Capital expenditure in the hospitality industry

Hotels of any size are costly investments to begin with. The costs involved in maintaining the property to the necessary levels to keep attracting customers can at times be very high. Capital expenditures projects in the hospitality industry are primarily focused on the achievement of customer safety and comfort in a clean, friendly, and healthy environment. This paper will describe what capital expenditures are, what is involved in setting up a capital expenditure plan, how it is funded, and who the stakeholders in the process are.

Keywords: capital expenditure, return on investment, funding Capital Expenditures in the Hospitality Industry General accounting principles define capital expenditure or CAPEX, as an amount of money spent to acquire or upgrade productive assets, such as buildings, machinery and equipment, to increase the capacity or efficiency of a company for more than one accounting period, (Businessdictionary. com, 2010). In the hospitality industry, capital expenditures include furniture, fixtures, and equipment as well as major improvements to the buildings, landscape and systems.

The creation of new business units within a hotel or resort may be capitalized. From the above definition it can be deduced that capital items are generally big ticket items, expected to support the quality of an operation for many years. These items also will have a substantial impact on the property owner’s cash flow and net profit, as well as on the performance of management to deliver customer and associate satisfaction, associate productivity, and superior financial results.

In many instances it is difficult (and too often open for interpretation) what is a CAPEX item and what is a regular maintenance or repair item. An example of this is the choice between replacing a whole roof versus continuously fixing leaks, which demand substantial man hours from operations. A thorough understanding of a property’s needs for capital expenditures should be clearly defined and agreed to by owners and their assets managers on one side, and management on the other.

Since capital expenditures reach beyond the normal fiscal year budgeting process, agreements in writing between owners and management should be drawn to protect the vision both parties may have for the business and its future. As much as any business, the fundamental objective of a hotel is to attract and retain profitable customers, who will chose the hotel for a variety of reason, including its appearance, number of outlets and recreational facilities. Both the owners and operators need to subscribe to the goal of maintaining the hotel to the level needed to ensure that the fundamental objective is met.

There will certainly be times where owners and operators will disagree on the specific level of quality necessary to achieve the objective, and as such there will be discrepancies in the required amount of funding that should be made available. The owner’s point of view regarding how much they want to spend might differ if the initial reason for owning the property is for short term gains, such as upgrading the property for resale, or they might have a long term vision such as making the property the centerpiece of a community project or support facility in a business park.

Whichever the owner's reason for owning the property, the management team cannot operate in a vacuum and disregards the owner's goals and limitations. CAPEX can add significant financial burdens to the owners. Cash reserves are often held, and expenditures timed by the operator, thus limiting the owner from free access to cash flow. In addition there may be tax implications; while operating expenses may be posted against current profits, CAPEX items are generally written-off over a multi-year period.

From the management team's perspective, the effectiveness of a hotel operator is fundamentally measured by the capability to maximize market share and profitable revenues, as well as the ability to contain operating costs within reasonable levels, as defined by both the company and industry standards. Capital expenditures offer the management team an opportunity to reduce labor cost repair and maintenance of equipment, gain market knowledge by upgrading to better systems, and increase associate productivity by providing them with the necessary tools to do a more efficient job.

In order to keep the priorities of the business separate from the preference of the individuals involved, the capital expenditure process requires solid analysis and planning. This is more significant if the management team is aware that they might face pushback from the ownership team when it comes to the release of funds for a particular project. Once approved by the ownership group, capital expenditures are normally funded through one of three sources: * An escrow fund established for the replacement of fixed assets * Projects that can be classified as having a return on investment * Owner's out-of-pocket special projects.

Industry practice, followed by major hotel chains is to set up an escrow fund of three to four percent of total sales. This percentage is often less during the first three years of operating a newly built hotel, as there is less need to replace equipment. Analyses conducted by the International Society of Hospitality Consultants have shown that these reserves are often insufficient to keep a hotel or restaurant operating to customer’s expectations and with the efficiencies that new technologies provide (Hotels-online. com, 2000).

Making the funding proportional to sales, supports the theory that less revenues are indicative of either less usage (and subsequent less wear and tear), or that lower pricing will correspond to lower customer expectations. Funds are added to the escrow account on a monthly basis based on sales for the prior month. The disbursement of the escrow funds is the responsibility of the management team, and with the endorsement of the property’s owner.

