

# Canadian September 2007 Lodging Outlook



## HVS



SMITH TRAVEL RESEARCH

## What Were The Major Factors Affecting Capital Expenditures From 2000 To 2005?

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Successful hotel performance depends on the ability of asset managers to foresee capital expenditures. It is thus essential for hotel consultants and managers to be informed of current trends in capital expenditures and the factors that influence capital spending. "CapEx 2007, a study of capital expenditure in the hotel industry," produced by the International Society of Hospitality Consultants, provides a good overview of historical and current capital expenditure trends. This study examines the spending patterns of different types of hotel products, including full-service/luxury, extended-stay, and select-service hotels, between 2000 and 2005. This article will discuss the findings of this study and the variables that have affected spending trends from 2000 to 2005. These factors are business cycles, depreciation, and ownership structure.

### What are capital expenditures?

Capital expenditures are the total money spent on renovation, refurbishing, and replacing furniture, fixtures and equipment (FF&E) over a specific period of time and the cost to correct or update obsolescence (e.g. technology

updates, wear and tear, and updates for meeting brand requirements). The amount spent on capital expenditures is generally calculated as a percentage of total revenue. Capital expenditures are necessary for maintaining or improving a hotel's competitive condition; they are thus essential to hotel operating performance. The study indicates that capital expenditures averaged 5.1% of total revenue in the sample period, ranging from a high of 6.0% of total revenue for extended-stay properties to a low of 4.7% for full-service/luxury properties.

### Business Cycles

Business cycles have a direct impact on capital spending. The CapEx 2007 study examined hotel operating practices between 2000 and 2005. This period started "with a boom, became a bust, and then began some recovery."<sup>1</sup> The boom was the tail end of a prosperous period for hoteliers that ran from 1995 to 1999, during which time there were strong increases in capital spending. Poor economic conditions between 2002 and 2004 caused cash flows to decline, which in turn caused capital spending to diminish. In particular, the fallout from the terrorist

attacks on September 11, 2001, had a negative impact on occupancy rates and ADR, which caused capital spending on hotels to decrease. This slowdown in demand caused operating budgets to tighten. As a consequence, hotel owners began to negotiate brand requirements, and hotel chains and construction departments started closely examining proposed designs to ensure brand compliance. By the end of 2004 and the beginning of 2005, owing to a substantial increase in asset transactions and acquisitions by new owners, capital spending increased and much of the capital improvements occurred in the form of brand conversions, which added to increasing spending ratios. From these trends, we can observe that capital expenditures of hotels are extremely sensitive to business cycles and economic conditions.

### Depreciation

Depreciation also affects capital expenditure requirements. As a hotel ages, the amount spent on capital expenses and on repairs and maintenance (R&M) increases. The CapEx 2007 study demonstrates that capital expenditures and R&M costs increase

<sup>1</sup>International Society of Hospitality Consultants. "CapEx 2007, a study of capital expenditures in the hotel industry." Alexandria, VA: The Educational Institute of the American Hotel & Lodging Association. (2007): 11.



## What Were The Major Factors Affecting Capital Expenditures From 2000 To 2005? (Cont'd)

as a hotel ages. Generally speaking, minimal capital expenditures are allocated to newer hotels, and capital expenditures increase each year thereafter. According to the Capex 2007 study, hotels less than 5 years old had  $\pm 0.7\%$  of total revenue allocated to capital expenditures,  $\pm 3.1\%$  of total revenue was apportioned to hotels aging between 5 and 15 years, and  $\pm 10.5\%$  of total revenue was spent on capital expenses for hotels older than 15 years of age.

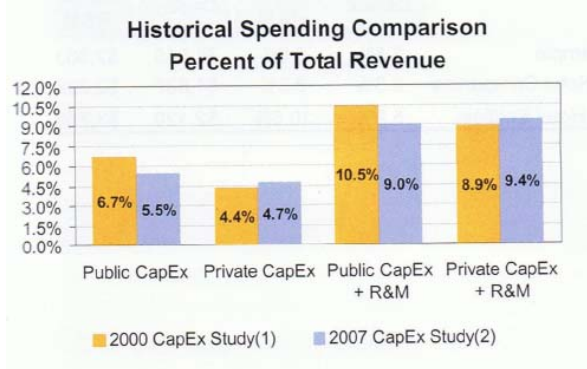
### Ownership Structure

The type of ownership structure also has an influence on capital spending. Generally speaking, there are two

types of ownership: publicly traded hotel companies (i.e. REITs and C-corporations) and privately held hotel entities (e.g. private corporations, equity funds, and pension funds). According to the CapEx 2007 study, publicly traded hotels have a higher spending ratio than privately owned hotels. Comparing the CapEx 2007 study to the CapEx 2000 study, the capital and R&M spending ratios for publicly owned hotels decreased, whereas an increase occurred for privately owned hotels.

There are several factors that can explain this spending pattern. As discussed earlier, world political events and economic conditions

between 2000 and 2005 had an impact on the amount spent on capital expenditures. Public and private companies employed different approaches for dealing with the changes in the marketplace, specifically, public companies' CapEx spending contracted to a greater degree than private companies'. In addition, the number of hotel transactions increased in 2004 and 2005, and several new private investors were attracted to the market. Renovations, re-branding, and market repositioning followed these transactions, resulting in higher capital spending ratios for hotels that are privately owned. Lastly, the rise in professional asset management in the private sector, concentrating on the return requirements of investors and additional profits, also contributed to the increase in spending ratios for hotels with this ownership structure.



Source: International Society of Hospitality Consultants. "CapEx 2007, a study of capital expenditures in the hotel industry." Alexandria, VA: The Educational Institute of the American Hotel & Lodging Association. (2007): 11.

### Conclusion

Capital expenditures are extremely sensitive to business cycles and economic conditions. Regardless of the hotel type, capital expenditure and repair and maintenance costs increase as a hotel ages. The type of ownership structure implemented has an effect on the amount spent on capital expenditures. As previously summarized, average capital expenditures for all hotel types was 5.1% of total revenue for the study period. ▲

## HVS - CANADIAN LODGING OUTLOOK

### DEFINITIONS

Occupancy:	Rooms sold divided by rooms available.
Room Revenue:	Total room revenue generated from the sale or rental of rooms.
Average Daily Rate (ADR):	Room revenue divided by rooms sold.
Room Revenue Per Available Room (RevPAR):	Room revenue divided by rooms available (occupancy times average room rate will closely approximate RevPAR).

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