

HIGHEST AND BEST USE

HOSPITALITY CAPEX

PART I:

WHAT'S A CAPEX, AND WHY SHOULD I CARE?





What's a CapEx?

It depends.....

BusinessDictionary.com offers the following definition:

“An amount spent to acquire or upgrade productive assets (such as buildings, machinery and equipment, vehicles) in order to increase the capacity or efficiency of a company for more than one accounting period.”

Hotel owners, operators, brands, and accountants all tend to have different perspectives on the definition of capital expenditures (CapEx), but most definitions of hospitality CapEx are based on the tax law/accounting treatment of fixed assets.

The accounting perspective is the most straightforward. Accountants are interested in compliance with GAAP (Generally Accepted Accounting Principles), and the easiest fixed asset and tax accounting process.

The operator's perspective is slightly more complex. Typical management contracts include incentives for increasing revenues and operating profit. Any CapEx that raises revenue or reduces expense is likely to be a financial benefit to the operator; regardless of the cost of the CapEx.

For example, when an operator replaces (CapEx) a broken piece of equipment, rather than repairing it (operating expense), the “savings” go right to the profit line and potentially earn incentive compensation. In similar fashion, an operator increases “profit” if they reduce maintenance cost (OpEx), even if that lack of maintenance reduces the useful life of the hotel's equipment (CapEx).

The brands are also in an interesting position regarding CapEx. Brands have a strong financial incentive to increase hotel revenue (they collect more franchise fee), but they do not participate in hotel capital costs. Brand required renovations and improvements increase fee revenue at no cost to the brand. It is easy to require something if you don't have to pay the bill!

However, the hotel owner's perspective is probably the least ambiguous, since they are the ones paying the CapEx bill.

Here is the definition of a capital asset from a prominent Mid-Atlantic hospitality REIT:

“A new physical asset with a normal service life of at least one year, a minimum unit cost of \$500 (including taxes, freight, installation, and fees), and an aggregate cost of at least \$1,000.”

Owners are typically concerned with four major types of cash flow over the life of their hotel investment;

- Purchase price,
- Operating profit or loss,
- CapEx, and
- Sales price.

Owner's want to minimize cash outflows, and maximize cash inflows. Purchase price and CapEx are the only flows directly controlled by the owner, and it is almost always the owner's practice to spend the least amount of money on CapEx possible. It is critically important to Owners that they get the “highest and best use” out of each CapEx dollar.

The owner's definition is the only one that really matters, and for long term success, operators, brands, and accountants should understand the owner's definition of CapEx, and align their CapEx planning and execution with the owner's objectives.

Does CapEx matter?

Of course CapEx matters, particularly to hotel owners.

Capital expenses are a material ongoing cost to all owners of hotel properties. According to the **ISHC CapEx 2014** Study, capital expenses average over 7% of a hotel's gross revenue, every year. There is variation in these percentages by property type, age, location, and ownership, but in every case, CapEx is a material expense to hotel owners.

It is also a fact that most Hotel owners are perennially short of capital funds. Optimal use of capital is crucial to the long term financial success of any hotel real estate investment.

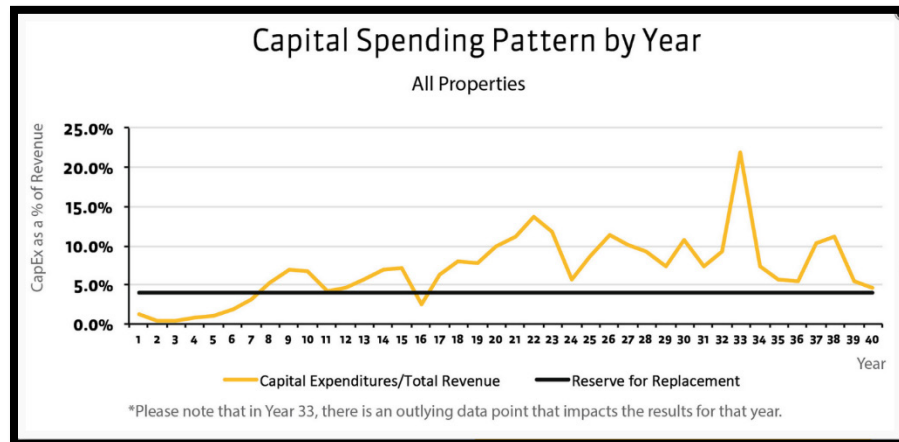


Figure 1: ISHC CapEx2014

What's important?

