Article | Intelligent Investment

Risk/Reward: Evaluating Hotel Capex Through a Finance Lens

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Capital expenditure (Capex) deferments, impending property improvement plans (PIPs), higher interest rates, and budget constraints make the diligent allocation of capital more important than ever.

There are six key areas capital commitment committees look for when evaluating a hotel Capex plan for approval; brand, operational impact, food & beverage opportunities, property condition, budget and financing. Following are six corresponding considerations to address when evaluating plans.

1. **Leverage your brand relationships to negotiate extensions or modifications of your PIP requirements.** Come prepared with your guest satisfaction scores, revenue per available room (RevPAR) Index, the impact of displacement and closures on revenues, and the cost and timeline assessment from your project management team. Have these discussions early and often. If you own a portfolio, consider offering to renovate a lagging asset in a high-growth market instead of a leading asset in a lagging market regardless of their PIP cycles, assuming they are part of the same family.

2. **Collaborate with revenue management, in-house or external project management advisors, and the GM to time and scope the renovation for maximum impact and minimum disruption.** It can be challenging to predict shifts in future demand patterns and to assess new cyclical patterns. When trends shift from heavily business travel to more leisure, group, or combination travel, what amenities should you eliminate and which should you add? What does your consumer research suggest? Should your loyalty lounge be converted into a skyline bar? Should some of your meeting space be converted into an attractive pool? Would it be possible to add a rooftop bar or speakeasy in underutilized interior space? How long are supply chain delays running? When will demand be the lowest and the revenue loss be minimized? How will the renovations impact guest satisfaction and public ratings?

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3. **Apps, a growing expectation of instantly meeting needs, and labor constraints make reassessing F&B a must with any remodel.** At properties in or around metropolitan areas, guests venture out for food or frictionlessly order delivery from any number of chains and independents alike. The hotel F&B has to offer an experience, not just food, and doing so profitably in today's environment of labor shortages and high inflation is no easy feat. Consider whether you can pre-sell rooms with F&B (commonly breakfast or even a Modified American Plan). This will facilitate staffing, higher capacity utilization, and ultimately higher cash flow. If not, can you constrain the menu to a cocktail-forward tapas-style menu with three entrees and a grab-and-go venue? If none of those options are viable and leasing out the F&B space isn't an option, can it be converted into meeting space, a lounge, a members' area, etc. and can you form partnerships with a "ghost kitchen" or several restaurant venues in the area? Get creative. Work with an expert in the area to refine the potential financial risk/reward.

4. **Conduct a building conditions assessment before starting.** The physical health of a hotel is often an overlooked area of opportunity. A building conditions assessment can reveal the overall health of the property and help identify a timeline and costs to address any building deficiencies as well as furniture, fixtures, and equipment (FF&E) condition concerns. When a building conditions report reveals concerns such as a deteriorating HVAC, or faulty roofing/exterior envelope, planned capital deployment may have to be redirected to address higher priority areas of concern that if not addressed, could greatly impact a hotel's operation and trickle down to the bottom line.

5. **Build a realistic and complete long-term capital budget; don't rely on the 4% rule.** Two key capital budgeting concerns to be mindful of are depleting FF&E reserve accounts for routine expenditures and failure to replenish accounts after deferments. Without a solid understanding of the funding in place and what still needs to be raised, improvement projects often stall, negatively impacting guests, returns and morale. Once there is a good understanding of FF&E reserve amounts owners and operators can make strategic decisions about funding future capital expenses, either by a one-time infusion or by increasing the reserve percentages. All franchisors and most lenders require owners to set aside a percentage of their revenues (typically 4 to 5 percent) in a restricted bank account to fund future replacements and upgrades. The reality is that these minimum percentages are usually insufficient to cover actual upgrade costs. Calculating a more realistic budget that considers multiple variables such as the hotel's age, type of property (full service or limited service), chain scale, inflation, shifting consumer preferences, and type of ownership (public or private), and more will help determine the overall scope of required improvements over time and to calculate a more realistic amount of funds that will be needed in the FF&E reserve.

6. **Finance the investment.** This first line is always FF&E reserves. If reserves are insufficient, refinancing, (particularly if a property is not highly leveraged) should be considered. During the refinancing process, lenders will evaluate how new capital projects will impact future operating performance and consider revenue loss or displacement due to disruptions during construction. It is best to work with an integrated finance and project management consultant or develop your own forecasts and estimates to effectively negotiate during this period. Other potential sources of funding include Property Assessed Clean Energy (PACE) programs or financing and incentive programs backed by local utility companies. Local and state governments often offer economic development grants for projects that will generate tax revenues and create employment opportunities in "opportunity zones," or areas where capital investment is needed. Alternative approaches, which may be considered less attractive, include issuing a capital call to equity partners, selling common or preferred equity, selling the asset to an entity willing to assume the cost of renovation within the purchase price, moving the asset to a lower tier (rebrand), or changing the hotel to independent.

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