Wayside case

Business

WAYSIDE INN INC CASE STUDY 2. Company Analysis Wayside Inns was formed in 1980 as the successor to United Motels Enterprises, a company that operated several franchised motels under licensing agreements from two national chains. Wayside has been experiencing brisk business and is currently operating at near full capacity. To capture more business Wayside is considering a 40-room expansion for the motel.

We shall evaluate the company using a SWOT analysis. Threats – Competitors are expected to expand – New customers may get shifted to other competitors due to lack of space in Wayside . Evaluation of the Proposed Investment It is provided in exhibit 3 of the case that Wayside turned away an average of 9, 181 customers in a year. If Wayside were to expand, these turnaway would generate additional revenue to the company. Besides, as shown in the SWOT analysis, new customers may get shifted to other competitors and this puts Wayside at a disadvantage.

Nonetheless, the increase in revenue for the company will not serve as a good reason for the company to expand. It all depends on the returns with respect to the capital invested. Here we shall look at 1) return on investment (ROI) and 2) internal rate of return (IRR). 1. Return on Investment Indicator| Current| Upon expansion| ROI| 27. 06%| 24.

25%| At first sight, we will realize that upon expansion, the return on investment of the company immediately drops by 2. 81% and this may seem like a bad investment. However, we need to delve deeper to decide if ROI is a good indicator. ROI measures the net income over the total investment. One problem with ROI is that it will increase when capital assets depreciate.

The ROI in the first year may be lower but thereafter it will increase, rendering this indicator ineffective to determine if they should take on the project.

Another point to note is that investments that are above the company's cost of capital should be undertaken as it adds value to the company. However, by using ROI the company may reject investments that are above the cost of capital if it reduces ROI. 2. Internal rate of return We shall compare the IRR between not taking on the investments and taking on the investment. For simplicity, the cash flow for each period would be the operating income and we assume the cash flow would be in perpetuity. For the cash flow after expansion, we assumed that the cash flow will reach a terminal of $733, 012.

This is based on the maximum revenue that could be obtained for implementing 40 rooms taking into account the current capacity and the number of turnaways which are maxed at 40 per day based on the " Turnaway" table as shown in Exhibit 3(Appendi Indicator| Current| Upon expansion| IRR| PV = CF/R – I0 = 397, 504/R – 1, 469, 263. K = 27. 06% | PV = CF/R – I0 = 733, 012/R – 2, 573, 789K= 28. 47%| We see from here that the internal rate of increased from 27. 06% to 28.

47%. This clearly indicates that this investment would bring additional value to the company and thus should be undertaken. 3. Layne Rembert's concern Layne Rembert is concerned if the ROI would decrease and the effects of the planned expansion on his incentive compensation and how his income for the year will be affected. Firstly, with regards to the ROI, it will indeed decrease from 27.

06% to 24. 5%. This is due to the increase in investment from $1, 468, 798 to $2, 573, 789 and that the increase in net income is less than proportionate, hence reducing ROI. However, the compensation package is made in such a way that the ROI bonus includes both the ROI portion and the Performance Factor portion. With the increase in the size of the investment, there is a jump in the value of the performance factor to the next investment tier, from $36, 000 to $45, 000.

Therefore, the absolute amount of ROI bonus increased from $9, 743 to $10, 914. Furthermore, he has also not taken into account the sales volume bonus, where an increase in the revenue generated will impact the amount of compensation bonus received. Accordingly, his compensation will increase from $1, 469 to $4, 361 due to the increase of the sales volume with the expansion. In conclusion, the initial decrease of the ROI will be compensated by the increase of the Performance Factor and the sales volume bonus and overall, his compensation will increase and his concern is not justified. 4.

Compensation Package The current compensation package has a few problems. Currently, ROI is used to calculate the bonus. ROI = Net Income/Investments where investments are equal to the total value of assets minus depreciation. With the depreciation of the fixed assets every year, the ROI would naturally increase resulting in greater bonuses for the inn managers every year. To address this issue, we propose that Wayside Inns Inc use annuity depreciation method.

In this method, the ROI value will be unaffected by depreciation. Therefore, this leads to more accuracy in the calculation of ROI bonus and will be a

better indicator of the performance of the inn managers. The second problem with the compensation package is that the ROI used to calculate bonus provides different incentives for different levels of investment due to varying performance factors. This means that although a certain investment may be good for the company, the unit managers may be against it as it would affect their compensation packages. In the earlier parts of the report, ROI bonus was good as there was a jump in the tier of performance factor.

