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# DECISIONS, DECISIONS... WHICH HOTEL OPERATING MODEL IS RIGHT FOR YOU?

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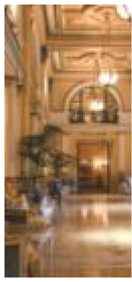

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# The Choice of Models

*The hotel industry has seen a proliferation in the number of players and stakeholders that can and should be involved in a successful hotel. Hotel brands, owners and management companies have created permutations and combinations of operating models that, when used appropriately, will increase profitability, make a project more attractive to lenders and add value to guests.*

*Given this, the question owners must then ask themselves is: What model is right for my hotel? This article aims to provide a brief overview and comparison of leases, franchises and management agreements.*

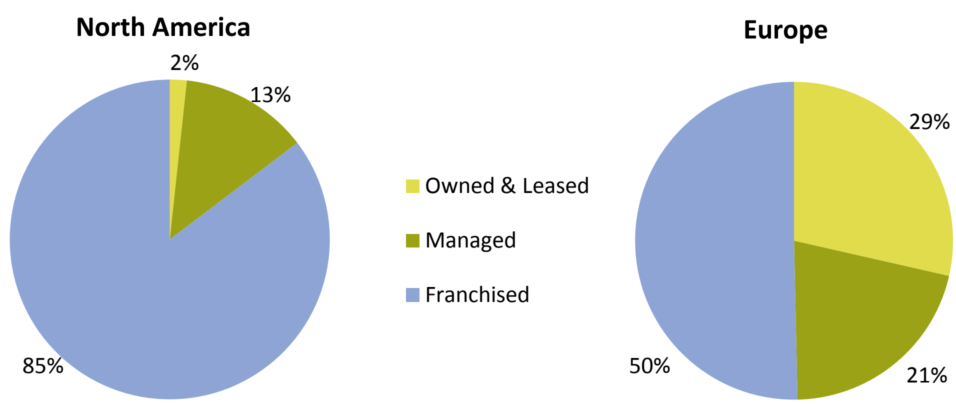
## An Overview of the Models

A **lease** is defined as a contract by which one party conveys land, property, services and so forth to another for a specified period of time, usually in return for periodic payments. A lease involves a landlord and tenant, the latter of whom can choose to either operate the hotel directly or subcontract operations using management contracts and/or franchises. Under pressure from investors to lighten their balance sheets, major hotel companies have moved away from ownership as well as leases, as fixed lease payments must be disclosed as a liability on their balance sheets. Using variable lease payments circumvents this requirement, and has helped leases remain a viable operating model in Europe, especially in countries such as Spain and Germany. Comparing operating models from a sample of major hotel chains reveals that this model is much less present in North America (see Figure 1).

Under a **hotel management agreement** (HMA), a brand or management company will take over the operations of a property from the owner in exchange for a fee. The owner will bear all risks (including employment contracts), while the operator deals with all management issues. While hotel owners and operators can provide significant value to each other, their goals and priorities might not always be aligned and can sometimes conflict owing to the 'client-facing' nature of hotel chains. Considering this and the generally long-term and binding nature of an HMA, it is advisable that careful and expert negotiation is used to ensure mutual benefits. Hotels with management agreements form a significant portion of major hotel chains' portfolios in Europe, and slightly less so in North America.

Under a **franchise**, a franchisee has the right to use a brand, the distribution channels, and other proprietary knowledge of a franchisor. The owner retains all risks and liabilities of the business, but, unlike an HMA, they also retain control of the property. A franchisee has the option to either operate the asset directly, or hire a third party operator to run the property on their behalf. While not always necessary or appropriate, using a third-party operator can bring valuable expertise, flexibility and strong cost control to brand distribution systems. Whilst chains are customer-facing, third-party operators are owner-facing, which may result in a greater alignment of interest. As with management agreements, the different goals of the parties involved require a franchise deal to be properly

**FIGURE 1: NORTH AMERICA VS EUROPEAN OPERATING MODELS IN MAJOR HOTEL CHAINS**




[1] Companies sampled include Accor, IHG, Hilton, Hyatt, and Marriott
Source: HVS research

structured to meet the requirements of the owner, brand and, if present, third-party operator. Franchises are by far the most dominant operating model in North America, and has been the emphasis of major chains' expansion strategies across the world.

The following paragraphs briefly describe the pros and cons of each of these models.

