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CAPITAL EXPENDITURE PRACTICES: A LEARNING OPPORTUNITY FOR SMALL AND MEDIUM SIZED ACCOMMODATION

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ABSTRACT

Due to its ‘easy-to-setup’ nature, small and medium sized accommodation (SMSA) is gaining popularity among business ventures plunging in Malaysia hospitality industry. However, given the current competitive environment of the SMSA industry, where strategy is becoming more saturated than before, and head-to-head competition is a predictable scenario, it is has come to the point that these businesses should take a pause to review and capitalizes on its own potential of internal strength. This paper intends to highlight the aspect of capital expenditure as a possible strength to be capitalized for SMSA business to remain competitive and viable in the industry. McConnell and Muscarelle (1985) provide evidence that firm performance is affected by capital expenditure decisions. A review of the study of capital expenditure of the hotel industry report (CapEx 2007) could provide an insight for learning opportunity for SMSA to take advantage in planning and managing their capital expenditure. It is proposed that future research should consider studying capital expenditure from the aspect of Malaysia SMSA applicability.

Keywords: Small and Medium Sized Accommodation; Capital Expenditure; Hospitality Industry; Accommodation Business; Competitiveness

BACKGROUND

In general, the accommodation industry has quite a number of investment in its capital to equip and also improve guest amenities and services including flat screen televisions, high speed internet access and redesigns of guest rooms, lobbies and restaurants. In addition to this, the criteria set from rating classification set by tourism legislator should be abide, which require proper planning on maintenance of all these capital invested.

The challenge in managing hotel capital expenditures is that they are many grey areas and subjectivity and thus, require a through understanding with regards to the different ratings or classification scheme. Consequently, this topic area has not received the attention it deserves especially in developing countries.
The increase in tourist arrivals in Malaysia over the last few years has brought about a pressing demand for hotel accommodation. This has set the rapid demand and emergence of small and medium-sized accommodation (SMSA). For the purpose of discussion of this paper, SMSA would refer to Orchid rated hotel. This is based on a classification scheme used by the Ministry of Tourism. Based on data obtained released by the Ministry of Tourism Malaysia as of March 2011 there are a total of 761 orchid rated hotel spread throughout Malaysia. This is a short of 80 from the total of 841 establishments of one to five star-rated hotels.

From a numerical standpoint, this development is favorable and welcomed in the sense of its positive contribution to the local economy through its multiplier effect. However from a different spectrum this would signal the necessity to be precaution to the accommodation operators, of the vulnerability of the tourism industry that would eventually affect the tourist arrival – to whom the accommodation are targeted for.

In an unwanted scenario, should the market takes a downturn, accommodation operators (due to insufficient cash flow), abandon the needed capital expenditures to maintain the accommodation.With limited resources, hotel managers are under pressure to prioritize and balance between investment and returns with the objective of increasing stakeholders' value.

Failure to invest in capital expenditure may result in loss of market share due to inability to offer the desired level of service quality at attractive prices. Wall (1982) states that within the hospitality and tourism industry, both the behavioral component and the quality of the environment (biophysical) are recognized by consumers. At the micro level, capital expenditure affects strategic planning (Bromiley, 1986), production decisions (Nicholson, 1992) and firm performance (McConnell and Muscarelle, 1985). Existing studies which examine issues related to capital expenditure include Kuh and Meyer (1957), Dusenberry (1958), Jorgenson (1963), Kuh (1963), Jorgenson and Siebert (1968), Grabowski and Mueller (1972), and Elliot (1973).

SMSA AND CAPITAL EXPENDITURE

In Olson (1998) outlined five major forces driving change that could affect the tourism and hospitality industry in the new millennium. This includes capacity control, safety and security, assets and capital, technology, and new management.Recollecting occurrences since the paper were published, to date, most of all of these five forces of driving change we have witnessed and to an extent players in the industry had even experienced it, either through its positive or negative implications.

To date, where the market become saturated than before, and head-to-head competition is a predictable scenario, it is has come to the point that these businesses should take a pause to review and capitalizes on its own potential of internal strength.In order to become viable perhaps the capital expenditure aspect for a typical SMSA should be treated as important as it is to a star rated hotel.

Griner and Gordon (1995) describe capital expenditure as the amount of investment incurred to acquire property, plant and equipment. Sartono (2001) further expands the definition of capital expenditure to include investment made to support organizational development. Collier and Gregory (1995) adopt a field study approach to examine capital budgeting practices in the hotel sector. Their study is partly motivated by the fact that hotel business is highly capital-intensive.

During the recent years, the industry has invested large amount of expenditures to improve guest amenities and services including flat screen televisions, high-speed Internet access and redesigns of guest rooms, lobbies and restaurants. Despite that, the Internet has changed the way businesses operate; accommodation establishments have begun to employ ICT to improve their daily operations and control their assets (Buhalis, 2003). The Internetalso plays an important role mediating between customers and hotel companies as a place for information acquisition and business transaction (Liang and Law, 2003).

