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IS PROFIT ENOUGH?

Paul Beals

The greatest gift is the power to estimate correctly the value of things.

—Francois, Duc de La Rochefoucauld

Vignette I

After a two-year hiatus, I have resumed research into lodging investments. In a follow-up interview with a hotel investor who has provided data for a long-term study, I ask the almost philosophical question: "Do hoteliers understand better the objectives of ownership?" "Well," my interlocutor responds, shaking his head, "we've got them to at least understand NOI [net operating income], and that's a step in the right direction."

Undeniably, the general re-engineering of lodging operations in the nineties yielded results more pleasing to investors—witness, for example, the roughly ten percent improvement in income before fixed charges between 1990 and 2000. But have we truly moved toward a better understanding between lodging operators and owners? Or do hoteliers and investors remain estranged because they do not speak a common language or comprehend each other's objectives? And, more important, what can we, as the hospitality industry's financial-management educators, do to close the gap?

The divergent mentalities of investors and hoteliers are tellingly illustrated by observing that they count using two different methods. The accountant's profit is an abstraction, and the investor accordingly is little concerned with it, except to the extent that taxable income, measured (roughly) according to GAAP, impacts taxes. Investors count in cash and measure outcomes in concrete terms—net cash flows from operations versus capital outlays. Hoteliers count in terms of accounting profit and measure it on a relative basis at intermediate steps—departmental profit percentage, gross profit percentage, income before fixed charges as a percentage of total revenues. Moreover, hoteliers stop counting significantly short of the famous bottom line, yielding not a starkly drawn absolute measure of their effectiveness but a relative, incomplete one.

Always convinced that metaphors speak volumes to students, I frequently explain that profits are like food and cash is like oxygen. Depending on his *avoirduois*, one can go some 30 days without food, while oxygen deprivation beyond nine minutes bankrupts the human organism. Investors seek cash with the same urgency as the human organism seeks oxygen—asking frequently, as one hotelier wailed, "What have you done for me lately?" On the other hand, hotel operating companies, especially those intent on building their brands, can afford the longer view and an orientation toward accounting profits.

Vignette II

A graduate student observes that three large-cap hospitality stocks are "affordable" because each trades in the \$20–\$30 price range. Flabbergasted, I ask her if mere per-share

price is any indication of value. She comprehends her gaffe, if vaguely, and my confidence is restored until she observes later in her presentation that the company with the highest earnings per share is the "one you want to own."

The student in question is a better-than-average performer who has finished her entire business-school financial management sequence. Apparently, there has been much discussion of profit, but very little emphasis on value. I suspect, further, that she is not alone. Specifically, if AHFME members asked all students—undergraduate and graduate alike—finishing the financial management sequence in their respective institutions to identify the most important measure of a firm's performance, I suspect 90 percent would respond with some variant of "profits."

At a recent forum of hospitality chief financial officers jointly sponsored by Arthur Andersen (UK) and American Express, an AMEX executive concluded the proceedings with the observation that "the finance role has evolved from one focused on accountancy to a strategic leadership role." Hospitality industry leaders, especially financial management specialists, cannot embrace this role unless their training expands beyond mere consideration of profit. They must be brought to an understanding of the larger picture—the value of the enterprise, measured in cash flows, against the value of firms in the same sector, as well as in comparison to alternative investments.

A Starting Place

For most of our students, financial management will remain the most challenging subject matter in their curriculum, and there is a natural tendency to simplify already challenging material by teaching "plug-and-chug," debit-and-credit accounting. However, the truly conscientious instructor should begin the process of orienting the student to the financial realities of the hospitality industry from the very first financial accounting course. Teach not only the operating cycle and the elegance of the matching principle, but also the cash-to-cash cycle. Introduce capital flows and differentiate them from operating flows from the beginning, instead of leaving them for the end of the course or (more likely) a subsequent course in finance. If students can distinguish between capital flows and operating flows, they might actually come to understand why principal repayments are not tax deductible and that depreciation does not measure "a decline in asset value," "wear and tear," or any of the other non sequiturs accounting texts employ. Similarly, if students come to you in a managerial accounting course and report that their financial accounting instructor omitted altogether, or passed over lightly, a discussion of the statement of cash flows, it's time, in the lingo of our students, to back the truck up and teach the SCF—and not in a mechanistic, fill-in-the-blanks spreadsheet treatment, but through the Socratic method, so that they are forced to articulate their understanding of the flows.

A colleague emphasizes the importance of comparative performance by relating to seminar participants his standard answer to the polite inquiry, "How's your wife?" He uses his response—"Compared to what?"—to illustrate the superiority of measures like return on equity and the price-earnings ratio to the simple measurement of profit. Although it is not an example most of us would use in any venue, let alone a college

campus, it is provocative and focuses participants on the measures the marketplace uses to evaluate firms. But ROE and the P/E ratio both remain accounting-based, historical measures. In addition to giving greater emphasis to these measures, our teaching should also include discussion of earnings before interest, taxes, depreciation and amortization as a measure of the firm's cash generating ability, and EBITDA multiples as a measure of the firm's values. Finally, we should also be willing to introduce economic value added (EVA) as an alternative measure of a firm's operations and capital-investment decisions. The jury is still out on the effectiveness of EVA as an alternative measurement system, but introducing EVA to students has the dual advantages of emphasizing cash flow over accounting profit and generally demonstrating the limitations of historical accounting.

The approaches just suggested are hardly exhaustive. There are countless ways to teach the accounting model without compromising its significance, but while also giving students a more sophisticated, market-oriented view of the appropriate measures of hospitality industry performance. Our colleagues surely have the creativity to develop more approaches than the scant handful above. Whatever the techniques we use, however, we must move the emphasis away from simple profit if we are to serve our students well.

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