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European Hotel Sector: Choosing the optimal operating structure and partner

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The profitable outcome of a hotel investment depends on many factors. Macroeconomics, market, and location determine value potential (see the first and second papers in our European Hotel Sector series); demand-driven transformation determines realisation of that potential (see our third paper). But even the best-laid plans are dependent on the operating structure and partner to help manage risk and look for return opportunities.

The process of identifying the optimal operating structure and partner can be complex, and it requires careful consideration of factors such as targeted risk/return, flexibility desired, as well as market experience and expertise required. In this paper, we share some insights on selecting an operating structure and partner to optimise a value-add investment.

KEY TAKEAWAYS

- Typical operating structures include a lease, a management contract, or a franchise. Which is best depends on a range of factors, including risk/return, operations involvement, experience needed, market segment, asset liquidity, and flexibility desired.
- Operating partners can be hotel groups under one of their own brands or 'white label' groups operating under third party brands. Factors to consider when evaluating potential partners include track record, market penetration, market experience, and segment experience.
- A hotel's operating structure and operating partner can help manage risk and look for return opportunities, so careful selection is critical to success.

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Operating structures

Typical operating structures include a lease, a management contract, or a franchise. Which is best depends on a range of factors, including targeted risk/return, level of operational involvement, experience needed, market segment, asset liquidity, and flexibility desired.

Leases

Lease structures are common place in the European hotel market but uncommon in the U.S. and Asia. There are broadly three types of lease structure: fixed, hybrid, or variable.

Fixed lease – The operator leases the building and pays a fixed rent only, which is indexed as a percentage of an inflation measure [e.g. the Consumer Price Index (CPI)] so income is predictable. The operator manages all aspects of hotel operations. As such, a fixed lease has the lowest perceived risk. Return potential is accordingly low. The owner is relatively protected if the hotel performs poorly, but if it does brilliantly, the owner does not share in those wins.

Hybrid lease – The operator leases the building and pays a rent with both fixed and variable components. Fixed rent typically represents about 70 percent of the total stabilised rent, although this can vary. The variable element is usually associated with asset performance, typically measured by revenue. The risk is relatively low, considering the owner receives the minimum lease amount even if performance drops significantly. The owner is not responsible for operations, however they share in the upside potential of the asset performing well.

Variable lease – The operator leases the building and pays variable rent, linked to the performance of the hotel, usually measured as a percentage of turnover, profits, or combination of both. A variable lease comes with a higher perceived risk and return potential. As with fixed and hybrid lease structures, the owner is not responsible for operations and is insulated from business activity, but the lease payment is wholly dependent on performance and there is therefore no protection from a downturn in performance.

Prevalence of lease structures in Europe

Lease agreements are usually required by the institutional investors that comprise a significant portion of the European market. As regulated entities, these investors are restricted to the level of exposure to the operating business of the hotel.

Although accounting rule changes now require operators to account for leases as a liability, which has pushed some operators away from leases toward other hotel operating structures, others have continued and new companies have moved into this space. We believe demand from institutional investors will continue to make lease models an attractive option in Europe for the right properties.

Management contracts

With a management contract, the owner pays a management company a fee to manage the hotel but the owner retains full operational risk , including employees, as well as all Furniture, Fixtures, and Equipment (FF&E) liability. As such, this structure has a high-risk and high-return profile. When the hotel is performing well, the owner benefits. But if profit or trading goes down, the owner will be negatively impacted.

Management contracts may be ideal for owners with significant operations experience and market knowledge because they give the owner more influence on the hotel's operation. For experienced owners, exercising more control may help generate profits over time. Hotels with management contracts tend to be less liquid, especially for non-prime assets, so having appropriate performance clauses and break options are key to driving value where vacant possession can offer significant value. However, this is not always achievable and many existing management contracts don't have such provisions and can be challenging to get out of.

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Franchises

Franchises are the fastest-growing hotel operating structure in Europe. In 2008, around 40 percent of internationally branded hotels in Europe were franchised; by 2022, 60 percent were.[1]

Under a franchise structure, the franchisor provides the franchisee with the brand, training, technical services, marketing, and software needed to operate the hotel to the franchisor's specifications. The franchisee pays a fee to the franchisor to operate the hotel under the franchise. The franchisee funds all capital expenditures and operating expenses (including franchisee fees) and retains all the profit.

The owner may also choose to appoint a "white label" operating company to run the hotel under the franchise. This operating company will manage all aspects of the hotel on the owner's behalf. White label operators may then offer the hotel owner a lease or a management contract. Although this structure has higher levels of fees, since you are paying the brand and white label operator, it can still offer better performance and overall returns. Most of the major international brands have moved their attention away from hotel operations and focus their business efforts on marketing and distribution, which created wide spread growth in white label operators as they came in and focused purely on the hotel operations. Under this model you get the best of the brand, in its marketing and distribution capability, and an operator who is focused so you benefit from both. In addition, white label operators tend to be more flexible with termination rights, offering the owner the ability to offer incoming buyers vacant possession which in today's market creates significant value.