These expenditures are long-term in nature and commit large amount of financial resources at risk. With limited resources, SMSA managers should be able to overcome the challenge to ensure that every capital expenditure decision does not lead to operational inefficiencies. Failure to invest in capital expenditure may result in loss of market share due to inability to offer the desired level of service quality at attractive prices.

Hotels generally incur large expenditures and these are classified into two broad categories. The first group is termed revenue expenses for which their associated benefits are realized within a year. These expenses are also known as period costs. The period costs are deducted from the annual revenue in the same accounting period when the expenses occurred. Thus, revenue expenditure reduces the taxable income for the year. The second group of expenditure is classified as capital expenditure and their benefits extend over a period beyond one year (William and Raymond, 1997). They include expenditures incurred to purchase long term assets such as land, buildings and equipment or commonly referred to as Property, Plant and Equipment (PPE).

INSIGHT ON GUIDELINE FOR CAPITAL EXPENDITURE DECISION MAKING

According to the International Society of Hospitality Consultants (2000), the variation in capital expenditure classification is due mainly to the flexibility in its definition. For example, KPMG (1999) excludes new hotels built or acquired in its definition of capital expenditure. Only items which are recorded in the balance sheet as fixed asset expenditure are included as capital expenditures. On the other hand, the International Society of Hospitality Consultants (2000) study reports that capital expenditure also includes capital improvement costs that prolong the economic life span of an asset.

According to Brignall (1997), approximately 75 percent of hotel total costs are committed and fixed in nature. The cost per square meter of hotel rooms can reach £1300 or £13.6 million in total for a 150-room hotel (Ransley and Ingram, 2001). Comparing small to large firms, Barclay and Smith (1995) show that the latter are able to commit and afford higher fixed costs of debt and thus, carries higher debt level. In addition, Sheel (1994) states that these large firms also enjoy lower costs of debt since their large size is associated with low likelihood of bankruptcy.

CapEx2007: A Study of Hotel Expenditures in the Hotel Industry

The CapEx 2007 study conducted by the International Society of Hospitality Consultant's (ISCH), review of capital expenditures in the hotel industry, tracking the trends and history of these expenses. Unfortunately this study is conducted in the United States and only covered hotel types such as full service/luxury hotel, select service hotel and extended stay hotel. This study highlighted 9 significant findings that could be use a reference and lesson to understand the domain of capital expenditure by SMSA. Summarized here are the findings of CapEx 2007:

1. The sum of capital spending, regardless of property age, was less that that in the CapEx 2000 and CapEx 1995 studies. This decline is conjectured to be a result of poor economics conditions for most period between 2002 and 2004. What this data tells us is that the tourism and hospitality industry is highly sensitive to the social and political events that shape the world in general. The impact of September 11, 2001 was felt through a decline in occupancy rate, ADR, and capital spending on hotels.

2. The CapEx 2007 study confirms that capital spending on hotels increases as the hotels age. Capital expenditures can be insignificant in the initial years of a new hotel and increase dramatically from year to year thereafter.

3. The percentage of repairs and maintenance grows as a percentage of revenue as hotels age, with exceptions when properties are completely renovated and/or repositioned. The hotels analyzed for this study indicate a fairly consistent expenditure in repairs and maintenance over the life of the assets. Expenditures by percentage of total revenue range from 3 to 4.5 percent.

4. The short-term trends in repairs and maintenance expenses in CapEx 2007 reflect the impact of the circumstances surrounding September 11, 2001 and the hospitality downturn in 2002 and 2003. Decreasing revenues and available cash flow moderated dollars spent, but the percentages of revenue spent on re- pairs and maintenance remained fairly constant. Generally, the lowest expenditures in repairs and maintenance, expressed as a percentage of revenue, occurred in 2000, a particularly strong year for the hotel business in general.

5. On a long-term basis, CapEx 2007 data indicates that all hotels, from new to older hotels, spent on average 8.5 to 9.8 percent of total revenue on combined capital expenditures and repairs and maintenance. There are exceptions, but generally, where sufficient reliable data exists to analyze, there is a dramatic and continuous increase in spending on hotels older than eleven years of age.

6. From a historical perspective, the CapEx 2007 survey revealed an overall decrease in spending from prior study results for hotels owned by public companies. Conversely, privately owned properties demonstrated an increase in spending from the prior study.

7. The 2007 survey revealed that capital spending as a percentage of total revenue for hotels owned by public companies exceeded that spent on properties owned privately.

8. Within the Full Service/Luxury and Extended Stay property types, spending of privately- owned hotels analyzed as a ratio to total revenue and on a per available room basis was higher than spending on hotels owned by public companies.

