

## The Economics of Entertainment

A Big Box Might Just Be Your Best Bet

— by Jerry Merola —

We've all seen them before. You know the ones – those big empty buildings once occupied by national giants such as Montgomery Ward, Kmart, Service Merchandise, and Bradlees, to name a few. In the real estate world, they're known as the "big box," with typical building sizes ranging from 45,000 – 85,000 square feet. Similarities abound between these structures, as most are of concrete block construction with either sixteen or eighteen foot ceilings. Add to that acres of front-load parking, major artery access, and a heavy electrical load spec and you've got the makings of a very well outfitted entertainment venue.

### Watching The Market

If you're currently in the design stage of entertainment development, you've probably been wrestling with the decision of whether to buy, lease, or build the necessary structure. Throughout the United States, leasing has been the hot ticket during the past few years, as national-level retailers have opted to preserve capital to allow for more aggressive store expansion. This in turn has fueled a dramatic volume of commercial growth, with "power centers" being constructed in nearly every medium-sized consumer

market in the country. These power centers are newly-built, master designed commercial hubs containing no fewer than five major national retailers. We've all seen them huddled together – Target, Marshalls, Michaels, Dick's Sporting Goods, Best Buy – in fact, the design of the complex even looks the same in multiple markets.



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As these major retailers expand into the "B" and even "C" markets, the older, less competitive retailers are falling on hard times. The result in many markets is the closing of these older stores, after which they often sit dormant for two or more years waiting for their next occupant.

On the surface, it would seem plausible that if a 65,000 square foot Kmart store closed, a Target or WalMart could easily occupy the space. After all, the building is already built and designed for a significant consumer load. Why then do we often see the Targets and WalMarts of the world building a brand new structure just steps away from the idled site? The answer lies in operational programming. Most of the larger scale retailers design their stores to exactly match the layout, occupancy, and appearance criteria necessary for efficient operations. While it might be less expensive to simply refurbish an existing structure, the potential loss of store efficiencies would quickly outweigh any initial savings.

### Looking For White Elephants

Five years ago, the idea of taking one of these behemoth buildings and converting it to entertainment use seemed almost ill-conceived. Cheap money combined with the availability of undeveloped acreage was a recipe for building from the ground up. In fact, this was the model of choice for most entertainment venue designs in operation today. But the cycle has since changed, with interest rates more than doubling in three short years. Coupled with the

rise in rates is a general scarcity of land parcels suitable for full-scale development. After accounting for wetlands provisions, zoning, area impact assessments, and the general public's dissatisfaction with urban sprawl, the number of truly useable parcels has narrowed dramatically. And if these conditions haven't been significant enough to get in your way, the most recent escalation of construction materials pricing surely will. Copper, steel, concrete, and plastics prices are soaring, fueled by the dramatic demand created by Hurricane Katrina combined with the explosion of the China's commercial infrastructure. Commercial building costs have risen by as much as 25 percent from a year ago, with many general contractors now hesitant to offer fixed-price contracts.

Suddenly that dormant big box retail store starts to look pretty interesting. After all, what's not to like? Virtually all such venues were approved and built in time periods before the term "urban sprawl" became front-page news. As a result, most are ideally located along major artery roadways with other retail anchors along their borders. Their original designs called for very significantly sized parking areas, which will often meet new regulatory standards with little to no modifications. The utilities are already in place and sized for operations that far exceed the typical entertainment center user. The added bonuses are often larger-than-normal pad signs along the frontage roadway (some of which are no longer permitted for new construction), heavy duty loading dock infrastructure, and sometimes, full-scale food preparation facilities (hoods, grease traps, multiple-bay sinks, and built-in coolers). There are actually very few users beyond the entertainment-style developer that can use open floorplans such as these, making our industry the logical inhabitants of these suitable-but-often-bypassed gems. Ultimately though, the most compelling argument for leasing or purchasing a dormant big box unit is often price. If leasing, you might be surprised to find out that the former retailer (i.e. - Kmart) is still obligated as the lease holder, with multiple years remaining on the lease. As the subtenant, you'll be looking to pay a lease price that subverts, but does not replace, the leaseholder. So, if Kmart is paying \$10.50 per square foot, you might want to offer \$5.00 per square foot. In the end, the national retailer's income statement improves and you get the benefit of a below-market rent for a defined period of years.

### Putting The Deal Together

Although it will require more legwork, one of the best approaches in working with these large spaces is to partner with another lessee. Through your real estate broker, it might prove helpful to spread the word that you're in need

of another sub-lessee, for perhaps 50 percent of the building. Once the two of you can agree philosophically on the use of the structure, now its time to approach the landlord and/or current lessee. Since the building will need to be subdivided, it becomes more likely that a landlord will pay for such modifications if he can see that the entire space will be utilized. After all, the building will require two separate storefronts, a segregation of utilities (power, HVAC, water), construction of new restroom facilities for each space, dedicated loading docks, associated dividing walls, and specific exterior signage. Improvements and modifications of this type could easily surpass \$500,000, however, such an investment on the part of the landlord is probably well spent, given that the building could remain dormant for years without a source of income.

If you've passed on the existing large-box space in your area, I'll encourage you to take another look. In a rising interest rate and construction materials market, the argument for raw development has eroded. Moreover, the timeline from land purchase to certificate of occupancy continues to lengthen, opening the door for a potential competitor to enter your marketplace while you're navigating the juggernaut of new construction. So take another look - you might find that the best option has been right under your nose all along.

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