Hedging Your Bet:
Methods To Reduce An Operator's Exposure At Poor Performing Locations

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01/26/00

Eventually it's going to happen. Despite extensive research, pre-planning, and careful positioning, your newest operating location is proving to be a "dud". You've spent weeks reconditioning and purchasing equipment, hiring and realigning technical staff, and making (or providing capital for) improvements at your client's new entertainment facility. You've even presented a strong case to your lender to release additional funds to cover this new business opportunity. Factor in the hours that have been spent designing game layouts, writing and negotiating contracts, applying for and paying license fees, and absorbing the cost of equipment delivery to the site. Any way you slice it, your up front costs have been heavy, indeed.

Hindsight is always 20/20. After the fact, many an operator has asked himself or herself, "What was I thinking when I entered into this revenue sharing contract?" The answer is usually always the same - the client's "concept" proved to be more grandiose than the actual execution. What looked like a $10,000/week location is actually a $5,000/week location. Unfortunately, it's the game operator that ends up paying a substantial price. To hedge against such occurrences, our firm encourages our clients to employ a series of techniques to more accurately target the true potential of a new account. Below is a synopsis of these techniques:

Confirm the Strength and Capability of the Client.

Don't be afraid to ask for the client's financial data or current performance data. If the location is a new enterprise, request to see a copy of the business plan, feasibility study, and funding package. The business plan will help to identify the location's key objectives, which may or may not blend well with your own. If a feasibility study has been performed, consider having it reviewed by an industry expert to confirm that the findings are indeed achievable. If a study has not been performed, and your equipment investment is likely to be significant, I strongly suggest that the operator commission his or her own study BEFORE making contractual commitments. This may prevent an over-investment in a facility that cannot generate adequate revenues to support your profit objectives, or more importantly, your note payments. Why wait until the equipment has been placed and the dollars spent to determine that things should have been done differently? Finally, ask for a copy, or at least a summary, of your client's funding package. This will outline the client's ability to follow through on planned attraction purchases, building improvements, and theming motifs, as well as confirm that adequate working capital will be available during the facility's "ramp up" stage. This is critically important, as a facility can quickly become insolvent from heavy start-up expenses, and be unable to continue operations.

If your client already has an established a track record at the location, request a full year of game collection information, and if possible, the actual weekly collection reports. Verbal assurances and generalizations should be avoided, as these may prove to be completely unfounded once you've placed your own equipment at the site. Historical collection information is also important in determining what types of games have been most effective in the past, and what volume of equipment is truly needed. Many clients have the perception that more games will earn more money, when in fact a lower quantity of carefully selected units can achieve the same or greater results.

Develop An Operating Agreement That Defines Performance Criteria

During the negotiation process, both the location owner and the operator have the best intentions and aspirations in mind - sales will be strong, patrons will happily spend more money each time they attend, staff will be well trained and easily accessible, and attraction quantity and quality will be second to none. All of these goals may indeed prove true, but if they don't, how can the game operator protect his or her investment from under-utilization?

The most effective method is to establish a benchmark for acceptable levels of performance. Let's say that you've invested $100,000 in new amusement equipment at a client's location. Early indications and representations made by the client suggest that the games will generate approximately $5-6,000 per week. During the first few weeks of the grand opening, these estimates prove accurate, however, during the weeks following the event, game revenues continue to fall, and begin to stabilize in the $2,500/week range. Despite the revenue drop, your technical team continues to fully service the site to insure that all equipment is clean and operational. The culprit appears to be a decline in patron traffic to the facility. Questions start to arise such as, "Is our client promoting the facility effectively?" and, "Are all of the planned attractions installed and operating to draw patrons to the facility?". The operator's share of revenues generated from the games is no

longer able to cover the costs of labor, repairs, or debt service on the loan note. To prevent this type of damage to your own business, incorporate several key criteria into the Amusement Operating Agreement, including:

