Hotel Operating Models: The Basics

The way hotels are managed and operated has evolved over a number of years and will continue to do so, unsurprisingly given the increasing complexities of today's hospitality market and, most recently, a global pandemic. Disruptors such as Airbnb and Yotel have been widespread, putting increased pressure on the traditional players with their alternative models and removal of unnecessary extras. The current pandemic is, however, disrupting not only the traditional models but also the disruptors themselves in many cases.

Despite all of this, the existence of four key operating models remains largely unchanged. These are:

1. **Owner operated** – the operator owns and operates the hotel under its own brand, bears all costs of operation and upkeep but benefits from all revenue;
2. **Leased** – the operator takes an occupational lease and operates the hotel under its own brand;
3. **Managed** – the operator contracts with the owner to manage the hotel under a brand for a fee;
4. **Franchised** – the franchisor (brand owner) gives the franchisee (hotel owner/lessee) a licence to run the hotel under the franchisor's brand in return for royalty payments.

Whilst the first of these is self-explanatory and largely autonomous, set out below is a brief summary of the key components of the second, third and fourth models, appreciating that hybrids are possible across models and across single assets.

### 1. Leased

A hotel asset may be leased to an operator tenant, with the owner/landlord realising value from the rents payable under the lease. The owner/landlord transfers operational responsibility to the operator tenant and incurs minimal financial risk but retains title to the property and therefore retains the value of the reversionary interest. Often the lease will contain an element of turnover rent, but otherwise the operator tenant takes the risk on revenue, is ordinarily directly responsible for furniture, fixtures and equipment expenditure and indirectly responsible for the upkeep of the building (which may be carried out by the owner/landlord and reclaimed from the tenant).

In a strong market, and depending on rent levels, an operator may be more willing to enter into a landlord/tenant relationship; a lease structure offers a high level of control in terms of the quality of the brand and expenditure on the building, with profits after payment of rent being for the operator tenant’s sole benefit.

The drawback for operator tenants is the burden of rent obligations (to the extent these are not turnover based) in a weaker market – where the hotel underperforms, rental payments are a balance sheet liability which might have a negative impact on value. Depending on the terms of the lease, termination may also be difficult, which is a potential disadvantage for both parties depending on the circumstances.

Recent events and the enforced closure of hotels, although hopefully both short term and temporary, will no doubt influence thinking on the leasehold model, both from the perspective of the tenant in terms of the performance of the hotel vis-à-vis its rent obligations, and from the perspective of the landlord in terms of its remedies where a tenant is unable to pay its rent when due.

### 2. Managed

In a managed hotel structure, a third party management company will be appointed by the owner to operate the hotel on its behalf, in exchange for a management fee comprising a base fee (a percentage of turnover (gross revenues)) and an incentive fee (a percentage of net operating profit return to the owner). There is also likely to be a charge for technical services (e.g. design and engineering/architecture) as well as a licence fee and access to systems fee, and possibly also a fee for access to a loyalty programme. Owners may select management companies that are also brand operators, in which case, brand fees will also be payable and the owner will be required to comply with the operator’s brand standards.

We have always prioritised aligning Owner & Operator interests – whether that is through maximising revenue per square meter or through how we structure the operating model. We adapt our thought process based on the company priorities, owner investment priorities and local norms. In the US, Middle East & Asia, we solely look at management and ‘manchise’ agreements while in Europe we look at management, ‘manchise’ and select lease opportunities. As an ‘asset light’ operator, our preference will always remain for management agreements, but we understand the need to contribute key money or put in place a limited operator performance guarantee for those strategic deals."

Rohan Thakkar, SVP, Development and Strategy (EMEA), Yotel
Under this structure, the owner remains responsible for capital expenditure and general upkeep of the hotel and bears the performance risk, but benefits from the experience of the operator (and, potentially, its brand) and maintains a significant element of the upside if the hotel is successful.

A managed (or franchised) structure may of course incorporate the lease model described above, for example, where a PropCo holds title to the asset and leases the whole of the asset to an OpCo (see Figure 1 below). The operator is appointed by the OpCo to manage the hotel and provide branding (with OpCo paying a management fee as set out above). The PropCo benefits from rental income from the lease to the OpCo and, assuming the PropCo is an offshore investment vehicle, the PropCo will not be taxed on any capital gains. Lenders tend to like this structure because in the event of PropCo default the lender could, subject to any relevant change of control provisions, dispose of the PropCo with the benefit of the OpCo lease, rather than enter into a Non-Disturbance Agreement with the operator (see below). From a financing perspective, it will be important to ensure that the lease provisions are at arm’s length and for a rent that is sustainable from the likely profits of the hotel.