To ensure the funds are available and allocated in an appropriate manner, management prepares an annual budget plan that consists of: * Forecasted sources of revenue List of replacements planned for purchase during the year * Fund reserved for capital expenditure projects to be executed in future years * Estimated timeline of funding and disbursement * Line item responsibility and approvals to execute the process Return on investment (ROI) projects are capital expenditures intended to expand the earnings potential capacity of a hotel. To include ROI projects in an annual capital expenditure plan, management will be required to use an approved method of calculating the return a project may produce.

The calculation for ROI takes into consideration the gains from the investment, less the cost of the investment, divided by the cost of the investment (Investopedia. com, 2010). Special projects are most often funded by owner out of pocket funds. Owner funded projects outside those covered by escrow or ROI qualified sources may have to be initiated when emergencies arise, or there are shifts in property positioning or management company, or similar out of the ordinary events.

Also, as escrow funds are often underfunded, property owners and management may have agreed that certain types of projects will always be executed under the owner's discretion. Examples of special projects falling under the category of emergency are; new legislation is passed that requires the retrofitting of the building with a certain safety feature such as sprinklers, or additional exits, natural disasters such as hurricane damage, or a boiler room explosion. Although some of these types of project costs may be covered by insurance they are still emergency capital expenditures no matter who pays for them.

Examples of special projects falling under the category of shifts in property positioning , as may happen if the owner decides to change the brand or management company. Changes in brand may often require a shift in position in the market, especially if the brand image is being upgraded. If nothing else the signage will need to reflect the new name of the hotel, and that alone can be costly. Changes to systems the new brand uses will also have to be capitalized. A critical component of funding capital expenditure projects in the hospitality industry is timing.

The primary aspects to be considered are: * When will the funds be available to pay for the project execution * What impact will the project have on revenue generation * How long will it take to execute the project When setting up a capital expenditure plan (CEP), management must carefully estimate the “ remaining life” of capital goods and structures. Major renovations, such as redo of guest rooms and roofing replacement can easily cost in excess of one year’s escrow reserve. Multi-year set-asides must be estimated.

Good work in this phase will prevent shortfall for other needed items in future years. For administrative purposes capital expenditure projects may be classified into: * Replacement of furniture, fixtures and equipment (FF&E) * Building upkeep * Facility upgrades, downgrades and expansion This classification will allow owners and management to measure management’s efficiency in keeping the property in competitive condition. Spending of FF&E funds should be have a direct reflection as to how much a management cares for selecting and maintaining the assets entrusted to them.

Building upkeep needs to be analyzed separately because the quality of construction and weather conditions that affect the building are out of the hands of management. These conditions can have a special impact on the useful life of an asset. A poorly designed or constructed building may begin to show flaws a lot sooner than expected, just as a hurricane may cause damage to the building that was not predicted. Facility upgrades, downgrades and expansion projects fall generally into the ROI category, and are reviewed from time to time for the accuracy of the return projections.

Further classification includes detailing what operating departments have submitted requests for CAPEX items to be included into the CEP. Each operational department head puts together a wish list for the consideration of the property executive committee. These projects will be grouped together according to their estimated costs to quickly identify the required approval levels. For example, hotels will receive a list of requests from: * Engineering * Rooms and related (housekeeping, front office) Food and Beverage (restaurant, bar and recreation outlets) * Support departments (administration, finance, loss prevention, human resources, and sales and marketing) * Resort type hotels may also have requests from Golf and Spa, or other major departments that may form the hospitality complex Each department will list their requests grouped into the following order: * Building improvements and replacement of FF&E with costs higher than $20, 000 each (except for ROI projects) * Replacement of

FF&E under $20, 000 (often referred to as 0 to 20 funds) * Return on investment projects Some departments also add initial department priorities, and phases of desired execution to their submittal. It is to the benefit of the department head to fully analyze his proposal prior to submittal so the request has a better chance of being approved. Once all the individual departments have submitted their list of priorities, the executive team will then further prioritize the list.

First priority is often any items having to do with life safety, such as adding sprinklers, security cameras, smoke detectors and the like * At times there might be regulatory requirements mandated by law that result in a project such as the Virginia Graeme Baker Pool and Safety Act (Poolsafety. gov,

2010) * Any projects that are related to contractual obligations between the stakeholders such as those that ensure the brand integrity * Projects with are deemed quality essentials, in other words projects that will benefit guest or associate satisfaction.

Quality essential projects are the true life-line of the business. After all if there are no customers there is no need for the business to begin with, and if there are large numbers of unhappy associates they will not offer the appropriate service to keep the customers happy. * Projects that enhance productivity, are cost cutters, such as energy conservation projects, are maintenance savers or create new revenue centers will also be classified by the executive team. A good management team will ensure that no project is initiated before funding is secured.

