Is It Time to Rebalance the FF&E Reserve Account?

By Chad Crandell
President,
Capital Hotel Management
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As a result of the recent sharp declines in the stock market, investment advisors are counseling their clients to rebalance their investment accounts to reflect the dynamics of a changing economy. That same advice can be applied to hotel owners and their capital expenditure allocations.

With the hotel industry still struggling to recover from a recession and the hangover of the September 11 terrorist attacks, owners should be spending time with their asset managers re-evaluating their capital expenditure priorities. Declining revenues are causing Furniture, Fixture & Equipment (FF&E) reserve accounts to shrink, making the decision to allocate funds between emergency repairs, hotel brand standard requirements and planned renovations and replacement of FF&E all the more difficult.

Successfully managing a hotel asset is always a juggling act that requires careful and on-going attention. Lenders, who control the purse strings, want to clearly understand capital expenditure plans and, as a result, may require that certain projects be done, even if they aren't necessary at the time.

To find out how you can best rebalance your capital expenditures account, begin with reviewing all the documents with your franchisor, management company and lender. The latter is especially important if you are due shortly for a refinancing or are trying to renegotiate your existing loan. If so, consider taking out some equity to cover your FF&E expenditures. While it hurts in the short-term, it could pay significantly higher returns as the economy rebounds.

Because development is in sharp decline, owners now are in a better negotiating position when dealing with their franchisor. With a lot of flag-switching taking place , brands are more willing to work with their franchisees to keep them in the system. Take advantage of this window of opportunity to modify or extend the timing of committed capital requirements to your hotel that were negotiated in a significantly different operating environment. Ideally, a capital program should be developed for a period of 10 years, that reflects the renovation life-cycle of the hotel. This 10-year capital plan should then be updated annually concurrent with a 10-year proforma to evaluate budgeted FF&E reserve allocations against anticipated capex funding requirements. This way, the commitment of annual capex funds to renovations and replacement of FF&E are done in context with the capital needs in subsequent years to avoid a situation where inadequate funds are available to address future capital requirements. With a 10-year plan, you have more flexibility on the timing of capital expenditures, which can be especially useful if you plan a major renovation in 5 to 6 years based on "saving" FF&E reserve funds to meet this cost without requiring new capital from the owner.

Certainly the last two years are a good lesson. Because revenue is down over that period, there will be lower reserves. But, wear and tear also should be less than planned. With a more flexible plan, owners can complete the "have-to-do" projects versus those projects that were scheduled for completion according to a plan that may no longer be viable.

In organizing your 10-year capex plan, prioritize your capital expenditures, breaking them into three categories: have-to-do (e.g., fix the roof when it leaks), nice-to-do (replace carpeting and other soft goods), and smart-to-do (those items that require additional investment to generate higher revenues, such as a makeover of a restaurant or upgrading meeting facilities).

In every case, estimate the return on investment. Any expenditure that has a projected return higher than your investment hurdle rate should be moved up to the top of the list.

Balance that against which expenditure will have the most immediate guest impact. Obviously, a front-of-the-house investment will almost always generate a better return that a back-of-the-house investment…for the short-term. If you have limited funds, go with what gives the greatest immediate returns.

If funding remains a problem, consider leasing. While leasing often is more costly in the long-term, it may be your only choice if you need new televisions or telephones. When creating the contract, negotiate a buy-out option that will allow you to periodically acquire the equipment outright at an attractive price. When looking at computers, leasing may be the best option. With the constant improvements in computers, their useful life is about three years. It is better to get new computers to make your employees more productive if they are working on obsolete equipment.

The last thing to consider in your balancing act is maintenance. While you may be tempted to reduce maintenance to keep cash to pay the bills--shampooing the carpets annually instead of semi-annually, for example--that strategy could come back to haunt you. Carpet stains built up over a longer period, often making them impossible to remove, which results in having to replace the carpet several years ahead of schedule.

Asset management is no longer a passive, once-a-quarter review process. It requires constant review and oversight, in all aspects of the operation. FF&E budgeting is just one of the many balls that must be juggled to help assure maximum hotel profitability.

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Editor’s note: *Co-founder of Capital Hotel Management, Chad Crandell is president and operations leader of hotel investment advisory/asset management services for CHM. Since its* *inception, the company has provided asset management services to owners/ developers/investors on hotels and resorts throughout the United States valued at more than $1.0 billion.*