

# The Brave \$tatement

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## Theme Parks Capex Management - Searching for Predictability



In the Winter edition, with our USA associates, Harrison Price Company, PKFCA examined examples of why the attraction business deserves public support.

This issue carries the theme (no pun) forward. Based on our work together on several theme park projects, we have asked Harrison (Buzz) Price to prepare this article. Buzz carried out the first feasibility study for Walt Disney in the '50s - another one the bankers said would never work. Buzz deals with the **critical issue of capital reinvestment and its impact on theme park attendance**.

### *The night was dark and stormy . . .*

I've always wanted to open with that line. Actually, it wasn't a dark and stormy night but I had eaten a pepperoni on rye at 10 PM.

I was asleep, having the strangest nightmare. All the usual ghosts from my past were there in my dream.

Roy Disney (Senior) was there, concerned and asking "When will it all end? My brother keeps investing and investing. This has got to stop. Where's that report you are working on?"

Walt was there in my dream too. However, he wasn't answering Roy. Walt was reviewing some plans and models for more Disneyland expansion. Walt would turn to a very young Marty Sklar and tell him to answer Roy, and Marty would recite one of those famous Walt quotes like "You can't put a price on creativity." Marty may have made a lot of Walt's quotes.

Finally, thank goodness, I woke up. My lovely wife of 54 years, Anne, opened one eye and said sweetly, "You idiot. I told you not to eat the pepperoni!" I got up to contemplate the meaning of my dream.

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The dream had some basis in truth. In the '50s and '60s Walt was ploughing almost all the profits from Disneyland back into the park. His brother Roy was worried. Roy sensed there ought to be some kind of rational limit on reinvestment and he hoped he was approaching it because Walt was spending all the profits - literally. Roy had actually asked me for a study defining rational reinvestment levels. At the time, I couldn't think of how to do that. Our industry was too new. There just wasn't enough data available.

Then it hit me! In my dream the ghost of Roy had come back to get his report now, because 35 years later the data was available. After performing 3,000+ studies over the last 48 years, I had what I needed.

I mumbled "Thank you, Roy", and, wide awake, I dove into my half-century accumulation of paper.

Everyone agrees you need to reinvest that if you don't freshen your product the public will stop coming. **But how much?** What percentage of operating profit can be reinvested? That's the multi-million dollar question--literally. The reinvestment is most often dealt with as a percentage of the operating profit expressed as EBDITA (earnings before depreciation, interest and taxes). Thus, if the park has an EBDITA of \$10 million and a CAPEX for the year of \$4 million, its CAPEX ratio is 40%. Most often the ratio will be between 25%-50%, but not always the case. Walt Disney in the '50 and 60s was a 100% man. Ruud D'Clercq at the Dolphinarium in Holland resuscitated a moribund park with a vigorous CAPEX averaging 110% of EBDITA over 6 years 1992-97. Attendance went up 8.4% compounded annually. They wanted growth and development and reinvested every available dollar. They **got** growth. Does that mean that **you** should reinvest that much?



Harrison (Buzz) Price

There is a need for balance. If decent attendance, revenue and profit growth is obtainable with a ratio of 25%-50% that leaves a remainder of EBDITA for the stockholders and banks, or accumulating reserves for a rainy day (literally).

### In This Issue

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So the annual rite of spring, positioning the CAPEX commitment, is not the same for everyone. CAPEX influences an old park very differently than a new park. In the later life of a park, it can be a frustrating process, beset by the occurrence of a phenomenon James Thurber called “recessive knee”, a timid response. That happens when CAPEX is enthusiastically committed and nothing happens. Attendance doesn’t go up or, worse yet, it drops.

The only option left to management then is to massage the per capita revenue upward while muttering “what did we do wrong.”

Finding the optimum position has baffled more than a few. That’s why Roy asked us for a proposal to figure out an optimum reinvestment policy.

I believe my dream was right in that he was trying to contain or corral his fast moving younger brother. However, the work was never done. He no doubt rightly decided to go with the flow. He did say at the time--”where does it end? It’s like a rolling snowball.”

The history of CAPEX strategy is a fascinating arena when you are buying or selling a park. Any time there is a merger or a buy out, the CAPEX history is scrutinised carefully by the buyer to judge the reliability of EBDITA, the primary determinant of value. The seller may have prepared for this D Day (Divestiture Day) by jazzing reinvestment for a term prior to the great moment and/or increasing discounting and marketing expenditures while deferring maintenance and axing other operating costs, non-essential and essential. The buyer diligently interprets the numbers and manipulates the earnings multiple with his abacus.

