment centers can do well despite good management.

A Family Entertainment Center Operator's Business Strategy

For most family entertainment center operators, growth has been primarily through real estate development of existing attractions and implementations of new ones. As a result, most operators try to operate the most modern and unique family entertainment center circuit within the industry.

Most operators have built modern facilities in under-served mid-to-large-sized U.S. markets as well as in major U.S. metropolitan areas. In such markets an operator frequently competes with a variety of entertainment attractions including theaters and amusement parks. An operator gains maximum potential by positioning its family entertainment centers in properly fitted demographic areas with an easily accessed location.

Some operators have generated additional revenues through in-park advertisements and sponsorships, corporate events and private parties. Some of these family entertainment centers have built their operations around private parties, especially those involving birthdays.

Operating Revenue From Family Entertainment Centers

Family Entertainment Center's Revenue And Expense Sources

Family Entertainment Centers primarily generate their revenue from arcades, concession, and birthday party sales. A list of the different sources of revenue and expenses from the operation of a family entertainment center along with a typical range calculated as a percentage of total sales can be seen in Table 2-1 on page 46.

Facility Revenue

Revenues are directly related to:

(1) Attendance, which is driven by the quality of the offerings, including the variety, cleanliness and convenience of the location of the operation,

(2) The types of attractions relative to what is available in the immediate area,

(3) The price of the attractions,

(4) The demographics and ease of access of the facility, and

(5) The level of customer service.

Arcades

Coin-operated game sales are an operator's second largest revenue source, if not the largest when including redemption games. Arcades typically represent a quarter to a third of total revenues. Most operators have devoted considerable management effort to increasing arcade sales and improving the operating income margins from game revenues. These efforts include implementation of the following strategies, which can also be applied to all other facets of the facility:

(1) **Optimization of Product Mix**
An operator must design and plan an appropriate layout of gaming machines so as to compliment one another rather than detract from the other's revenues. Doing so can prove to be difficult; however, a properly laid out game center allows patrons to experience all of the products including the lowest margin games as well as the highest margin games, thus increasing revenues and operating margin as well as managing traffic throughout the center.

(2) **Staff Training**
Employees are continually trained in "cross-selling" and "upselling" techniques. Employees must be able to determine which patrons in the arcade area are not playing a game, and for what reason. They can then address the reason in the appropriate manner and hopefully get the patron to participate in the game play.

(3) **Facility Design**
Newer facilities are designed to include at least two to three attractions, usually including a miniature golf course and arcade. Strategic placement of the attractions within the facility heightens their visibility, aids

in reducing the length of lines and improves traffic flow around the most popular and less popular attractions.

(4) **Cost Control**
Operators negotiate prices for their game supplies directly with arcade vendors on a bulk rate basis. Items include redemption tickets, game tokens, as well as the machines themselves.

Lastly, facility operators have the option to profit-share their arcade. This option allows the operator to gain the latest video games at no initial cost, but in return, a portion of the revenues are given to the arcade game provider. Half of all operators choose this option as it allows them to get the latest games and equipment without having to spend additional capital. Expected revenues per machine should be +/- $6,000 per year, depending on the type of game.

Birthday Party Revenue

Family entertainment centers typically host birthday parties every week. Depending on the size and location of the facility – hosting as many as 30 birthday parties per week is not unusual. A typical birthday party will cost between $10 to $18 per person with the average around $13. There is usually a minimum person count as well, which helps ensure proper income for the amount of preparation needed. All in all, birthday parties will constitute close to a quarter of all revenues.

Concession Revenue

Concession sales are also an important revenue source, typically representing close to 10-15% of total sales. Operators have recently begun increasing the quality of food selections as well as offering unique food items from different ethnic flares in hopes of retaining patrons during dining hours. Furthermore, unique food offerings can be priced differently so as to increase operating margins for specific food items.

Other Revenue Streams

Operators actively engage in efforts to develop revenue streams in addition to admissions, coin-operated games and concession revenues. Certain family entertainment centers have made use of strategically placed vending machines, sponsorships and unique spins on normal attractions to increase revenues. A range of revenue streams as a percentage of total income can be seen in Table 2-1 on page 46.

Operating Expenses From Family Entertainment Centers

General Operating Expenses

Family entertainment centers either own their property or lease the property under a triple net lease. Operators incur a range of costs contingent upon their operating strategy and area in which they are located. Under a triple net lease, costs such as insurance on the property, real estate taxes, and common area maintenance are typically assumed by the lessee. Additionally, a one time cost for the initial startup should be factored into the expenses. Depending on the assets purchased for the facility, the cost can range from $100,000 to $3 or $4 million, which will be amortized over several years.