Expansion Planning - When & How Much

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WHEN

AND

HOW MUCH

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FOREWORD

When to expand and by how many units are some of the most serious questions which eventually face many tourist operators. Whatever the reasons for that decision, the consequences may be far-reaching and can pose problems for even the most seasoned operator.

This booklet is intended to clarify some of the major factors which should be considered in deciding for or against expansion.

The Ministry of Industry and Tourism is interested in the well-being, profitability and well-planned expansion of the Provincefs Tourism industry.

Programs administered by the three Ontario Development Corporations, the Tourism Development Branch and the Tourism Operations Branch are designed to:

- provide advisory, technical and management services to all types of tourism businesses in Ontario, and *to*
- provide financial aid to qualifying businesses unable to obtain financing through the regular lending institutions.

In the interest of good planning and good business, find out how we may be of assistance to you before committing yourself to expansion costs.

EXPANSION PLANNING
WHEN and HOW MUCH

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CONTENT PAGE

Source: Ontario Development Corporations
Tourism Development Branch, Ministry
of Industry and Tourism

Prepared By:
Ron Larner
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Should I Expand?

The "X-Motel" is a well-managed and comfortable place to stay. Prospective guests are frequently turned away because accommodation is full — yet net profit provides only a modest standard of living for the hard-working owner.

Why not expand then, and capture the extra business passing by?

At first glance, expansion seems the logical solution to this frequent situation found in the motel industry. But in too many cases, just such an expansion is the downfall of a promising business.

Proposed expansion should be very carefully weighed before making any definite decision, Ask yourself:

- How much will expansion cost?
- Where will the money come from?
- What interest rate will I have to pay on borrowed money?
- How long will I get to repay borrowed money?
- How much gross revenue will the extra accommodation bring in?
- What extra operating expenses will I have to pay?
- What additional net profit will result?
- How will my annual cash position be affected by the expansion?
- Am I planning the right size of expansion?

Each of these questions must be carefully considered. Know the answers before committing yourself to expansion. The following will serve as a guideline:

Expansion Costs

Do not rely on guesswork. Get firm quotations for the erection of buildings. Prepare a detailed list of furniture and equipment required and price the list carefully. Be SURE of your costs.

Obtaining Finance

Few operators can finance the entire cost from their own pockets. Decide how much you can put in — the balance will have to be borrowed. You must satisfy prospective lenders that this is a sound investment. Support your application with financial statements of the business, and a forecast of future operations for at least one year ahead. Prove that the investment will generate a worthwhile return and that you will be able to repay the loan.

Never assume you will be able to borrow money. Do not put a spade into the ground until funds are **assured.**

Interest Rates

This is an important factor. Interest rates for mortgages in the tourist industry are generally high. You will probably have to pay at least 10 per cent and rates of 12 to 14 per cent are more likely.

Remember that if you borrow $40,000 at 12 per cent, interest charges in the first year will be about $4,800 — a heavy burden for any business.

EXPANSION PLANNING WHEN and HOW MUCH	Subject: REPAYMENT TERMS GROSS REVENUE

Repayment Terms

Normally, the repayment period for mortgages in the tourist industry does not exceed 10 years. Frequently an even shorter period is allowed. Remember, borrowed money must be repaid within the term of the mortgage. Avoid a mortgage you are not reasonably sure you can afford to repay.

Beware of short term mortgages requiring a large final payment. You may have difficulty in making that final payment, and be unable to refinance the mortgage. Failure to meet mortgage payments may cost you your business.

Gross Revenue

Do not guess at the gross revenue from proposed extra accommodation. You must determine how many days in the year the present accommodation is full; how many people are turned away on these days; and the average rate you could have obtained.

Not uncommon reasoning by many motel operators goes something like this: "1 have 10 rooms and my gross revenue is .$45,000 a year. I figure that if I doubled the number of rooms I could double my gross revenue". Seldom, if ever, does it work out this way. And the reason is simple: additional rooms will bring in revenue **only on** those days when existing accommodation is full.

Consider the "X-Motel" again. With 10 rooms, it is located, in a busy town and much of its business, year around, is commercial. In studying an average two-week period for the establishment, it will be seen that on four occasions during the two weeks, the proprietor turned away eight or more prospective guests. He planned to add 10 rooms to capture the business being turned away.