All through the process, CAPEX, the seller’s rooster, in the dawn’s early light, crows a description of a rosy future: “The snowball will grow and it will not melt”.

Not everyone believes that CAPEX-induced growth is a virtue. Available EBDITA can be distributed to the stockholders. In that case, to misquote the old hymn, *Yield is the temptation*. Many years ago I worked for a successful financial leader, Henry Harris, who put Marineland of the Pacific together. He believed that the park had been put together by sweat and risk and now was the time for partnership dividends. Near zero CAPEX was OK. The park went from 1.8 million attendance in its first year (the year before Disneyland opened) steadily downward to 800,000 over a decade. Meanwhile, George Millay and Milt Shedd opened up Sea World in San Diego (a smaller nearby market) operated with maximum reinvestment and swallowed Marineland’s trade. Three or four subsequent owners of Marineland could never find the key to turning the park around by investing against Sea World with higher cost dollars. Marineland closed in 1985. Playing catch up with current money after under investing in prior years is not easy. This is a classic illustration of the first rule of holes which is: It is *a lot easier to stay out of a hole than to get out of one*<sup>1</sup>

As I sat there in the middle of the night, remembering the proposal to Roy and contemplating the problem of predictability, I wondered how could one define a reinvestment model that would communicate a “par for the course”. What affect will a given reinvestment produce, a standard of departure, applicable to different operations and objectives. Maybe I could scrounge up enough points on an XY scattergram to compute a correlation that would express a normal reaction to reinvestment. Maybe it would tell us, **in general**, how much growth in attendance might be expected to result from different levels of CAPEX commitment. The Y axis would be annual attendance gain (or revenue growth) in percent; the X axis would be CAPEX as a percent of EBDITA.

Now, 35 years later, maybe I finally had the answer to Roy’s question. So in the dark of the night I went looking through my files for points to plug into the computer. I found 139 in the period of

time 1978 to 1998 in 24 parks in 4 countries around the world. Within an hour I had reached my first definite conclusion. I decided I should have thought of this sooner when I had billable contracts on the subject.

The definitive sequence is straight forward and it goes like this:

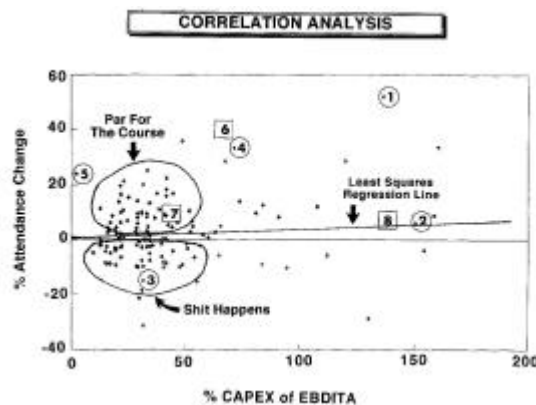
- Attendance and per capita and profit rate produce operating profit (EBDITA).
- EBDITA multiplied by the CAPEX commitment percentage equals capital expenditure.
- Attendance for the year less the prior year attendance equals the attendance gain derived from capital expenditure.

The input data is simple enough tabulated as follows:

Attendance Gain	Capex Commitment
A = Attendance Year N	D = EBITDA Year N+1
B = Attendance Year N+1	E = Capex Year N+1
C = Percent gain	F = Capex Ratio E÷D

Points plotted in the scattergram are F above, EBDITA as a percent of CAPEX on the X axis (the cause) and C above, percentage attendance gain on the Y axis (the effect). The results are shown in Figure 1. In many cases, attendance gain is more appropriately faded to a year later, lagging the impact to the next season. As another alternate, CAPEX could be computed as a percent of cash flow (a higher percentage). EBDITA is probably the better basis because it is a clean operating number before depreciation, costs of finance and other adjustments and its use in CAPEX budgeting is common practice. What actually happened?

I plotted all the points and fitted a line of regression by least squares in the **Correlation Analysis** below.



The least squares fit is a straight through the scattergram in which the sum of the squared distances from the line to each point is a mathematical minimum. The line is placed to achieve that minimum. This line best expresses the linear relationship of the points. As a straight line, it is expressed as  $Y = A + BX$ . It turns out to be  $Y = 0.5329 + 0.0594X$ . Its correlative results are measured by Excel as follows:

$$R^2 \text{ (coefficient of determination)}^2 0.0217$$

$R^2$ , the coefficient of determination, is defined as the measure of correlation between X and Y, the cause and effect relationship.

