

A Look at Projections; Is It Time for Change?

For decades, industry participants have performed simple cash flow projections when examining lodging assets. Typically line item revenues and expenses are projected based on current value dollars and vary within a projection only in concert with inflationary influences. While praised for their simplicity and ease of understanding, these financial models neglect an important factor of cash flow projections; that being the influence of efficiencies and inefficiencies that hotel operations have on bottom line Net Operating Income.

To accurately examine the future cash flow potential of a lodging asset, we believe that one must utilize a fixed and variable model to project both line item revenues and expenses. This fixed and variable approach is a long-standing foundation of basic managerial accounting. Moreover, this kind of analysis is the most appropriate means by which to emulate the complex interrelationship of utilization and profitability with a complex and dynamic income producing vehicle such as a hotel. The fixed and variable approach is considered a more technical method of which to project both line item revenues and expenses as it allows for the forecasting of efficiencies and inefficiencies in revenues and expenses as related to fluctuations relative to a base, or index of variability.

It is widely accepted in the industry that the majority of fluctuations beyond the fixed portion of line item revenue, are occupancy dependent. In the past, however, the industry has indexed fluctuations in expense relative to the corresponding departmental income or, in the case of Undistributed Operating Expenses, to Total Revenue. For example, the variable component of Food and Beverage Expense would be calculated relative to changes in Food and Beverage Income, whereas the variable component of Administrative and General Expense would be indexed to Total Revenue. This methodology dictates that line item expenses vary solely with fluctuations in corresponding Departmental Revenues.

Pinnacle Advisory Group recently set forth to test this method of calculating the fixed and variable components of line item revenue and expense through simple linear regression analysis. By examining both Departmental Expenses and Undistributed Operating Expenses on hundreds of actual financial statements via a simple linear regression analysis, we tested the viability of utilizing occupancy as common base, or index of variability. Specifically, we tested the statistical significance of utilizing fluctuations in occupancy as the basis of the variable component of all line item revenues and expenses, rather than linking the variable component of these costs to the corresponding line item revenue.

Through a complex understanding of statistics that is beyond the scope of the summary discussion presented here, we have determined that there is, in fact, statistical justification for utilizing occupancy as a common base of variability when employing the fixed and variable approach to cash flow projection. It is important to note that our findings also support conventional methods whereas each line item's variability is linked to the corresponding Departmental Revenue and Undistributed Operating Expenses are linked to Total Revenue. In sum, the most influential aspect affecting the variable portion of line item expenses is fluctuation in occupancy. As such, a fixed and variable model of cash flow projection that takes occupancy differences into consideration is the model that Pinnacle Advisory Group employs. This does not mean that there are not other influential factors. Therefore, we believe that the comprehensive analysis behind these findings warrants continued research. Initial indicators validate our approach while simultaneously inviting further research on the topic.

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