Only true emergencies may override this rule. The following steps are recommended to be undertaken in sequential order: * Prepare a property budget plan. Realistic estimates of escrow reserves based on forecasted revenues need to be detailed. This detail needs to be both for month over month for the coming year, and year over year for at least the next eight years.

* Estimate the available free cash flow, month by month to ensure the funding of escrow reserves can be secured and eventual ROI and special unbudgeted projects can be considered. Obtain the necessary internal approvals (from the owners and / or management company) needed to set aside the funds, and detail the spending authority of the funds. This will be described below. * Consider bank or other lenders to fund projects where

time-value of money is less than the cost savings or profit potential that can be obtained by early execution of a CAPEX project. * Quarterly reforecast sales to ensure that possible changes in market conditions will not create a shortfall in funding efforts.

It is a critical part of the plan for all parties involved to fully agree on who will be responsible for the disbursement. A spending authority will be authorized to commit funds and control spending. Hotel management contracts with property owners normally stipulate that the property management has the authority to commit the spending of escrow funds for capital goods projected for replacement. Generally senior officers of the company overseeing local management will provide approval for the Capital Expenditures Plan (CEP) budget.

Any projected spending on major CAPEX items (over $20, 000 for example), shall have the endorsement of the property owner before the project is started, and be offered to review after the project is concluded. Return on investment and special projects should always be jointly approved by corporate officers and the owning company, and if so agreed in some occasions the execution of the special projects is in the hands of the owning company. A clear understanding of all the stakeholders involved in the process is necessary to facilitate the approval process of the capital expenditure plan.

Understanding everyone’s agenda will make the process somewhat smoother. The three major stakeholders are the owner of the property, the owner of the brand (Marriott, Hyatt, Hilton for example), and the operator.

These three stakeholders invest their money, time and effort in the success of the hospitality business. It is in their best interest to present the property in an image that best serves their objectives. Besides these three primary stakeholders, the neighborhood, local trade and tourism associations, local authorities and others might have an interest in the well being of the business.

Although all stakeholders in a business seemingly have the same goal in mind, their motivations to achieve it can be very different. CAPEX is an area where different approaches to common objectives can create significant conflict. A solid contract between primary stakeholders and good cooperation is the best remedy to avoid costly mistakes in the conduct of business. The owner of the property has the biggest stake in the business; a major investment that cannot be easily transformed or moved. Ownership in the hospitality industry comes in many different forms.

The independent owner, who sometimes may also function as the operator, will seek to operate in a profitable manner, and will shape the look and feel of the property around personal preferences. CAPEX for this type of ownership will center on what is believed to be the minimum necessary to keep the guest coming back. Another type of owner is a real estate investment company or REIT, which more often entrusts the upkeep of the property to a management company. This type of owner will communicate expectations to the operator and assign an asset manager to oversee performance.

Another type of owner is the time share owner, or fractional owner. Under such an ownership the owner places their trust in the operator of the property to achieve quality upkeep for as long as their investment is held. Generally they are not interested in disposition of funds, expansion or change in service levels, but rather in maintaining or increasing the property value. The owner of the brand, also known as the franchiser, lends their reputation of quality to a physical asset.

The case of a chain operated business (such as Marriott, Hyatt, etc. this means keeping the property in the physical condition that best identifies it with the quality reputation the brand stands for In many cases operators and franchisers are the same company. Marriott Hotels, Starwood, Wyndham, Hyatt are examples of this type of operators. These companies generally place a property management team which is trained and indoctrinated to maintain the quality of the brand. Other operators manage independently and franchise the flag from a recognize brand. Interstate Hotels & Resorts for example is a company that operates different brands for third party owners.

Interstate is the United States largest independent hotel management company, and has international properties as well (IHRCO. com, 2010). Whichever the operating company's business model, hospitality is created " on-site"; a management team investing time and effort, leading a number of associates to serve the customer to the highest level of quality. In summary, capital expenditure investing in the hospitality industry requires a large amount of managerial analysis, careful planning, sensibility towards the needs and wants of different stakeholders, and commitment to execution.

A detailed capital expenditures plan (CEP) is not only recommended but mandatory part of the annual business plan. The CEP section should define the project list, with clearly listed projects, their objective, their cost, start and end dates (specifically for any projects under the $20, 000 and over level), and where applicable the Net Present Value (NPV) of the project. List should include the source of the funds (escrow funds, ROI funds, owner out-of-pocket funds). Who is in charge of executing the project must also be described.