Asset Management

Demystifying working capital for hotel owners

by *Celeste Ledoux, CHMWarnick* | Aug 22, 2016 12:44pm

As an asset management firm, we often get questions about working capital; specifically, what level is appropriate for a given hotel? These questions typically stem from a need for cash to pay debt service or fund capital investment, the desire to improve cash investment returns by pooling and investing at a higher level, or as a result of one hotel comparing more favorably in terms of working capital needs to another within the same portfolio.

I wish the formula were simple. Remember when $1,000 per room was the standard? Some days I am not even sure the question being asked is even the question at all.

What I do know is that all owners want to get the most return they can out of an asset—cash is king. Am I getting the maximum cash out of the property? Answering whether a particular property is distributing the maximum amount of cash each month is an easier question. We can look at the cash flow forecast and determine the amount of cash the property needs to retain each month. Active oversight of the balance sheet ensures the property is turning assets as quickly as possible and paying bills at the end of the credit term.

The more difficult question to answer is: "Why does one hotel require more working capital than another?"

Clearing Up Confusion

Let's start with the basics: **Working Capital = Current Assets - Current Liabilities**.

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The formula appears easy enough, but for some reason the concept has become confusing for the hotel industry. Management contracts dictate "Initial Working Capital or Required Working Capital," however, the amount stated only equals real working capital on day one of a hotel's opening. After that, the property makes or loses money, distributions are made, long-term assets are purchased and working capital is no longer the same, but rather a moving number.

To make matters even more confusing, in practice, some management companies take the working capital number in the management agreement and retain that amount of cash at the end of each month. At some point the terms "cash" and "working capital" became interchangeable. A CPA by trade, I fought it for a while, but now, I find it easier to just make sure I know what the other party is talking about when they say working capital, rather than point out the correct terminology.

As I said, if we are talking cash, I can usually answer that question after working with the property team and getting a sense for operational needs. However, if the question is truly about working capital, it takes a little more work.

Another confusing concept is that hotel owners are looking for their property balance sheets to have low working capital. For a typical company, a higher working capital number is a sign of financial health, because it is a measure of whether or not a company can pay its short-term bills. Hotels are not typical companies, primarily because we are not analyzing at a full set of books, but rather only looking at hotel operations. For the most part, we are looking at Accounts Managed by Owner – most often current assets and current liabilities (excluding short-term portion of debt).

So for the sake of this discussion, you have to think of non-cash assets as "bad" and liabilities as "good."

Beginning The Analysis

So, you want to see how your hotel stacks up against other hotels?

Step 1. **Know what the working capital is** for the subject asset. In order to do this, you need to be looking at the detailed balance sheet and remove anything that is neither operating, nor short-term. Replacement Reserves, Fixed Assets, Old Liabilities from acquisition that won't get paid, and bad assets should all be adjusted off. In the short-term, these items will not become cash, nor will they draw from cash.

Step 2. **Identify comparable hotels.** There are so many things that make balance sheets difficult to compare, there are times I think the whole exercise is useless. However, there are some things you can do to improve comparability.

- Pick hotels with the same operator and brand franchise. The differences are more significant with the brand managers because they have more centralized services and have the ability to dictate how those are paid. Marriott modified its accounting system so that working capital stays the same by putting the income or loss for the period on the balance sheet and then routinely distributing the income. Marriott also treats employee liabilities and property taxes different than most other brands or brand managers. Picking hotels with common management and brand becomes virtually impossible when you work your way through the rest of Step 2. In the end, you will have to explain

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the differences in working capital requirements based on the brand and/or manager.

- Pick hotels with a similar mix of business. Segmentation plays a huge part in how quickly a hotel stay is converted into cash. You simply cannot compare a group house to a transient operation. And watch out for those Crew Contracts…they may put heads in beds, but they are the slowest to pay.
- Geography – Property tax amounts and the timing of when they are paid, vary significantly from jurisdiction to jurisdiction. Some are 100 percent in arrears, some are paid two times a year in arrears, and some are prepaid. Given the size of taxes at a particular hotel, these variances can significantly impact a working capital analysis. Is your property in a hurricane or earthquake zone? It probably has a significant prepaid at the start of the term year.

Step 3. Once you have a handful of comparable hotels, you need to **comb through those balance sheets** and make the same adjustments that you made to your subject hotel in Step 1 to the comp hotels.

Step 4. **Look for exceptions**–and there are many. Anything else unusual going on or unique to a specific property? A hotel undergoing renovation may have huge liabilities related to those payments that can't be easily separated from regular accounts payable. Are the lender reserves on the hotel balance sheet? If so, remove them. Seasonal fluctuations can also have an impact in certain markets so it is important to look at several months to a year.

Conclusion

Analyzing working capital is a great educational exercise, but it can be time consuming, so consider the below pros and cons so that your team can understand the goal of the project.

Pros for low working capital:

· More cash to owner to pay debt service, pay for renovations, allocate to other investments in the portfolio, or distribute to increase IRR.

· Owner can consolidate and invest cash for their whole portfolio. Most cash at hotels is not earning much interest, if any.

· Limited cash forces the manager to operate more efficiently (collect A/R – grow A/P).

· Less risk of fraud or fraud will come to light earlier.

Cons of low working capital:

· Cash management is unpredictable and time consuming especially over a short time frame. Many owners find the variances frustrating. Further, where do you want to your property teams' efforts focused –managing cash or managing labor? Labor can be 60 percent of a hotel's costs–savings by actively managing labor is significant and permanent.

· This is all about timing. The owner will have to pay these liabilities eventually. If you grow A/P to an untenable state, capital calls may result or you will get a surprise at disposition.

· Can owner fund the hotel if cash becomes really tight? Many can't so it is important to have this conversation with ownership before pulling cash out.

· Seasonality has a big impact in certain areas, making lower levels difficult to maintain.

Celeste Ledoux is managing director and CFO of CHMWarnick, a provider of hotel asset management and owner advisory services. The company asset manages over 50 hotels comprising approximately 21,000 rooms valued at roughly $10 billion. CHMW's owner advisory services cover virtually every aspect of the hospitality industry, and all phases of a hotel's life cycle, including specialized ownership accounting services. For more information, visit www.CHMWarnick.com.