



# When is Enough...Enough...or Too Much?

Do you know whether or not the budgeted surplus for your club this financial year has been set correctly? Your club may be well ahead of budget but find its physical assets are falling into disrepair. There's no point saving money, only to risk a club's viability in the longer term. Alternatively, your club may be on budget but find it's unable to meet the aims of its strategic plan and charter. So, how much is really required to meet all of these goals?

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**F**or much of the past 50 years, the New South Wales club industry operated in a somewhat artificial business environment. The introduction of gaming machines half a century ago gave clubs a lifeline whenever more cash was needed. Over the years, many clubs removed themselves from financial difficulties by simply adding more gaming machines to cover any trading deficits or to fund capital expansion. Budgets were largely developed using the previous year's figures as a guide and adding something to account for inflation and "growth." But over time, the relevance of a budget to a club's underlying financial requirements could become increasingly out of touch with reality.

The introduction of the cap on New South Wales gaming machines in 2002, new gaming machine duties, future smoking laws, and the proliferation of a range of entertainment choices now

herald an era where clubs must operate with finite resources in a highly competitive environment. This means operating with greater financial discipline than even before. While clubs are not-for-profit organisations, they must generate sufficient net income to support operations, support future plans, and ensure they meet their charters.

Calculating the optimal level of profit for a public or private company is a relatively straightforward process. Shareholders and owners have an expectation for the level of return they expect for their investment. Companies set budgets that provide an adequate return to investors while protecting the business assets. Many companies also aim to generate sufficient profit to fund future growth and call on investors where necessary.

Although the activities undertaken by clubs are directed toward community

benefit, there are clear parallels with private and public companies. Like any other business, clubs still need to take into consideration what surplus is required to maintain their existing assets while generating income for other purposes. This is particularly important in an increasingly competitive market. A club's recreational offer must be attractive and be upgraded as required.

In addition to preserving existing assets, a club also needs to take into account where it is headed. Today's surplus should provide the capital base to execute the strategic plan. In contrast with public and private companies, where investors may find themselves being approached to underwrite growth, clubs need to fund strategic plans from their own resources or borrow from banks and other financial institutions when appropriate.

Most importantly, clubs need to earn sufficient income to meet their founding

charters. The size of that income needs to also take into account their role in supporting community projects. These requirements will vary depending on commitments.

Bearing in mind asset preservation, strategic direction, and individual club charters, when is enough revenue surplus enough? Although the appropriate level will vary from club to club, there are benchmarks that can be applied across the board.

## Preserving Assets

A typical rule of thumb is that a business should earn a pre-tax surplus of between 7 and 10% on the value of its assets. In effect, this measure is a return on assets (ROA) based on an arbitrary cost of capital. On this basis, if a club has assets of \$10 million, it should have a normal operating surplus (after gaming duty but before company tax) of between \$700,000 and \$1 million per annum. This level provides a good starting point for maintaining existing assets, providing a base surplus to meet club objects, and ensure money is in the bank to support the strategic plan.

The principle is simple but very few clubs in New South Wales today are achieving a return on assets of this magnitude. So, why would this be the case? Competition is much tougher, particularly from hotels, casinos, and new forms of entertainment, such as the internet. The cost of trading is higher as well, with greater compliance costs and lower gross margins. Creating an additional challenge is the increased level of investment required to provide services to members and remain competitive. The net result of all these factors is that margins and overall surpluses are shrinking while capital costs continue to increase.

However, this does not mean that it's impossible to prosper and grow. In order to address the challenges, clubs need to look more closely at a range of efficiency measures to ensure they are generating an appropriate level of income from operations.

Key questions to ask include:

- **What gross margins are being achieved on food and beverage sales?** Clubs must realise that the

days of giving away food in order to attract patrons are over. The numbers simply don't stack up.

- **Are promotions being run as a cost or profit centre?** Promotions should be run on a self-funded basis, and not cost more than what they bring in.
- **Is each department making a positive contribution to overheads?** A sure fire way to improve this is to pare back loss-making operations.
- **Are wage percentages in line with industry averages and are they appropriate?** Improving rostering efficiency and productivity is a necessity in today's competitive market.

## A Disciplined Approach

Aside from taking steps to optimise net revenue, clubs should ensure that any new projects are undertaken using a disciplined approach to capital management. In effect, all proposals to spend capital works should be formally assessed using return on investment criteria, and considered in the context of the club's strategic plan.

A traditional rule of thumb used for investment purposes is a hurdle rate of 10%. In other words, an investment proposal should show a positive outcome when the value of money over time is taken into consideration. If it doesn't, the club could be better off leaving the money to gather interest in a bank.

Feasibility studies should be conducted to properly estimate the cost of a proposal. These studies provide an independent review of revenue and operating cost forecasts. Formal investment assessment techniques, such as discounted cash flow analysis, should also be used to gauge a proposal's financial viability. This analysis technique takes into account the club's cost of capital and ensures members' funds are being used wisely to grow the club's asset base.

## Using the Strategic Plan

Planning for long-term prosperity requires the development of a strategic plan. A key issue for clubs is to make sure that there is sufficient income from operations to help seed fund

long-term projects associated with this plan. Any approved project should be cash flow positive in the medium to long-term and improve the club's asset base. Remember, new ventures or developments typically soak up money in the early stages until they become cash generating.

Consider adopting a banker's perspective when determining how much surplus is enough. When a bank assesses a loan application it looks for sufficient security in the form of property. It also considers the ability to service the loan through cash flow. In the case of a club this means ensuring current cash flow from existing operations, as well as projected cash flow from investment proposals, can service any debt. Secondly, investment proposals that have been independently reviewed by credible third parties need to show adequate projected cash flow to service the debt and payback the principal.

## Consider Your Reason for Being

Sustainability and investment issues are important components of the surplus question. Addressing them ensures the club will continue to thrive. This is essential if clubs are to continue supporting the community.

Last, but most certainly not least, clubs must consider their charters as well. Each one has come into existence to meet the needs of members in supporting worthwhile community activities. The amount that is required to service these projects must also be taken into account when determining how much net income needs to be generated.

Ultimately, the question of how much is enough is clearly a complex issue which cannot be simply answered with an arbitrary number. ■

**About the Author:** Greg Russell is a chartered accountant with expertise in hospitality and gaming. His company's services include strategic planning, financial analysis & modelling, reporting, amalgamations, social impact assessments, and restructuring.