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Vital information for hotel decision makers

How to choose the best franchise contract

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The lure of the hotel business holds many pitfalls for the first-time hotel investor. Here's how one investor worked through the process.

By Gary Isenberg
HNN columnist

There is something about the hotel business that seems to attract first-time hotel investors and owners.

Tempted by the potential for attractive internal rates of return and high profit margins, experienced commercial and residential real estate developers jump at the chance to enter into what they perceive as a lively, more interesting market segment. Or perhaps ego comes into play, as they are enthralled with the idea of owning a grand and/or hip hotel, compared with a staid office building or a cookie-cutter condominium tower.

There are two distinct aspects of running a hotel that newbies might fail to grasp. There is the "hotel business," which appears so spirited and fun to an outsider (and it can be.) Then there is the "business of hotels," which involves the nitty-gritty of daily operations and structuring long-term contracts such as a franchise agreement—elements that are unfamiliar to many new hotel real estate investors.

While there are many commonalities between hotel and conventional real estate investments—debt and equity, leveraged returns, internal rate of returns, cost of capital, valuation, capital improvements, to name a few—it is those same similarities that might lull an inexperienced investor into a misleading sense of comfort. Many newcomers are blind to the complexities and fundamental nuances associated with owning a hotel.

A hotel is a day-to-day neighborhood operating business, an ongoing concern, which happens to be housed in the bricks and mortar of a real estate investment. A hotel differs greatly from other forms of commercial real estate such as office, retail and multifamily assets, where tenants are committed to long-term leases and turnover typically occurs once every several years. Contrast that to a hotel, where room inventory is sold every day. Hotel rooms are perishable products with a shelf life of 24 hours, and any unsold units results in permanent lost revenue.

Yet the daily sale of guestrooms affords hoteliers the ability to adjust pricing every day. With today's technology, pricing can be upgraded in a split second, which presents an opportunity to profit from variations in immediate and short-term demand trends. Again, this alluring possibility might cast a deceptive spell over inexperienced hotel investors as room rates can just as easily plunge downward. That same pricing flexibility, coupled with perishable inventory, breeds a volatility that might shock unprepared newcomers.

The unpredictability of the hotel business paired with a hospitality rookie renders navigating through the planning, negotiating and development phases quite hazardous. Bad decisions due to lack of industry specific knowledge and newness to the sector can have devastating and everlasting consequences, impacting future revenues, profitability and fundamental asset valuation.

Experienced advisors

Many of these pitfalls can be avoided if newbie investors team up with an experienced team of hotel advisors. One development company learned this firsthand as it made its entry into the "business of hotels."

This real estate organization had a successful track record of developing both commercial and residential high-rise buildings in major markets. A plot of land zoned for hotel development located in a major urban submarket was acquired at a deeply discounted price. Deciding to construct their first hotel, the company contacted a major, nationally recognized hotel chain and obtained a franchise proposal. The application along with the required fee was submitted for brand approval.

Shortly thereafter, the enchantment with the "hotel business" faded and the reality of the "business of hotels" became evident. Recognizing something was amiss the builder swiftly contacted an advisor for assistance.

Let's talk franchise terms

One of the most important decisions a hotel investor confronts is whether to franchise, and if so, with which brand. Yet for many investors new to the hotel space, this is unfamiliar territory and one that presents the most potential traps.

The terms and conditions of a pending franchise application submitted by the aforementioned real estate organization had not been negotiated. Typically, an application submitted to a hotel company's franchise committee for approval is based on predetermined terms and conditions.

In this particular case, the contract structure presented was a standard off-the-shelf franchise agreement. It is nearly impossible to negotiate terms and conditions of a deal after the hotel franchise company's committee has approved it. Realizing these implications, the organization's advisor immediately requested that the brand temporarily suspend the approval process.

The advisor subsequently conducted a competitive "Request for Franchise Agreement" process, which entailed contacting several other

hotels brands and obtaining proposals outlining vital terms such as franchise fees, license agreement duration, area of protection, as well as the willingness to offer key money.

This competitive process narrowed the field to two finalists: the original brand, (Brand A), and a second bidder (Brand B). The competing companies both offered desirable select-service brand affiliations and were members of larger, internationally recognized hotel companies made up of many individual hotel trademarks.

