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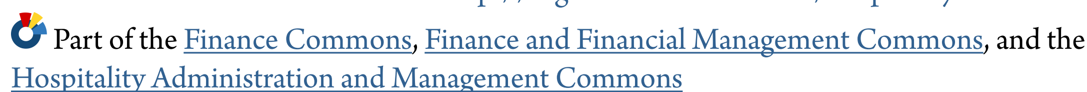
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Alternative Financing Sources and Their Impact on Profitability

Abstract
This article explores the advantages and disadvantages of various financing alternatives for the hospitality industry and discusses their potential effect on the profitability of the firm. The author provides background and perspective for developing the appropriate financing arrangement for a specific hospitality enterprise.

Keywords
John Stefanelli, Amortization/amortized, Debt, Short term, Long term, Financing, Property leasing

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Alternative Financing Sources and Their Impact on Profitability

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This article explores the advantages and disadvantages of various financing alternatives for the hospitality industry and discusses their potential effect on the profitability of the firm. The author provides background and perspective for developing the appropriate financing arrangement for a specific hospitality enterprise.

Persons fail in the hospitality industry for several reasons. Overoptimism may be a problem, or poor management; sometimes a lack of adequate reserves for replacement can turn a viable operation into one that quickly loses business to a more contemporary competitor.

However, inappropriate financing, such as expensive funds and/or excessive leverage, is often the major difficulty.

Financing must be adequate, well balanced, and obtained at a reasonable cost. Unless these conditions are met, the hospitality property, while conceivably having the ability to enjoy considerable business, simply cannot support the improper financing arrangement.

For instance, the typical businessperson often seeks maximum leverage. Unfortunately, once it is necessary to struggle with a debt load that suddenly becomes too heavy for the particular business in question, the ownership quickly turns attention away from product and service and concentrates on questionable ways to extricate itself from the financial bind. Preoccupation with the bills implies that customers and employees are neglected. From this point on, it is only a matter of time before failure occurs.

Many good properties have been operated by distressed owners. The hospitality property is good in that it earns a fair operating profit; however, it cannot service the capitalization structure selected for it by the owner or owners.

Sometimes a business is undercapitalized, hence doomed to failure, because of an inaccurate estimate of the amount of assets needed to operate it efficiently and effectively. Generally, the typical hospitality operation requires investment in the following assets: real property; leasehold improvements; personal property; inventories of food, beverage, and operating supplies; working cash; deposits; licenses; organization fees; pre-opening expenses, such as labor and advertising; financing fees; franchise fee; and contingency fund. There are four ma-

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jor types of funds to be considered: equity, lease, long-term debt, and short-term debt.

Equity Funds Are At Risk

Equity is "at risk" capital. It is money put into the business by the owner or owners. There is no guarantee that it will earn an equity dividend, nor is there any guarantee that the ownership will salvage anything if the company fails.

Equity can be raised in several ways. The owner or owners can utilize:

- personal equity from the sole owner
- personal equity from one or more partners
- equity raised as the result of incorporation and subsequent sale of shares of stock to several shareholders
- retained earnings
- syndication
- joint venture
- venture capitalist
- merger
- some government-sponsored program

The primary advantage with equity is the fact that the businessperson is relieved from following a rigorous debt service payment schedule. Not only are there no requirements to provide a return to most equity investors, but the fact that the capital structure is equity heavy implies that the operation enjoys a competitive advantage.

For instance, the international company, McDonald's Corporation, owns outright much of its real property. While it may be true that the company does not enjoy the benefits of leverage, it also is true that it can undercut competitors' menu prices because it can afford to forestall an equity dividend while debt-laden competitors cannot.

The primary disadvantage with equity financing is twofold. First, it usually is quite costly to court investors, especially if a large incorporation is planned. Second, there is a good probability that the equity dividend will be a delayed one. The equity holder often must wait for a considerable period of time before he or she can enjoy a cash return. The present value then of the typical equity investor's income stream can be quite unattractive. It certainly is better than losing everything due to a heavy debt load, but it may speak badly for a company if investors must wait too long for their reward.

Lease Funds Are Common

Hospitality operators frequently lease real and personal property. In some instances, it is necessary to lease real property because the owner will not sell it. The major disadvantage with leasing is the inability to own the property at the end of the lease term, although some leases do allow a purchase. Another major disadvantage with leasing is its cost; in the long run, it is often the most expensive form of financing.

