

The Decision To Buy, Lease, or Revenue Share

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For years now, there has been several schools of thought over the decision to buy, lease, or revenue share amusement and ride equipment within leisure entertainment complexes. Many an owner has commented that buying the equipment outright has put more in his coffers each year, while amusement operators have argued that the value of working with an experienced professional can easily be seen in healthy increases in game grosses and overall facility performance. Still others contend that leasing is the key to success, as the risk of depreciation is eliminated while monthly liabilities are predetermined. Three schools of thought and three solutions. Which one is correct? The truth is, it depends. Consider the changes within the industry over the last ten years: equipment cost has skyrocketed, with the average game unit costing \$6,000 - 8,000; the selection and type of units available is greater than ever; and the cost of skilled labor has doubled and the relatively low national unemployment level has led to a scarcity of quality individuals.

For many years, writers on this topic have attempted to create charts and guides that would closely resemble a typical facility owner's operating position. Simply choose the column that applies and follow the format as stated seemed to be the general consensus. Trouble is, every operating position is unique, particularly when factoring variables such as management and staff expertise, size and revenue volume of the subject facility, federal and state tax brackets, access to secondary resale markets, lender's debt and equity criteria, local availability of quality distributors/game operators, and abundance of capital. Its possible that a blending of purchasing, leasing, and revenue sharing may enhance some operations, but it must be consistently evaluated so that changes in the market are balanced and controlled effectively. Most importantly, consult your tax advisor to understand the specific impact of these three options on your taxable income and financial statement appearance.

Ask yourself when the last time was that you carefully studied the relationship between each game's market value and its weekly revenue generation? What about its market value to its book value? How about the facility's true costs for technical labor, replacement parts, insurance rating upgrades, and ancillary support equipment associated with game maintenance? The answers to all of these questions will help to determine the most appropriate solution and establish a future guideline to follow for evaluation down the road.

The Decision To Buy

Effectively outfitting game areas within a leisure entertainment complex requires knowledge, foresight, and capital. First and foremost, the facility's budget and/or borrowing capacity must be examined to determine if sufficient capital is available to permit the investment in game equipment. If the subject is a new facility, care must be taken to avoid diminishing working capital funds that might be necessary for sustaining the operation during start-up and off-peak periods. Consider also that a portion of the game portfolio may be devalued by up to 50% in the first twelve months, an alarming issue to those utilizing bank loans in excess of 24 months. Interest costs, increased covenant criteria by lenders, and/or investment potential of such capital must also be considered in analyzing true costs and opportunity costs.

Next, the correct selection and type of games is not only critical in attracting guests to the facility, but in protecting the facility's capital investment. Just because a unit is new to the market from a well-known manufacturer does not mean that it will be a shining star. Manufacturers' "testing" results can vary markedly from your own and should not be relied upon for purchasing decisions. A game's actual performance results within the subject facility's market region is likely to be a better indicator, but can be difficult to obtain from current users. Buying games at the "right" price will help to lower the overall cost basis and permit the game operation to more easily produce targeted returns. This step cannot be overemphasized, as the value of a game may drop rapidly as a result of new introductions, chronic service problems, or diminished play experience. Reducing the cost basis will help to lessen the impact of these conditions and allow for improved rates of return on the units within the game portfolio.

Now that the correct games units have been purchased at the right price, there lies the issue of preventative maintenance and service. Many game units, particularly video simulators and redemption units, are prone to constant service, as the number of mechanical parts is significantly greater than a standard upright video. Inexperienced or under-experienced service personnel can easily damage a \$3,000 PC board or a \$300 power supply, for which no manufacturer's warranty will cover. The very best purchase deal in the world can't erase the lost confidence of a customer turned away as a result of inoperative equipment.