In a basic owner/operator structure (see Figure 2 below), the only income for the owner is directly from the trading profits of an operational business which, absent a guaranteed minimum return given by the operator, lenders may be nervous about, particularly at the moment. Invariably operators will want to protect their position as operator for the maximum length of time possible. This may impact dealings at OpCo/PropCo level and, in terms of financing, a debt funder is likely to be required to enter into a Non-Disturbance Agreement with the operator under which the management and branding arrangements stay in place following an event of default or enforcement action by the funder against the owner.

Figure 1.

Hotel management agreements are often heavily negotiated due to inherent tensions between the desires of the owner and those of the operator, although in strong markets the larger operators such as Accor, IHG and Marriott-Starwood are often able to adopt a “take it or leave it” approach with owners. The owner on the one hand will be keen to control costs and maintain operational oversight with a view to ensuring long term economic success for the hotel asset, whereas the operator will want maximum autonomy to earn fees and manage the hotel as part of a brand portfolio to increase the value of that brand over as long a term as possible. Fees, performance tests, budgets and termination rights are likely to be the most contentious provisions, but the parties may also find themselves at odds on other matters, such as control of employees and potential development restrictions in the local area.

3. Franchised

A hotel benefiting from a franchise agreement will be owned and, subject to the use of a third party operator, operated by the franchisee owner of the hotel under a franchisor brand name, with the ability for the owner to use a package of rights (e.g. operating systems, loyalty programmes and trade marks) comprising that brand in exchange for a fee and compliance with specified brand standards. A franchise fee will be payable, which is likely to comprise an initial fee, a royalty fee based on room revenue, a marketing contribution and a reservation fee with additional fees payable for other optional technical services. As for managed hotels, the owner retains the performance risk but, unlike in a management agreement scenario, it also retains control of the property. If the hotel owner is an experienced operator, it may choose to operate the hotel itself, but otherwise a third party non-branded operator will be required. Franchise agreements are likely to run for shorter periods than management agreements (5-15 years verses c. 20 years) but there are likely to be similar issues in terms of negotiation of, for example, fees and termination rights as well as tensions over the owner operator being bound by brand initiatives that may not be relevant to its particular asset. Franchise arrangements are attractive to brand owners because they allow them to grow the brand with limited expenditure and no operating risk. The lack of control of operations by the franchisor does, however, expose them to brand damage risk if standards are not properly adhered to, so quality control audits should be included in the agreement if there are concerns in this regard. Further, franchising is a regulated activity in many countries, so the brand owner will need to
be mindful of potential disclosure and registration obligations and/or
good practices, particularly in the US.

Conclusion
For a long time, there has been a clear focus on “asset-light”
strategies, popular with listed hotel companies wanting to return
funds to shareholders and focus on their franchise and managed
models. In times of significant economic uncertainty, hotel
companies are wanting to avoid capital investment and/or divest
themselves of equally significant real estate. This approach remains
but, whilst it’s unlikely we will see hotel operators owning large
portfolios of real estate in the near future, consideration needs to be
given to how operators can offer “skin in the game”, whether that’s by
way of key money funding (often now needed to be competitive) and/
or a leasing structure.

Crucial to the continued success of the sector will be, in part, finding
appropriate compromises in relation to the conflicting interests
touched on above; the models described are not necessarily mutually
exclusive with hybrid “manchises” or “franchise-light” models
surfacing as potential solutions to specific owner and operator
concerns.

The hotel industry has been hard, one of the hardest, hit by the
global pandemic and undoubtedly there will be a period of recovery
and, for some hotel companies, transition as it becomes clear what
consumers need and expect as well as what can be delivered safely.
Within the operating models described and in the short to medium
term at least, we’re likely to see a greater use of technology, less
focus on meetings and events space and perhaps an increase
in smaller, more functional guest rooms. Greater consideration
will no doubt be given to how market risk is shared between the
relevant parties, be it through increased instances of turnover rent
provisions in leases (as has been the subject of much discussion in
the retail space) or alternative performance-linked arrangements.
It’s not all doom and gloom; the hotels industry and the operating
models behind it are accustomed to linking financial obligations and
performance, so a further adjustment in that direction may be less
of a shock to parties who would potentially lose out. And from a
behavioural sciences perspective, recovery in industries that provide
for investment in experiences rather than material goods is predicted
by many to be likely in the medium term (supported in the UK by the
Chancellor’s recent VAT cut for accommodation), as consumers seek
to compensate for their Covid-19 cancellations.