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THE RISE OF THIRD-PARTY HOTEL OPERATORS IN EUROPE

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Introduction

In broad terms, there are two types of hotel management companies: branded operators and third-party operators.

Branded Operators: In the case of a brand operator, the branding company is also the management company. By signing a contract with a brand operator, a hotel investor can contract both of these specialised components of a hotel investment in one agreement, reaping the benefits of a well-known brand and experienced management. The use of a brand operator is traditionally most common among larger, full-service hotels.

Hilton, Hyatt, IHG, Marriott, and Accor are examples of brand management companies that operate hotels in addition to providing the flag. This arrangement does not imply, however, that all of their properties are operated by the brand; for example, most have both brand-managed properties and franchised properties that are managed by third-party operators or the owners themselves.

Third-Party Operators: Third-party operators (TPOs) are unaffiliated with the owner or the franchise brand and are often referred to as White Label operators in the UK. This business model, which emerged in the USA, has gained significant traction in Europe in recent years. In the case of a TPO, owners may obtain branding using a licensing agreement between the owner and a hotel brand. The use of TPOs has traditionally been most common among small and mid-sized hotels, especially for hotels that are limited service or extended stay. However, this has evolved in recent years with many owners choosing the services of the more experienced and credible TPOs for large corporate and luxury hotels.

There is an increasing number of hotel management companies operating hotels across Europe. However, the depth of in-house resources and scale of operation and experience can vary widely. Larger companies do not have a single hotel brand they operate; rather, they operate a broad range of hotel brands.

Chart 1 shows the evolution of the number of hotels and rooms for major TPOs in Europe over the last decade. Since 2012, the number of both hotels and rooms operated in this sample grew by approximately 40% and is forecast to grow by an additional 5% by 2025, according to existing announcements.

CHART 1: EVOLUTION OF THIRD-PARTY HOTEL OPERATORS 2012-22 AND FORECAST PIPELINE – SAMPLE OF MAJOR OPERATORS IN EUROPE

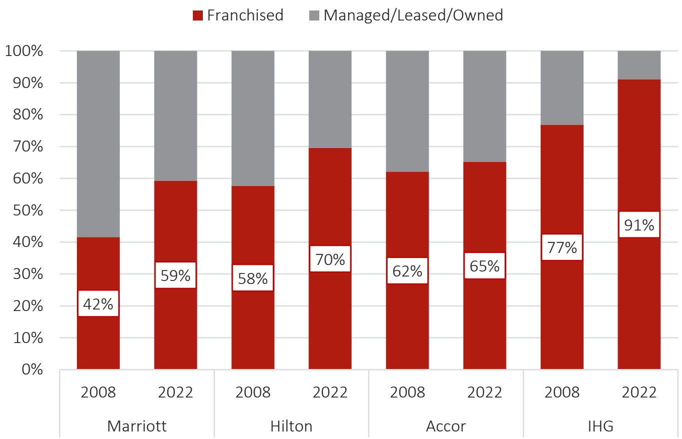
Source: AM:PM, November 2022

Growth of Third-Party Operators Fueled by the Rise in Franchising

Over the last two decades, most branded operators have moved from the operational management of hotels to focus on brand development and distribution. This has led to a rise in the use of franchising, whereby the business owner can use the franchisor's brand name, intellectual property, reservation system and operational support tools in exchange for paying a franchise fee. This drive towards franchise models by the major brands has arguably fuelled the rise in TPOs.

We present a comparison of the proportion of franchise agreements relative to the total portfolios of some of the biggest brands in Europe for the period 2008 to 2022. All of the major hotel brands analysed increased the number of franchised assets relative to their total portfolios across the period. Whilst this may also indicate the proportional increase in limited service and extended stay properties, the trend is clear.