It is the proportion of variation in attendance gain that has been “explained by” the relationship between X and Y expressed in the regression line. It turns out that the degree of correlation expressed by  $R^2$  computes to 0.022 where 0 is no relationship (random) and

$$R^2 = 1 - \left\{ \frac{(y-y \text{ regression line value})^2}{(y-y \text{ mean value})^2} \right\}$$

<sup>1</sup> For those not familiar - the second rule of holes states *If you are in a deep hole - stop digging!*

where 1.00 would put all the points on a fitted line of regression (perfect causal or dependent relationship). What this shows is that the data I collected express an almost totally random relationship. Degree of investment resulted in a nearly random response on attendance, positive to negative. When I lagged the attendance gain to the year following, the results were essentially the same ( $R^2$  a trifle higher at 0.0328, still essentially random).

So, there is no pat answer. It's show business. I shouldn't have eaten the pepperoni. I had a glass of milk and stared at the data. Slowly the points began to speak. What the data tell us is that this is an art more than a science. All the little individual points are very subject to a diversity of different conditions like:

- magnitude of the reinvestment
- marketing and advertising effectiveness and specific demographic objectives
- discounting strategies
- impact of the new product or concept
- age and size of the park (it's easier to get a large impact on a smaller or newer operation)
- under or over investment condition of the park
- the wild card of weather, and
- what the competition does.

But random or not, each of these points has a story to tell:

- That high point 1, 52% attendance gain against a 137% CAPEX to EBDITA commitment in 1995 reflected the success of a major rebuilding of the park (Dolphinarium).
- Point 2, 6% attendance gain against a 154% CAPEX commitment in 1996 reflected a diminishing effect on continuing major reinvestment (Dolphinarium).
- Point 3, 15% loss of attendance against a 31.6% corporate commitment to CAPEX in 1993 reflected interdiction by a raging flood of the Mississippi River (Valley Faire).
- Point 4, 33% attendance gain against a 72% CAPEX commitment in 1992 reflected a great building effort by a new owner and a major marketing campaign. It also followed a 142% CAPEX commitment in the prior year (a major European park).
- Point 5, a remarkable 24% gain in 1993 against a small 2% CAPEX commitment, resulted largely from a heavy CAPEX commitment (54%) in the prior year (Hellendoorn). It was a lagged effect.

So then I tried to approximate a couple of interesting points that weren't in the data:

- Point 6<sup>3</sup> is *my estimate* of the effect of Indiana Jones at Disneyland in 1995:

Estimated Cost	\$90 Million
Estimated CAPEX on Indiana Jones to EBDITA	60%
Gain in Attendance	37%

Not all this gain was attributable to Indiana Jones. A new effective season pass could have generated at least half the gain or more. Nevertheless, the total gain in revenue was about \$40 for every new attendance generated in 1995 (about \$152 million) and the effect has

<sup>3</sup> Not included in the 139 points.

held up strong to the present day. In revenue terms, half of that number is 84% incremental payback in one year (assuming a 100% drop down to EBDITA). That's a championship reinvestment.

- Point 7<sup>2</sup> is *my estimate* of the effect of Mystery Lodge at Knott's Berry Farm in 1995:

Estimated Cost	\$8 million
Estimated CAPEX to EBDITA	39%
Gain in Attendance	9%

- Point 8<sup>4</sup> is *my estimate* of the effect of Back to the Future at Universal Studios Hollywood in 1993:

Estimated Cost	\$58 million
Estimated CAPEX to EBDITA	135%
Gain in Attendance	4.4%

At this point, I slugged a glass of port, went back to bed and tried to sleep. No luck. As I lay there I asked the question, "What can we do with this exercise that would shed light on a proper CAPEX management approach?"

It's like baseball. The only way to never strike out is never go to bat.

The best suggestion I can make is to study the reinvestment and its reflected data wherever you can find it; the record of what works and what doesn't work--what sells and what doesn't sell. We learn more from experience than computer models in a merchandising environment.

In the Correlation Analysis there are 59 points that indicated attendance decline for a given CAPEX investment. Conversely, 80 points were on the plus side of the line. That's a batting average in this case of 0.576, better than Babe Ruth.

The baseball analogy may work well in CAPEX management. A lot of base hits (see the par for the course circle in the Correlation Analysis) may get you farther than striving for the homerun. Homerun kings tend to have average batting averages. Mark MacGwire had the most home runs in 1998 but Sammy Sosa had a higher batting average and his team won more games.

