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Hotel capex: Are you reserving enough? Four step process as it relates to planning

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As an advisor to hotel owners in New England and across the county, and many that are very sophisticated real estate investors, I'm always surprised by how little thought they give to long term capital planning. Fortunately, later this month, the issue of capital planning for hotels will be in the spotlight again when the International Society of Hospitality Consultants (ISHC) and the Hospitality Asset Managers Association (HAMA) release the latest update to its long running study of the issue. The original study was completed in 1995 with updates in 2000 and 2007. The report presents data on trends in capital expenditures (capex) by various hotel segments, including luxury, full-service, select service and extended stay. It offers readers factual data on how capital is spent to maintain competitive positioning, achieve brand standards, and continue the life cycle of hotels.

Traditionally, lenders and managers have required owners to reserve 4 percent of revenues to cover anticipated future capital expenditures. Based on this requirement, many owners (and operators) fall into the trap of believing that if they simply reserve 4 percent of their revenues they will be fine. In fact, one of the main goals of the Capex Study is to shed light on the fact that 4% is not enough. In the 2007 study, full service hotels spent an average of 5.1% of revenues, select service hotels 5%, and extended stay hotels 5.9%.

The 2007 study also found that capital expenditures vary with the age of the property. Older properties require more capital investment. While properties less than 5 years old reported spending less than 2.5% of revenues on capex, older properties spent significantly more. Specifically, hotels more than 15 years old spent more than 8% of revenues. In addition to the age of the hotel, other factors such as occupancy, product type and construction have an impact on capex.

What's an Owner to Do?

We recommend that owners follow a four step process as it relates to capex planning:

1. Thoroughly evaluate the property - There are two critical reports that new owners can use in evaluating the property: the Property Condition Report (PCR) and the Product Improvement Plan (PIP). The PCR will provide an evaluation of the entire building including systems and furniture, fixtures and equipment (FF&E). The PIP is prepared by the brands and identifies capital items that will need to be addressed in order to maintain compliance with brand standards. Together, these two reports provide hotel owners with most of the information they need for effective long term capital planning.

2. Develop a long-term plan - We typically develop a 10 to 30 year plan for our clients. The long horizon allows us to incorporate major expenses such as roofs, HVAC systems, and elevators. Our

plan has two components:

a. Identification and timing of the expenses - Critical elements include FF&E, equipment, technology, and systems. All of these have typical useful lives that can be utilized (e.g. guest room soft goods typically have a 5 to 7 year life).

b. Cash Flows - Capital reserves can be found in the owners 10 year profoma. Longer term projections may be estimated by applying an inflation rate of 3.0 percent. We then apply our estimated expenditures over the projection period in order to identify shortfalls, which typically occur during renovations or when major systems require replacement.

3. Determine How to Fund Anticipated Shortfalls - While reserves are funded at a fairly constant rate, capital expenditures are much more erratic. In addition, capital expenditures will increase over time. Owners have two options when it comes to funding anticipated shortfalls:

a. Increase the reserve for replacement - The advantage to this approach is that it ensures that adequate funds are available when required. The disadvantage is that it ties up funds that could be used for other purposes.

b. Identify Other Sources of Funding - By having a long term plan, owners can prepare for the years in which additional capital is required. Sources include additional equity from the current investors, taking on new equity investors and lenders, through a refinancing.

4. Monitor and Update Regularly - Each year, as part of the budgeting process we update our long term plan looking at the timing of capital requirements, and updating expected costs to reflect any changes that might have occurred or additional information that has come to light over the last twelve months. It is also important to update anticipated reserve funding. When updating reserve funding, however, it is important to be realistic about the long term and to consider the cyclical nature of the business.

Conclusion

Long term capital planning requires an upfront investment of time. This initial investment, however, will pay off over the long term, by allowing owners to effectively and realistically evaluate their investment and long term income prospects. Too often, owners fail to adequately reserve enough funds or identify other sources to pay for necessary capital projects. This can lead to diminished competitive positioning, loss of franchise affiliation, or even loss of the asset. Smart owners are always looking at, and preparing for the future.

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