CHART 2: THE PROPORTION OF FRANCHISED HOTELS IN BRAND'S PORTFOLIO IN EUROPE



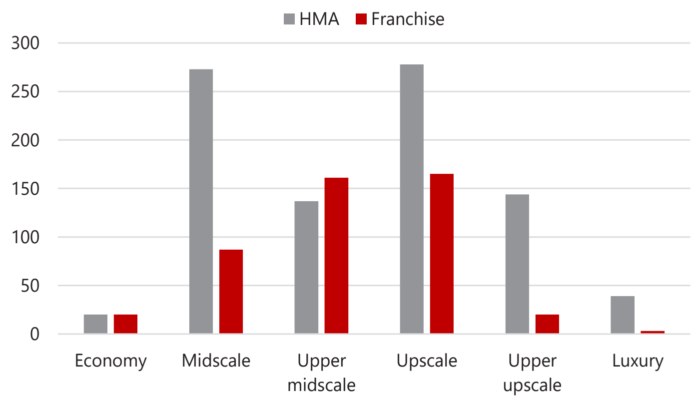
Sources: HVS; AM:PM Hotels

US Comparison – How Much Further Might this Trend Develop?

In the USA, most franchised hotels in the midscale segment and upwards are third-party managed. Texas-based Aimbridge Hospitality, for instance, manages more than 1,500 hotels in the USA, substantially more than any of the major global hotel brands and dwarfing the 372 hotels and 61,217 rooms managed by Hyatt Hotels, the largest branded hotel company operator in the region. Highgate alone operates nearly 10% of the total market in Manhattan. HHM has a portfolio of more than 135 hotels, all third-party-managed independent and branded hotels. These examples indicate the sheer size and potential of the TPO model.

We are of the opinion that other European markets, arguably led by the UK, will emulate the USA in that TPOs will become increasingly popular moving forward.

CHART 3: TRADITIONAL HOTEL MANAGEMENT AGREEMENTS VS FRANCHISES IN THE AUSTRALIAN HOTEL MARKET



Sources: HVS; AM:PM Hotels

Australia/New Zealand Comparison

Similarly to European markets, hotels in Australia and New Zealand are mostly independently operated. Branded hotel stock has increased markedly in the region in recent years, however, and now equates to around a quarter of the hotel stock. Of the branded hotels, a third fall under a franchise-model system with the lion's share being brand-managed. We highlight the number of hotel management agreements versus franchises for different hotel classes, based on the number of properties, in Chart 3. As can be seen, traditional hotel management agreements continue to dominate.

The TPO model is much less established in Australia and New Zealand, accounting for less than 1.0% of total supply. Given the evolving investor profile in the region and the growth of TPOs with global reach, we are likely to see a marked increase in the TPO model across Australia and New Zealand in the coming years. TPOs with an existing presence in the region include Gatehouse Hospitality, 1834 Hotels, La Vie Hotels & Resorts and Vista Hospitality Group.

The Advantages Of Third-Party Management

The growth of third-party agreements reflects an increased desire for flexibility from owners and a recognition that TPOs may drive higher profits and be more aligned with owner objectives. We provide a brief overview of the advantages of such an arrangement in the commentary below.

Term

Competition between TPOs to gain access to new owners and markets has meant that many are willing to offer shorter terms than that normally associated with brand management. Whereas brand-managed properties typically require a term of 20-30 years, excluding automatic extension periods, typical agreements with TPOs tend to range from 5-10 years. We have, however, seen much shorter third-party agreements, with annual contracts occasionally being awarded in turnaround-type scenarios. In our experience, automatic extension periods are relatively uncommon in third-party agreements.

Termination Rights

Branded operating contracts typically include strict, often costly, provisions with regard to liquidated damages or termination fees. The approach of most TPOs, on the other hand, is typically more owner-friendly when it comes to the break of the contract, with many such agreements providing owners with a right to terminate at relatively low cost in the event of a change of ownership. This considerably improves the liquidity of the asset as owners can attract a wider pool of investors through the prospect of an unencumbered asset.

Horizontal management structures

In our experience, corporate teams developing performance projections for TPOs tend to have direct involvement in operations, with fewer management levels between 'management contract sales' and on-the-ground teams. In many cases, those responsible for developing annual budget pro formas will be the same regional operational personnel ultimately responsible for overseeing performance. In short, this generally improves reliability of projections and accountability for performance versus brand-managed operations.

Owner engagement

Traditional brand management agreements contain no way for the owner to force the manager to alter payroll, other than in connection with the manager's proposed annual operating budget. This can lead to misalignment between the owner, who may consider staffing levels to be overloaded, and the management, who consider staffing structures necessary for brand standards. Some third-party agreements that we have seen include monthly or quarterly owner meetings, with owner-friendly approval rights, whereby owners are able to comment on staffing levels and/or propose the removal of the manager when they are reasonably considered to be underperforming.

