UNDERSTANDING MAINTAINABLE INCOME

One of the most hotly debated and often misunderstood concepts when determining the profitability of an accommodation business is the concept of 'maintainable income'.

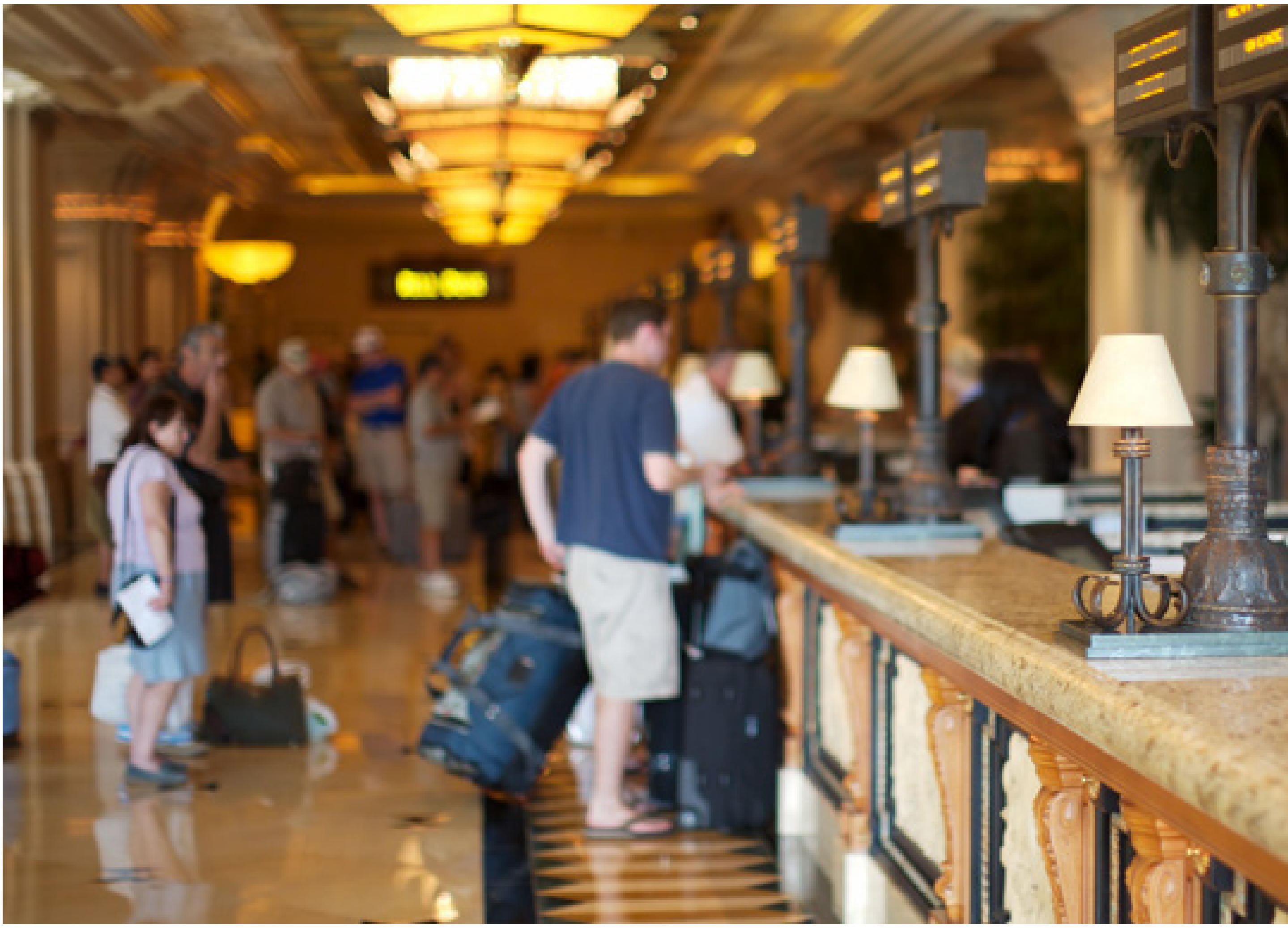
by TONY ROSSITER

The concept of 'future maintainable earnings' is a longstanding valuation principle, and possibly the most commonly used method of valuing an accommodation business is the capitalisation of the maintainable earnings of the business.

In a management rights context, the capitalisation rate is referred to as the 'multiple', whereas in other accommodation businesses it is generally expressed as the return on investment percentage or 'capitalisation rate'.

Determining the multiple or capitalisation rate is very much the domain of the valuers and agents specialising in the Industry, and is outside the scope of this article.

However, typically valuers and agents will rely on industry specialist accountants to determine the maintainable income and then apply their multiple or capitalisation rate to that income to determine the business value.



