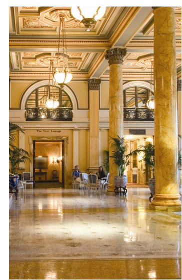
MARCH 2011

RevPAR- ADJUSTED BUDGETS: THE ONLY ONES WORTH LOOKING AT

(PART 1 OF 3)

Miguel Rivera
Senior Vice President,
HVS Asset Management & Advisory



www.hvs.com

HVS Asset Management & Advisory
100 Bush Street, Suite 750, San Francisco, CA 94104 USA

Budgets are a good planning tool for hotel operators, owners, and other stakeholders. However, it is inappropriate to use them as benchmarks to measure a manager's performance. It is intriguing then that so many people in the industry use them as targets to measure and reward performance. Perversely, this very fact makes budgets even less reliable, as it gives everyone involved in the budgeting process strong incentives to sway the numbers to their own advantage. Budgets are, at best, educated guesses of future performance, but they are not a substitute for indicators of actual performance against the rest of the market. One of the best ways to make budgets relevant is to adjust them using actual RevPAR indexes as the year progresses. This article describes a way to make these adjustments.

PART I

This article is the first of a three-part series that will explain the rationale, methodology and results related to RevPAR-adjusted budgets. Adjusting budgets for a market's RevPAR performance is proposed as a far superior tool to measure management's performance, compared with unadjusted budgets. This first article explores the perils of using unadjusted budgets, and lays the foundation for the introduction of RevPAR-adjusted budgets.

MISALIGNMENT OF INTERESTS

Budgets are usually prepared by hotel operators and presented to hotel owners, who generally have a chance to review and approve them before they are finalized. Hotel general managers and other members of the executive team are often compensated with bonuses that depend partly on how their hotel performs relative to the budget. This gives them every incentive to produce the most conservative budget that the owner will approve. In other words, if the budget sets the bar, it is in their best interest to set the bar as low as possible. This is generally true whether the executive team works for a hotel operating company or directly for the owner.

While hotel management companies are rarely directly compensated based on their performance against budget, the tenor of their relationships with ownership groups often revolves around how they performed relative to budget. Therefore, hotel companies also have a bias toward conservative budgets. By contrast, ownership groups are able to demand more of their operators the more aggressive the finalized budgets are; therefore, their best interest is served by having the operator agree to the most aggressive budget possible.

BUDGETS AS PLANNING TOOLS, NOT PERFORMANCE BENCHMARKS

Perhaps the best example of why budgets should not be used as performance benchmarks has occurred over the last three years. In 2009, nearly every hotel in the country performed below its budget. In retrospect, this was not surprising; in 2008, nobody had the foresight to predict the extent of the financial crisis or its impact on the hotel industry. To have judged managers at the end of 2009 based on their failure to meet budget would have been unfair. Their performance should have been judged against the market. Even declining revenue per available room (RevPAR) should have been praiseworthy, if it meant a smaller decrease than for the rest of the market.

By contrast, in 2010 many budgets reflected very conservative assumptions made in the midst of an unusually uncertain environment. At the end of that year, it would have been unwise to praise operators based on their performance exceeding budget. The excess performance that the market produced for them was as much out of their control as the underperformance generated the previous year. Management performance, again, should have been judged against the market.

There is a need then to separate between results generated by the market and those generated by management skill. The most practicable way to do this is to adjust the budget on an ongoing basis based on RevPAR performance against the market. RevPAR encapsulates both occupancy and average rate (ADR) performance into a single metric. It is also an indicator of a hotel's total rooms revenue performance (since RevPAR X Available Room Nights = Rooms Revenue). Because there is an inherent tradeoff between a hotel's occupancy and its ADR (it is easy to achieve a high occupancy at a very low ADR and vice versa), RevPAR represents the best measure of overall hotel performance within its marketplace. Comparing a hotel's RevPAR to those of its competitors using a RevPAR index (Property RevPAR / Market RevPAR X 100) provides the best indication of how competitive that property is within its market. One of the best signs of good management is a high and/or increasing RevPAR index[1]. Generating the maximum capture of revenue market share creates the greatest potential for maximizing profits. Market-wide RevPAR data are readily available in most locations through a service like Smith Travel Research. It is worth pointing out that in order for RevPAR indexes to be truly relevant, the set of competitive hotels selected to calculate them is of great importance; it should truly reflect the competitive options potential guests face when choosing a hotel in the location and of the product type concerned.

Yearly budgets, of course, still have a place in planning capital and labor needs. In fact, they have a multitude of other valid uses—but performance measurement is not one of them.

MEASURING MANAGEMENT PERFORMANCE

Management's effectiveness in generating cash flow must be judged on two primary metrics: first, its ability to generate an appropriate share of revenue within its competitive market; and second, its ability to convert that revenue into cash flow available to the owner.

In order to make meaningful comparisons between actual and budgeted results that focus on management's—rather than the market's—performance, HVS strongly recommends restating budgets in terms of the RevPAR that should have been achieved given an explicit or implied RevPAR penetration target. The second article in this three-part series will illustrate how to accomplish this.

---

1 Some qualifiers to this statement are warranted. By "high RevPAR index" we mean a high RevPAR index for the property in question after taking into account its physical condition, location, amenities, and other physical attributes. Hotels with substandard attributes cannot be expected to outperform the market, but good managers can achieve higher RevPAR indexes than hotels—regardless of their condition—would warrant on their own merits. Furthermore, market leading hotels often cannot keep increasing their RevPAR indexes forever, as competitors copy their practices, entice away their clients, or begin collecting the "low hanging fruit" in their own operations. Finally, within some narrow ranges, a lower RevPAR can sometimes lead to a higher profit. This can happen depending on the particular occupancy and ADR mix of such RevPAR, and the fixed and variable cost structure of a particular hotel.

About HVS

HVS is the world's leading consulting and services organization focused on the hotel, restaurant, shared ownership, gaming, and leisure industries. Established in 1980, the company performs more than 2,000 assignments per year for virtually every major industry participant. HVS principals are regarded as the leading professionals in their respective regions of the globe. Through a worldwide network of 30 offices staffed by 400 seasoned industry professionals, HVS provides an unparalleled range of complementary services for the hospitality industry. For further information regarding our expertise and specifics about our services, please visit www.hvs.com.

About the Author

Miguel Rivera is SVP of Asset Management & Advisory at HVS. He advises clients on maximizing real estate value and aligning a property's operations with its investment goals. He has more than 14 years of experience in real estate finance, including asset management, brokerage, financing, credit ratings, and appraisals. Prior to joining HVS, he was SVP at Jones Lang LaSalle Hotels, where he worked on more than $880-million worth of hotel real estate transactions while leading that group's Latin American operations. He holds an MBA from Yale and a BS in Hotel Administration from Cornell.

For further information, Mr. Rivera can be contacted at:

HVS Asset Management & Advisory
100 Bush Street, Suite 750
San Francisco, California 94104
United States of America
Tel: +1 (415) 268-0368
Fax: +1 (415) 896-0516
mrivera@hvs.com