9. Construction costs rose steadily from the end of 2002 through the beginning of 2004, with a great jump in construction costs occurring between 2004 and 2006. The cost to build new once again exceeds the cost to renovate or reposition. With the high cost of ground-up development,

understanding the cost to renovate, refresh, and maintain the existing inventory is even more critical.

Orchid Rating Classification

In a local context, perhaps criteria that could serves a guideline to capital expenditure for SMSA is the Hotel Classification Scheme by the Ministry of Tourism Malaysia. As the philosophy and approach to operations management in the hotel sector is guided by the desired level of service quality. This factor is captured in the hotel classification rating system. The classification system signifies that hotels are independently branded with respect to their quality. Customers' satisfaction has been shown to be positively related to service quality (e.g., Cronin et. al, 2000; Green and Chakrabatry, 2007). High customer satisfaction, in turn, will result in customer loyalty (McCain et. al., 2005). High quality or high star rating hotel is thus, expected to invest more in capital expenditure to support their high quality service quality and delivery. In this labor-intensive industry, inefficient capital expenditure management will reduce service delivery and quality and result in reduction in a hotel's image and, star rating.

Table 1 to Table 4 are the extracted minimum requirement for Orchid rating of hotelset out by the Ministry of Tourism Malaysia.These criteria are categorized under four component which include cleanliness and hygiene standard, building safety and guest security, facilities and services and bedroom requirements.Regardless it just starting up or already operational the criteria outlined from Table 1 to Table 4 above could serve as a rough guideline for SMSA managers to focus, when considering its capital expenditure decision-making.

Table 1: Cleanliness and Hygiene Standard

A. CLEANLINESS AND HYGIENE STANDARD				
CRITERIA		1 Orchid	2 Orchid	3 Orchid
A. 4	KITCHEN	All Categories : Food Prepared must comply with the hygiene requirements of the Health Authorities. Kitchen/pantry must be in accordance with the requirements of Health Authorities. Separate cooking, washing, storage area and utensils for halal and non-halal food. Food compartments should be labeled accordingly.		
A. 5	REFUSE	All Categories : All refuse and garbage must be disposed off daily from the room premises – containers and refuse area to be kept in a sanitary condition. Encourage usage of separate waste bins (brown/blue/orange) for recycling purposes (Glass / paper / plastic /aluminium)		
A. 6	INSECT AND VERMIN PROTECTION	All Categories : Effective protection pest control in all areas of hotel at all time. Encouraged to use ECO–safe or botanically based pesticides.		

Table 2: Building Safety and Guest Security

B. BUILDING SAFETY AND GUEST SECURITY				
CRITERIA		1 Orchid	2 Orchid	3 Orchid
B. 1	CORRIDORS	All Categories : Safe, well and clean with adequate corridor precautions (emergency light, exits and directions)		
B. 2	FIRE SECURITY AND SAFETY FACILITIES	All Categories : In accordance with local fire – fighting and fire prevention laws – under the Uniform Building By Laws 1984. Possess the Certificate of Fitness for occupation. Installation of meters / equipment to monitor and control energy consumption.		
B. 3	EMERGENCY POWER SUPPLY	All Categories : Battery lamps/torch lights are made available in the event of power failure.		

Table 3:Facilities and Services

C. FACILITIES AND SERVICES				
CRITERIA		1 Orchid	2 Orchid	3 Orchid
C. 1	RECEPTION AREA	Proper reception area with at least one staff in charge.	Proper reception area with a suitable main entrance. At least one staff in charge.	A comfortable reception area with tables and chairs. A suitable main entrance with at least one staff in charge.
C. 2	PUBLIC TOILET	All Categories : At least one public toilet near the reception area furnished with wash basin and biodegradable liquid soap dispenser. Public toilets for the disabled (OKU) to be made available (In accordance to OKU Act 2007)		
C. 3	THERMAL CONDITIONS FOR COMMON AREAS	All Categories : Fan provided with good ventilating system.		
C. 4	PUBLIC TELEPHONE	All Categories : At least one public telephone at the reception area (local calls and operator assisted) or equivalent		
C. 5	LIFTS/ ELEVATOR	All Categories : Lift/elevators required for building of 60 feet and above or more than five storeys high.		
C. 6	FRONT DESK SERVICES	All Categories : Guest registration book to be provided attended by at least a staff.		
C. 7	TAXI SERVICE	Not Compulsory	Not Compulsory	Service on call Taxi to be provided.
C. 8	TOURISM INFORMATION	Not Compulsory	Not Compulsory	Tourism brochures and pamphlets to be provided.
C. 9	FIRST AID FACILITIES	All Categories : Provision of first aid box containing medicine, ointment, bandages etc. (to be replenished, to observe the validity of the product used and inspected from time to time)		

