

## Christie + Co Market Analysis

### Is the UK hotel sector sitting on a capex time bomb?

The lack, and misallocation, of capital expenditure could see a significant number of hotels miss the initial phase of a recovery that is moving ever closer, and also impact on their long-term viability, according to Christie + Co, the specialist property agent and advisor.

Capital expenditure (capex) tends to be one of the first things to be cut during a downturn, as owners focus on short-term survival over long-term strategy. A significant number of hotel owners either cannot afford or are ignoring the continuing need for capital expenditure throughout their businesses.

At the same time, lenders and operators are increasingly taking an active interest in the Capex and Furniture, Fixtures and Equipment (FF&E) reserves of the hotels that they are involved in to see if the funds are being used as intended or as a means to mitigate trading shortfalls. They now want to see that a clear rationale exists for how the capex fund is being, and will be, used.

Customer expectations are also constantly evolving, and hotels that are failing to update their offer could lose repeat business in the face of new hotel supply coming into the market.

Andreas Scriven, Head of Consultancy at Christie + Co, said: “Capex is often the first thing to be cut during a downturn, but owners who haven’t invested are likely to miss out on the initial upturn in trade when it comes. In addition, a hotel that has not seen investment is at risk of affecting a brand’s reputation, which is of significant concern to brand owners looking to protect their brand equity.

“Any lack of investment now will impact businesses at the beginning of the recovery and in the long-term, as they are not only competing against existing hotel supply but also new supply entering the sector. The list of underinvested, underperforming legacy hotels in the UK is already long, so owners seeking to avoid being added to that list need to ask themselves if they can afford to stand still. Similarly, lenders who refuse to release additional funding for capex programmes may find themselves with a permanently impaired asset on their books.”

## Capex terminology:

**Property Operation and Maintenance (POM)** — operating costs incurred in the upkeep of the hotel, its grounds and its fixtures and fittings, including staff wages and costs of wages.

**The Furniture, Fixtures & Equipment (FF&E)** of a hotel are often exposed to heavy use and must be replaced at regular intervals. Periodic replacement of FF&E is essential to maintain in the quality, image and income potential of a hotel. As such, a 'sinking' fund is set up to accumulate capital for the periodic replacement of FF&E, typically a percentage of gross revenue. Included in this category are items that are typically capitalised rather than expensed, which means they are not included in the operating statement, but nevertheless affect an owner's cash flow.

**FF&E Replacement Reserve** — provision for the replacement of FF&E to allow essential capital expenditure to maintain the fabric of the property throughout its economic life.

**Percentage of Revenue** — This is somewhat dependent on the positioning of the hotel. In general, hotel management and franchise agreements typically provide for a reserve for the replacement of FF&E of 3-5% of total revenue. For new openings, this will start lower and be ramped up in the initial years.

**Routine and Discretionary Capital Improvements** — Typically, capital improvements are divided into routine capital improvements (which are funded through the FF&E reserve account), which are required to maintain revenues and profits at their present levels, and discretionary capital improvements (also called ROI capital improvements) These later capital movements are investments that are undertaken in order to generate more revenue and profits, such as the conversion of offices into meeting rooms. The latter require owner approval and are in addition to the funds expected from the reserve account.

**Capex Programme** — It is generally recommended that Capex takes place on a rolling programme, with each area of the hotel receiving investment every six to eight years. The level of investment (e.g. hard or soft refurbishment) and frequency of investment generally depends on the quality of the original furniture and fittings, plus the occupancy and wear and tear at the hotel.

— Ends —

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