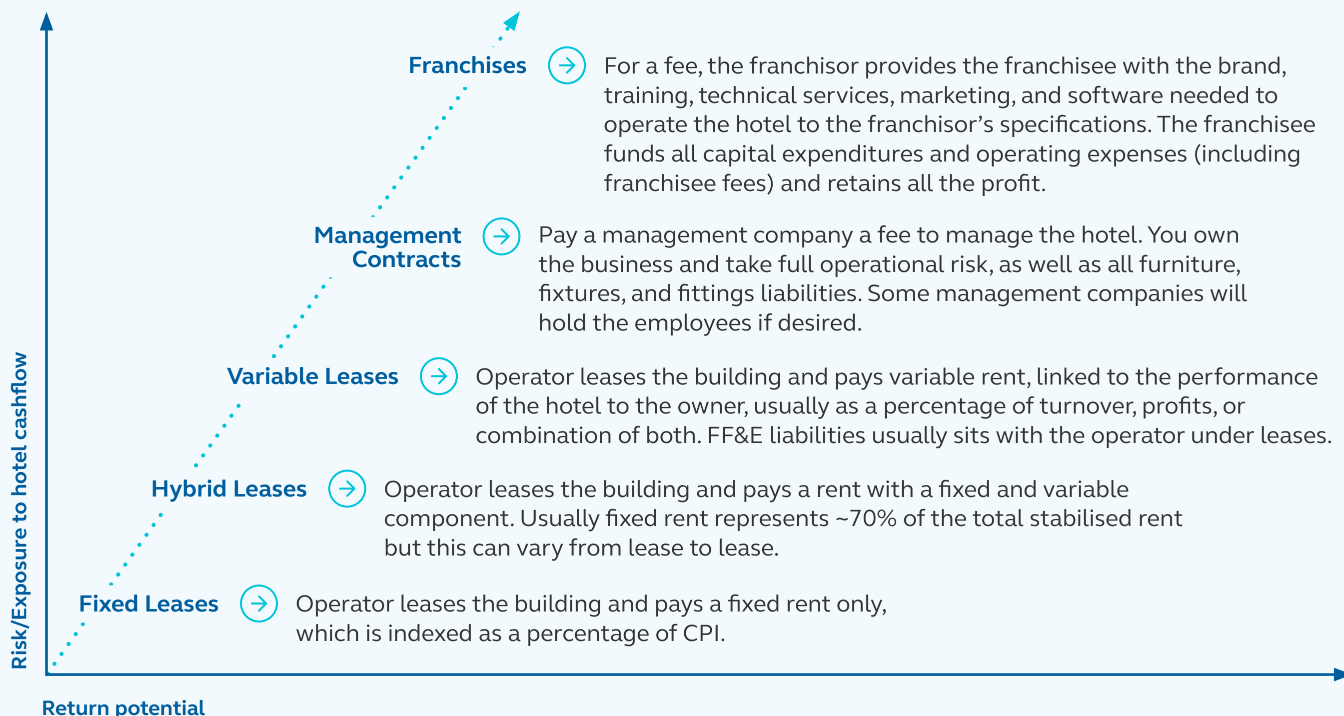
Choosing the right structure: consideration factors

The optimal operating structure depends on a range of factors, including targeted risk and return, level of operational involvement, knowledge needed, market segment, asset liquidity, and flexibility desired.

Targeted risk and return

Each type of operating structure provides a unique level of exposure to a hotel's underlying operational performance, offering different levels of risk and return. Risk is largely driven by exposure to hotel cashflow.

EXHIBIT 1: Different operating agreements carry distinct risk return profiles



[1] HVS Webinar: Lease, HMA or Franchise, 20 Sep. 2023. Data is for Accor, Hilton, Hyatt, IHG and Marriott, by hotels (not rooms).

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Operational involvement

Each operating structure requires a different degree of operations involvement from the owner. Some structures, such as leases, require no owner involvement in operations. In others, such as franchises, the owner is heavily involved in operations and carries all the associated risk.

Expertise

The more heavily involved an owner is in operations, the more experience is required to succeed. For owners new to a market or without significant hotel operating experience, a more hands-off structure like a fixed lease may be the best way to optimise the value-added investment. For owners with deep market knowledge and/or significant hotel operating experience, the higher return potential of a franchise might be desirable.

Market segment

The most prevalent operating structures differ by market segment. Leases, for example, are common in the economy and mid-market segments but rarely seen in upper-level segments, where management contracts are more prevalent. Smaller brands and innovators tend to offer leases or management contract—they are still focused on hotel operations and want to protect their brand reputation during the growth phase.

Structure flexibility

Some management companies offer the option to flip the contract to a franchise—usually at the point of sale, so the new owner has the option to keep the existing structure or change. Operators want to retain hotels in their network, so they are usually willing to provide some flexibility to buyers. For owners, having a flexible operating structure widens the buyer pool and increases the liquidity of the asset.

