HRIM 382
LECTURE 09

Profitability Ratios

This group of ratios describe the hotel/restaurant's ability to convert revenues into profits. It is also an indication of management's ability to control costs. Analysts look at profits in two ways: 1) as a percentage of sales, and 2) as a return on invested capital.

Ratios as percentage of sales

Profit Margin

1) **Profit margin: NI/TR**

$65,100/$1,500,000 = 4.3%

For every dollar of sales owners earn $0.04 in net profit.

If the margin is lower than expected, review departmental profit performances first, and then focus on service departmental performances second.

Gross Operating Profit Margin

2) **Gross Operating Profit Margin (Operating Efficiency Ratio): GOP/TR**

$375,000/$1,500,000 = 25%

This reflects costs controllable by the GM, consequently it is a good measure of the GM's performance.

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Return on Assets

Ratios as return on invested capital:

3) **Return on Assets (ROA): NI/TA**

$65,100/$640,000 = 10.2%

The owners made $0.10 net profit on each dollar of asset they own.

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Return on Assets (cont)

This captures the earning power of the hotel's assets. Note: A very high ratio may be the result of older assets (low net asset values), while a very low ratio may also be due to relatively newer assets (high net asset values).

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Return on Equity

4) **Return on Equity (ROE): NI/TOE**

$65,100/$310,000 = 21%

For each dollar the owners have invested they have earned $0.21 in net profits.

Note: sometimes a very high ROE may be the result of large earnings from sale of extraordinary items.

Earnings Per Share

6) **Earnings Per Share:**

$$\frac{\textbf{Net Income – Preferred dividends}}{\textbf{\# of common stock outstanding}}$$

Earnings Per Share (cont)

Where convertible securities, options, warrants and other agreements exist which may potentially change the number of outstanding common stock, FASB requires the reporting of two types of EPS: 1) primary EPS, and 2) fully diluted EPS (dilution that will result from conversions, exercises, and other contingent issues).

EPS can be affected by the purchase of treasury stock.

Price-Earnings (P/E) Ratio

7) **Price-Earnings (P/E) ratio: Market price per share/EPS**

The average P/E ratio for the Dow Jones Industrials ranges between 10 –18. Corporations with positive expected future earnings tend to have relatively high P/E ratios.

Activity Ratios

These ratios measure the effectiveness with which management uses the assets of the hotel/restaurant to generate revenues.

Inventory Turnover

1) **Inventory Turnover: Cost of Sales/Average Inventory**

$200,000/$5,000 = 40X

Inventory Turnover (cont)

This ratio measures the number of times inventory turns over during a period. Generally, the greater the number of times the better, because inventory can be expensive to maintain and perishable. This turnover ratio is calculated separately for food inventory and for beverage inventory.

Fixed Assets Turnover

2) **Fixed Assets Turnover: TR/Total Fixed Assets**

$1,500,000/$440,000 = 3.41

This measures management's effectiveness in using the fixed assets of the hotel/restaurant. A low turnover ratio suggests that assets are not being utilized efficiently.

Operating Ratios

Read these on your own: pp.217 – 223

- Average Room Rate
- REVPAR
- Food Cost percentage
- Average Check
- Beverage Cost percentage
- Labor Cost percentage

Issues about Financial Performance Measures

Handout # 5b

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Quality of Earnings

Analysts often express the opinion that the earnings of one hotel company are of higher quality than the earnings of other similar hotels. Why?

- Profits are the lifeblood of any business.
- Continuous losses can use up owners equity, drain assets from the business, and put the hotel at the mercy of creditors.

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Quality of Earnings (cont)

- When evaluating the future prospects of a hotel business, we must assess:

1) the size of the earnings.
2) trend in earnings growth rate.
3) source of earnings.
4) stability of earnings.

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Quality of Earnings (cont)

A volatile earnings performance over a period is less favorable/desirable than a steady stream.

A trend of increasing earnings is preferred over a trend of flat earnings.

Earnings from operating activities are preferred over non-operating activities.

Quality of Earnings (cont)

- Choice of significant accounting policies directly affect earnings quality, eg.
  - revenue and expense recognition and timing
  - inventory valuation methods directly affect COS and ultimately earnings

Quality of Earnings (cont)

- the lack of application of the conservatism principle of GAAP in low-balling revenue estimates and high-balling expense estimates can also influence the quality of earnings
- enormous pressure on management to show earnings growth leading to earnings management.

Financial Leverage

The use of debt in a hotel/restaurant's capital structure. Debt is good, but to be used prudently.

Positive financial leverage:
where ROA > cost of debt.

Negative financial leverage:
where ROA < cost of debt.

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