The room rentals and turnaways for an average two week period were as follows: –

DAYS

	M.	T.	W.	T.	F.	S.	S.	M.	T.	W.	T.	F.	**S.**	**S.**	TOTAL
Rooms Rented	10	10	10	10	2	4	7	10	10	10	10	2	3	6	104
Turned Away	2	4	9	8	—	—	—	4	6	10	8	—	—	—	51

Source: Ontario Development Corporations
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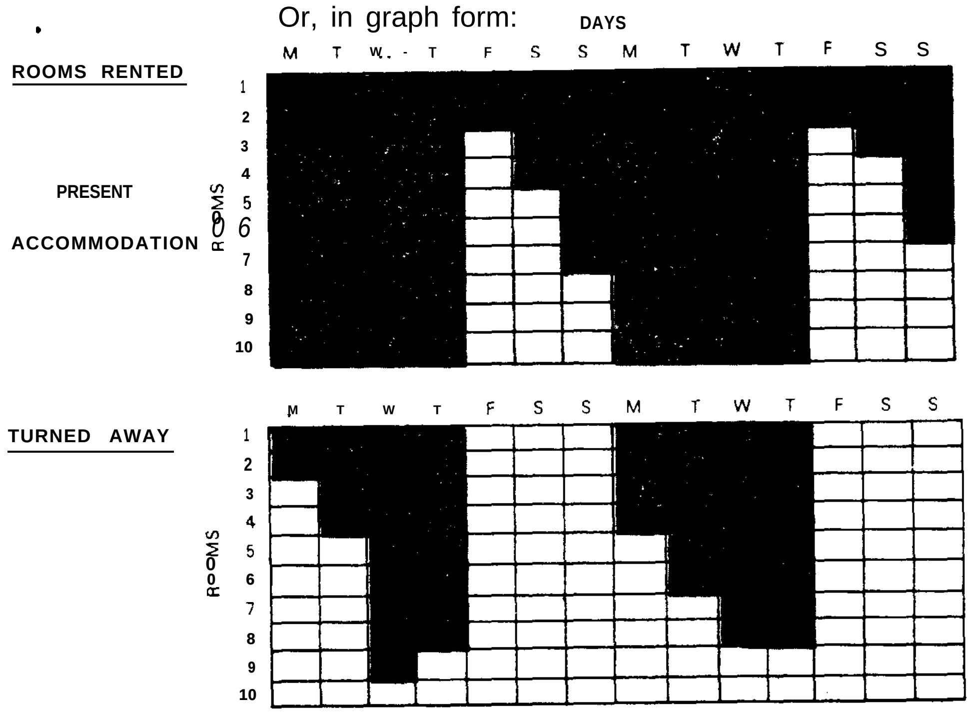
Or, in graph form:



ROOM-DAYS AVAILABLE
140

ROOM-DAYS RENTED
104

% OCCUPANCY
74.3%

ROOM-DAYS AVAILABLE
140

ROOM-DAYS LOST
51

% OCCUPANCY
36.4%

Present accommodation. then, has an occupancy rate of 74.3 percent whereas the additional rooms would achieve an occupancy of only 36,4 per cent. Doubling the number of rooms would clearly not double revenue.

Extending this average two-week period to a full year, and assuming an average of $9.00 **room rental** per day, the revenue from the additional rooms would be:

Room-days available = 365 x 10 = 3,650
Room-days let — 36.4% of 3,650 = 1,328
Revenue = 1,328 x$1 5.00= $19,920

Additional Operating Expenses

Each additional rented room involves direct expense for laundry, soap, lighting, wages, etc. In addition, some expenses will be incurred whether or not the additional rooms are rented — heat, maintenance, taxes, mortgage Interest, etc.

Do not under-estimate your expenses. Study each item carefully to estimate the probable increase.