Challenging brand position

Whilst all parties, whether TPO or branded operator, value both brand integrity and quality level, there are often occasions when brand guidance or brand standard changes would impose additional restrictions or costs on the owner. When TPOs are involved, there is the ability to challenge such guidance to ensure that it is in the best interests of the owner and not just the brand.

Further, unlike brand managers, TPOs will typically only engage in brand initiatives that genuinely improve the hotel's profitability, not those designed to bolster the strength of the brand. In addition, whereas brand managers will always adhere to all brand standards, third-party managers will frequently challenge brands and push back when these are deemed excessively costly.

Fees

Fees within most HMAs tend to incorporate both base and incentive fees. These operator rewards are set against business performance results. The base fee is typically set against total revenue, and the incentive fee against gross operating profit (GOP) or adjusted GOP (AGOP). The projected combined total of these remunerations during an operating stabilised year is a critical measure for the operator, often set against a predetermined minimum value.

The base fee is generally considered as the basic fee for the provision of the brand value. This is the operator's cost of resources in support of the supervision of the hotel management team and is typically charged as a percentage of total hotel revenue (net after VAT). It typically ranges from 2% to 4% in brand-managed agreements and from 1% to 3% in TPO agreements.

The incentive fee is considered a reward for performance, designed to motivate management to control operating costs and be more conscious of profitability. The incentive fee is typically scaled within bands of percentage GOP. These bands are typically in the range of 6% to 10% of GOP/AGOP in brand-managed agreements and 5% to 8% in TPO agreements.

In addition to the above, individual fees and system charges within brand agreements serve to materially increase fee payments to operators. Such fees typically cover services such as head office/cluster cost allocations, accounting and audit costs, software and support licences, travel costs and marketing costs. These costs are typically streamlined or absent from most TPO agreements.

Whilst the use of a TPO often implies additional overall fees, as management fees are payable in addition to franchise fees on branded properties, third-party operators would claim that enhanced revenue performance and streamlined operational efficiencies more than tip the balance in their favour.

Focus on Value

Historically, HMAs have regularly demonstrated that owners and branded management companies can have conflicting expectations with regard to their respective roles, responsibilities and objectives. Whilst both brand managers and TPOs seek to maximise revenue and profitability, TPOs are often additionally focussed (and often compensated) on the value of the owner's investment. This has led to several TPOs widening the scope of their services, acting as an advocate of the owner in contract negotiation with brands. In many cases, the scope of third-party involvement can extend to asset management, investment management and design and construction consultancy types of roles, engaging with not just owners but wide-ranging stakeholders.

In some cases, we have seen TPOs willing to contribute 'sliver equity' to a hotel development project, repositioning or newly acquired asset, thereby reducing the developer's need to contribute equity. Similarly, the notion of 'sweat equity' in third-party management agreements has increased in popularity in recent years. Operators may be willing to exchange lower headline fees for a percentage of the equity released at exit. This may be in the form of a sale or refinance. In this structure, the interests of the operator and the owner become more aligned on the value of the asset as well as underlying profits.

Operational advantages

There is no clear trend in the ability of TPOs to out-perform branded managers when it comes to operational performance. However, some larger TPOs do benefit from operational advantages. Less restricted by brand dogma and guidance, TPOs can react more quickly to changing macro and property-specific conditions. This includes undertaking independent revenue strategies (aside from brand cluster pricing) and choosing (as a franchisee) which brand programmes to participate in. This entrepreneurialism allows some operators to claim overperformance relative to traditional brand management.

Similarly, we have seen cases whereby branded operators are only able to enter into supply contracts or subleases which meet brand approval. In contrast, many TPOs will offer competitively priced contract procurement, that is appropriate for the hotel in question. TPOs may also be required to account to the owner for any discounts or benefits it receives so that they can be priced into budgets or passed onto the owner. These provisions may help avoid the owner being overcharged for services.