1. A Written Commitment of Each Party's Responsibilities

Nothing is worse to an operator than setting up a new facility, only to find that the "promised" double spiral roller coaster or high-quality food concession has not materialized. These components were probably incorporated into the feasibility study, and that same feasibility study relied on their existence in achieving attendance targets and revenue objectives. Unfortunately, changes in budgets and financing availability can cause some of these key attractions to be crossed off the list. Instead of the games being a nice ancillary attraction in a spectacular facility, they are now the MAIN attraction in a run-of-the-mill facility! As we're all aware, this is not necessarily a good thing, as those missing components were the primary draws to bring patrons to the site.

To guard against such an unfortunate event, each Amusement Operating Agreement should clearly identify each party's responsibilities, including equipment offerings, staffing requirements, hours and days of operation, and location/placement of amusement equipment within the facility. Should the location owner fail to follow through on these contractual agreements, the operator can declare the owner in breach of the agreement and demand that such default be cured or that the operator be compensated for losses sustained. This may also give the operator the ability, at its option, to terminate the agreement in an effort to lessen its loss exposure, instead of maintaining an unprofitable operation.

2. A Flexible Asset Schedule

Typically, an operator's decision to place a certain amount of equipment at a site is based upon forecasted revenues. If these revenue levels do not fully materialize, the operator needs the ability to remove a specific level of equipment from the site in an effort the "right size" the game operation. This can be done in a few ways, by either using a minimum revenue level per machine or a more scientific method that compares the current asset value of a game to its average weekly collection revenue. If such minimum levels of revenue are not met, the operator would then have the right to remove the appropriate number of units necessary to bring the per game revenue average back in line with contractual standards. Conversely, if the operation's per game revenue exceeds a pre-defined level, the operator would (happily) invest more equipment at the site to adequately support the increased demand. This type of program encourages the location owner to take all necessary steps to maximize attendance levels, knowing in advance that the game operator's level of investment is completely dependent upon the facility's performance. Units removed from the location can then be relocated to a higher earning facility or liquidated to reduce outstanding debt instruments.

Check Out The Competition

Whether you're looking at a new or existing location, take some extra time to examine the quality of the surrounding competitors. Can your new client successfully compete in the market, and if so, for what period of time? Even though your games may be generating strong revenues, the balance of the facility may be failing as a result of poor attraction selection or low perceived value as compared to the competition. The outcome might be the premature closing of the facility, leaving the operator with a warehouse full of equipment and a pile of unpaid loan notes. If you're not convinced that the client's facility offers a better entertainment value than the competition, carefully determine whether the client's forecasts are realistic, and if not, whether revised forecasts are capable of sustaining the facility's debt and operating loads.

Evaluate The Location's Management

Management is by far the key ingredient to successful entertainment operations. An experienced management team knows how to please the guest and when to reinvest in new attractions offerings. Many new entrants to the entertainment industry have failed to recognize the warning signs that, left unchecked, can permanently disable the facility's chances of success. Take a moment to understand your new client's management philosophy and prior business experiences and confirm that he or she has what it takes to operate the center. After all, you're making a substantial investment at the site, all of which hinges on management's ability to steer the ship in the right direction.

Last But Not Least, Hedge Your Bet!

Be prepared for the unexpected. When choosing equipment and assigning manpower, examine the worst case scenarios now BEFORE making long term commitments. If a location closes, can you reassign your technicians to alternate locations, or will they be collecting unemployment for the next six months? If the client is requesting specific or unique game equipment at the site, will you be able to resell it later and how much of its value will be lost? Is the location within your general trading region, or will it require technicians to travel great distances, resulting in increased costs to your

company? These questions, as well as others, are important to answer, at the very least for the purpose of reducing your company's risk and preserving the foundation that you've worked so hard to create.

We may not have the ability see our future through a crystal ball, but we can control much of its outcome - at least as it applies to revenue sharing game equipment!

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