Probable expenses of the proposed "X-Motel" expansion illustrate the point. Financed by a 12 per cent mortgage for $30,000 with the principal repayable over 10 years, the additional expenses can be estimated:

Wages $1.50 per room-day	=1,328x $1.50	$1,992
Laundry and sundries $1.50 per room-day let	= 1.328 × $1.50	1,992
Heat, light, water		800
Maintenance		750
Taxes		300
Insurance		400
Mortgage Interest (First Year)		10,800
	Expenses before depreciation	$17,034

Additional Net Profit

Having prepared a forecast of additional revenue and expenses, the difference will be your expected net profit from the expansion, before depreciation. For the "X-Motel" then, the net profit would be:

Additional revenue	$19,920
less additional expenses	17,034
Net profit, before depreciation	$ 2,886

Depreciation of buildings and equipment, however, is just as much a real expense as any other payment made to operate a business. If you buy a new television set **for one of your rooms it may cost around $300. In one year's time it will not be worth more than, say, $240 and in five years will probably need replacing. The value of the set has been used up over the period, and must be charged against revenue to determine the real net profit.**

Applying this principal to the "X-Motel" example, the real net result is quite different from the apparent $2,886 profit shown above. Assume that the $90,000 cost of expansion comprises brick buildings costing $75,000 and equipment valued at $15,000. Using the maximum capital cost allowances granted by the Income Tax Act, depreciation would be:

Buildings — 75,000 at 5%	$3,750
Equipment — 15,000 at 20%	3,000
	$6,750

The proposed "X-Motel" expansion then, would actually result in a net loss of $3,864 after charging depreciation. Obviously the expansion would be unwise unless the number of guests can be greatly increased.

Annual Cash and Expansion

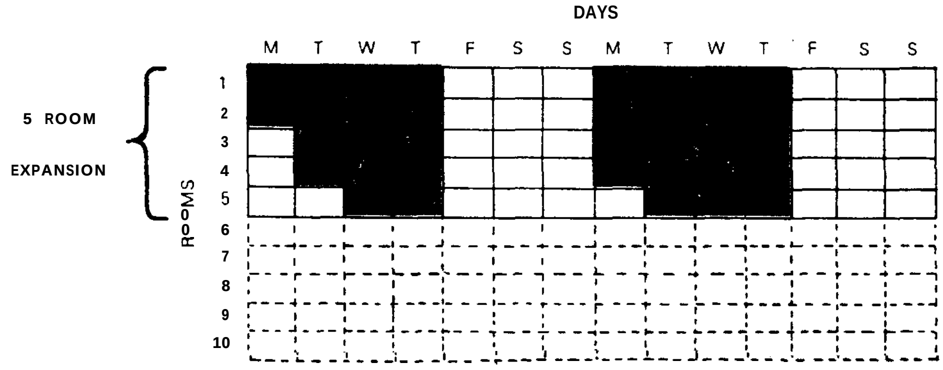
As depreciation is the writing off of an asset already purchased, it is not an actual cash expense in the period. The cash increase resulting from operations of the expansion is therefore the net profit, before depreciation. For the "X-Motel", the operating cash increase from the proposed expansion is $2,886. However, requirements for principal due under mortgage and other loan agreements have to come from the cash increase. The "X-Motel's" cash position would be:

Net profit, before depreciation (cash increase)	$2,886
less repayments of mortgage principal — 1/10 of $90,000	9,000
Cash Increase (decrease)	($6,114)

The expansion would have resulted in a net cash **decrease of $6,1 14in the first** year. The proprietor needed to improve his annual cash position, but the proposed expansion would have the opposite effect, Probably he would have been unable to make the principal payments under the mortgage, and may have lost the entire business.

The Right Size of Expansion

The size of the expansion should also be carefully considered. It is possible you may make more profit **if the expansion is smaller. Fixed expenses will be lower and the percentage of occupancy will be higher, as the "X-Motel" chart shows: –**



FIRST 5 ROOMS ADDED	Room-days available	70
	Room-days rented	35
	% Occupancy	50.0%
LAST 5 ROOMS ADDED	Room-days available	70
	Room-days rented	16
	% Occupancy	22.9%

The occupancy percentage for the first five rooms is 50 percent, but for the other five rooms it would be only 22.9 per cent. Assuming that only five rooms were added at a cost of $45,000, with the same mortgage terms, theprobable revenue and expenses of the five room expansion would be:

Additional Revenue

Room - days available = 5 x 365 = 1,825		
Room - days let = 50.0% x 1,825= 912		
REVENUE = 912 x $'15.00=		$"13,680

Additional Expenses

Wages =912x $1.50	$1,368	
Laundry and sundries = 912x $1.50	1,368	
Heat, light, water	400	
Maintenance	375	
Taxes	150	
Insurance	200	
Mortgage interest (First Year)	5,400	9,261
Net profit before depreciation		4,419

Depreciation

Buildings --$37,500 at 5%	**1,875**	
Equipment -- 7,500 at 20%	1,500	**3,375**
Net Profit		**$1,044**