Let us consider the case where the company proposes an investment that causes the total investment value to be about $1, 800, 000. Then, the ROI bonus would be calculated as follows. ROI = Net Income/1, 800, 000 * 36000 = 0. 02 * Net Income. There is no increase in the performance factor if the investment was originally at $1, 468, 789. The inn managers have an incentive to try and raise the invested amount to slightly above $1, 800, 000 so that the performance factor would be $45000 as shown below.

ROI bonus = Net Income/1, 810, 000 * 45000 = 0. 0248 * Net Income. As seen there would be an increase in the bonus when the managers push up the investment from one tier to the next. There is incentive for the manager to increase the investment value that may have no added value to the company as the net income in both the cases would be the same. This flaw in the compensation package leads to goal incongruence. Although the regional manager can apply his discretion to ensure that the performance factor does not increase, it does not negate the fact that the managers may be incentivised to spend excessively.

Besides, there may always be exceptions where he does not know the motive of the inn managers and just agree with the spending which increases the investment value without lowering the performance factor. Additionally, following the earlier analysis, inn managers will likely be against investments within a tier where the performance factor is the same although the investment may be good for the company. This is because the net income would likely not increase proportionately to the investment in the initial years. This means that the initial ROI would be lower with the new investment and when it is multiplied to the same performance factor as before, the overall ROI bonus component will be lower. One proposition that we considered will be to change the bonus from using ROI to EVA (with annuity depreciation).

EVA = Net Profit – Capital Charge As long as the increase in profits are greater than the increase in the cost of capital of the firm for the additional investments made, the inn managers compensation will increase and inn managers will take on projects that are above the company’s cost of capital. This will lead to goal congruence. Bonus can be calculated as EVA multiplied by a company determined percentage. In addition, the usage of EVA could lead to additional benefits such as the ability to use different interest rates for different assets and that inns at different regions can have different cost of capital. However, one main disadvantage of EVA is that it is a dollar amount and therefore, it is subject to high fluctuations.

For example, if the economy is doing very well and any inn faces consistent high demand. The inn managers may decide that the demand for the inn is relatively price inelastic and charge higher rental charges per room. As such,

the net income for that year would be extremely high and as a result, EVA will be high leading to unreasonably high bonus. This is not entirely fair because the workload and responsibility of the managers probably did not increase by the same amount. Inn managers may get unfairly rewarded for a good performance by the inn due to the strong state of the economy.

This disadvantage is reduced in the usage of ROI because ROI is a ratio As such, given the analysis above, it is observable that both ROI and EVA have their own advantages and disadvantages. Consequently, we feel that both of them should be used together in the calculation of inn managers so that their individual weaknesses can somewhat be reduced. We propose that 50% of the bonus be calculated using EVA multiplied to a company determined percentage and the other 50% is determined using the ROI multiplied to the performance factor. Next, we propose that the sales volume incentive should be eliminated. This is because the sales volume growth is calculated based on last year sales is not a good indicator of the performance of the company and the inn managers as it may be very volatile and even contradictory to the performance of the company. For example, a mediocre year of sales that follows a poor one will show revenue increases and inn managers will be rewarded although they may not truly deserve it.

Likewise, a good year that follows an excellent year will not be rewarded due to the negative growth in sales volume and no bonus would be given. Staff will not be rewarded correctly for their work and they will lose the incentive to perform well. Additionally, the company might face cash flow problems if it rewards the staff too much in a year. Hence, we propose the elimination of this sales volume growth incentive bonus. We feel that these would not lead

to any negative consequences because the use of EVA would already encourage staff to try and increase sales as much as possible due to the presence of net profits in its calculation.

At the same time, the staff will not be motivated to decrease costs by sacrificing quality as it will affect their net income. We also feel that some number of employee stock options could be given to the inn managers if Wayside Inc is a listed company. This is because employee stock options directly connect the performance of the company to the benefits attained by each individual inn manager because good performance will cause the stock prices to rise and the inn managers may benefit from dividends or capital gains from the sale of the stock. Therefore, each inn manager would then have a greater incentive to increase the performance of the company. We also feel that the compensation of inn managers does not give much emphasis on non-quantitative measures such as customer satisfaction and service quality. These are important factors for this particular industry as service quality and customer satisfaction plays a great part in determining the level of demand for the service provided by the inn.