There are several advantages, though, that are highly prized by most tenants:

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- It is much easier to qualify for a lease than it is to qualify for a loan, which typically is needed to purchase real property.
- The same is true when comparing the lease with the costs of seeking equity investors.
- If a businessperson must borrow money to purchase the property, generally there is a considerable down payment required. Often this is not the case with a lease arrangement; a minor lease deposit may be the only monetary requirement.
- Some locations are so expensive that one hospitality operation located there cannot generate enough income to justify the land costs. For instance, a major retail development, with one shop space earmarked for a cafe tenant, will overcome this problem while simultaneously allowing affordable rent for all shopkeepers and a built-in clientele for the cafe proprietor.
- At the end of the lease term, the businessperson can walk away. This can be a considerable advantage if the neighborhood suddenly has deteriorated and/or the hospitality enterprise in that location has fallen into disfavor with its market.
- Leasing provides considerable leverage which, if everything works out as planned, will maximize the present value of the future income stream of the particular hospitality business. For instance, the small amount of equity that a businessperson controls can be used to lease two cafe spaces or to purchase one cafe space. With the former, there is more risk, but more potential reward, while the latter position is much more conservative.
- The tenant is not burdened with the disposition of the property, should this become necessary.

Long-Term Debt Has Advantages

It is unlikely that a businessperson would finance the hospitality enterprise solely with equity funds or a combination of equity capital and lease financing. Normally, to optimize the present value of future cash flows and provide the maximum yield on equity, it is necessary to incur some debt on either a short-term or a long-term basis.

Generally, short-term debt is used to cover seasonal business lulls or to finance an anticipated temporary boom period. Long-term debt is the preferred alternative if the funds are to be used to capitalize a much larger portion of the business.

Long-term debt can be raised in several ways. The owner or owners can utilize:

- real property mortgage
- personal property lien
- personal promissory note
- possibly some government-sponsored program
- loans collateralized with property other than the hospitality business itself

The primary advantage with a long-term debt load is the potential hedge against inflation that it provides. If the interest rate is fixed, the scheduled payments may seem onerous at first, but once the hospi-

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tality enterprise begins earning more income due to inflationary trends, the fixed payments become more attractive.

Unfortunately, lenders are not as willing to grant fixed-rate loans these days. It therefore becomes necessary to accept floating interest rates, which provide no hedge against inflation. Also, even though a fixed rate seems a good bet today, there is no guarantee that the economy will not enter a recessionary trend, which makes the fixed payments more burdensome than they were initially.

There are other disadvantages with long-term debt:

- If a payment is missed, the collateral can be taken, thereby causing the borrower to lose the use of it as well as to lose the amount of equity that has been paid up, assuming the loan provides for amortization of the principal balance.
- The lender typically has stringent insurance requirements, i.e., he or she normally stipulates that the collateral must be insured for a considerable value.
- The lender may note other ancillary stipulations that are unattractive to the borrower. For instance, he or she may require a compensating balance in a non-interest bearing bank account.

Short-Term Debt Is Expensive

This type of financing is temporary. The maturity typically is one year. The loans are not intended to replace permanent, long-term financing, but are used to finance some of the highs and lows of the hospitality enterprise's particular business cycle. They also are used to finance temporary projects, such as remodeling the front office area of a lodging operation.

Short-term debt can be raised in several ways for a number of purposes: construction loan, stretching accounts payable, stretching cash dividend payouts, accelerating accounts receivable, customer advances, revolving line of credit, inventory loan, vendor loan, and trading rooms, food, and beverages for needed products and services.

In general, it is recommended that the businessperson utilize short-term debt funds very judiciously. This is the most expensive source of financing and should never be used if long-term financing can be substituted for it. The costs of short-term debt funds sometimes are difficult to compute. For instance, when a purveyor allows the hospitality enterprise the use of credit, the cost of this credit must be recovered in the purchase prices of the goods being sold. The large hospitality enterprise probably enjoys an advantage because the purveyor understandably does not want to lose a big account. The small hospitality operation, though, probably is not so lucky.

Another dimension to short-term debt that often goes unnoticed is the damage to reputation that can occur if the businessperson uses some of the techniques noted above. For instance, stretching accounts payable, asking vendors for loans, and expediting accounts payable presumably will affect negatively the company's image and standing in the community.