Net Cash Change

Net **profit, before depreciation**	$4,419
less mortgage principal – 1/1O of $45,000	4,500
Cash increase (decrease)	($ 81)

Comparison of 10 room and 5 room forecasts

	10 Room	5 Room	Difference
	$	$	$
Profit, before depreciation	2,886	4,419	1,533
Net profit (loss)	(3,864)	1,044	4,908
Net cash increase (decrease)	(6,114)	(81)	6,033

It is obvious that the 5 room expansion is more sensible than the proposed 10 rooms. Substantial improvements are shown in PROFIT BEFORE DEPRECIATION, NET PROFIT and NET CASH.

But would a 5 room expansion be the most profitable number of rooms to add? Would a smaller or larger number be more profitable?

FINDING THE MOST PROFITABLE SIZE

The expenses of expansion fall into two different types – FIXED EXPENSES and RENTAL EXPENSES.

FIXED EXPENSES are those costs which are incurred even if the rooms are not rented. To provide a room for rent we must build it, furnish it, heat it, maintain it and pay taxes and insurance on it. These costs must be paid even if the room is vacant.

RENTAL EXPENSES are those costs which are incurred only when a room is rented. Wages must be paid for the room to be cleaned and made up after it has been used and money must be paid for the laundering of sheets, pillow cases and towels and for soap, matches and other items.

In our example, we have assumed that the cost of a room is $9,000 – $7,500 for construction and $1,500 for furnishings – and that all of this money is borrowed at 12% interest, repayable over 10 years. We can therefore estimate the Fixed costs of providing and maintaining a room for rental as follows: –

Heat, light, water	**1/1 Oth of expenses forecasted for 10 rooms.**	80
Maintenance		75
Taxes		30
Insurance		40
Mortgage Interest – $9,000 at 12%		1,080
Depreciation – at maximum rates		675
TOTAL FIXED COSTS		$1,980

EXPANSION PLANNING WHEN and HOW MUCH	Subject: THE MOST PROFITABLE SIZE

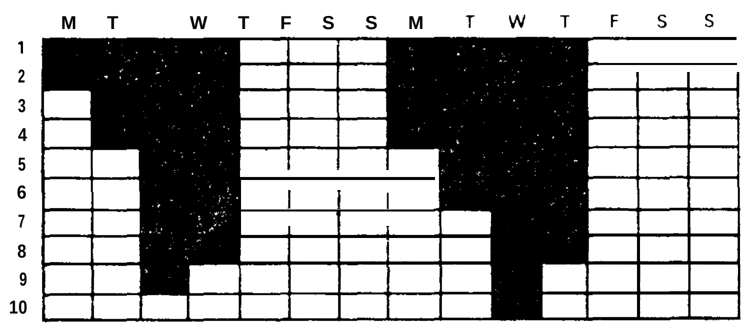
These fixed costs must be recovered out of the NET revenues of renting the room. Out of the daily rental rate of $15,we must first pay the RENTAL EXPENSES. Only the balance will be left to pay fixed costs.

The rental costs would generally be about $3.00-1.50 a half-hour of labour to clean and make up the room .$1.50 for laundering and other housekeeping costs. So our $15.00 rental revenue is reduced to a net revenue of $12.00.

Each time the room is rented, net cash of $12. is earned towards the fixed costs. If we divide $12. into the fixed costs, it will show how many times the room must be rented to cover those costs – i.e. $1,980 ÷ $12 = 165 days. If the room rents for more than 165 days in the year, it will be profitable. If it rents for less, it will be unprofitable.

The "Turnaways" chart of the "X-Motel" shows how many times each room would rent in an average two week period. By extending this to cover a year, we can readily see which units would rent for more or less than the "break-even" figure of 365 days.

