

Case Exercise No. 1, Winter 2000

Restoration of the Bijou

Three years ago, on the outskirts of the small Midwest city of Sylvania (population 93,427), a large mall was built, together with a 12-screen multiplex cinema. Citizens were pleased with the new options that became available to them, since until then their shopping and social lives had been confined to eighteen shops, two restaurants, and a bar located on the city's Main Street, on either side of and across from the city's one movie theater, the Bijou. This theater had been built during the 1920's, when movies were relatively new, and theater owners could afford to build lavish ornate palaces with plush seating, gilt ornamentation, and huge glass chandeliers in the lobby. Even the marquee of the Bijou was once stunning in size and splendor, large enough to cover a considerable crowd waiting to buy tickets, and illuminated with more flashing light bulbs than were probably present in all of the other establishments on Main Street put together. Twice since it was built, however, the Bijou was remodeled in the style of the times, causing much of the original decoration to be papered over or hidden behind new more austere wooden moldings. The chandeliers had been stored in the basement, and many of the light sockets on the marquee had been disconnected and covered over to save energy. What remained was a more conventional movie theater, but with far more seats facing its single screen than could be filled for any but the biggest blockbuster movies of the year.

The Bijou had been struggling even before the arrival of the multiplex, which now was able to offer a far greater variety of first-run movies for its audience, without the difficulty of finding parking that inevitably confronted patrons of the Bijou if indeed it did manage to attract a crowd. The crowds became progressively smaller as the multiplex grew in popularity, and it wasn't long before the stores and restaurants on main street were feeling the loss of business as well. Within a year, the owner of the Bijou was forced to close it down and put the building up for sale. For two years now, various developers have tried to come up with profitable uses of the building, or at least of the land on which it stands, but the fact that none of the neighborhood businesses are prospering has usually convinced potential users that it would be hard to make a profit in that location. The only prospective buyer of the property who has gone so far as to make a proposal to the Sylvania City Council was from the owner of a string of pornographic movie theaters in another city who wanted to convert the Bijou to the House of Pleasure, which would use the Bijou's stage for performances of nude dancing, its screen for three dimensional X-rated movies, its lobby for vendors of adult books and sexual paraphernalia, and its balcony for purposes yet to be specified. The City Council rejected the proposal, but only barely.

The following week, a group of Main Street merchants got the permission of the Bijou's owner to hold a meeting of concerned citizens in the theater to talk about what might be done to prevent the further decline of Sylvania's downtown. What they came up with was a plan to renovate the Bijou, restoring it to its original splendor, then run it as a non-profit theater for classic and independent films, and for occasional stage events. By

keeping it open as an active theater, they believed that it would once again draw people to Main Street, where they would also spend time and money in the other establishments nearby. They realized, of course, that the restored theater would not be able to cover its costs, since it had not been able to do that even with first-run motion pictures. But they felt that saving the downtown was important enough that the city should provide a subsidy to the theater, and they resolved to work out the details of this idea and present it to the city council.

One of the first difficulties that they ran into, however, was the problem of parking. With only on-street parking available nearby, few would be likely to attend events at the Bijou even if they were offered. The plan was therefore extended to include construction of a parking structure on land behind the Bijou. Fortunately, the city already owned a large empty lot immediately behind the old theater, acquired a year ago when a developer who had planned to erect an apartment building there had instead defaulted on city property taxes of \$62,400. The city council had been considering various options for use of the land, and it had tentatively decided to turn it into a small park and playground for the residential neighborhood across the street. This use of the land had been forcefully advocated by one Millicent Bygones, owner of a day-care center located in a vintage 19th century house adjacent to the empty land. Millicent was not at the meeting, and she was not part of the group of citizens, mainly merchants, who now spent two months in consultation with architects, drawing up plans to renovate the Bijou and to build a parking structure on the empty lot.

The planners also had discussions with several potential users of the theater: the Sylvania Consortium for the Performing Arts, a group of local theater aficionados who for more than a decade had brought professional performers to Sylvania to perform in the high school gymnasium; the Sylvania Film Co-op, which had begun only recently to offer a series of second-run films in the basement of a local church; and the Sylvania Players, an amateur theater group that put on two plays a year but was forced to rent the high school auditorium of a neighboring city because of the lack of a suitable facility in Sylvania. All three were enthusiastic about the use they would make of the Bijou if it were restored to operation, although the Consortium and the Co-op were reluctant to commit to paying rent to support the venture.

