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2010 Hotel Franchise Fee Guide – Europe

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Introduction

The Hotel Franchise Fee Guide – Europe aims to assist owners in increasing their understanding and awareness of the franchise business model. Franchising in Europe is still much less developed than it is in the USA, but it is gaining ground. The importance of selecting the appropriate franchise affiliation for a given hotel resides in the impact that the brand will have on the positioning of the hotel within a given market, its capacity to maximise occupancy and achieve room rate premiums, and the potential benefits of the chain's distribution channels and know-how. All of these factors will ultimately be reflected in the bottom line, hence the interest from both owners and lenders in properly understanding and considering the overall benefits that a brand brings to a hotel, and weighing the additional franchise costs attached. Note that the fees outlined throughout this article apply solely to hotels operating in Europe.

Management vs. Franchise Contracts

It is important to distinguish between management and franchise contracts in order to understand the potential benefits of a franchise. Although similar in some ways, there are notable variances between the two types of agreement that are worth considering.

- A management contract will typically be set for a period of between 15 and 25 years, whilst a franchise agreement is likely to last for a shorter period of about five to 15 years. Both forms of agreement typically offer renewal options, which are negotiated together with all the other aspects of the contract;
- The operator's fee under a management contract is based on a fixed percentage, often referred to as a 'base fee', typically ranging from 2-4% of total revenues. Management contracts are also likely to include an incentive management fee to the operator, typically broadly estimated to be about 10% of the adjusted gross operating profit (AGOP). For a franchise, the revenues payable to the brand owner come from the various fees charged to the hotel per reservation, broken down by royalty, marketing, reservation and other such fees;
- In regards to management contracts, some companies provide management services alone, whereas others (such as Marriott or Hilton) offer both management services and a brand name affiliation. When a management company has no brand identification, the property owner can often acquire a franchise that provides the necessary image and recognition;
- The issue of perceived control also plays into deciding between a management and franchise contract. Owners can maintain greater control of the management of their property under a franchise (as opposed to having the operator run the hotel under a management contract). Additionally, the likelihood of securing a franchise agreement in emerging destinations will probably prove more difficult than establishing a management contract, as the chain representatives will require a certain level of comfort and familiarity with the market and local labour pool.

Franchising in Europe

Franchising in Europe is not as uniform or as standard as it is in the USA. In the USA, because the Federal Trade Commission regulates the sale of franchises, information regarding each franchise fee structure is readily available through disclosure documents known as either a Uniform Franchise Offering Circular (UFOC) or Franchise Disclosure Document (FDD). Franchisors must reveal and adhere to all terms of the franchise agreement as set out in these documents, thereby eliminating (in theory) any potential for negotiating a more or less favorable contract. We note that this article is limited to the information those franchisors and franchisees we surveyed were willing to disclose.

In general, the independent nature of countries in Europe has resulted in a slower uptake of franchise agreements throughout the region. There is, however, evidence of increasing interest in this model both from operators and developers. Requirements and laws can vary greatly from country to country and thus necessitate different barriers to entry in each location. As Europe continues to integrate further, however, it is expected that franchise agreements will continue to increase in popularity.

Most hotel franchises in Europe are currently in Western Europe. A comprehensive study into franchising in Europe, carried out by European Franchising, showed that the largest number of franchise systems operating within Europe were in Germany, the UK, France, Italy and Spain. Germany, the UK and France showed 'domestic' systems mostly, whereas Denmark, Belgium and Austria imported most of their franchise systems.

Before 1980, the sale-and-leaseback formula was more popular in Europe than it was in the USA. Accor's expansion in the two-star and three-star market during that time is a prime example. Since 2000, however, in an effort to further expand their companies, European hotel groups have been signing more management agreements and franchise agreements with hotel owners.

Changes in Ownership Structure in Europe

The hotel ownership model in Europe is slowly changing. Although the model remains largely 'owner-operator' based – that is, a hotel company, or an individual hotelier, owns and operates its own hotels – the implementation of franchise arrangements is increasing. This is especially true in the more developed markets of Western Europe where international hotels are an established presence and where hotels are considered to be a mainstream asset class. Owners may thus be not only hotel companies but also property companies, institutions, funds and banks.

The franchising model has received a boost in recent years as the biggest international hotel chains, under pressure from shareholders to return capital, have put properties up for sale. As a consequence, hotel chains are now mainly franchisers and managers, rather than owners.

