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Staying power - finding the best model for investing in hotel and resort developments

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Owning a hotel or resort may be a dream. Once you have fallen in love with a project, which is often a prerequisite, there is much to consider such as location, segment, size, service concept, business mix, demand generators and facilities.

Something less obvious to first-time hoteliers, is selecting the right business management model.

There are probably few truly passive real estate investments, but hotel businesses are especially active and require day-to-day attention. Professional management and distribution are often only part of the answer. Seasoned hotel investors will tell you that professional managers need to be monitored and challenged to enhance guest experience and drive asset performance.

New development vs acquisition of existing hotel

This choice is often driven by the real estate opportunity at hand. In both developing and mature markets, ideally where hotel demand exceeds current and short-term newroom supply, there can be significant upsides if you are prepared to take on development risk.

Advantages of a new development:

- Opportunity to create a bespoke asset, optimising the concept, space planning and room mix. It is, at times, more cost effective developing a new property than trying to change the space configuration and rectifying the flows in the structure of an existing property;
- tapping unmet demand with a new story instead of inheriting the legacy of the existing property;
- reduced capital expense requirements in the first five years of operation; and
- competitive tension created in the operator selection process with the right offering and location.

Advantages of acquiring an existing hotel:

- Often a less risky way to learn about hotel investment lifecycles and operations;
- availability of existing cash flow saves the time required to build and stabilise operations – even if the hotel needs renovation or refurbishment, the process can often be in phases, without the closure of the entire hotel;
- existing cash flow will also assist in securing debt finance and co-investors; and
- tapping a new market segment can be a game changer for capital values. For example, the fast-moving CBD hotel sector, with global operators developing new brands to chase younger leisure and business travellers. Unlocking a new market segment for an existing, perhaps under-loved, property can be a game changer for capital values.

Management vs franchise

Most hotel operators no longer own the hotels carrying their brands. Instead, they favour the “asset-light”, or “asset-right”, model. Hence, if you own the capital asset, you will need to decide on the following:

- Self-manage and self-brand, or

- self-manage with the benefit of a brand and distribution system you license from a professional hotel operator, or
- engage one of the hotel operators to manage your property under their brands.

Unless you are an experienced hotelier with a dedicated team of hotel professionals committed to your asset, then self-management or even franchise may not be your best option. As the largest global operators consolidate and grow their market share, an independent hotelier – without access to a significant room distribution system and economies of scale – will be an increasingly niche option. An alternative would be to have your hotel managed by a branded professional hotel operator.

Developers and investors should be aware of the core concepts of the Hotel Management Agreement (HMA), which is effectively a combination of a licence and service contract, and certainly not a lease:

- The hotel owner benefits from the upside returns and bears the downside risks of the business, while the operator's revenue stream is limited to its management fees (which are usually driven by total operating revenue and gross operating profit – so not directly linked to the owner's net income);
- the owner is obligated to not interfere with day-to-day operations of the hotel, with rather limited ability to influence the business;
- the hotel has to comply with the operator's brand standards, both operational and physical, at all times, including changes thereto throughout the terms of the HMA;
- unless an owner's return guarantee is agreed with the operator, the owner is not assured of any level of income. However, when the business generates insufficient cash flow to cover operating and non-operating expenses, the owner must provide additional working capital;
- the owner, when needed, has to undertake capital improvements for the hotel to stay competitive and meet brand standards;
- typically, the HMA term is long (10-30 years) and the owners have limited rights to terminate the operator;
- the operator enjoys full indemnity from the owner in case of third-party claims related to hotel operations; and
- hotel staff are the employees of the hotel owner, albeit it is the operator who selects and hires them with little or no involvement from the owner.
- Should the owner wish to be more independent from the operator, or to make the operator share the business risks, then hybrid business models, such as a man-chise or joint venture, may be considered. Usually, operators are fairly selective in taking on joint ventures.

Selecting the right hotel operator/franchisor

If you have decided that engaging a third-party operator or brand is the right business model, it is time to pin down potential candidates for the hotel operator/franchisor's role. One must remember that the selection process is not just choosing a big brand. It is finding a partner that best matches your particular hotel, in terms of added value with due consideration of local market specifics, competition among rivals, and potential for growth. You will also want to drive competitive HMA terms that reflect the opportunity you are giving the operator by appointing them to brand your property.

In order to optimise the operator selection process, the developer should identify its top priorities and ensure they are reflected in the request for proposal. In our discussions with owners and developers, the following priorities often arise:

- Developer's investment strategy – build-to-own or build-to-sell? In the latter case, you should negotiate the right to terminate the HMA on sale if the buyer requires vacant possession;
- brand and market positioning – Is the brand and operator forward thinking? Does their philosophy match yours?
- initial term of the HMA and conditions for extension (depending on the strength of the brand in the local market, bargaining strength of the parties, availability of a truly working performance test, etc);
- exit strategy – availability of an effective performance test, or alternatively, termination without cause, subject to payment of reasonable pre-agreed liquidated damages;
- minimum required exclusivity area (depending on the location, existing and anticipated supply and demand in the immediate market/submarket);
- key money from the operator;
- extent of developer's expected involvement in the business (for example through efficient budget approval process, spending limitation hurdles in respect of major expense items such as furniture, fittings and equipment, CapEx, outsourcing of services, etc);
- competing properties the operator controls in the local market – How will they impact your asset? How will the operator use that scale to benefit your business?
- requirements of any financier – subordination of operator's incentive fee, contract term, termination on sale subject to pre-agreed liquidated damages, sliding scale of base and incentive fees, loan-to-value ratio, etc.

Owners have different priorities at different stages of a project. Initially, it may be securing finance or development approval, thereafter, getting the hotel to operating maturity as quickly as possible, and then focusing on bottom- line performance, operator's fees and maximising the exit opportunity.

Only projects with the most sought after locations and sponsors will tick all the boxes in the above list. Developers often have to choose possible deal-breakers carefully, with an estimation of their bargaining position.

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