Table 4: Bedroom Requirements

D. BEDROOM REQUIREMENTS				
CRITERIA		1 Orchid	2 Orchid	3 Orchid
D. 1	MINIMUM SIZE OF BEDROOMS	All Categories : Minimum Standard requirements Size : 8 sq m Heights: 2.5 m.		
D. 2	NON - SMOKING ROOM	Not Compulsory	Not Compulsory	Not compulsory – Smoking Room to be provided.
D. 3	BEDROOM FURNITURE	1. Beds with clean linen, blankets, clean pillows and mattresses. 2. Waste basket. 3. Hangers/hooks for Clothes. 4. Elements of Malaysian Batik and local (Malaysian) decoration to be provided	1. Beds with clean linen, blankets, clean pillows and mattresses. 2. Waste basket. 3. Hangers/hooks for Clothes. 4. Night Table. 5. Elements of Malaysian Batik and local (Malaysian) decoration to be provided	1. Beds with clean linen, blankets, clean pillows and mattresses. 2. Waste basket. 3. Cupboard with hangers. 4. One table with one chair. 5. Elements of Malaysian Batik and local (Malaysian) decoration to be provided
D. 4	BED LINENS, TOWELS	All Categories : Introducing sheets and towel re-use program to reduce usage of water detergent and energy consumption. (To be changed upon guest's request – for the same guest)		

Table 4: Bedroom Requirements (continued)

D. BEDROOM REQUIREMENTS				
CRITERIA		1 Orchid	2 Orchid	3 Orchid
D. 5	BEDROOM WINDOWS	All Categories : Must adhere to standard building codes set by appropriate authority. Curtain or blinds for window.		
D. 6	BEDROOM DOORS	All Categories : Each room must be numbered and has individual key with latch/double lock. Materials used should be fire resistant.		
D. 7	SOUND - PROOFING FOR BEDROOMS	All Categories : To adhere to the local authority standards. Encourage to existence of noise control program from hotel operation		
D. 8	THERMAL CONDITIONS IN BEDROOMS; VENTILATIONS	All Categories : Fan in all rooms. Each room shall be capable of being naturally ventilated by means which be controlled by the room occupants.		
D. 9	BEDROOMS COMMUNICATION	Not Compulsory	Telephone provided at least in every floor.	Telephone in every room for local calls and operator assisted.
D. 10	DRINKING WATER IN BEDROOMS	Drinking water provided upon request.		Drinking water provided.
D. 11	INFORMATION MATERIALS IN BEDROOMS	All Categories : Information on fire prevention / guidelines, house rules and room tariff / charges to be displayed.		
D. 12	KIBLAT SIGN IN BEDROOMS	All Categories : Kiblat sign displayed clearly on the ceiling of every room.		

TAKING A LESSON

This paper intend to put forward ideafor consideration of SMSA to take advantage of the availability of information surrounding them and also practices from their 'big brother' of the star rated hotels in embracing the aspect of capital expenditure. The CapEx 2007 findings pointed out the implication of economics conditions towards capital expenditure, the association of hotel age and capital spending through repair and maintenance, the proportion of capital expenditure spent from total revenue and increase of construction costs.

As for the orchid rating classification system, from the criteria listed out under the four different components, attention should be given when planning to equip the establishment – in evaluating the best dollar spent on the furnishing and equipping the establishment especially the criteria that could be regarded as capital expenditure. However, it should be noted that since there is yet a standard definition of capital expenditure in the hospitality industry, the boundaries between capital expenditure and expenses remain unclear.

SMSA can be considered as a blooming segment in the Malaysian tourism industry. As easy for anyone with the right and adequate resources can venture in this business, it is also easy for it to seize operation due to either the vulnerability of the tourism industry or even more caused by the deficiencies of the management itself.In lieu to that, this paper proposed that capital expenditure could be an added advantage should these SMSA embrace and eventually practice it, taking lessons and examples from star-rated hotels.

Prior to this, there is a need to clarify and set a clear accepted or standardized definition of SMSA itself, as in the context of this paper it would only limited to the orchid classification. Future research is required in deriving to a standardized definition of capital expenditure especially in the accommodation industry in general.

CONCLUDING REMARK

Although in general, the spending of SMSA is not as much as star rated accommodation with regards to capital expenditure in reference to it physical and facility requirement, it should not be a reason to overlook in planning for capital expenditure. SMSA operators should spend time for capital expenditure planning and management needs of their property. It should be acknowledged the importance of understanding the investment lifecycle of their establishment and implement the most beneficial investment strategy for capital expenditure. In lieu to this, there is a need to educate SMSA operators about the life expectancy of major capital items and the costs of maintaining an accommodation business in competitive condition throughout the various stages of its lifecycle.Eventually, this would ledto ask a related question such as how do SMSA make decisions on capital expenditures? What are the problems (in terms of clarity of criteria) that SMSA operators have when making these decisions and what is the magnitude of these problems?

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