

Canadian August 2003 Lodging Outlook



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Maybe The Reserve For Replacement Should Be 7% to 11% of Revenue

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To succeed in today's competitive marketplace your hotel must look, feel and be totally up-to-date. From the exterior curb appeal to the technology behind the telephone switch, the traveling public has become highly sophisticated in their hotel selection process. They know what they want. They know what is available; and they will not accept less than what they need. Hotel owners and operators must constantly upgrade and update their product in order to remain competitive.

Forty years ago, owning and operating a hotel was relatively simple. Guests were content with black and white televisions. Phones were single-line, rotary dial. Doors had real keys with tags. Front desk clerks could quickly survey the status of all the rooms with the color coded room rack. As long as the property's exterior was clean and sported a fresh coat of paint travelers would turn off the highway for a night's rest.

Today, hotels must anticipate the current and future needs of their guests and constantly change and improve their product. Outdated facilities suffer from what is known as functional obsolescence or a loss in

value caused by changes in style, décor, technologies, efficiencies, etc. Hotels with items of functional obsolescence may exhibit lower revenues and/or higher operating costs. The ultimate effect is a smaller bottom line profit and less value. Most items of functional obsolescence are curable, which means that by putting money back into a hotel in ways that correct the functional deficiencies hotels are able to reverse any adverse impact.

Hotel operators recognize the need for curing functional obsolescence when they establish a reserve for the future replacement of furniture, fixtures and equipment (FF&E). These items have relatively short lives and either wear out or become outdated in appearance. Remember shag carpeting, pink tiled bathrooms, rolling television carts and swag lamps? All out-of-date by today's standards. Even if a pink tiled bathroom was in perfect condition, guests would feel they were in a dated facility and the level of satisfaction would decline. Forty years ago an appropriate FF&E reserve for replacement would have been 2% of total revenue. Today, the industry standard has risen to 4% to 5% of

revenue because FF&E now represents a higher component of a hotel's total cost.

Looking into the future, hotel owner's must recognize this standard reserve for replacement will not be sufficient to handle technology replacements and upgrades. I predict the hotel room of tomorrow will contain highly sophisticated and very expensive technology that will add another 2% to 3% of total revenue to the reserve for replacement.

We still have not covered the total picture. The FF&E reserve for replacement described above is generally defined as personal property not permanently affixed to the real estate. It does not include plumbing, electrical systems, heating and air conditioning, exterior façade and structural components. These become old over time and also must be replaced. I have never seen a hotel owner or operator actually put aside a reserve for the replacement of major permanent components, but if they did, it would probably amount to 1% to 3% of total revenue.

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Adding the various reserves for replacement provides an indication of how much money must be put back to a hotel in order to protect it from functional obsolescence and physical deterioration. Between 4% and 5% are needed for FF&E, tack on 2% to

3% for technology and another 1% to 3% for permanent components yields a total requirement of 7% to 11% of total revenue.

While I do not think hotel owners should actually set up a reserve for

replacement to cover all of the expenditures described above, these outlays of capital are real and ultimately reduce the investor's long-term yield.

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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