For hotel companies, engaging in franchises, management agreements, and third-party management structures (with and without a franchise on top) provides a way of rationalising their portfolios by selling off hotels and releasing capital to expand their brands. Hotel companies thus have the ability to focus on their core business of franchising and managing while growing and expanding, without carrying the risk associated with ownership.

Challenges and Opportunities for the European Market

Today, European hotel groups consider a host of critera when choosing between managing/franchising hotels and owning properties. We note the following challenges and opportunities for the market.

- *Heterogeneous market*: Europe consists of many small markets. Hotel companies such as Louvre Hotels, for instance, might be very successful in France, but are relatively unknown elsewhere in Europe. Moreover, legal requirements differ from country to country. For instance, before entering a franchise agreement, the franchisor has to comply with mandatory disclosure requirements intended to protect the franchisee. France, Spain, Italy and Belgium, for example, require such disclosure agreements;
- *Low brand penetration rates*: the European market has seen the continuing infiltration of brand operators and there are further opportunities. However, it is estimated that only 25-30% of the hotel stock in Europe is domestically or internationally branded; the proportion is 70% in the USA;
- *Brand recognition*: as the world becomes a smaller place, so brand recognition becomes more instantaneous. This enables companies to enter markets more efficiently and the start-up periods ahead of a stabilised operating level being reached are shortened. On the other hand, establishing brand names that are less

widely known in a particular region will take longer; a US-brand under a franchise contract might not be able to spread as quickly in Europe as it might in the USA, for example;

- *Brands in Resort Areas*: a brand may not always represent such a clear benefit to a resort property as it may do for a city centre, more commercially focused hotel. Many times, customers tend to look for the destination's 'brand', and are more likely to be attracted to the appeal of a given destination, regardless of the hotel brands present in it. Indeed, in Europe the branding of a resort hotel often comes through the branding of the tour operator through which the booking of the hotel (and elements of the package) was typically contracted;
- *Cost of Brand*: for hotels in key locations, or which enjoy a reputation of their own or some other special circumstances, a franchise may simply not present sufficient added demand to the Hotel and/ or a premium in the rate that justifies the cost of the brand;
- *Ethnocentrism*: franchisors sometimes find it necessary to adapt their standard norms and values to the unique cultural characteristics of each target country. For example, what works in the USA may not work in Russia. As such, the franchisor may need to create revised brand standards for that region;
- *Financing*: until recently, unlike in the US, the European banking system found no necessity for a brand name before making a loan. However, this is certainly changing and private hoteliers in Europe will generally need to have a brand name in place in order to secure financing (where this is available);
- *Owner's Perception*: owners may not feel there is a need to have a brand, for which there are clear costs attached, and sometimes not so clear benefits. The franchisor needs to make a compelling argument in order to persuade the owner as to how a brand is likely to increase the hotel's return on investment.

However, the general view is that as Europe is a widely unbranded territory, it presents more opportunities than threats. Competition between the main players seems to spur determination and so most of them target similar countries and similar hotels within those countries.

Franchisors in Europe

Our research consisted of surveying a sample of hotel companies (from the most prominent to smaller organisations, from budget to full service hotels) which currently franchise in Europe or are considering doing so.

We have discussed strategies and procedures with these companies and the results of this research are the aggregate data presented in this report; Table 1 lists these hotel companies. We note that the brands included in the table are those that have existing franchises in Europe or have the potential to expand into the European market.

General Conditions and Requirements

After conducting our interviews and research we found that many hotel companies share a few key trends; namely, there is no set formula defining what franchisees and franchisors look for in a project. Often, whether a hotel is existing or a new-build does not matter to the franchisor. The importance lies in whether the brand can easily fit the building: 'If they can make it work and if it offers a promising opportunity'. Often, conversions are just as capable of achieving a profitable return as new-builds. Furthermore, size, building and facility requirements tend to vary from project to project as there is rarely a standardised mould that all franchisors/ franchisees look for across their portfolios. Most commonly, these characteristics tend to vary quite widely based on brand and market requirements. This is a point of difference between Europe and the USA; the US market has traditionally developed far more new-builds than Europe and also has more uniform regulations across the country.

