

# Why the Management Team Should Be Important to Hotel Lenders

by Stephen Rushmore

**L**enders that originate hotel loans without thoroughly investigating the quality of the management company or management team are overlooking one of the most important components of a hotel investment. Hotels are more than real estate; they are businesses requiring highly specialized management expertise supervising the operation on an ongoing basis. Hotels generally do not fail because of problems with the real estate; they usually go under because management is inept. It is incredible how many well-recognized lodging chains are incapable of generating revenues while at the same time minimizing expenses. Some operators seem to believe that if superior service is provided and the guest is satisfied, the bottom line is not important.

Lenders rely on net income to fund debt service, so the bottom line is vitally important. Unfortunately, very few hotel lenders perform the necessary

due diligence to verify the money-making ability of the management company.

To illustrate these observations, the data base of Hospitality Valuation Services was researched for actual hotel operating statements; three were found that represent similar hotels, each containing approximately 350 rooms and each situated in large metropolitan areas. The average room rates also form a narrow band ranging from \$95 to \$113. Anyone would recognize the names of these three operators; in fact, the reader has probably stayed at one of their hotels.

The three profit and loss statements in Table 1 illustrate the performance of these operators.

□ *Chain 1* has what might be called competent management. The hotel is operating at 75 percent occupancy and its departmental expense ratios are in line with industry standards: Rooms expense at 24.8 percent and food and beverage at 82.3 percent. The income before fixed charges is 24.5 percent and the bottom-line profit per room is \$9,425. Using a 10 per-

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TABLE 1. PROFIT AND LOSS STATEMENT FOR THREE HOTEL CHAINS

	Chain No. 1			Chain No. 2			Chain No. 3		
Number of rooms	350			350			350		
Occupancy	75.00%			64.00%			75.00%		
Average rate	\$95.00			\$100.00			\$113.00		
	\$	% of	\$ Per	\$	% of	\$ Per	\$	% of	\$ Per
	(thousands)	Gross	Room	(thousands)	Gross	Room	(thousands)	Gross	Room
<b>Revenues</b>									
Rooms	9,102	56.50	26,006	8,176	58.30	23,360	10,827	57.50	30,934
Food	4,005	24.90	11,443	3,450	24.60	9,857	5,528	29.30	15,794
Beverages	2,155	13.40	6,157	1,370	9.80	3,914	1,541	8.20	4,403
Telephone	337	2.10	963	280	2.00	800	414	2.20	1,183
Other income	509	3.20	1,454	750	5.30	2,143	531	2.80	1,517
Total revenue	16,108	100.00	46,023	14,026	100.00	40,074	18,841	100.00	53,831
<b>Departmental Expenses</b>									
Rooms	2,255	24.80 <sup>(a)</sup>	6,443	2,630	32.20 <sup>(a)</sup>	7,514	2,050	18.90 <sup>(a)</sup>	5,857
Food & beverage	5,069	82.30 <sup>(a)</sup>	14,483	4,420	91.70 <sup>(a)</sup>	12,629	4,807	68.00 <sup>(a)</sup>	13,734
Telephone	364	108.00 <sup>(a)</sup>	1,040	405	144.60 <sup>(a)</sup>	1,157	414	100.00 <sup>(a)</sup>	1,183
Other income	0	0.00	0	300	40.00 <sup>(a)</sup>	857	420	79.10 <sup>(a)</sup>	1,200
Total expenses	7,688	47.70	21,966	7,755	55.30	22,157	7,691	40.80	21,974
<b>Departmental income</b>	8,420	52.30	24,057	6,271	44.70	17,917	11,150	59.20	31,857
<b>Undistributed Operating Expenses</b>									
Administrative & general expenses	1,498	9.30	4,280	1,506	10.70	4,303	1,601	8.50	4,574
Management fee	786	4.90	2,246	500	3.60	1,429	565	3.00	1,614
Marketing	783	4.90	2,237	990	7.10	2,829	885	4.70	2,529
Property operation & maintenance	669	4.20	1,911	460	3.30	1,314	772	4.10	2,206
Energy	741	4.60	2,117	920	6.60	2,629	603	3.20	1,723
Total UDOE	4,477	27.90	12,791	4,376	31.30	12,504	4,426	23.50	12,646
<b>Income Before Fixed Charges</b>	3,943	24.40	11,266	1,895	13.40	5,413	6,724	35.70	19,211
<b>Fixed Charges</b>									
Property tax	322	2.00	920	168	1.20	480	641	3.40	1,831
Insurance	48	0.30	137	252	1.80	720	38	0.20	109
Reserve for replacement	274	1.70	783	421	3.00	1,203	509	2.70	1,454
Total fixed charges	644	4.00	1,840	841	6.00	2,403	1,188	6.30	3,394
Net income	3,299	20.40	9,426	1,054	7.40	3,010	5,536	29.40	15,817

(a) percentage of departmental income

cent capitalization rate equates to a value per room of \$94,000, which is in line with the rule of thumb that states that every dollar of average rate equates to \$1,000 of value on a per room basis (\$95 average rate equals a value per room of \$95,000).

□ *Chain 2* has management that should be tagged incompetent. Even though this hotel is located in a market where the areawide occupancy is 72 percent, the operator's lack of marketing expertise is evident by the fact that the achieved occupancy level is only 64 percent. The expense ratios are totally out of control. Rooms expense is at an astronomical 32.2 percent, while the food and beverage department must be losing thousands of dollars with a departmental

expense ratio of 91.7 percent. The income before fixed charges is only 13.4 percent and the profit per room is a meager \$3,010. Using the same 10 percent capitalization rate, the value per room of this property is only \$30,000.

□ *Chain 3* has what must be classified as super-competent management. Its occupancy is somewhat above the areawide average and its room rate has also been maximized. The all-important expense ratios demonstrate strong management control with rooms expense at 18.9 percent and food and beverage at only 68 percent. The income before fixed charges is 35.7 percent and the profit per room stands at an incredible \$15,816. This indicates a value per room of

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\$158,000 using the 10 percent capitalization rate, an enviable achievement.

Based on a continuous review of hotel financial statements, I would estimate that only 5 percent of the hotel management companies in the United States can achieve the superior results demonstrated by Chain No. 3. More than 60 percent should be classified as incompetent and the remainder can only be considered as fair-to-good hotel operators.

**Summary.** What do these conclusions mean to hotel lenders and investors? They mean that the management company should be investigated as thor-

oughly as is the real estate and the borrower. Lenders and investors should demand that their feasibility study or appraisal use the demonstrated operating ability of the management company that will be running the property rather than some generic-hypothetical management that most feasibility firms utilize. A broad sample of actual operating statements from the management company should be reviewed, then selected statements that represent properties that are similar to the intended investment should be evaluated. Investors and lenders should overlook the flashy service, gourmet restaurants, and fruit baskets and concentrate on the bottom line. ■