Chapter 6: Family Entertainment Center Asset Valuation (Equipment)

Knowing how much the family entertainment center's furniture, fixtures and equipment are worth will determine the amount of goodwill that is being paid, as part of the overall purchase price. Valuing these assets is different from valuing other types of assets, such as real estate and intangibles, because the values can differ depending upon the specific circumstances, such as liquidation value, going concern value, and installation costs, among others.

Introduction

This is a critical chapter for family entertainment centers, since in most cases, equipment values are lower than that represented by facility owners. A seller may state that the equipment is worth $800,000, but the liquidation value may be $100,000 or less. We will carefully describe the differences in equipment types and their functionality and provide the three valuation methods for family entertainment center equipment.

Family entertainment center equipment has remained fairly standard over the past several decades, with the most significant improvements being made in arcade machinery. Technological improvements related to arcade games advance rapidly and force operators to replace these items every two to three years if they wish to compete with home entertainment systems such as the Xbox 360 or Playstation 3. Because of this very reason, many operators profit share with a third party operator. The third party operator installs the newest equipment when it is released. Therefore, the family entertainment center does not need to invest any additional capital.

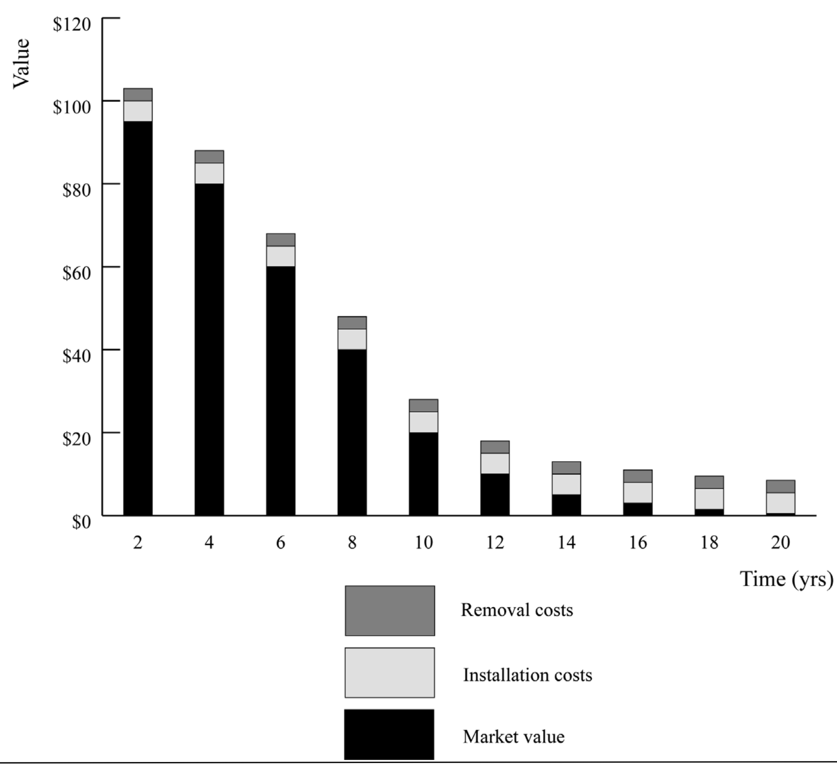
For the purpose of our valuation, we will assume that the operator owns the arcade equipment that is used in the operations as well as all of the other equipment listed in Table 6-21 on page 140.

Values of a family entertainment center's equipment can differ depending upon technology, manufacturer, age and selling circumstances. In most cases, the pieces of an operation will be worth less individually, than if they were part of a "turn key" operation, where each piece is an integral part of the overall product. Similarly, the time until the sale is also a factor. The longer you can wait to sell your equipment, the higher the probability of obtaining a wholesale or retail value. Also, installation must be taken into consideration when valuing a family entertainment center's equipment. Most equipment requires installation with heavy machinery or, at least individuals knowledgeable with installing such equipment. Furthermore, items such as rock walls and soft play centers are extremely costly to ship, which affects the overall price of the equipment.