TABLE 1 Hotel Companies Surveyed – Chain and Brands

Accor	Sofitel	**Leonardo Hotels**	Leonardo Royal
	Pullman		Leonardo Inn
	M Gallery		Leonardo
	Novotel		Leonardo Boutique
	Mercure	**Maritim Hotels**	Maritim
	Suitehotel	**Marriott International**	Marriott
	Ibis		Courtyard by Marriott
	All Seasons		Marriott Executive Apartments
	Etap		Renaissance
	Hotel F1		Ritz-Carlton
	Formule 1		JW Marriott
	Adagio		Autograph
	Hotel Barriere		Edition
Best Western	Best Western	**Starwood Hotels & Resorts**	Sheraton
	Best Western Premier		Westin
Hilton Worldwide	Hilton		W Hotels
	Hampton by Hilton		The Luxury Collection
	Doubletree by Hilton		Four Points By Sheraton
	Hilton Garden Inn		Le Méridien
	Conrad		St. Regis
	Waldorf Astoria		
InterContinental Hotels & Resorts	InterContinental		
	Crowne Plaza		
	Holiday Inn		
	Express by Holiday Inn		
	Staybridge Suites		
	Indigo		

Source: HVS Research

TABLE 2 Typical Brand Requirements – Europe

	Budget	Mid-scale	Upscale
Room Size	19-21 m²	24-30 m²	28-40 m²
Room Count (minimum)	50-100	75-100	100-275
Term (years)	←	10-30	→
Renewal Option (years)	←	Usually (eg, 5-10)	→

Source: HVS Research

Table 2 sets out the general conditions required for building and design purposes and the terms for franchise agreements in Europe, by segment.

Types of Hotel Franchise Fees

One of the important economic considerations in evaluating a potential hotel franchise is the structure and amount of the franchise fee. Franchise fees are often second or third only to payroll and/or food and beverage in a hotel's operating expenses.

Hotel franchise fees are the monies paid by the franchisee to the franchisor for the use of the brand's name, logo, goodwill, marketing, and referral and reservations systems. Franchise fees normally include an initial fee with the franchise application, and continuing fees paid periodically throughout the term of the agreement.

Initial Fees

The initial fee typically takes the form of an amount based on the hotel's room count. For example, the initial fee may be €50,000 plus €300 a room for each room above a room count of 150. Thus, a hotel with 125 rooms would pay €50,000 and a hotel with 200 rooms €65,000. The initial fee is paid upon submission of the franchise application. This amount covers the franchisor's cost of processing the application, reviewing the site, assessing market potential, evaluating the plans or existing layout, inspecting the property during construction, and providing services during the pre-opening or conversion phases. In the case of the reflagging of an existing hotel, the initial fee structure is occasionally reduced. Some franchisors will return the initial fee if the franchise is not approved, whereas others will keep a portion to cover the cost of reviewing the application.

Converting the affiliation of an existing hotel will likely require the purchase of new towels, brochures, operating supplies, and headed paper printed with the franchisor's logos, just as a new build would require. The potential affiliate may have to undertake property refurbishment or renovation. New franchises and conversions also pay for the cost of signage. Some franchisors require the owner to pay a property improvement plan fee. Although these potential costs are not quantified in our study, they must be considered when measuring the costs and benefits of an affiliation. Requirements of this kind vary from brand to brand, especially if some of these costs are waived as an incentive to sign with the franchisor, and the need varies from hotel to hotel.

Continuing Fees

Payment of continuing franchise fees starts when the hotel assumes the franchise affiliation, and fees are usually paid monthly over the term of the agreement. Continuing fees generally include a royalty fee, an advertising or marketing contribution fee, and a reservation fee. In addition, continuing fees may include a frequent traveller programme and other miscellaneous fees.

Calculation of Continuing Franchise Fees

The assessment of continuing franchise fees is typically based on one of several different formulas. In general, the calculation of royalty fees is based on a percentage of rooms revenue. However, a few hotel franchisors charge an additional royalty fee based on a percentage of food and beverage revenue. Advertising, marketing and training fees are usually calculated as a percentage of annual rooms revenue.

In some cases, reservation fees are based on a combination of a percentage of rooms revenue, an amount per available room per month, and a fixed amount, which depends on the source of booking, per reservation.

Many franchisors now require franchisees to bear their fair share of the costs associated with the operation of a frequent traveller programme. Frequent traveller programme assessments are typically based on a percentage of total revenue or rooms-only revenue generated by a programme member staying at a hotel, or a fixed amount for each room occupied by a programme member. Many brands also require hotels to contribute a one-off participation fee, whereas others use a combination of all three methods.

Generally, these various fee formulas are applied individually but, in some cases, franchisors combine a number of formulas.

Each fee structure offers advantages and disadvantages; a fee based entirely on a percentage of rooms revenue is beneficial for hotels that derive a significant income from food and beverage sales. Fees based on an amount per available room are fixed, and tend to benefit high-volume hotels but penalise properties with lower operating profits. The payment of a reservation fee based on the number of reservations received is equitable, as long as the reservations equate to occupied room nights and no-shows are excluded.