“Highest and best use of owner’s capital”

Highest and best use of owner’s capital is the most important objective of hospitality Capital Expenditure planning.

However, this high level objective doesn’t always help in developing specific strategy and tactics for capital investments. It is more useful to focus on some of the more specific planning objectives when building a good capital plan.

Here is a short list of important CapEx planning objectives (in priority order) that will help achieve *“highest and best use of owner’s capital”*:

- Provide advance notice of property/portfolio capital funding needs.
- Plan both property level and portfolio level investment cycle, acquisitions, and sales.
- Optimize property market position and revenue potential.
- Optimize property operational efficiency.
- Lower property risk (service disruption, equipment failure, life safety).
- Harmonize property stakeholder’s interests; owner, asset manager, operator.
- Optimize CapEx project execution.
 - fiscal control
 - Low overhead costs: management time, administration, accounting
 - Best value/pricing for purchases, contractors, project management
 - Minimal disruption of service and operations,
- Maximize the return and minimize the cost of CapEx.

Any CapEx planning process that does not satisfy these objectives will fail to meet the overall objective of *“highest and best use of owner’s capital”*.

What should Owners and Operators do?

Take action!

Hospitality asset owners and operators should take the following three steps to improve the CapEx planning for their properties.

1. Communicate investment objectives

Hotel owners need to understand their own portfolio and property objectives, clearly articulate those objectives, and communicate those objectives to their asset managers and operators.

Core assets have very different CapEx planning objectives than assets that may be held for only two or three years. Successful properties in strong markets will have different CapEx priorities than failing properties that are about to be sold. It doesn't make sense to replace individual pieces of FF&E in a property that is being scheduled for a complete renovation, while it does make sense to replace FF&E in properties where renovations will be delayed.

Communicate well, and asset managers and operators will be able to deliver CapEx plans that reflect the owner's investment objectives.

2. Require a high standard of CapEx planning

Asset managers and operators charge a substantial fee for their services. Owners should demand that they earn their fee when it comes to CapEx planning.

Good CapEx planning requires three important elements:

- **Systematic process**

CapEx planning should be supported by computer software systems integrated with accounting, purchasing, maintenance, and asset management systems. A systems supported approach makes it less expensive to maintain good data about the past, present, and future capital needs of the property, and provides continuity through management and personnel changes.

- **Long term perspective**

A ten year forward looking CapEx plan will provide adequate advance notice of all of the property's CapEx requirements. At minimum, CapEx plans should include the owner's remaining "hold" period for the asset if less than ten years.

Long term planning contributes significantly to both the completeness and the accuracy of the planning effort as scope and budget detail is added to projects as they become closer in time.

- **Completeness**

The CapEx plan should include everything that the property will need to continue operating the business efficiently and effectively: PIP's, renovations, building exterior projects, building systems, major overhauls or upgrades to equipment or systems, Brand required upgrades, etc.

The more inclusive the plan, the easier it is for ownership to make the larger property and portfolio investment decisions, and the less likely that ownership will be surprised by an unexpected funding need.

Set a high standard, and don't accept incomplete or poorly done CapEx plans.

3. Make it a conversation

Operators and asset managers are closest to the guest, most aware of their competitive set, and have the most specific knowledge of property condition. They are also most aware of how guest satisfaction, market position, and property condition change during the year. Take advantage of this knowledge to inform CapEx planning.

The planning effort will be more effective if it is part of daily operations rather than an annual "exercise". Make CapEx a specific part of property operations reporting, even if major projects are being executed by third party project managers. Discuss CapEx project status and planning during every owner and asset manager meeting.

Let these conversations drive adjustments to the CapEx plan during the year, and support better investment decisions at both the property and portfolio level.

Summary

1. What's a CapEx?

Whatever the property owner defines as CapEx.

2. Does CapEx matter?

Yes, a lot. Particularly to hotel owners.

3. What's important?

Squeezing the most value out of every capital dollar;

"Highest and best use of owner's capital"

4. What should Owners and Operators do?

Know their investment objectives, communicate, demand a high standard of management and planning, and keep a lively conversation going throughout the year.

R-A Associates provides management consulting services focused on creating and sustaining the long term value of hospitality real estate assets.

- Property Planning and Design,
- Facilities Operations, and
- CAPEX.

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