Subsequent to a series of intense negotiations, the previously treacherous ground became clearer and more navigable. The proposal from Brand A was by far the more economically advantageous in terms of key money and franchise fee ramp-up. However, there is more to the financial costs associated with a brand affiliation than just the franchise fee alone.

Beyond the franchise fee

Hotel franchise companies typically charge a series of ongoing fees and expenses often referred to as a "program fee" or "fees for centralized services." Furthermore, these costs are mandatory and non-negotiable.

Typically included in this tier of affiliation expenses are charges for centralized reservations, frequent guest packages, marketing services, information technology and employee training programs. What services are included in this menu of franchise fees and the charge for each varies by individual hotel company. The basis and description for such charges are detailed in a brand's franchise disclosure document.

For the purpose of this article, these charges are collectively referred to as "Other Affiliation Charges." It is imperative to combine these "Other Affiliation Charges" with the estimated franchise fee to accurately determine the total ongoing affiliation cost of a specific hotel brand.

Utilizing the same revenue and occupancy projections for both competing hotel companies, the advisor prepared a side-by-side comparison of "Total Ongoing Affiliation Expenses" that revealed "Brand B" as offering lower costs.

Ongoing Affiliation Expense Comparison	Brand A % Of Revenue	Brand B % Of Revenue	Variance
Franchise / Royalty Fee (FULL)	5.0%	5.0%	0.0%
Other Affiliation Charges	3.9%	2.9%	1.0%
Total Ongoing Affiliation Expense	***8.9%***	***7.9%***	***1.0%***

"Total Ongoing Affiliation Expense" for "Brand B" is 1,000 basis points in cost percentage below "Brand A." Assuming revenue of $200 million over the course of the entire life of the franchise agreement, the difference in "Total Ongoing Affiliation Expense" favors "Brand B" and equates to an estimated savings of $2 million.

Let's dig deeper

The above comparison does not include any ramp-up in franchise fee or the contribution of key money. Although the proposal from "Brand A" reflected the highest economic incentive in terms of key money and ramp-up in fees, the "Brand B" bid, as previously illustrated, was less expensive on an ongoing basis after the ramp-up period. Therefore, over time "Brand B" appeared to be a better financial alternative.

To further illuminate the true cost of the franchise agreement on the investor's bottom line and to identify which brand best supported the investment strategy of the client, the advisor prepared an analysis of various assumed holding periods by comparing the negotiated offers of both brands, including the "Total Ongoing Affiliation Expense," ramp-up in franchise fees and key money.

The analysis revealed that "Brand A" and "Brand B" were virtually in a dead heat in cost comparison for a five-year hold period. However, each year thereafter, the financial advantage tilted in favor of "Brand B" due to the continuous savings attributed to the lower "Total Ongoing Affiliation Expense." The advisor determined that while "Brand A" was more expensive in the long term, it best supported the investment goals of the client. Key money enabled the developer to build the required investment capital stack, and the franchise fee ramp-up provided increased profit and greater return on equity. In addition, an extended area of protection added a safeguard throughout the anticipated asset hold period of five years.

As a direct result of this more detailed analysis, this newcomer to the "hotel business" was able to successfully navigate the intricacies of the "business of hotels." Most importantly, they had the opportunity to choose the branding solution that best supported its investment strategy.

Gary Isenberg serves as President of Asset and Property Management Services for LW Hospitality Advisors (LWHA). Mr. Isenberg's more than 30 years of diversified hospitality experience in management, asset management and finance experience resulting in a demonstrable track record of creating and enhancing hotel property values and maximizing return for owners and investors. Previously, Mr. Isenberg served as Chief Operating Officer for Field Hotel Associates (FHA), a privately held hotel development, ownership, and management company. During his tenure with FHA, Mr. Isenberg led the development of several hotels from conceptualization through opening and responsibility for day to day management. Mr. Isenberg spearheaded multiple re-organization and repositioning initiatives, and cultivated numerous revenue enhancement and cost containment programs. During 16 years with ITT Sheraton (predecessor of Starwood Hotels and Resorts Worldwide) Mr. Isenberg held a variety of positions, involving mergers and acquisitions, finance and operational disciplines. Mr. Isenberg earned a Bachelor of Science in Business Management with minors in Corporate Finance and Information Systems from Fairleigh Dickinson University. Mr. Isenberg can be reached at 212.300.6684 ext.108 and/or gary.isenberg@lwhadvisors.com