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Opinions

With CapEx, is it time to ditch replacements reserve?

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Changing how CapEx property improvements are funded will require the commitment of all stakeholders, including both investors and lenders.

By David Berins

It's now been 23 years since the International Society of Hospitality Consultants first published its “CapEx, A Study of Capital Expenditures in the U.S. Hotel Industry.” That seminal publication, and its subsequent updates in 2000, 2007 and 2014, provided hard data confirming that the percentage reserve for replacements baked into every deal underwriting, appraisal, lending document, franchise agreement, management contract and investment prospectus was bogus, or at the least an incorrect method of assuring that hotels were adequately capitalized.

But, other than increasing the typical reserve from 3% of revenues to 4% or 5% (after a ramp-up for new properties), not much has changed. Several factors in our industry are impacting the amount and frequency of capital investment required to keep a hotel competitive:

- The profile and motivations of owners changed substantially in the past 23 years. Institutional owners with long-term investment horizons were replaced by private and public equity funds with short-term perspectives. The percentage reserve that was designed to smooth out the capital calls for long-term players was irrelevant to investors holding for five years or less.
- The proliferation of brands that accelerated in the past few years has driven a need for far higher investment in legacy brand properties, especially within the same family of brands. Owners are being forced to repurpose their properties to fit them into slots that the multi-brand companies have created to spur unit growth and dodge impact issues.
- The costs of construction, furniture, fixtures and equipment, and operating supplies and equipment have skyrocketed and are likely to get worse if international trade disputes can't be resolved. This upward pressure on property improvement plans and costs of regular replacements, combined with increasing interest rates, make CapEx needs harder to predict and to fund from reserves.

So, what does all this mean? Almost no one thinks the current method of capitalizing replacements of and renovations to not only FF&E, but building systems like elevators, roofs, chillers, windows and the like is working. Is it time for the percentage reserve for replacements to go? Yes! It is broken, and we need to fix it. But how?

Changing the method of funding CapEx will require the commitment of all stakeholders, putting aside their parochial interests for the common benefit of clarity in the capital markets on this very important difference between hotels and other types of commercial real estate. Investors and lenders need to know that a better system for funding CapEx is being implemented, not just commented on with each update of the ISHC study.

Fundamentally, the new method should include a long-term (e.g. 20 years) rolling prediction of probable capital improvements that will be needed on an area-by-area, line-item-by-line-item, basis. The scope of "regularly scheduled replacements and renovations" projects for soft goods, full renovations, reconceptualizations, technology and other categories of projects should be negotiated, and included in detail, as appendices to all the license, management and financing agreements as commitments by all parties.

For example, if the franchise agreement calls for a full lobby renovation in years eight and 16 of a 20-year license, then the brand cannot impose material changes to the lobby except in those years. When an owner sells or refinances a hotel, any PIP should tie to the regularly scheduled replacements and renovations that have been agreed to and the buyer must assume the commitment. If a management company wants to re-concept a restaurant, it should be scheduled according to the plan, not ad hoc. All parties, whether they will be involved in the property for five years or 30, should not only comply with their commitments, but to assure that their successors will as well.

The funding of these scheduled replacements and renovations can be accomplished in a variety of ways to be agreed upon and committed to. For example, scheduled replacements of certain FF&E (certain carpets, rugs or drapes) might be funded by a typical reserve based on either usage (occupancy) or time (e.g. every five years) and larger projects can be funded by contractual commitments (e.g. letters of credit or proof of funds to be provided by owners on a date certain in advance of the deadline for starting the project) or deposited into actual sinking funds.

However the funding mechanism is worked out, it should not (with certain exceptions):

- depend on the economy, or performance of the hotel in a slump;
- be accrued or otherwise booked without being funded;
- be distributed to sellers or owners on a sale or refinancing; or
- be under the control of the management company or brand.

But it should:

- be held by the lender or an escrow agent and released on documented draw requests in accordance with the latest 20-year plan; and
- be transferred to a buyer if the property is sold.

Big change requires big thinking. The adoption of periodic updates to the uniform system of accounts for hotels is an example of various constituencies agreeing to industry-wide updates. The American Hotel & Lodging Association, its Industry Real Estate Financing Advisory Council members and legal committees should be heavily involved in implementing this long-needed change. Lenders and investors will also want a say.

It will take time and work, but it's time to stop kicking the can down the road. Investments, loans and transactions should be based on the real costs of owning a hotel. Let's get to work!

This article is an excerpt from ISHC CapEx 2018: A Study of Capital Expenditures in the Hotel Industry. The book presents data on trends in capital expenditures by various hotel segments, including full service, select service and extended stay and will be available January 28th, 2019. Please visit ishc.com/ishc-cap-ex/ for more information.

David Berins, ISHC, is a 52-year veteran of the lodging industry including leadership roles in operations, ownership, asset management and consulting. He has been a valued business advisor to many of the industry's most prominent brands, investors, developers, management companies and lenders. He is known for his strategic vision, fact-based thinking, objectivity and candor. David is also a member of the AAA Panel of Neutral Arbitrators and is frequently called upon to help resolve disputes involving hotels.