UK Case Study – RBH Hospitality Management

RBH Hospitality Management is a leading third-party hotel management company in the UK. The group has a 20-year track record, having successfully operated more than 190 hotels and 26,000 bedrooms. It is a key partner for IHG, Accor, Marriot and Hilton, but also has extensive experience of operating independent hotels. The group offers a major capital team in-house which has overseen the project management and technical support of 50 new-build hotels and 14 hotel rebrands. In addition, the group provides asset management services to owners, including advising on capital expenditure projects supported by the operator's design and development team. The group has experience of materially increasing asset value through such initiatives.

RBH has a number of examples of successfully transitioning hotels from direct brand management to franchise. One such example involved the transition of more than 20 large hotels previously managed by a brand. Many of the hotels were reliant on MICE business and many had in excess of 300 guest rooms. Through a comprehensive cost-saving plan, the operator increased annual EBITDAR by more than £14 million, representing a 5% increase in margin. The operator also achieved a notable increase in guest satisfaction over the same period. The operator's business plan can be summarised into three key areas.

Payroll and Staffing

- A comprehensive review of payroll enabled a restructuring of key departments, providing greater efficiency without impacting guest experience;
- Key payroll expenses were saved upon transition with more than £800,000 of savings in brand travel and subsistence cross charges;
- Implementation of RBH training programmes, motivating and enthusing team members which improved engagement and, subsequently, productivity.

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Procurement

- By implementing RBH processes and procedures, from guest supplies through to HR accounting changes, significant savings were identified. Many of these savings were greater than originally expected through the renegotiation of existing supplier relationships and bulk-buying power, given the increased RBH portfolio size;
- New key performance indicator (KPI) targets were introduced for all hotels, which resulted in material savings in linen, printing and stationery, food and beverage, employee relations and professional services fees.

Revenue Management

- Through RBH's commercial leadership team, the group identified numerous ADR opportunities across the portfolio;
- The RBH Central Sales team refocussed the business mix across the portfolio, focussing on increased contribution from more profitable corporate groups and incentives at the expense of existing lower-rated corporate contracts with last-room availability. As a result, in the first 12 months of managing the portfolio, RevPAR across the portfolio increased by 4.5%.

Conclusion

The advantages of HMAs are well understood. Similarly, their pitfalls have also been well documented. Whilst the pendulum of bargaining power has swung toward owners over recent years, the choice of operator is not clear cut.

It can be argued that the fundamental focus of brands remains the brand's success, and that this can conflict with the interests of owners. The increasing popularity of third-party managers is, in our view, due to the perceived alignment of interests, specifically regarding asset value and profitability. However, different owners and properties require varying responses. Understanding the culture, capabilities, scale of in-house resources and experience of each group is key to ensuring those priorities that are most critical to the success of an owner's specific investment's needs. Some of these factors may include local market knowledge, project phase (under construction, open, mature), and asset type, among others.

Third-party managers should not be perceived as solely a competitor to hotel chains – indeed, they can be complementary. Owing to their close relationship with franchisors, and the relative flexibility of the franchise model, independent management companies have become key to developing relationships between brands and hotel owners on a large scale. This trend is only likely to increase moving forwards, with a rise in the number of credible and established TPOs.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought concerning your specific circumstances.

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Worked Example

In Chart 4, we consider the impact of a profit and loss account under brand managed and TPO scenarios. For the purposes of this analysis, we have assumed a 200-room midmarket hotel in a regional UK market.

Under the brand-managed scenario, we have assumed a base management fee of 3.0% of total revenue and an incentive fee of 8.0% of AGOP (GOP after the base management fee). For the TPO scenario, we have similarly considered typical fee arrangements, assuming a base management fee of 1.5% of total revenue and an incentive fee equating to 6.0% of AGOP. In addition, as part of the third-party scenario, we have accounted for a franchise fee of 6.0% of rooms revenue and 2.0% of non-rooms revenue. We have also accounted for potential cost savings as discussed throughout this article within the TPO scenario.

As can be seen, this example reflects a higher profit margin under the TPO than the brand-managed scenario. Whilst this is provided as an indicative example only, it does reflect our experience of profitability under both scenarios.

