Changes in the Hotel Industry's Financial Picture

by Sean F. Hennessey

During the 1990s, the hotel industry has witnessed a stunning turn of fortune. At the start of the decade, the industry recorded its biggest loss ever, at $5.7 billion (after debt service and income taxes). Occupancy levels were eroding, and room rates were losing ground after inflation. Investor interest was down sharply, sending asset prices downward.

Today, the industry is as strong as it has ever been. Profits are at record levels. Occupancies have retreated slightly from 1995's high, but remain strong in most markets. Rooms rates have grown well above inflation levels and are estimated to do so for at least the next four years.

Table 1 presents a summary profit and loss statement for the hotel industry that demonstrates the magnitude of the changes that have taken place.

The sizable changes suggest that counselors and other analysts should have a different approach to analyzing hotel financial statements than they did 10 years ago. The following comments will highlight a few of the major changes that flow through hotel operating results during the 1990s.

OPERATING DEPARTMENTS

Rooms

One significant change has been the importance of cancellation penalties. With market conditions relatively strong, hotels should be capturing penalties for not occupying reserved rooms. Most frequently, hotels charge a fee of 25 percent to 100 percent of the room rate for an unused reservation. Additionally, many hotels now collect

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Table 1

Comparative Hotel Financial Information, 1990 and 1997[1]
(stated in average amounts per available room)

	1990	*Percent of Total[2]*	1997	*Percent of Total[2]*
Occupancy	63.3%		72.9%	
Average Room Rate	$71.07		$112.81	
REVENUES				
Rooms	$17,338	*64.0*	$29,700	*64.2*
Food and Beverage	8,127	*30.0*	13,119	*28.3*
Telephone	650	*2.4*	1,223	*2.6*
Other Operated Departments	568	*2.1*	1,513	*3.3*
Rental and Other Income	433	*1.6*	668	*1.4*
TOTAL REVENUE	27,117	*100.0*	46,223	*100.0*
DEPARTMENTAL EXPENSES				
Rooms	4,872	*28.1*	7,371	*24.8*
Food and Beverage	7,103	*87.4*	9,908	*75.5*
Telephone	584	*89.9*	525	*43.0*
Other Operated Departments	597	*2.2*	1,106	*2.4*
Total Departmental Expenses	13,156	*48.5*	18,910	*40.9*
DEPARTMENTAL PROFIT	13,961	*51.5*	27,313	*59.1*
UNDISTRIBUTED OP. EXPENSES				
Administrative and General	2,874	*10.6*	3,635	*7.9*
Marketing	1,735	*6.4*	2,645	*5.7*
Franchise Fees	380	*1.4*	311	*0.7*
Property Operations and Maint.	1,573	*5.8*	2,208	*4.8*
Energy	1,491	*5.5*	1,643	*3.6*
Total Undistributed Op. Exp.	8,053	*29.6*	10,442	*22.6*
GROSS OPERATING PROFIT	5,908	*21.9*	16,871	*36.5*
Management Fees	624	*2.3*	1,561	*3.4*
INCOME BEFORE FIXED CHARGES	5,204	*19.5*	15,310	*33.1*

a fee for checking out early, without notifying management in advance. Because cancellation fees typically apply to group business as well as other customers, the fees can be sizable. During a recent month, a California hotel derived 10 percent of its room revenue from cancellation fees.

Master folio billing charges, early departure charges and cancellation charges have all been areas of supplemental revenue growth for hotels and can be expected to increase as long as conditions remain strong.

Food and Beverage

In 1990, many hoteliers had practically given up on food and beverage service, tagging it as a money-losing department that most guests didn't appreciate. Today, hotel food service outlets have gained more respect, and travel journals like *Gourmet* magazine regularly cite hotel restaurants among the finest eateries in many cities.

It is important to look at the composition of food and beverage revenue at a hotel. Typical revenue sources include restaurants, lounges, banquet catering, and room service. Most often, the restaurant and room service are unprofitable or marginal due to the round-the-clock labor they require. Catering and lounges, on the other hand, often benefit from tight scheduling and sizable liquor mark-ups. The

composition of revenue from the various food and beverage outlets will inform a proper cost analysis for this department.

A recent trend has been strong increases in room service. Many travelers are using their computers to log on to corporate computer systems at the end of the business day, and as a consequence are forced to spend more time in guestrooms. Hotel managers are responding by increasing menu prices for in-room dining and adding delivery charges and mandatory gratuities to guests' bills.

Another growing area of F&B profitability is meeting room charges. In 1990, meeting space was typically given away to customers in exchange for associated guest room and catering business. No longer is this the case. Meeting rooms are rented as a separate charge in most commercial hotels.

The following list identifies some areas that hoteliers are targeting to improve revenue in the food and beverage department.