## Leases – Advantages and Limitations

The main advantages owners find in leases are the stable, predictable returns and the resulting lower degrees of risk. This makes obtaining financing easier and appeals greatly to institutional investors. However, as leases are generally not the preferred operating model for brands and management companies, it can be difficult to attract capable operators, particularly in the case of smaller and strategically less-important properties. Furthermore, the fixed payments come at the cost to the owner of profiting from the upside of the business when the hotel is performing strongly (in the cased of fixed leases).

From the tenant's perspective, a lease offers a high degree of control over operations, positioning and the product itself. In good times, operators can receive more than they would have under a management contract (depending of course on rent levels), as all profit after expenses and rent go straight to their pocket. In difficult times, however, the obligation of meeting rent payments creates additional risk and a debt-like liability on the balance sheet. As mentioned previously, the advent of hybrid and variable leases might defer this problem, but it does require an owner willing to share the risk of the business. Figure 2 provides a summary of the advantages and limitations of leases.

## Management Agreements – Advantages and Limitations

Management agreements provide the owner with solid upside potential after payment of fees when compared to a lease. The opposite is of course also true, as the owner assumes the operating risk. HMAs may also include contractual provisions that effectively give the owner increased control over the maintenance and condition of the building and property. It allows the owner to enter the hotel industry without the requirements of extensive experience or having an operations and management team in place.

Brand operators will almost always prefer a management agreement over a lease. It allows for the expansion of the brand, the receipt of management and brand fees and the opportunity to earn incentive fees often with minimal investment. However, earnings are limited to the fees received, and, depending on the fee structure, exposes the operator to higher market risk. There is also a degree of dependence on ownership for project development and capital investment. When insufficient capital investment is received, the brand can be negatively impacted.

Management contracts can be complex, longer in term, and binding. They can be and often are the choice model for both owners and operators, but they must be entered into with expert advice and careful negotiation to ensure the interests of all parties are as aligned as possible. Figure 3 on the following page outlines management agreement pros and cons. For an extensive collation and comparison of key terms and clauses of management contracts, the HVS Hotel Management Contract Survey is available for purchase online from the HVS Bookstore.

**FIGURE 2: LEASES ADVANTAGES AND LIMITATIONS**

| Party | Advantages | Limitations |
|---|---|---|
| **Owner** | • Limited experience required<br>• Easier to predict returns<br>• Lower market/operating risks assumed<br>• Easier to obtain financing<br>• Shorter term<br>• Appealing to institutional investors | • Covenant strength<br>• Lack of appetite from brands and operating companies<br>• No control over hotel operations<br>• Less control over hotel positioning<br>• Potential loss of upside business |
| **Tenant** | • Growth of the brand (if a brand)<br>• Potential benefit from upside<br>• Control over quality of product and capital expenditure investment to strengthen brand<br>• Stronger tenant's right in the event of foreclosure | • Higher market/operating risks assumed<br>• Operating loss risk + rent payments<br>• Termination and exit might be difficult<br>• Liability on balance sheet<br>• Impact on credit rating, debt capacity, share price |

FIGURE 3: MANAGEMENT CONTRACT ADVANTAGES AND LIMITATIONS

| Party | Advantages | Limitations |
|---|---|---|
| **Owner** | • Limited experience required<br>• No operations team or management effort<br>• Easier to finance with strong brand and operating company<br>• Access to Development, Design and Operations support from brand<br>• Solid upside potential after fees | • No control over hotel operations<br>• Higher market/operating risks assumed<br>• Operating loss risk + fees payable<br>• Lack of control over brand reputation<br>• Bound to brand-imposed global initiatives |
| **Brand Company** | • Brand growth with minimal investment<br>• Growth of operating structure<br>• Brand + management revenues with minimal investment<br>• Opportunity to earn incentive fees<br>• Lower market risk | • Earnings limited to fees<br>• Incentive fees subject to higher market risk<br>• Dependence on ownership for project development and capital expenditure – potential brand risk |

## Franchises – Advantages and Limitations

When a hotel owner chooses to operate his or her hotel under a franchise agreement, they gain instant access to global distribution systems and strong development, design and operations support from the brand. As a franchisee, they benefit from the use of a tried-and-tested business model, a strongly protected and supported brand name, and a large upside potential after fees. However, the reverse is also true as the owner assumes greater market and operating risks with no guarantee of success. Many of the benefits depend on the size and scale of the franchisor, and the franchisee may need to commit to chain-wide initiatives that have little return on investment for their individual hotel. An experienced operating team or third-party operator is required, although this can actually be an advantage, as discussed later in this article.