Although it may be argued that the easurement of returns in the current compensation package will account for these factors as returns are only high if service quality and customer satisfaction is high, it is not entirely true. The correlation between them is not perfect. For example, at a particular location, Wayside Inns Inc may be the only firm to have an inn there. Customers who travel by that route always use this particular inn. So even if the service quality may not be high, customers do not have a choice and the revenue of the inn will not be affected.

However, if a competitor observes this and sets up another inn nearby, providing better service quality to customers, they will be drawn away and this is not good for Wayside Inns Inc. As such, they should also focus on customer satisfaction and service quality so as to ensure that they keep up their reputation and image and do not let competitors survive on any weaknesses they may have. For this, the 20 point evaluation system proposed by Kevin Gray should be included companywide for all inn managers and have a certain weight in the calculation of the base salary. This system measures issues like cleanliness, complaint levels and personnel attitude that are measures of service quality. It is fair to measure the performance off the inn managers based on this system as they have direct control over the factors mentioned above.

However, we agree that the measurement of this is subjective and that is why we propose it to be a small percentage in the base salary. Furthermore, the inn managers should know about the implementation of this system, so that they can increase their salaries by working to improve on the various factors. Other factors that could be implemented in the 20 point evaluation system * Number of repeated customers as that is a good indication of customer satisfaction and since Wayside targets business travellers, it would be reasonable to have a high repeated customers * Nature of complaints if there are too many so as to know the severity of the problems * Adjustments for uncontrollable factors like natural disasters so that the inn managers' compensation is not extremely affected by such incidents especially in light of the fact that revenue and thus, the bonus of the inn managers would be affected by them. . Performance measurement system for regional manager

There are both advantages and disadvantages for basing the RGMs' compensation package on the same factors as the inn managers' compensation package. The main advantage for using the same factors for the RGM is that it will align the goals of the inn managers and the RGMs.

For example, the usage of ROI model to measure RGMs' and inn managers' bonus compensation will encourage both of them to focus on efficient use of capital investments. However, there are also disadvantages such as goal incongruence when using the same factors without sufficient adjustments to the performance measurement due to their job scope. Imagine the case when the RGM is measured based on the weighted average of all the inns under them. As it is easier to have investments in inns with lower ROIs, RGMs would then be biased towards expansion in low profit inns and little or no expansion in high profit inns. This may not be beneficial to the well-being of the individual inns and the company. Another shortcoming is that the RGM have different controllability factors.

As such, the same 20 point system used by Kevin Gray to evaluate the inn managers should not be exactly the same for the RGMs as they do not have direct control over the operations of the motels. Further, there may be possible collusion involved if the same evaluation factors were used. RGM will have the incentive to provide high scores to their inn managers as the scores contributes to own scores. We proposed using similar compensation package for both managers but adjustments should be made. Instead of using the 20-point performance evaluation, the regional managers can be rewarded based on long terms objectives which are set with the top management.

On an annual basis, review of the objectives will be made. Also, the company can require the inns managers to submit yearly reports on the progress of each inn to keep track of the RGM performance. 6. Appendix Exhibit 3: “ Turnaway” Statistics for 1991 and number of customers it can cater with expansion| Sunday | Monday| Tuesday| Wednesday| Thursday| Friday| Saturday| Total| 442| 1, 357 – 3 = 1, 354| 1, 440 – 13 = 1, 427| 1, 986 – 174 = 1, 812| 2, 283 – 339 = 1, 944| 1, 175-50 = 1, 125| 498| 9, 181, 8602 filled with expansion| ——————————————– 1]. Revenue = No of rooms* Price + Other revenues = (47, 184+8, 602)*30. 10+ $40, 571+ $25, 050 = $1, 744, 780 *We have recalculated the projected revenue with no of rooms based on current capacity+total no of turnaways.

The total no of turnaways is not inclusive of the amt exceeding 40 per day based on the turnaway table. Cash Flow = Revenue*Operating Margin = $1, 744, 780*(624, 235/1, 485, 859) = $733, 012 *Operating margin is taken to be Operating income/Total Revenue