- Menu Prices (including in-room dining)
- Banquet Prices
- Banquet Room Charges
- Banquet Bartender Charges
- Minibar Prices
- Banquet and Meeting Cancellation Charges

Telephone

Hotel managers feared a dearth of telephone revenue with the advent of company calling cards and other sophisticated telephony advances. However, there has been ample room for hoteliers to improve telephone revenue. In fact, the predominance of business travelers with computers is likely to foster a strong increase in connection charges as these road warriors log on to proprietary database, Internet, and e-mail services. Zero-plus telephone charges and room-to-room phone charges offer other examples of how managers are driving more revenue from the telephone department.

Other Operated Departments

Formerly labeled "minor operated departments," this category has tripled in importance during the 1990s. Hotels have become more aggressive about charging for health clubs, business center services, and the like.

Amenity fees, business center prices, and the like constitute the major initiatives of hotel managers in driving more revenue from this department.

Rental and Other Income

Proper investigation of rental and other income requires an analysis of this line item's various components. Hoteliers frequently evaluate whether to operate or lease out restaurants, gift shops, and other guest services. While revenue from an operated restaurant would show up in food and beverage revenue, a leased restaurant would be posted to this line item. Similarly, an operated gift shop's revenue is posted to other operated departments, while a leased shop is properly in this revenue category.

Parking Charges are an example of how hotel companies seek to improve the revenue from this department. By simply marking up the cost of parking for hotel guests as well as people attending banquets and meetings, hotels are able to improve their profit picture. Negotiating better commission structures for public telephones, vending machines, and video games is another area of management focus.

UNDISTRIBUTED OPERATING EXPENSES

A recently emerging concern relating to undistributed operating expenses is the propensity for operators to cut back on these expenditures in times of decreasing profitability. While industry profits continue to rise, the pace of improvement has moderated. In order to maintain profit growth, operators sometimes look to cut back on marketing, maintenance and general oversight. The impact of these cutbacks is not likely to be felt in the short term, thereby postponing the pain of weakening revenue growth. However, these "savings" frequently create negative long-term consequences that need to be thoroughly evaluated.

Administrative and General

One change in financial statements has to do with the costs reclassified under the most recent edition of the Uniform System of Accounts for Hotels. Liability insurance, which had traditionally been posted to the administrative and general department, was reclassified as part of the insurance expense under fixed charges. This reclassification is important for both comparative purposes (to prior years and to comparable statements) and for its potential impact on incentive management fees. Since many management contracts have incentive fees tied to Gross Operating Profit levels, moving any expense into fixed charges has the result of increasing GOP and incentive management fees, while reducing the owner's profit.

Credit card commissions are showing a slightly downward trend. More hoteliers are negotiating commissions with credit and charge card companies.

Miscellaneous sources of short-term savings in the administrative and general category (as well as other operating departments) include cutting back on training and bonuses. A savvy counselor will identify these items and evaluate their potential impact on future performance levels.

Marketing

The biggest area of change has been the growing cost of frequent guest programs. These loyalty programs have not been as powerful a tool in the hotel industry as is the case in the airline industry, but their popularity is increasing. Studies have shown that the loyal customers tend to pay higher room rates (up to 25 percent more), spend more per visit and visit more often. These fees can surpass $10 per occupied room, and thus can be more expensive than even property maintenance. The recent announcement by Starwood of its new frequent guest program is widely expected to create a "points war" where the customer will be offered ever-richer rewards.

Franchise Fees

While the strength of brands may be ebbing in consumer products, it continues to be an increasing trend in the hotel industry. Even as franchisees unite and look for a better deal from franchisors, there is little evidence that royalty fees will moderate. Although franchise fees decrease as a percentage of total revenue in the Smith Travel data, reporting differences distort what has generally been a rising cost.

An important value consideration with franchisors (and some management companies) concerns the issue of Product Improvement Plans (PIPs) required as part of any change of ownership. Now that there is more profit to be distributed in the industry –and new brands emerging as competitors- many franchisors are requiring substantial capital expenditures to meet ever-higher standards. For small and mid-sized hotels in particular, it is not unusual for the PIP to be 10 percent or more of the asset value.

Property Operation and Maintenance

Maintenance is an area where hoteliers have spent a lot of effort in recent years. Strong profits have encouraged owners and operators alike to take care of accumulated maintenance needs. In many properties, a detailed view of maintenance expenditures can reveal items that are non-recurring and thus suggest future moderation in PO&M expenses.

Since 1990, every additional dollar of revenue taken in by the industry has resulted in 70 cents of GOP. This demonstrates the high operating leverage of the hotel business: that it costs relatively little to rent each incremental room. In addition, hoteliers benefited from the demand-pull inflation that accelerated room rate increases without requiring corresponding improvements in product quality.