At the end of the two months, the group presented to the city council its proposal to a) renovate the Bijou at a cost of \$12,000,000 and b) build a free parking structure for 440 cars at a cost of \$8,500,000. Because they wanted to encourage people to come to the facility, they would not charge for renting the theater, nor for parking in the structure. They therefore asked that the city pay both for the costs of renovation and construction, and also, thereafter, that the city pay for the maintenance of the parking structure and the operating costs of the theater – utilities, maintenance, and administration – leaving it to the users of the theater to pay only for the additional costs of the events that they put on. The operating costs were projected, at today's prices, to include \$240,000 a year for utilities, \$60,000 a year for maintenance, and a \$42,000 annual salary (plus 15% fringe benefits) for a full-time paid administrator who would be responsible for lining up a steady schedule of movies and other entertainment events in the theater. The figure for utilities includes electricity, heat/air conditioning, and phone. Water, which would cost an extra \$14,500 a

year at normal rates, was not included since it is provided by the city. Maintenance of the parking structure was estimated to add an additional \$120,000 a year to the city's budget for maintaining streets.

After contemplating this proposal for several weeks, the city council held a hearing to allow interested citizens and others to express their views. The following are excerpts from the testimony at that hearing:

John Herbivore (owner of Herb's Sporting Goods, 114 Main Street, across from the Bijou): "I'm all for it. My sales fell almost in half when people stopped coming to Main Street after the multiplex opened up. I've already laid off half my sales people, and I'll have to close down if something isn't done. You get people coming down here for movies, and they find out they can park too without a hassle, and I figure I'll be back in business like I was before."

Nellie Clingcoffee (owner of Bide-a-While Tavern just south of the Bijou): "I agree with Herb. I used to watch the crowds when they came and went at the theater, and I'd say that of every ten people who attended an event, one would stop somewhere before or after for something to eat or drink and spend around \$10 a person. And maybe one in twenty would also visit the shops and spend even more, say an average of \$25 a person. I'd guess that after we pay for the costs of what we sell, at least half of that money stays in town as incomes of the merchants and their employees."

Bonita Springs (agent at Whippoorwill Realty, 210 W. 4th St.): "Since the opening of the mall and the multiplex, the value of business property on Main Street has declined almost 20%. If the proposal can bring the downtown area back to life, I see no reason why properties on Main Street could not return to what they were worth before." Asked how much property she was talking about, Ms. Springs responded, "Not counting the theater itself, there are 21 commercial properties on Main Street that would be affected, and their average value today is about \$160,000 each."

Andy Appleheaver (President of the Sylvania Film Co-op): "We've been showing one movie a week in the church basement, charging \$1 a ticket and getting an average of 80 people attending each week. Using the Bijou, we could probably double the ticket price and still get four times as many people, or we could leave the price at \$1 and maybe get 1000 people a week."

[After similar testimony by representatives of the Sylvania Consortium and Sylvania Players, the council commissioned a study of the demand for use of the renovated theater for movies, plays, and other events. The consultants, a firm called Just Ask Us in Ann Arbor, Michigan, based their report primarily on the experiences of similar facilities in other cities, such as the Michigan Theater in Ann Arbor. They estimated that with good management the theater could provide an average of ten events per week, with the size of audiences depending upon the price charged. For an average event, it was estimated that at a ticket price of \$1, the theater would nearly fill all of its

1200 seats, while at a ticket price of \$5, the average sales would be 500. Costs of a movie, play, or other performance vary greatly, according to Just Ask Us, but the average seems to be about \$1000.]

Millicent Bygones (Owner of Don't Fuss Day Care, on Elm Street next to the proposed parking structure): "I am certainly all in favor of fixing up that theater, but I must object strongly to the parking structure. Even though Elm Street is only one block away from the business district, it is a residential area. A parking structure will be noisy, smelly, and dangerous for the children who play here and who come and go from school. What's more, I think it is impossible to build a parking structure that isn't ugly. I think the city should go ahead with its earlier plan to turn the vacant land into a nice park, and find someplace else for the parking structure." Asked if she wasn't worried about her own business, Ms. Bygones replied, "Yes, well, that too, although I am mainly concerned about others in the neighborhood. But yes, I expect that my own income will go down if this is built, by \$1200 a month. I've already been told that my insurance will go up \$800 a month, and I'm guessing that I'll have to cut what I charge for day care as well, costing me another \$400 a month."

Omigosh Whatnow, (Homeowner, 121 Elm St.): Millicent is absolutely right to be concerned. There are eight houses on our block of Elm St., in addition to her day care center and the vacant lot where you plan to put the parking structure. I know for a fact that our property values will fall if this structure is built. I just had my home appraised for a home equity loan, and the appraiser knew of the plan and turned in two different valuations for my property, one without the parking structure at \$152,000, and one if the structure is built at \$138,000. That structure is going to cost me fourteen thousand dollars, and I'm sure that the same will be true of the other seven private homes on the block.

Holliman Beancounter (City Treasurer, Sylvania): "I'd just like to remind the council that they should not expect much of an increase in tax revenues to pay for this project if it is adopted. The city does not have an income tax, so even if incomes rise as some have suggested, that won't raise city revenues. We do have a property tax, of course, but as we've heard, we will lose taxes on some properties at the same time that we gain on others. Furthermore, our property tax rate is only 3% of assessed valuation (which is in turn only half the market value) per year. All told, I think you had better just assume that there will be no automatic increase in city revenues if the project is adopted, and you'll need to look elsewhere for financing."