The franchisor can grow their brand or brands at a greatly accelerated pace with minimal investment, given that monitoring costs for franchises are lower than those required in a management contract. From a brand perspective, royalty fees are earned with little capital at stake, low market risk is assumed, and there is no operating risk. Better results, increased efficiences, and cost savings come at the cost of operating control and fees being limited to revenue-based franchise fees. As with the franchisee, the franchisor's brand can be negatively impacted by non-conforming or poorly performing hotels.

Master franchises are also becoming increasingly common. Under this scenario, the franchisee will typically benefit from the right to use the brand for more than one unit, usually over a specified region, and commits to a pre-defined schedule of openings. Figure 4 provides an overview of the advantages and limitations of franchising for both the owner and brand company.

The advantages and limitations discussed for each of the models are largely derived from the source of income, the services provided, and the contractual and fiduciary obligations of the parties involved. Figure 5 on the following page provides a brief comparison of the three models discussed in the above sections.

FIGURE 4: FRANCHISE ADVANTAGES AND LIMITATIONS

| Party | Advantages | Limitations |
|---|---|---|
| **Owner** | • Full operational control within brand standards<br>• Instant market presence and access to global distribution systems<br>• Access to Development, Design and Operations support from brand<br>• Stronger upside potential for profits after fees (5-9% of rooms revenues) | • Experienced operating team or third-party operator required plus management effort<br>• Higher market/operating risks assumed<br>• Operating loss risk + fees payable<br>• Lack of control over brand reputation<br>• Bound to brand-imposed global initiatives |
| **Brand Company** | • Growth of brand with minimal investment and effort<br>• Increased brand fees with minimal investment and effort<br>• Low market risk and no operating risk<br>• Ability to terminate if non-compliance issues | • Risk of quality of operation, guest and employee satisfaction, and brand image<br>• Fees limited to franchise fees<br>• Does not contribute to the growth of the operating structure |

FIGURE 5: COMPARISON OF TYPICAL OPERATING MODELS

| | Franchise | Management Contract* | Lease |
|---|---|---|---|
| **Income** | BRAND: royalty + other fees<br>OWNER: Operating Profit after fees | BRAND: base + other fees<br>OWNER: Operating Profit after fees | TENANT: profits after rent<br>LANDLORD: rent receivable |
| **Services provided by Hotel Company** | Brand, S&M support, reservation system and purchasing | Management, hiring & training staff, brand, S&M, reservations, purchasing | Management, hiring & training staff, brand, S&M, reservations, purchasing |
| **Contract term (years)** | 10-20 + years (average +/-15) | 15-30 (even 40 sometimes!) | Generally 20 or more |
| **Employees and Operating Company** | Owner's responsibility | Owner's responsibility | Lessee's responsibility |
| **Financial Commitment** | Owner's all or most (brand might consider key money) | OWNER: all or most<br>BRAND: may provide key money or guarantees | Fixed rent, variable rent or combination |
| **Prop Tax, Insurance and large renovations** | Owner's responsibility | Owner's responsibility | Normally landlord's, but can be negotiated |
| **FF&E replacement** | Owner's responsibility | Owner's responsibility | Lessee's responsibility |

## The Big Chains – Where do they fit in?

Considering the above pros and cons of the various operating models, where do the big chains fit in, and under what models do they see themselves achieving their growth objectives in the coming years?

While it is true that there is no one-size-fits-all model and that all operating models will have a place amongst most of the large chains, many companies are placing an increasing emphasis on franchising. At present, branded properties account for an estimated 53% of the global hotel market. Five of the largest branded hotel companies (IHG, Accor, Marriott, Hilton and Starwood) together account for 30% of the current global branded room supply and 65% of the development pipeline, which indicates an increasing shift away from independently operated hotels worldwide.

Given the large proportion of branded rooms in the global pipeline, significant insight can be gained from analysing the portfolio of the big chains and their respective growth strategies. Large differences still remain between North America and Europe as illustrated in Figure 1 at the beginning of this article. For example, IHG, which has 76% of its properties in the Americas, leans heavily towards franchising. In the USA, more than 90% of its current rooms supply and pipeline are franchises. In Europe, franchises still represent the significant majority of its portfolio at 80%. Franchises also represent three quarters of the company's European pipeline, with management contracts accounting for the remainder.

