Hotel News Now

Opinions

Shorter ownership means longer franchise agreements

28 AUGUST 2018 7:14 AM

Hotels these days sell with a lot of runway on their franchise agreements, and incoming owners are more likely to extend the agreement and thereby prolong the revenue stream of the franchisor.

By Gary Isenberg

As hotel revenues soared over the past decade in an up-cycle that keeps going and going, owners now pocket their investment profits in a much shorter time frame—typically three to five years. Instead of waiting seven to 10 years to grab their targeted return on investment, investors can quickly monetize their investment and plow their cash into the next attractive asset class.

A steady upward climb in operating fundamentals is, of course, fueling these shorter hold periods. Since the dark days of 2009—when average daily rate dropped 8.5%—the industry has reversed course, as Cushman & Wakefield documents: In the past 11 years, ADR and revenue per available room rose by an average annual rate of 3%.

The 2017 recap from STR mirrored those same upticks. Between 2016 and 2017, ADR leapt 2.1% to hit $126.72, while RevPAR shot up 3% to land at $83.57. (STR is the parent company of Hotel News Now.)

No doubt those eye-catching numbers piqued the interest of lodging buyers. In its 2017 roundup of hotel transactions exceeding $10 million, LW Hospitality Advisors recorded 182 one-off transactions with an average per-room price of $267,000, leading to an annual total of $13.6 billion. In 2016, the sale of 173 hotels amounted to a combined $12.7 billion. The per-room sales price was higher that year at approximately $300,000. Despite that 11% decline in per-key price, 2016 and 2017 were similarly active transaction years.

And what's been good for investors has been great for the hotel brands. As hold periods compress, hotels now sell with a lot of runway on their franchise agreements. Hoping to avoid a hefty termination fee to exit the contract, incoming owners are more likely to extend the franchise pact beyond its original termination date, thereby prolonging the revenue stream of the franchisor.

Why brands love PIPs

If the original deal dictated a flag fly over the property for 10 years and if the contract is being sold in say, the third or fifth year, the existing owner would have little inclination to pay the considerable liquidated damages to break a brand contract with so many years left on it. To complete the sale, the seller would be responsible for either paying those hefty fees or cutting the price. In the present frenzied transaction environment, however, the majority of hotels move encumbered with a franchise contract that may run for another five years or more — and that gives the brands the upper hand in property-improvement-plan negotiations.

Not only are the brands able to tack on five or 10 more years on a contract with five or seven years remaining, they can bump up their royalty fees, too. If the agreement was originally written under a franchise disclosure document that set franchise fees at 5%, the brand might revise the extended contract to reflect the updated 5.5% royalty structure. But that's not the only way brands benefit from a brand-new PIP. It's also a chance for them to get a (nearly) brand-new property on the new owner's dime.

Weeding out the obsolete

Under the franchise agreement, the franchise company can approve—or disapprove—a change in ownership for properties contractually tied to their flags. As the sales deal is being negotiated, the brands send in their PIP inspectors. After looking over the property, those inspectors could conclude the hotel isn't up to current brand standards. In fact, it may be so obsolete the franchisor might ultimately decide not to extend the contract beyond its end date. Many first-generation select-service hotels fall into the category, leaving any potential buyer with the task of finding a new brand affiliation.

Again, brand breakups haven't happened too often in this current buying cycle. Due the expensive liquidation costs, owners would rather extend the franchise contract and budget for a massive overhaul that kicks the property up to brand's current specifications and, ultimately, higher room rates.

Brands get a refreshed property paid for by the new owner. At the same time, owners receive more favorable financing from lenders if they own a property with a lengthy franchise agreement. The banks want to make sure the flag stays on the property throughout the term of loan. The possibility of expensive flag change during that period could make lenders skittish. They would rather have a stable franchise affiliation.

Yet as I like to remind my clients, PIPs are negotiable. Typically included in the PIP is a timeline for required renovations several years in the future. New owners can push those updates further out, however. For example, if a room makeover must be completed three years from now, I advise clients to convince the franchisor to give them a bit more time. PIPs are usually under-budgeted, so any leeway provides the new owner with some wiggle room to bring their new purchase in compliance.

Protected from a downturn?

Every up-cycle eventually takes a breather. In its analysis, C&W noted a slowdown in full-service hotel sales beginning the second half of last year. Citing statistics from Real Capital Analytics, 23% fewer full-service properties transacted in 2016 compared to 2015, with per-key price dropping from $255,000 to $177,000.

Such a dip in transactions shouldn't be too damaging to a brand's bottom line, as the dynamics of this cycle enabled the franchisor to extend agreements of newly renovated hotels, while increasing franchise fees charged annually. Extending franchise contracts well into the next decade keeps brand revenue at a steady, healthy level throughout the inevitable downturn. Is it no wonder that brands love change-of-ownership PIPs?

Gary Isenberg is President of LW Hospitality Advisors Asset & Property Management Services. With more than 30 years of diversified hospitality experience in Hotel Management, Finance, and Asset Management, Gary's expertise includes third party asset management, serving as an owner's representative, due diligence for real estate investors, and development services to negotiate management or franchise agreements. His asset management specialties include, among other services, capital budgeting and PIP costing as well as internal control and accounting.