One can also negotiate pre-agreed exit costs for the ability to remove a management company or brand at the point of sale. This can be particularly useful in creating extra value on exit by allowing an option for vacant possession on sale.

EXHIBIT 2: The optimal structure depends on a range of consideration factors

Operating structure	Consideration factor			
	Targeted risk/return	Owner's operational involvement	Owner's required expertise	Market segment
Franchise	Moderate risk exposure High return potential	Depends on the white label structure below franchise	High	Midscale Leisure
Management contract	High risk exposure High return potential	Medium	Moderate to high	Midscale Leisure Luxury
Variable lease	Moderate risk exposure Moderate return potential	None	None	Economy Midscale
Hybrid lease	Low risk exposure Moderate return potential	None	None	Economy Midscale
Fixed lease	Low risk exposure Low return potential	None	None	Economy Midscale

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Operating partners

The operating partner could be a white label operator, or a brand. Factors to consider when evaluating potential partners include track record, market penetration, market experience, and segment experience.

Brands

Hotel brands have established recognition, reputation, and standardisation that attract guests looking for a reliable experience. They have established, and continuously optimised, marketing programmes, loyalty programmes, technology platforms, and training—making it easier for owners to operate. On the other hand, working with a brand can lock owners into specific standards, pricing, and other operational requirements, giving owners less control over the hotel and its performance. If a brand operates multiple properties in the same area, it may promote more heavily in one over the others.

White label operators (WLOs)

White label operators have become increasingly popular in recent years. These are hotel management companies that collaborate with various brands. WLOs typically offer more flexibility and closer alignment with owner objectives. A WLO may be a more efficient operating partner than a hotel brand.

In fact, hotel brands are now investing in these types of arrangements, providing benefits such as flexible contracts and participation in the business for a predetermined period. This approach makes it easier to sell the property when vacant, eliminating the challenges associated with long-term management contracts, extending up to 20 years, that decrease liquidity.

EXHIBIT 3: Hotel brands and white label operators offer different benefits

Benefits of a brand under franchise*

- Brand recognition, reputation, and standardisation
- Brand resources such as marketing, advertising, loyalty programmes, technology, and training
- Expansion opportunities

Benefits of a WLO

- Flexible contract terms
- No tie to a specific brand, allowing some flexibility in operations
- Owners can be more innovative and creative

*When brand is not an operating partner

Choosing the right operating partner: consideration factors

Track record

Operators with strong track records are the least risky. Most operators will be able to show their successes. Key performance indicators to look for include time in market, guest evaluations, and industry recognition.

Market penetration

If a particular operator is over-saturated in a market, they may devote less time, effort, and resources to a new property. However, it can be advantageous for an operator to have more than one property in a market for synergies like market promotion. There is therefore a balance to be struck when evaluating a potential operator in this area.

Additionally, if an operator is under-represented in a particular market, they may not have the local experience and knowledge to drive strong hotel performance. Conversely, an operator's low market penetration can drive more favorable contract terms for the owner, if the operator is trying to enter or expand their presence in the market. Again, these need to be balanced carefully when assessing a potential operating partner.

Market experience

Ensuring that the operating partner has experience with the particular hotel type, market segment, and micro location is essential. An operator that is established in a market will have area-specific knowledge, relationships, and a healthy pipeline and reputation to bring customers in. Laws and regulations differ across Europe, so working with an operating partner familiar with the specific location can be helpful.

In other cases, it may be advantageous to select an operating partner with deep industry experience but new to the particular market. Such as, an operator that has already proven their concept in other markets and is trying to expand. For example, when a U.S. brand does very well, the natural progression is to expand into Europe. They have a track record of success, they have a high level of knowledge, and they have backing. A good business plan and strong industry experience mitigate risk for the owner.

Segment experience

In addition to considering the operator's in-market knowledge, experience with the particular segment the hotel fits in can be valuable. Luxury hotels are best run by operators with deep experience operating luxury hotels; digital hotels are best run by operators with deep experience in that segment.

Choosing the right investment partner

Most hotel owners do not work directly with operators but rather invest through a partner organisation. That provides an additional layer of insulation from risk, and the right investment partner will have the hotel industry experience and European market knowledge to select the optimal operating structure and partner—and provide oversight of the operating partner—to help generate the value-added investment.

Partnering with an investment firm that is well-versed in handling dynamic and management-intensive investments like hotels can lead to a more straightforward process, higher performance, and higher profit.

Conclusion

A hotel's operating structure and operating partner can help manage risk and look for return opportunities.

The hospitality sector is known for its complexity, competitive nature, and unique challenges. Selecting the right hotel operating structure and partner is a multifaceted decision that directly impacts a hotel owner's ability to operate at peak performance, and can help manage risk and look for return opportunities. It requires careful consideration, due diligence, and a long-term perspective to navigate the complexities of the hospitality industry successfully.

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