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Proper Balance Is Vital

Theoretically, the businessperson wants to earn the maximum equity dividend. The total amount of equity available to an investor must earn the maximum yield that is consistent with the risk of the investment. Typically, the hospitality investor has a certain amount of equity capital available and strives to earn the maximum amount of cash return for the least amount of equity invested. That is to say, maximum leverage normally is a primary consideration to investors in general.

The investor could utilize a computer program to generate the optimal capital structure. Such programs are used by most major real estate and accounting firms that provide feasibility studies to the industry.

Usually it is not necessary to use a computer program because, in fact, the typical investor has very few capitalization structures from which to choose. The computer programs, of course, assume that any number of combinations of debt and equity will be available to the investor, but this is not typical.

Many things have an impact on the profitability of the firm. Alternative financing arrangements are but one of them, but an extremely important one because a mistake made will cause tremendous irrevocable damage to the business.

Financing Decisions Follow Pattern

There is a set of procedures one can follow in deciding upon the best capital structure, i.e., financing arrangement, from among those available. An illustrative example might be a legalized betting parlor owner who wants to add a cafe, the major objective of which is to provide service to his regular clientele. A bit of profit would also be most welcome. The cafe will provide limited food, such as sandwiches, soup, and breakfast, plus limited bar service, such as mixed drinks and beer.

The estimate of initial investment needed to develop and implement the cafe is $136,750. The estimate of stabilized annual net income that will be earned by the cafe is $55,675 before financing costs.

The owner of the legalized betting parlor owns the real property in which the cafe will be housed. He also is in the enviable position of being able to finance the project with personal equity and does not need to borrow funds. If he funded the project with personal equity, he would earn an equity dividend of approximately 41 percent ($55,675/ $136,750 = 41 percent). If he decided to borrow the entire amount of $136,750 (he can do this since he has a good credit rating and adequate collateral), he would need to support an annual debt service payment of approximately $38,184 (based on a five-year, fully-amortized note, monthly payments, at 14 percent). His equity dividend under this capitalization structure would be an infinite percentage, as he has no equity in the project. However, his net income would be reduced to $17,491 from $55,675 per year because of the debt service requirement.

From a percentage point of view, it seems best to opt for the all-debt alternative. But from a cash point of view, the all-equity alternative seems best. Perhaps there is another alternative that would be more

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appealing. If the owner would prefer a debt:equity ratio of 1:1, he could borrow $68,375 under the same terms noted above, and come out of pocket for the other $68,375. The annual debt service payment would be approximately $19,092, leaving an equity dividend of 54 percent [($55,675 – $19,092)/$68,375]. This is a much better equity dividend percentage than the one associated with the all-equity financing alternative, but it does not yield as favorable an amount of cash money.

One must consider the after-tax net income if he or she is analyzing the investment for a specific individual. It is possible that the tax code actually encourages borrowing; i.e., it pays for the investor to assume additional debt. The owner of the legalized betting parlor could do quite well from a tax standpoint if he borrowed all of the money needed to fund the cafe project because he has other income that could be sheltered from taxes by the interest charges levied on the loan of $136,750.

Another dimension to this example, and one that pops up occasionally, is the investor who has the ability to select an all-equity financing arrangement, but prefers to borrow some money and invest some of the equity in another project. This is a form of diversifying one's investment portfolio. Unfortunately, when one diversifies, one normally is seeking to reduce risk. Hence, the equity dividend will be reduced accordingly.

Still another dimension to this example, and one which crops up whenever debt financing is contemplated, is the treatment of the equity buildup, which is the amount of the monthly debt service payment that goes toward reducing the original loan balance. Hence, one is building equity in the investment project which, by some persons' standards, should be considered as net income and used in the computation of the equity dividend. Of course, there are many persons who do not adopt this position, but they at least will agree that equity buildup does increase one's borrowing power.

One final dimension to this example is the effect a financing alternative will have on the other aspects of the operating statement. The owner of the legalized betting parlor will incur a slight amount of service charge expense if he decides to borrow money from his bank. He will not be required to maintain a compensating balance. Nor will he be expected to maintain more insurance coverage than he normally would carry. He, therefore, will experience a miniscule reduction in annual stabilized net income if he opts for debt financing.

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