TURNAWAYS



POTENTIAL RENTALS

Two Weeks	Full Year
8	209
8	209
7	182
7	182
5	130
5	130
4	104
4	104
2	52
1	26

Only rooms 1, 2, 3 and 4 would rent for more than the 165 days needed to cover the fixed costs of each room. Only those rooms would be profitable. The other six rooms would not bring in enough net cash to cover their fixed costs. The profit or loss of each room added can be calculated as follows: —

EXPANSION PLANNING WHEN and HOW MUCH	Subject: THE MOST PROFITABLE SIZE

Room	Rents In Year	Days Over (Under) Break-Even		Room Profit (Loss)	Cumulative Profit (Loss)
1	209	44	X$12	$ 528	$ 528
2	209	44	x $12	$ 528	$1,056
3	182	17	)($12	$ 204	$1,260
4	182	17	X$12	$ 204	$1,464
5	130	(35)	)($12	($ 420)	$1,044
6	130	(35)	x $12	($ 420)	$ 624
7	104	(61)	)($12	($ 732)	($ 108)
8	104	(61)	X$12	($ 732)	($ 840)
9	52	(113)	x $12	($1 ,356)	($2,196)
10	26	(139)	X$12	($1 ,668)	($3,864)

It is seen that profit increases uptothe fourth room, then declines rapidly into a loss. A 4 room addition would be the most profitable expansion and would “increase the “X-Motel’s” profits by $1,464.

But this is net profit, not net cash. How will the “X-Motel’s” cash position be affected by a 4 room expansion? This can easily be determined. In arriving at the fixed costs of a room, we included $675 depreciation. If we add this back to the net profit we arrive at the cash operation profit, as follows: –

Net Profit from 4 Rooms	$1,464
Add Depreciation – 4 x $675.oo	2,700
Profit before Depreciation	$4,164
Mortgage Principal Payments	$3,600
4 rooms x $9,000-10 Years	
Net Cash increase	$ 564

Thus, the 4 room expansion would cover its costs and improve the owner’s cash position.

NOTE: –

For simplicity, our examples have been based on an average two week period of occupancies and turn-sways. In practice, the need for expansion should be based on the actual daily occupancies and turn-sways over an extended period of at least a year.

Also, other factors which might increase demand in the future should be taken into account in estimating the rentals of the additional rooms.

Source: Ontario Development Corporations Tourism Development Branch, Ministry of Industry and Tourism	Prepared By: Ron Larner Bert Ho fmann

EXPANSION PLANNING WHEN and HOW MUCH	Subject: SOURCES OF ASSISTANCE

Ministry of Industry and Tourism Offices

Advisory Services and Business Counselling is available to existing or prospective tourist operators. Contact the Tourism Development Branch, Hearst Block, 900 Bay Street, Toronto, Ontario, M7A 2E5 (telephone (416) 965-4255) or the Tourism Industry Consultant in the Ministry Field Office-nearest to your location:

City	Address	Postal Code	Telephone
ARNPRIOR	Box 308, 146 John Street North	K7S 3H6	(613) 623-3153
BARRIE	Box 350, Highway 400	L4M 4T5	(705) 726-0932
BROCKVILLE	143 Parkedale Avenue	K6V 6B2	(613) 342-5522
FORT FRANCES	Box 815, 283 Church Street	P9A 3311	(807) 274-3250
HUNTSVILLE	Box 1410, 15 Main Street East	POA 1K0	(705) 789-4448
KITCHENER	305 King Street West	N2G 1B9	(519) 744-6391
KINGSTON	Suite 401, 797 Princess Street	K7L 1G1	(613) 546-0174
KENORA	Box 5140, 808 Robertson Street	P9N 3X9	(807) 468-6481
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NORTH BAY	Northgate Plaza, 1500 Fisher Street	P1B 2H3	(705) 472-9660
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OTTAWA	Suite 900. 220 Laurier Avenue West	K1P 5Z9	(613) 237-6280
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SUDBURY	767 Barrydowne Road	P3A 3T6	(705) 560-1330
THUNDER BAY	Box 5000, 435 James Street South	P7C 5G6	(807) 475-1325

Source: Ontario Development Corporations; Tourism Development Branch, Ministry of Industry and Tourism	Prepared By: Ron Larner, Bert Hofmann — 017S

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EXPANSION PLANNING WHEN and HOW MUCH	Subject: SOURCES OF ASSISTANCE

Financial assistance for Ontario's Tourist Industry is available from the Ontario Development Corporation (ODC), Eastern Ontario Development Corporation (EODC), or Northern Ontario Development Corporation (NODC).

Loans are offered ["or the establishment of new tourist operations and for upgrading or expanding existing operations. Details concerning all the services available from the Development Corporations may be obtained by cent.actinp, the head office of the appropriate corporation at :

Mowat Block
900 Bay Street
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or from any of their branch offices

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Source: Ontario Development Corporations
Tourism Development Branch, Ministry of Industry and Tourism

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