Family entertainment centers also have a wide variety of grades and quality to choose from in each attraction item. For example, a miniature golf course can cost as little as $20,000 and go for over $200,000; the types of attractions, scenery, and difficulty of the course are all determinants of the price. Because of this, it is important to understand what the target market will respond to with respect to quality of the attractions. Higher income areas might require more lavish scenery from their local family entertainment center, along with leading edge technology for the arcade and other items. On the other hand, different markets might expect less, and the operator does not need to expend as much on the property to gain the maximum amount of return on investment.

In the assessment of entertainment equipment, it is important to specify *exactly* what value is being used. When valuing real estate, personal property or businesses, the importance and definition of value to each of these disciplines is different. Real estate values rarely have to explain installation costs, since land is stationary. Personal property is typically valued based upon continued use and rarely uses the cost approach like with machinery and equipment. Also, business valuations grapple with the fair market value of the business, which is either a control or minority interest.

Figure 6-1: Installation Costs Relative to Age Life of Equipment

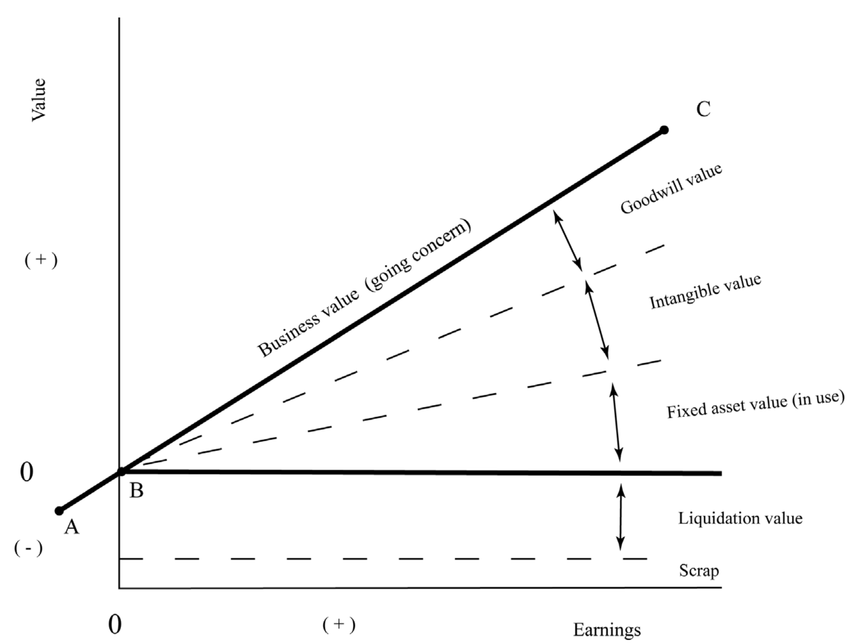


In many cases appraisers use "fair market retail values" for a purchase price allocation of equipment where the owner purchased the equipment at liquidation prices. Obviously if you are starting a business from scratch, then you are going to get the least expensive equipment that is still usable. When valuing a business and potentially purchasing the operation, the buyer must identify the downside of selling the equipment, or more importantly, finance the transaction. Bankers will only lend on a forced or orderly liquidation value, since they assume that they will have to unload the equipment at auction prices.

Value Definitions

As a result of all of the differences mentioned above, many value definitions are available and the right one is needed to be agreed upon before a value can be given. The American Society of Appraisers has definitions which apply to the valuation of machinery and equipment. These value concepts can best be seen visually in Figure 6-2, and are defined in Table 6-1 on page 120.

Figure 6-2: Valuation Definitions Relative to One Another



Purposes of Valuation Relative to Definitions of Value

One must first know the valuation purpose. This purpose usually goes hand in hand with the use of the valuation. For example, if the purpose of the valuation is for the allocation of a purchase price, or for an ongoing business, then the proper valuation concept would be the "Fair Market Value in Continued Use." This definition means the value of the assets to the ongoing business. If the valuation is to be used for financing purposes, then the proper value to be used would be "Orderly Liquidation Value," "Forced Liquidation Value," Liquidation Value in Place," or "Fair Market Removal."