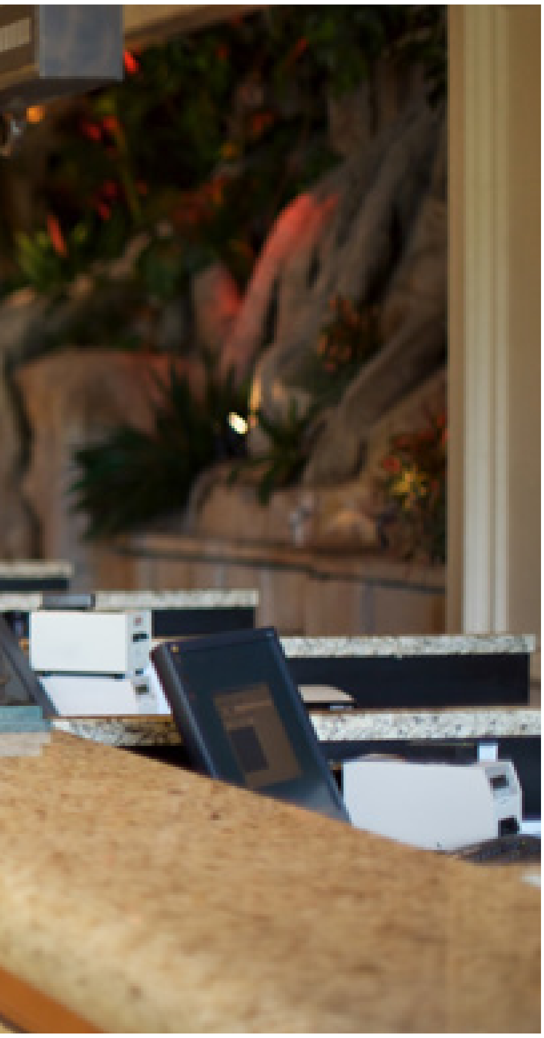
HOW IS 'MAINTAINABLE INCOME' DETERMINED?

Unfortunately there is no standard answer to this question. In the case of management rights, we have a number of generally recognised principles. However, the interpretation of these principles is often subjective and outcomes can vary.

One suggested definition of 'maintainable income' is: *"An average of the past profit history of the business derived from financial statements and representing the business's cycle, adjusted to reflect a true economic return"*. Interesting, but rather unhelpful!

Really, the concept of 'maintainable income' is centred on 'normalising' the income and expenses of the business to derive a profit figure that is considered to be sustainable into the future, assuming consistent trading conditions.

The process of normalising the income and expenses requires adjustments, which are often referred to as 'addbacks'. These addbacks seek to correct any anomalies imbedded in the income and expenses and include items such as expenditure of a personal nature, capital items, and extraordinary or non-recurring items.



The job of the industry specialist accountant is to correctly identify and make appropriate adjustments for these addbacks. Often, an accountant engaged by a seller may make a different interpretation to that of a buyer, with each professional seeking to ensure they are looking after the best interests of their client.

Typically, communication between the parties involved can resolve most differences of opinion. However, occasionally, a one-off event occurs that requires special attention.

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HOW ARE LARGE ONE-OFF EVENTS TREATED?

We last saw a significant one-off event that required special consideration with the G20 Summit held in Brisbane on November 15 and 16, 2014.

Although the official event was only for two days, we saw significant activity in the accommodation sector in the weeks preceding and post the event to accommodate security staff and local and international media, etc.

Generally, the event led to significantly increased one-off activity with inflated occupancy and massively increased average rates for the month of November 2014.

Often, the cashflows from this activity were not received until December or even January 2015, so accountants were required to carefully consider adjustments required to normalise this income.

The most common and generally recognised method of normalising this income was to look at the trading performance of the business for the same period in the previous year as a guide to what would have occurred in Brisbane in the absence of the G20.

Interestingly, in the Brisbane market, the G20 appears to have coincided with a general decline in corporate accommodation activity as a result of the slowdown in activity in the Queensland resources sector, with many properties unable to replicate their pre-G20 performance in the last two years.

The next big one-off event is undoubtedly the Commonwealth Games to be held on the Gold Coast 4–15 April, 2018. Again, the activity generated from this 11-day event will be spread over a significant period, with massive infrastructure development having occurred over an extended period in the lead-up to the event.

Speculation has begun over a possible post-Commonwealth Games hangover and how it might influence the accommodation sector.

Similarly to G20, the Commonwealth Games will require careful attention from industry accountants and valuers to ensure maintainable earnings and values are appropriately 'normalised'.

Sellers of an accommodation business should not expect windfall gains as a result of selling their property with inflated Commonwealth Games trading profits. Equally, post-Commonwealth Games buyers should be alert to the fact that they should not be paying for business value inflated by an event that will likely not occur again within their lifetime. **END**

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