Maintenance expenses should be evaluated together with capital expenditures. Many expenses can properly be considered either capital or operating in nature. Further, certain capital expenditures have the effect of reducing ongoing maintenance expenses.

Energy

The deregulation of utility companies and increasing efficiencies for major equipment has facilitated cost controls in the energy department. However, since service costs are relatively fixed and there is no labor in this department, opportunities for gains are generally related to improved equipment efficiency and manipulation of peak load periods. One benefit of improving technology is increasingly sophisticated property management systems (PMS's) that help control energy expenses.

GROSS OPERATING PROFIT

The industry's profit improvement discussed at the outset of this article is most dramatically seen from the context of Gross Operating Profit. Since 1990, every additional dollar of revenue taken in by the industry has resulted in 70 cents of GOP. This demonstrates the high operating leverage of the hotel business: that it costs relatively little to rent each incremental room. In addition, hoteliers benefited from the demand-pull inflation that accelerated room rate increases without requiring corresponding improvements in product quality.

Management Fees

Fees associated with retaining professional management are one of the few areas that have moved up during the 1990s. With scant new unit growth in the early 1990s, operators often discounted the price of management services as an enticement to owners. Now, growth options are more plentiful for operators, and strong profitability levels have created a "plenty of money for everybody" attitude.

That said, long-term management contracts — five years or more — continue to be a very strong negative value influence. Up until two years ago, it would have been appropriate to estimate market value by calculating the unencumbered estate's value and then subtracting out the estimated liquidated damages associated with terminating the long-term contract. Since many contracts are silent regarding early termination, values of these properties were subject to wide confidence intervals. Today, there is a minimal value discount for highly desirable properties with long-term management. Mid-market and economy hotels, however, remain marketable only unencumbered.

FIXED CHARGES

Property Taxes

As hotel prices fell dramatically in the early 1990s, so too did the assessments underlying real property taxes. Although values have improved sharply throughout the decade, assessments, by and large, have not kept pace. This has led most buyers to be wary of "reassessment risk," i.e., that upon sale, the assessor will increase the assessment to reflect the property's enhanced value. In some cases, it is possible for taxes to increase by more than 100 percent. It is fundamental to proper counseling to consider this risk in advising clients.

Insurance

As mentioned under administrative and general expenses, liability insurance is posted to this account, along with property insurance.

Reserve for Replacement (of short-lived assets)

Escrowing funds for ongoing asset replacement has become more pervasive than ever in the hotel industry. In part, this is the direct result of research published by the International Society of Hospitality Consultants. In its landmark *CapEx* study, it found that the traditional reserve of two-to-four percent of total revenue was woefully insufficient. The real economic cost of replenishing furniture, fixtures, and equipment at a level that ensures ongoing competitiveness was found to be closer to nine percent. As a consequence, the funds escrowed for replacement reserves are continuing to move upward.

SALARY RECAP

Most analysts recognize that the hotel industry is labor intensive. However, it is important to see just how far managers have been able to reduce payroll in the current market. Labor costs are certainly decreasing as a percentage of total revenue, amounting to 37.5 percent of revenues in 1990 and falling to 25.1 percent of revenues in 1997. However, in absolute dollars, payroll has basically been flat during the 1990s, as shown in *Table 2*.

Table 2

Comparative Payroll Costs[1]
(stated in amount per occupied room)

	1990	1997
Rooms	$12.70	$14.30
Food and Beverage	15.04	15.96
Telephone	0.47	0.48
Other Operated Departments	2.84	1.31
Administrative & General	6.02	5.36
Marketing	2.92	3.12
Property Operation & Maintenance	3.13	3.15
Total Payroll	**$43.12**	**$44.16**

The upshot is that hotels that have not kept pace in reducing labor costs have been left behind in today's market. While new hotels are designed to be much more efficient than older properties, there are still numerous techniques for managing payroll in every hotel. Positions such as night auditor have effectively been eliminated at many hotels, and several back office jobs such as accounting and payroll clerks that were once full-time are now part-time. A thorough review of payroll expenses is often a fertile area to investigate additional potential for expense minimization and profit growth.

CONCLUSION

The industry has seen a strong shift in profitability during the 1990s. This article has set forth a comparison of the industry in 1990 and 1997, showing the dramatic turnaround, and several reasons for the changes were cited. Now that the industry is heading into a period of more moderate profit growth, managers will look for ways to continue to generate strong earnings. Several examples of supplemental revenue growth were cited. The combination of background and current practices should enable professional counselors to approach hotel analysis with an enhanced perspective. REI

NOTES

1. Smith Travel Research, *Host Report*, 1991 and 1998 annuals
2. Departmental expenses are shown as a percentage of departmental revenue.