

## Case 27-3

## Phuket Beach Hotel: Valuing Mutually Exclusive Capital Projects\*

Mike Campbell, General Manager of Phuket Beach Hotel, paced his office and considered an offer made by Planet Karaoke Pub. Planet Karaoke Pub was expanding fast in Thailand. It was looking for a venue in the Patong beach area for setting up another outlet, and was eyeing an unused space owned by the Hotel. At this point, the space was located on the second floor of the main building and was very much underutilised. It was reserved for the construction of an alley linking to a new wing for the hotel, which would not be completed until two years later.

Planet Karaoke Pub offered to sign a four-year lease agreement with the hotel for renting part of the unused space. It proposed to pay:

- a monthly rental fee of 170,000 baht for the first two years; and
- thereafter, a 5 percent increment for the next two years.

In order to accommodate the hotel's expansion plan, Planet Karaoke Pub required only 70 percent of the unused space, which had a size of 3,000 sq. feet. This would allow the hotel to keep the remaining space for the creation of an alley two years later.

It was envisaged that the proposed pub would not affect the hotel's future expansion plan. Nevertheless, Mike was still a bit perplexed about the decision facing him. Similar development proposals had previously been rejected by the board of directors. One of the old proposals, which involved converting the space into a cigar and champagne bar, had been rejected by the board because it required a long payback period. Another proposal for the creation of a spa was discarded due to its low return on investment. Given that the present capital budgeting system ranked projects according to payback period and average return on investment, Mike decided to seek a careful analysis of the offer from the Pub.<sup>1</sup>

That evening, Mike asked to meet with Kornkrit Manming, the hotel's Financial Controller, to discuss the offer from Planet Karaoke Pub.

## THE MUTUALLY EXCLUSIVE PROJECTS

Mike's discussion with Kornkrit went as follows:

**Mike:** I see you have been busy. But I still need you to evaluate the offer from Planet Karaoke Pub for me, and to give me any positive or negative insights that you think are significant.

**Kornkrit:** No problem. I can present to you a detailed analysis within this week. But don't you think we should provide more alternatives for the hotel owners to decide?

**Mike:** That's what I've been thinking. Perhaps we can create a pub by ourselves. Karaoke pubs are spreading fast in Thailand. A number of surveys have shown that they attract a lot of customers and tourists.

**Kornkrit:** That sounds like a good idea.

**Mike:** Please assess the projects carefully. You may ask your new assistant Wanida to help you. This is simple, isn't it?

**Kornkrit:** I think the most difficult part is to estimate future profits and allocate overhead costs to each project. I'll work on this first. Then I'll ask Wanida to rank the projects according to their payback period and return on investment.

**Mike:** Good. I would like to have the results of your analysis next Monday.

## KORNKRIT'S ANALYSES

Kornkrit began his evaluation by reviewing the offer from Planet Karaoke Pub and estimating the revenues and costs associated with an alternative project, Beach Karaoke Pub.

*Planet Karaoke Pub*

To make the space ready for lease, the hotel had to set up partitions and a small kitchen. Various estimates of the up-front renovation costs ranged between 770,000 baht and 1,000,000 baht. The costs would be depreciated over the life of the project using the straight-line method, with zero salvage value. Since the existing toilets, elevators, and carpets would be utilised to

<sup>1</sup> Average return on investment = Average annual cashflow after taxes/Net investment

support this project, Kornkrit believed that a fair share of these overhead expenses should be allocated to the project. The pro rata allocation of the costs of these facilities, based on the floor area of the space used for the project, amounted to 55,000 baht. Due to the foreseeable increase in activity, Kornkrit would like to charge this project for an increase in repair and maintenance costs of 10,000 baht per annum. The pub would pay all utility and other expenses.

#### Beach Karaoke Pub

The project would require an up-front investment ranging between 800,000 and 1,200,000 baht. This represented the cost of a modern-style décor. Other capital investment, including chairs, bar tables, kitchen set-up, and karaoke equipment, would amount to 900,000 baht.

Food and beverage costs	25% of sales
Salaries	16% of sales
Other operating expenses	22% of sales
Depreciation: equipment & furniture	Depreciated equally over the life of the project using the straight-line method; with zero salvage value at the end
Annual capital expenditure	Equalled depreciation

Kornkrit estimated that salary expenses would account for 16 percent of sales. Staff could be recruited internally because the hotel had excess manpower at this point. The excess staff had long-term contracts with the hotel and were kept in order to meet the demands of the growing business. Repairs and maintenance costs were estimated to be the same as for Planet Karaoke Pub.