Buying games is one thing - selling them is another. The decision to sell game units must be based on several factors

including, current earnings performance, market value, upcoming game introductions, condition, and repair costs. The proceeds from these sales must adequately support a large portion of the upcoming purchase budget and it is therefore critical that the greatest market value be obtained. Doing so requires a strong network within the domestic and international secondary markets and the ability to potentially offer payment terms and/or warranties. Without these, the trade-in value will likely pale in comparison to market value, resulting in the need to divert new capital to the game operation from the facility's other profit centers.

What if facility management lacks the expertise to handle each of these key variables? There remains the option of hiring a qualified industry consultant to direct such operations. For a relatively small fee, equipment consultants can oversee the buys and sells, hire and train qualified technical staff, and schedule equipment rotations. The caveat, naturally, is to choose a professional that manages equipment in every region of the country and maintains an infrastructure of service, technical support, parts, and large-scale purchasing/resale power.

If you decide to own your own equipment, make sure to avoid the most common pitfall - holding particular game units too long. In most cases, the optimum time to sell units, particularly video, is while the current earnings are still relatively good. Accordingly, market demand and value remain strong, allowing for easy liquidation at attractive pricing levels. Once upgrades or a revised version of a game hit the market, thousands of dollars in resale value can be lost overnight. Don't get caught napping!

Leasing - An Alternative For The Millennium

The term "leasing" is most often heard in the automobile industry, where an increasing number of cars, particularly luxury cars, are being leased instead of purchased. The term also conjures up thoughts of "excess wear and tear", "excessive use", "capitalized cost reduction", and others. Amusement game leasing, however, doesn't have to be as complicated. Leasing is nothing more than an agreement to rent a specified unit for a specified period of time at a predetermined price. This alternative is particularly attractive for a location owner that has a proven track record of operating amusement games in his or her facility, but might not have the capital available for an outright purchase. The infrastructure of technicians, spare parts, and support equipment is already on site, with the only missing ingredients being perhaps, high quality games and the expertise necessary to match game selections with the facility's market demographics. This is the point at which a qualified game distributor or large operator can provide the equipment and the expertise, all at a predetermined rental price. In many cases, these same providers may be able to provide contracted service to maintain the leased equipment, at additional cost.

One of the key advantages to leasing versus buying is the elimination of asset risk. Under a lease, the Lessor must absorb the inherent depreciation of the game unit over the lease term, and bear the brunt of any resulting drop in value beyond the original forecast. The lease price on a new, expensive driving simulator might seem remarkably high compared to an alternate unit that has been in the marketplace for six or twelve months. As the depreciation curve begins to flatten, many quality, strong earning game units can be leased at extremely attractive prices to compliment the new units currently on the FEC's game floor. This permits the facility to change its look without heavily impacting its budget.

In recent years, many national chains have preferred to lease game equipment, as they perceive that the existing patron base will generate game revenues well in excess of 2 times the lease cost. The benefit, naturally, is the ability to retain a greater percentage of game revenues, as compared to a traditional 50% - 50% revenue share. In a high grossing location, this could equate to more favorable split to the FEC of perhaps 60% or more. While the facility may retain a greater percentage of revenue, it must also bear the cost of all expenses, such as tickets, tokens, merchandise, replacement parts, theft, vandalism, technical labor, and workmens compensation insurance. Here to, the facility is now 100% responsible for marketing and promotion for the game operation, typically a specialty of large game operators.

If leasing fits the needs of your business, try to limit lease terms to periods of 12 months or less, thereby providing the flexibility to alter your operating plan down the road. Additionally, work with a provider that is willing to allow game rotations throughout the lease term - this way the facility's game area will always look fresh and maximize its revenue potential. Be wary of leases that require the Lessee to pay for the replacement of circuit boards, monitors, and power supplies that become inoperative in the normal course of operation. However, replacement parts for normal wear and tear, vandalism, or damage caused by inexperienced technicians is typically the Lessee's responsibility; as such, it becomes necessary to supervise and secure game operations at all times.

Just as in purchasing equipment, the advantages of leasing equipment are subject to the facility's ability to adequately service the units, promote the game operation, train its staff on game operation, and creatively design an effective game layout. Sound like a lot? It is.

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