We have not reflected any potential revenue-enhancement measures within the TPO scenario. However, these may include initiatives such as optimised yield management through a full property management system (PMS) upgrade, increased flexibility to redesign and improve food and beverage concepts and/or any benefit from access to existing TPO corporate contracts. Further, additional cost measures such as the renegotiation of FF&E within a potential franchise arrangement have also not been reflected.

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CHART 4: P&L COMPARISON – HYPOTHETICAL 200-ROOM MIDMARKET HOTEL

	Brand				Third-Party			
Number of Rooms	**200**				**200**			
Occupied Rooms	**54,750**				**54,750**			
Days Open	**365**				**365**			
Total Occupancy	**75%**				**75%**			
Average Rate	**100**				**100**			
RevPAR	**75**	**%**	**PAR**	**POR**	**75**	**%**	**PAR**	**POR**
REVENUE								
Rooms	5,475	71.8 %	27,375	100.00	5,475	71.8 %	27,375	100.00
Food and Beverage	1,650	21.6	8,250	30.14	1,650	21.6	8,250	30.14
Other Income	500	6.6	2,500	9.13	500	6.6	2,500	9.13
Total	7,625	100.0	38,125	139.27	7,625	100.0	38,125	139.27
DEPARTMENTAL EXPENSES								
Rooms	1,369	25.0	6,844	25.00	1,095	20.0	5,475	20.00
Food and Beverage	1,238	75.0	6,188	22.60	1,238	75.0	6,188	22.60
Other Expenses	250	50.0	1,250	4.57	250	50.0	1,250	4.57
Total	2,856	37.5	14,281	52.17	2,583	33.9	12,913	47.17
DEPARTMENTAL INCOME	4,769	62.5	23,844	87.10	5,043	66.1	25,213	92.10
UNDISTRIBUTED OPERATING EXPENSES								
Administrative & General	572	7.5	2,859	10.45	534	7.0	2,669	9.75
Marketing	458	6.0	2,288	8.36	343	4.5	1,716	6.27
Franchise Fee	0	0.0	0	0.00	317	4.2	1,584	5.79
Prop. Operations & Maint.	305	4.0	1,525	5.57	305	4.0	1,525	5.57
Utilities	381	5.0	1,906	6.96	381	5.0	1,906	6.96
Info. and Telecom. Systems	76	1.0	381	1.39	38	0.5	191	0.70
Total	1,792	23.5	8,959	32.73	1,918	25.2	9,590	35.03
GROSS OPERATING PROFIT (GOP)	2,977	39.0	14,884	54.37	3,125	41.0	15,623	57.07
Management Fee	229	3.0	1,144	4.18	114	1.5	572	2.09
GOP AFTER MANAGEMENT FEES	2,748	36.0	13,741	50.19	3,010	39.5	15,051	54.98
FIXED EXPENSES								
Property Taxes	305	4.0	1,525	5.57	305	4.0	1,525	5.57
Insurance	76	1.0	381	1.39	76	1.0	381	1.39
Incentive Management Fee	220	2.9	1,099	4.02	151	2.0	753	2.75
Reserve for Replacement	305	4.0	1,525	5.57	305	4.0	1,525	5.57
Total	906	11.9	4,531	16.55	837	11.0	4,184	15.28
EBITDA after FF&E Reserve	1,842	24.1	9,210	33.64	2,173	28.5	10,867	39.70

Departmental cost control measures adopted:

Leaner staffing structures with refined bonus structure
Recruitment and training at head office level (often not chargable)
Increased purchasing power through wider non branded supply contracts

Undistributed cost control measures adopted:

Savings through clustered roles such as: HR, Sales & Marketing,
Finance & Accounting, Property, Operations & Maintenance
Reduced central staffing cost allocations
Increased owner empowerment to remove or replace senior management
Lower management fees

Source: HVS

About HVS

HVS, the world's leading consulting and services organisation focused on the hotel, mixed-use, shared ownership, gaming, and leisure industries, celebrated its 40th anniversary in 2020. Established in 1980, the company performs 4,500+ assignments each year for hotel and real estate owners, operators and developers worldwide. HVS principals are regarded as the leading experts in their respective regions of the globe. Through a network of 50 offices and more than 300 professionals, HVS provides an unparalleled range of complementary services for the hospitality industry. HVS.com

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