#### CAPITAL STRUCTURE

Phuket Beach Hotel has a capital structure consisting of 75 percent equity and 25 percent debt. The debt consisted entirely of loans from Siam Commercial Bank bearing an interest rate of 10 percent. The hotel owners' cost of equity was 12 percent. The corporate tax rate in Phuket was 30 percent.

#### THE TEST

Kornkrit was quite happy with his estimates, though it had taken him more time than he had originally thought. Now, he had all the figures he needed. The next step was to rank the projects according to the criteria set by the hotel's capital budgeting system. He saved his file and sent it to his new assistant Wanida, a recent graduate from Thammasat University. "Here

Kornkrit expected revenue to be generated 50 percent from walk-ins and 50 percent from hotel guests. Estimated total sales would be 4,672,000 baht for the first year of operation. Kornkrit arrived at this figure by assuming an average of 64 covers per day with an average check of 200 baht.

With a seating capacity of 32, the pub had to turn tables at least twice a day. Operating hours of the pub would be from 5:00 p.m. to midnight.

The projected length of the project was six years. Sales were expected to grow at 5 percent per annum in terms of the average check. Growth in covers would be limited due to limited capacity.

Kornkrit's estimates for operating costs were as follows:

you go, Wanida. This will test what you learnt at business school!" he thought.

The following is an excerpt from an email from Kornkrit:

To: Wanida Daoruang <wanida@beach-hotel.phuket>  
 From: Kornkrit Manming <kornkrit@beach-hotel.phuket>  
 Subject: Ranking Capital Projects

Dear Wanida,

... I have provided you with all the figures you need for the projection of future profits for the two projects. Please evaluate the projects on the basis of their payback period and their average return on investment. Note that future profits should be discounted at 5%. This is the interest rate we earned from our time deposits at Siam Commercial Bank. I believe some of our old proposals were rejected because we used a discount rate that was too high. Since we have enough cash on hand to finance the projects, I don't think we should take into account the cost of debt when estimating the discount rate.

Let me know if you have any questions.

Regards,  
 Kornkrit Manming

**TABLE A** Projection of Net Room Revenue (in Baht) (= Room Sales – Room Operating Expenses)

Year	1	2	3	4	5	6
Net room revenue	13,200,000	13,464,000	14,137,000	14,844,000	15,140,000	15,443,000

Wanida pondered the details of the projects. She thought there was something wrong with the hotel's capital budgeting system, which had not been reviewed for many years. The existing system ranked projects according to their average return on investment and payback period. It seemed to her that something was omitted in the analysis.

Wanida was also aware that certain aspects of the investment decision were difficult to quantify. The Chief Security Officer had expressed his concerns and displeasure over the security problems that a karaoke pub might bring. He was worried that the pub might attract unwelcome guests from outside. This might be a negative factor for the pub in terms of attracting tourists travelling with children. Wanida thought they accounted for 25 percent of the total patronage [see Table A for the projection on net room revenue for the next six years].

The following are the questions that Wanida considered:

1. What are the relevant cashflows associated with each project?
2. What criteria should be used to evaluate the projects?
3. How can I compare projects with different lives?
4. What discount rate should be used? Wanida thought the discount rate of 5 percent was too low. Investing in the two projects was certainly more risky than putting the money in the bank.
5. What are the key value drivers and how do they affect the attractiveness of the projects?

6. Which investment project should be recommended to the board of directors?

When Wanida got home, she had a talk with her husband about the proposed projects. Her husband, a social worker, reminded her of the increasing number of drug arrests in karaoke pubs. He suggested that as a good member of the community, the hotel should not be involved in this type of project.

## Questions

1. Assess the economic benefits associated with each of the capital projects. What is the initial outlay? What are the incremental cashflows over the life of the project? What is an appropriate discount rate to use for discounting the cashflows of the projects?
2. Rank the projects using various measures of investment attractiveness. Do all the measures rank the projects identically? Why or why not? Which criterion is the best?
3. Are the projects comparable based on the standard NPV measure, given that they have unequal lives? What adjustment or alternative method is required in comparing such projects?
4. How sensitive is your ranking to changes in the discount rate? What other "key value drivers" would affect the attractiveness of the projects? Estimate the sensitivity of your result to a change in any of the key value drivers.
5. Which project should the hotel undertake?