A quick thumbnail sketch of the different values and purposes can be seen in Table 6-2 on page 121.

Approaches to Valuation

Like real property and business valuation, machinery and equipment are valued through the cost, market, and income approaches. Value is almost exclusively derived through the cost and market approaches with the income approach being rarely used.

Cost

The cost approach is based upon the assumption that a purchaser would pay no more for an asset than the cost of creating a substitute with the identical utility of the subject asset being valued. This value usually establishes the upper limit of value. Once the replacement cost is established, the condition needs to be accounted for by applying accrued depreciation. As with real property, the depreciation considered is physical curable, physical incurable, functional & economic depreciation.

Table 6-1: Strengths Versus Weaknesses of Approaches to Value

Method	Strengths	Weaknesses
Cost	Good for special purpose assets.	Sometimes economic obsolescence can be overstated.
	Good for new assets.	Depreciation estimate is subjective.
	Good for isolation of different items of depreciation.	Effective age is difficult to estimate; if a machine was rebuilt, then this complicates analysis; time consuming.
Market	Most reliable indicator for individual items with established markets.	Certain items have no comparable sales, and adjusting is subjective.
	More accurate measure of depreciation.	Sales data is oftentimes questionable and not detailed, and buyer and seller motivation is unknown.
Income	Recognizes income contribution to a business.	Poor method if specific assets need to be segregated.
	Most accurate measurement of total depreciation of all assets.	Rates of return are subjective and need to be combined with the business value.

Sales

The sales comparison approach relies on the assumption that the value of the businesses' assets can be obtained based upon transactions of similar items selling in the secondary or used market. This is easy to see in concept but difficult in reality. Usually the comparable prices of equipment need to be adjusted for differences such as age, condition and capacity of the assets, model, location, date and type of sale (retail sale, auction sale, asking price, etc.). Also, if valuing the business under a continued use, then the value associated with the cost of assembly or installing the assets needs to be adjusted.

Income

The income approach breaks down the earning capacity of the business assets under investigation. This approach is rarely utilized for individual pieces and is more applicable when analyzing a production line or for a plant which produces a set product. This approach would not be used in valuing family entertainment center equipment. In summary, the strengths and weaknesses of all three approaches to value can be summarized in Table 6-1. Table 6-2 shows why it is imperative to use the right definition for the valuation of equipment, since each value definition will represent a different percentage of the reproduction or replacement cost new.

Table 6-2: Value Definitions and Users

Term	Short Definition	Users/Purposes	% of Total New Value
Reproduction Cost New	The cost of reproducing a new replica of a property on the basis of current prices with the same or closely similar materials.	Feasibility or alternatives for FEC expansion, change, modernization or relocation; used for special purpose equipment; insurance purposes.	95-100%
Replacement Cost New	The current cost of a similar new property having the nearest equivalent utility as the property being appraised.	Feasibility or alternatives for FEC expansion, change, modernization or relocation; used for special purpose equipment; insurance purposes; Review any insurance policy for exact definition.	95-100%
Depreciated Reproduction Cost	Reproduction cost new, less accrued depreciation.	Insurance purposes; Review insurance policy for exact definition.	Varies
Insurance Replacement Cost	The replacement cost new as defined in the insurance policy, less the cost new of the items specifically excluded in the policy, if any.	Insurance purposes; review insurance policy for exact definition.	Varies
Insurable Value Depreciated	The insurance replacement cost less accrued depreciation for insurance purposes.	Insurance purposes; review insurance policy for exact definition.	Varies
Fair Market Value	The amount expressed in terms of money, that may reasonably be expected for property in exchange between a willing buyer and a willing seller with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts.This and all fair market values assume that the assets are installed, operating, and are an integral part of the overall business.	Buyers of a business who want a break out for an allocation of purchase price; dissolutions of marriage, partnerships, or corporations to establish an equitable distribution; tax assessors; gift and state taxation.	Varies