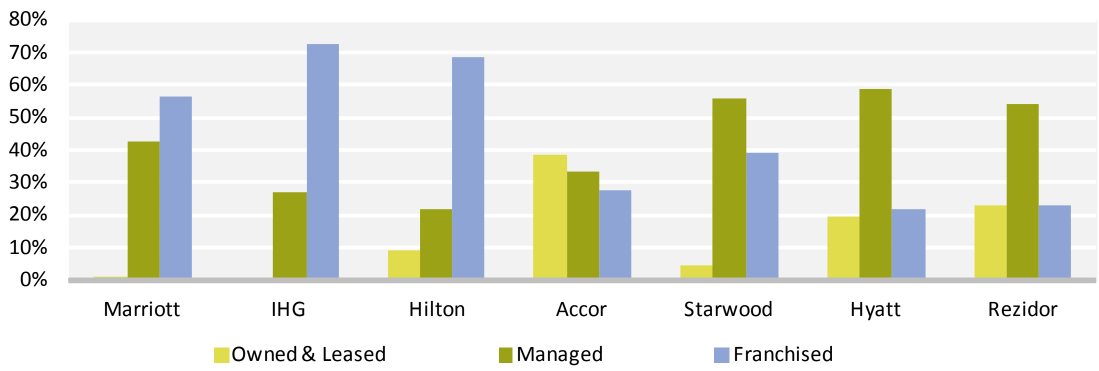
**Branded properties account for an estimated 53% of the global hotel market.**

At the other end of the spectrum, Accor's portfolio and pipeline highlight the differences between the two regions. With approximately 55% of room supply located in Europe, the company's global pipeline consists of only 20% franchised, 70% management agreements, and 10% owned and leased. Figure 6 provides a selection of the major chains' worldwide portfolios broken down by operating models.

The differences between these two regions are not restricted to major brands only. Independent hotels are still much more commonplace in Europe than they are in North America for a variety of cultural and legal reasons. In the USA, the franchise market is highly regulated, and franchisors are required to provide potential franchisees with a Franchise Disclosure Document prior to signing or payment. The increased transparency and ease of comparison between different franchise options increases the franchise model's attraction to hotel owners. In Europe, the regulations differ country-to-country, creating greater difficulty for the franchisor to roll out its brand.

**FIGURE 6: GLOBAL PORTFOLIOS OF MAJOR HOTEL CHAINS**

| | Year | Owned & Leased Rooms | Owned & Leased % Portfolio | Managed Rooms | Managed % Portfolio | Franchised Rooms | Franchised % Portfolio | Total Rooms |
|---|---|---|---|---|---|---|---|---|
| Marriott | 2014 | 9,879 | 1.4 % | 303,341 | 42.4 % | 401,545 | 56.2 % | 714,765 |
| IHG | 2014 | 3,190 | 0.4 | 192,121 | 27.0 | 514,984 | 72.5 | 710,295 |
| Hilton | 2013 | 61,670 | 9.1 | 150,318 | 22.2 | 466,642 | 68.8 | 678,630 |
| Accor | 2014 | 186,468 | 38.7 | 162,171 | 33.6 | 133,657 | 27.7 | 482,296 |
| Starwood | 2013 | 15,900 | 4.7 | 189,900 | 56.0 | 133,400 | 39.3 | 339,200 |
| Hyatt | 2013 | 28,039 | 19.4 | 84,919 | 58.8 | 31,441 | 21.8 | 144,399 |
| Rezidor | 2014 | 17,538 | 22.9 | 41,339 | 54.0 | 17,732 | 23.1 | 76,609 |
| **Total Rooms** | | **322,684** | **10.3 %** | **1,124,109** | **35.7 %** | **1,699,401** | **54.0 %** | **3,146,194** |




Source: HVS research, Annual Reports

As brands increase their presence in secondary and tertiary locations, small or tired independent hotels are finding it increasingly difficult to compete. This has created new opportunities and franchising potential for less-standardised brands such as Choice Hotels that are able to bring these hotels under their flag with more limited capital expenditure, giving them the exposure and brand recognition required to remain competitive. These players might be willing to use their balance sheet and propose different models of joint venture to owners.

## Third-Party Operators

With the increasing presence of branded hotels across the world and many major chains focusing on franchising as the choice method of expansion, owners and brand companies are left with the challenge of ensuring their mutual interests are in capable hands. While many franchisees are owner-operators and have the management expertise to be successful, there remains a gap between owners that are unable or unwilling to control the daily operations of the hotel and the franchisors that provide the brand. This is where third-party operators (TPOs) have come into prominence.