The individual predictability may be low but the aggregate performance of the 139 points does set an average standard of performance which is significant. The average CAPEX commitment for the 139 points was 42.3% of EBDITA. The average gain in attendance was positive and it was 2.724% over the prior year. With a 3 1/2% average gain in per capita, a 6.3% revenue gain is indicated. If an EBDITA level of 27% of gross revenues is a typical average performance, and we are committing 42% of it to get a revenue gain of 6.3%, then 42% reinvestment at 27% profitability gets a 1.7% gain in EBDITA (6.3 x 0.27). On that math, the snowball stays chilled. How that could work is shown in the next table.

If one just looks at the positive points (those with attendance gains) the result is naturally more favourable. In those cases an average 44.3 percent EBDITA commitment produced an average 10.5 percent gain in attendance. It does pay to beat the average reinvestment gain.

	Original (\$000)	Reinvestment (\$000)	After (\$000)
Total Investment	200	11.4 <sup>5</sup>	211.4
Gross Revenues	100	6.3 <sup>6</sup>	106.3
EBITDA	27	1.7	28.7
Indicated ROI Percent	27÷200		28.7÷211.4
	13.50%		13.58%

<sup>4</sup> Not included in the 139 points.

<sup>5</sup> 100 x 0.423 x 0.27

<sup>6</sup> 100 x ( $\Delta$  attendance x  $\Delta$  per cap) - 100  
100 x (1.02724 x 1.035) - 100

The best approach is to study the qualitative aspects of that top group with dogged determination. Look for examples of insight, inspiration and good judgement. Set a rational goal for attendance gain that you want for a given rate of reinvestment and set out to get it. There are many, many points in Figure 1 which validate positive, ambitious goals.

Finally, let me repeat, on average, a 42 percent EBDITA commitment to CAPEX gets an average 2.7 percent gain in annual attendance. Although we did not find the sine qua non of predictability we were able to express a statistically representative performance standard for average reinvestment effects taking into account both gains and losses in attendance. If you fall below that average gain you know you under performed. If you beat this norm there are grounds for optimism and/or celebration. To beat the average is a rational target.

The message of our 139 points is that these valiant protagonists ploughed back heavy money into CAPEX (and marketing) and on average achieved solid growth while maintaining or bettering ROI. They stayed in the game.

With that I slept until noon.

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## The Forgotten Guest

In this article David Barbuto, Director Pannell Kerr Forster Consulting Australia Pty Ltd discusses elements of resort development that are overlooked and are potential gold mines.

*"The more I meet people the more I like dogs"*

When Mark Twain penned these sagacious words he may have provided a signal to resort developer that is yet to be heeded. I have lost count of the number of resort developments we have studied where talented architects and visionary developers concentrate their skills and resources to provide a suite of attractions and demand generators for the resort.

Every one of these amenities and quality of finish etc. comes at a capital cost. This cost must be weighed against the potential return. Often this return may be marginal but the amenity is provided because of:

- conventional wisdom
- the need to match or exceed competitors
- perceived need (remember all those world championship golf courses to developed in the middle of nowhere for Japanese tourists to flock to because they could not play at home. Always a classic development process - overspend capex on something that guests couldn't get to or were intimidated to play on).

I suggest that significantly more attention must be paid to removing barriers to stay in addition to the focus on attractions.

One of the biggest barriers to resort stays is the family doggie and puss. A few facts first.

- 66% of the 6 million households in Australia own pets.

What about me?

- Australia has the highest incidence of pet ownership in the world.
- Typically, the major carer of the pet is female, married with children, living in the suburbs and most likely employed.
- 91% of pet owners report feeling "very close" to their pet, reinforcing that pets are integral members of the family unit, however constituted.
- Of the Australians who do not currently own a pet, 53% would like to do so in the future.
- Key pet ownership data is:



Proportion of Australian Households with Pets	
Dogs	42%
Cats	29%
Dogs or Cats	56%
Dogs or Cats or Birds	61%
Total is greater than 100% due to multiple ownership	

I suggest that the provision of a separate and dedicated "hotel" for pets would provide a dramatic competitive advantage with EBITDA returns in excess of 30%. This can be complemented with potential for capital and operating sponsorships from veterinary suppliers.

The pet hotel enables families to interact with their pets as often as they chose during their stay at the resort. The scope and scale of amenities that would be charged for include:

- 150 pet accommodation suites, with piped music, natural light and plants. These will be as runs rather than cages.
- Daily brushing, playtime, swimming and exercise.



David Barbuto

- Video monitoring, together with electronic fire and smoke monitoring.
- Contracted 24 hour on call veterinary service.
- Contracted pet grooming and family portrait services.
- Qualified individual and group pet training and obedience classes.
- Pet taxi from airport or rail station.
- 24 hour personnel in attendance, including administration of medications and attending to pets individual requirements.
- A comprehensive pet barn stocking a fill range of pet foods and accessories.

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