Henry Herringbone (Vice President of U-Park, Inc., a Chicago-based company that manages over 300 parking structures in various Mid-western cities): I think you people are ignoring an opportunity here, and my company is in a position to help you out. You are planning to allow people to park free in the structure, but that is really not necessary and you'll find that people will not at all mind paying a small amount for parking. My company has done an analysis of traffic patterns in Sylvania and how they

will be affected by the renovating of your theater (which, by the way, I think is a wonderful idea!). We estimate that by charging \$1 an hour for parking in the structure, you will assure that there are always available spaces to park, even during the most popular events in the theater, and you will raise revenues of \$2,000 a day. Our company will provide the necessary equipment and personnel to collect these charges, in return for only 40% of the revenues. This would generate an income of almost half a million dollars a year for the city to help cover the costs of the theater and parking structure. Indeed, if you are willing, we estimate that by charging \$2 an hour instead of \$1, we would increase revenues to \$2,500 a day, and you would net even more. However, I understand your desire to keep the cost down in order to attract people into the city.

Erskine Urgent (Owner of Urgent Drugs, 101 Main Street, and the self-appointed leader of the group of merchants who came up with the plan): “We do understand that of course this proposal is going to cost the city something, but we feel strongly that the purpose of this project is to draw people into downtown Sylvania, and we would be opposed to charging for parking. The more people, the better. In addition to the direct benefits to some of us doing business on Main Street, the entire community will be much better off having a downtown area that is thriving and alive, a place that we can be proud of, rather than yet another deserted string of empty storefronts left to rot in the sun. Other cities with the same problem have tried and failed to do anything about it, but we have a tremendous advantage that others don’t: The Bijou Theater! Under that drab exterior lies a glorious, splendiferous paragon of architecture that, with just a little work, can provide the centerpiece for the rebirth of downtown Sylvania. Who among us would not be willing to pay the small amount needed to bring this about?”

This concluded the testimony at the hearing. Most members of the city council felt enthusiastic about the idea, but they also felt very confused by the mass of information that they had just collected. They therefore decided to commission you (at less than minimum wage, I’m afraid) to extract the relevant information from all of this and put it together into a benefit-cost analysis. As is typical at this time of year, they feel rushed and they want your report in just a few days. And because they are already feeling overwhelmed by information, they want your report to be very brief, no more than two pages, with (at most) two additional pages of assumptions and calculations that they won’t read themselves but that will be checked by Mr. Beancounter.

Your Task:

Write a memo laying out who will gain and who will lose, and by how much, from the Bijou Theater restoration and accompanying parking structure. Do not attempt to place a monetary value on the sense of pride that Mr. Urgent appealed to in his testimony, but do try to quantify everything else that seems to matter so that the city council will know how much that sense of pride may cost the citizens of Sylvania.

To perform this analysis, you may have to make certain assumptions about things that were not mentioned in the description and testimony above. Please make no assumptions that change the basic flavor of the problem, like “I’m assuming that Millicent Bygones will blow up the parking structure if it is built, so there is no point in doing this.”

There may also be parts of the proposal that have not been explained sufficiently above, such as how certain things will be done, what prices will be charged, etc. In such cases you may need to decide on such details yourself, and you should explain and defend your decisions. Alternatively, or in addition, you may want to analyze and compare more than one possibility. You should also check the sensitivity of your results to information or assumptions about which you are most uncertain.

There is one detail that is definitely not covered above: how to handle one-time costs and benefits, like the cost of the renovation and a change in property values, versus ongoing costs and benefits such as the gain in consumer surplus for theater patrons and the revenues of stores which are repeated year after year. Since we have not yet dealt with time discounting in the course, you should handle these as follows. Assume a real interest rate of 3% a year and convert all one-time costs and benefits to perpetual flows by multiplying by 3%. Then perform all of your analysis in terms of annual flows of costs and benefits. You should also *not* worry about the possibility that any of these will last for only finite time.

The bottom line of your memo should be a recommendation to the city as to what it should do. This may either be simple – “Do it.” or “Don’t do it.” – or it may be conditional (“If this, then that”) if the best course of action depends crucially on something you don’t know. You may also want to include in your recommendation certain changes or additions to the proposal discussed above, if you think these would be an improvement. However, suggesting such changes is not necessary. In any case, though, be sure to indicate fully who are the gainers and losers from this proposal and by how much.

Your memo should not exceed two (8 ½ by 11) pages (with a font no smaller than 10 point – this is 10 point – and margins no smaller than 1 inch). If you use a table to display your results, this should be part of the two pages, if that is convenient. If not, it may appear on a separate page, but then an equivalent amount of space should be left in the two pages of text. You may also include (at most) two additional pages of assumptions and calculations, with the same font and margin requirements. You have 5 days to complete the assignment, which will be due at the beginning of class Wednesday, Feb. 23, at 8:40 AM.