Independent operators are an obvious choice for unbranded, independent properties, but can also be an excellent and valuable inclusion in franchised hotels. Owners may at first be hesitant to engage one, as it may seem like poor business sense to share the revenue and profit pie amongst three parties when it could be split between just two. As can be seen in the table below, the fees between independent and branded operators (based on full-service properties) are relatively comparable, although independent operators do see a wider range. When considering that the cost of operating under the brand is additional to these fees in the case of the independent operator, the nominal cost of the third-party operator may indeed be higher.

**FIGURE 7: BRANDED VS THIRD-PARTY MANAGEMENT**

| | Branded Operator | Third-Party Operator |
|---|---|---|
| **Loyalty** | To the brand | To the owner |
| **Priority** | Top line | Bottom line |
| **Base Fee** | 2.0-3.5% | 1.5-2.5% |
| **Incentive Fee** | 6-10% | 5-8% |
| **Cost of Brand** | Included in fees | Additional Royalty Fees |
| **Average Term** | 15-30 years, plus renewal terms | 5-10 years*, plus renewal terms |

*Highly negotiable, and can be as low as 1 year.

Source: HVS research, Cornell University

However, several key differences make third-party operators a suitable choice. These companies are loyal to the owner, where branded operators are loyal first and foremost to the brand. That is not to say that branded operators ignore the owner's interests nor that TPOs do not care for the brand standards dictated by the franchise agreement, but they do have different priorities. Brand managers will aim to present the brand in the best possible light and can therefore be less concerned with achieving economies in operation than an independent, TPO would be.

Flexibility is another key strength of TPOs. While a franchise agreement will still impose certain restrictions and brand standards that a hotel must conform to, they are generally less restrictive than the standards by which a branded management company would operate. TPOs often have a range of experience across several brands, and are able to adapt more easily to the specific needs and requirements of the business. For owners of multiple hotels under different brands, selecting a single TPO allows for homogenous reporting across all properties, increasing the ease of comparing performance across the portfolio.

So what exactly does the rise of TPOs mean for the brands? Are they now direct competitors in an already fiercely competitive environment? The answer is quite the contrary! While there have been and will certainly continue to be many instances where an owner will have both branded and third-party operators interested in managing their properties, the business models of the major chains and TPOs are actually complementary to a large degree. As mentioned previously, franchising is a preferred means of expansion for many brands, and engaging an experienced and reputable TPO such as Interstate or BDL-Redefine will help assure owners, franchisors and lenders that the business will be managed with competence. TPOs have allowed companies such as IHG to sell their flag first and direct their management efforts towards the hotels and brands they deem appropriate, while the owner is able to realise advantages of both franchises and management agreements while avoiding a number of the limitations.

Generally speaking, hotel chains will prefer to manage directly those hotels with higher price points and a larger number of guest and meeting rooms. They may also prefer to maintain tighter control and operate directly when developing new brands or entering new and emerging markets in order to protect and adhere to their vision of what they wish the brand to represent. For the remainder, franchises operated by TPOs can be an extremely effective model.

## Future Outlook and Conclusions

The main operating models offer a range of choice for both owners and management companies. Each comes with its own set of advantages and disadvantages that make them more or less favourable depending on the requirements and priorities of the owner. The lease provides predictable cash-flow to the owner, but removes the owner from taking part in the operations or the upside of the business (in the case of a fixed lease). Management contracts allow owners to enter the industry with little experience required and enjoy greater profits when business is good, but at the cost of assuming greater operating and market risk. Franchises provide the owner with the right to operate the hotel themselves under a brand name and to have access to the franchisor's distribution and marketing systems in exchange for paying royalty fees, however they must also have significant management expertise or make use of a third-party operator.

In the coming years, franchising will likely continue to gain ground as the preferred operating model for a number of reasons: major chains have placed increasing emphasis on franchising to meet their desired expansion pace; TPOs have proven competent in bridging the gap between owners and brand companies; and small independent hotels in secondary locations turn to flexible, less-standardised franchisors to remain competitive.

With that said, there will never be a one-size-fits-all operating model. The experience and risk appetite of the owner, the size and standard of the property, and the suitability and availability of potential brands are but a few of the components that factor into which model is most suitable.

## About HVS

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