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fresh ideas...

Tired of Making Money for Someone Else?

We first published this article in 2016. We called it "Taking the Next Step, Are you Ready ?" At the time we thought interest rates were low and demand for a lifestyle change among corporate types and small MLR operators was pretty strong. Turns out Bachman Turner Overdrive were right……you ain't seen nothin" yet !

Come 2020 and the great Covid reckoning and it seems everyone is moving their plans forward. In the hotel management and hospitality space managers who might have planned to do their own thing in 10 years are now looking to do something in a much shorter time frame. For many the prospect of running their own show and leveraging their skills to value add to their own business just makes good sense. Given the scale of property that many industry professionals have been running the partnership model is compelling and allows access to businesses that might otherwise be out of reach for a single individual or couple. Of course, for hospitality professionals the final decision is very much in the hands of those who control our state and international borders but there's no doubt that people are ready to move. My expectation is that as soon as some certainty returns to the tourism sector we will see a migration of managers from corporate life to full or part ownership of management rights and other accommodation assets. Needless to say if you are one of those contemplating a change we are here to help and look forward to having a chat.

Anyway, edited and updated but largely unchanged (except for interest rates) here's how we see things today.

Human ambition is an interesting thing. Even while confronting the terror and stress of a new role or business venture many of us are already thinking about the next step. I reckon it's all part of our innate survival instinct ingrained into us as a species. I'll bet that even while our distance Neanderthal cousins were dragging that Brontosaurus back to the cave they were already planning the next hunting expedition and perhaps some improved techniques and a more effective and efficient conquest. All the better to improve ones lifestyle and avoid the risk of becoming dinosaur poo!

This thirst for improvement and the next big step is certainly alive and well in the management rights industry. The vast majority of our clients, having mastered the day to day management skills inherent in successful business operation inevitably turn their thoughts to the next step up. For some they can sell their existing business and have the fire power to go bigger by themselves. However, for many operators there is frustration as they build the necessary skills to operate quite large businesses but lack the equity to go it alone in a big high net profit property.

This dynamic can lead to a disconnect between skill sets and business size where the business operator is arguably over qualified but lacks the financial capacity to step up to the sort of business they are qualified to operate. In fact, the same can also apply to salaried on site managers. They develop strong skills and drive value within the business while creating no additional wealth for themselves.

Fear not, I have a plan. Just as there are experienced management rights operators looking for the next opportunity there are investors looking for somewhere to place their spare cash. Hopefully somewhere that might yield a better return than bank interest, property or shares. Given the abysmal returns in many asset classes that wouldn't be hard.

So, how might all this work? Typically an operator or an investor will approach us and express some interest in purchasing a management rights. They may have one in mind or they may simply be on the hunt. They will seek our input in terms of funding options and in many cases ask us to help manage the acquisition process end to end. We are seeing many investors using self-managed super funds to invest albeit these types of decisions are obviously taken in conjunction with independent legal, compliance and tax planning advice.

The operator of the rights is referred to as the managing partner (typically a husband and wife team or similar) and is paid a salary package by the partnership. This will usually consist of a cash component and the use of the managers unit in which to reside. In most cases an allowance is made to cover relief for 4 weeks holiday and utilities and levies associated with the managers unit are paid by the partnership. Reasonable supporting labour costs are allowed in the budget and a working capital reserve is also maintained.

On top of the salary the managing partners receive a return on their equity investment. If they are 20% shareholders in the partnership they will receive an equivalent distribution of profits after bank interest and liquidity provisions. It is important not to confuse the salary paid by the partnership with the working partners investment dividend. They are two entirely different matters and should never be combined to reflect a total income. Doing so distorts the real return as there is a return for labour and a separate return on equity. They are totally different matters albeit investors love the idea of the managing partners having skin in the game. I hate that expression but it serves its purpose in this context!

Equity calculations are pretty simple. We take the total purchase price, add costs and working capital allowances, take off bank debt and the balance is the required equity. Most investors will look at their slice of the total equity pie, analyse their likely cash return and convert that to a return on equity figure. Provided the return is appropriate for the perceived risk in the deal investors are likely to proceed.

As you can see the managing partner essentially has a duel role. On the one hand they are investors in the ownership of the asset and on the other hand they are employees of the partnership. I use employee as a broad term, it may well be a contract arrangement but you get the idea.

I can't talk about this subject without a word on debt and gearing. At present interest rates are at record lows so the miracle of leverage plays a big part in the success of these transactions. In this case what we are talking about is the ability to borrow at sub 3% variable rates and acquire an asset that may well be showing a 14% return on investment and a >20% return on equity. Clearly the more of that sub 3% money you can get your hands on the better the return on equity will be. However, a word of caution. We do not support the concept of fearless gearing nor do we believe that rates will stay low forever. Prudent borrowers will always plan for interest rate fluctuations, cyclical trading conditions and some volatility in asset values. Placing a portion of the total debt on P and I and taking a slightly lower return makes sense to us and builds a buffer for the inevitable speed bumps.

It's fair to say that there's a lot more to these transactions than I can cover in this forum. If you would like to know more or are contemplating the next big step give me a ring.

Disclaimer : This article does not constitute investment advice. We are not financial advisors nor do we hold an AFSL. The percentages and concepts used are for illustration purposes only and should not be relied upon in any manner. Parties contemplating the purchase of any business or any investment should consult their professional advisors.

PS…never heard of BTO………check out YouTube or ask your Dad !

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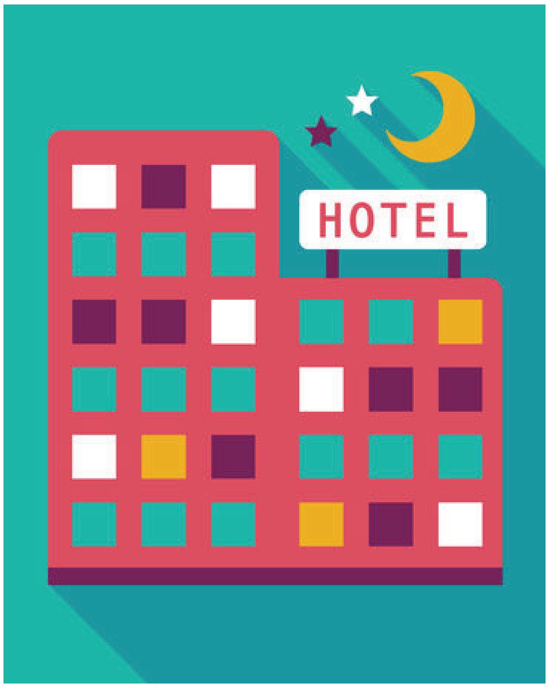

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