A potential franchisee should carefully evaluate the fee structure and project the total cost of the initial and continuing franchise fees, and then determine whether or not the price/value relationship warrants the acquisition of the franchise.

Royalty Fee

Almost all franchisors collect a royalty fee, which represents payment for the use of the brand's trade name, service marques and associated logos, goodwill, and other franchise services. Royalty fees are an important source of revenue for a franchisor. These fees typically range from about 2.5% to 5.0% of rooms revenues, although this is always subject to negotiations between both parties, and can change (depending on the operator's policy) between hotel categories.

Advertising or Marketing Contribution Fee

Brand-wide advertising and marketing consists of national or regional advertising in various types of media, the development and distribution of a brand directory, and marketing geared towards specific groups and segments. In many instances, the advertising or marketing contribution fee goes into a fund that is administered by the franchisor on behalf of all hotels within the brand. Franchisees ideally want their marketing fee contribution to directly impact their region (a London franchisee prefers their fee to contribute towards marketing efforts in the UK and not elsewhere), which may not always be the case. From our discussions with various operators, these fees can normally range from 1.0-2.0% of total revenue or 1.5-4.0% of rooms revenues.

Reservation Fee

The reservation fee supports the cost of operating the central reservations offices, telephones, computers and reservations personnel, all of which support the booking of reservations made through the reservation system. The reservation fee contains all distribution-related fees, including fees payable to third parties, such as travel agents and distributors. The calculation of this fee can vary significantly from one operator to the other. The fee calculation may be based on the number of bookings, the available rooms, the total room revenue, and so forth. Additionally, it can be determined as a percentage of revenues or as a fixed amount on, say, each one of the bookings generated by the brand. During our interviews, we came across various examples of fees charged, of which we list the more common ones below. We note that it is unusual for one or two of these to be applied together.

- €9.00-9.50 per room per month;
- 1.0-2.0% of rooms revenue;
- €3.15 per booking;
- €10.00 per GDS booking, €4.00-8.00 per Internet booking;
- €4.50 for full service properties, €3.00 for limited service properties;
- 8.0-12.0% of GDS or phone reservations, 6.0-10.0% per Internet booking.

Frequent Traveller Programme Fee, or Loyalty Fee

Some franchisors offer incentive programmes that reward guests for frequent stays; these programmes are designed to encourage loyalty to a brand. The cost of managing such programmes is financed by frequent traveller assessments. Similar to the reservation fee, there is not a uniform formula for a loyalty fee calculation as various companies choose to charge this fee differently. We note some example charges below. Again, only one would typically apply.

- 5.0% of qualified charges;
- €4.00-8.00 per booking;
- 3.00-4.75% of reservation;
- 6.0% of total revenue spent per stay.

Other Miscellaneous Fees

This category includes fees payable to the franchisor or third party supplier(s) for additional system and technical support. It also includes fees relating to training programmes, and national and regional annual conferences.

Sometimes franchisors offer additional services. These services generally include consulting, purchasing assistance, computer equipment, equipment hire, on-site pre-opening assistance and marketing campaigns. The fees for these services are typically not quantified in the disclosure document. Our survey considered only those costs that are mandatory and quantified by the franchisor.

Outlook for Europe

Most of the companies whose representatives we spoke to are primarily interested in expanding further into Western Europe. Leading cities such as London, Paris, Rome and Berlin are the most appealing on account of their stability and international focus. Countries that have the greatest interest are the UK, Germany, France, Italy and the Benelux countries. Most companies also envisage taking on franchise agreements in emerging markets such as Eastern Europe and Russia in the short to medium term. In general, almost all of the people we spoke to seemed keen on capitalising on sound opportunities, whether in an established prime market or in an emerging secondary location. Internationally established companies recognise that there is some 'catch-up' work to be done to achieve an international presence.

Conclusion

In evaluating the potential of a franchise fee it is important to recognise where the model has already worked effectively in a given market and is even considered commonplace in that particular location. In the USA, for example, approximately 70% of all hotels operate under a franchise agreement. In the most capitalistic market in the world, this demonstrates significant opportunity for other markets with similar supply and demand characteristics.

Most hotel lenders consider that to be competitive in today's hotel market, a strong brand affiliation is virtually essential. Many guests want to know the level of quality for which they are paying and would rather not risk an unpleasant surprise from a 'no-name' hotel facility. We note, however, that as the global traveller becomes more sophisticated, brand affiliation may not be as important as it once was.

The selection of a brand affiliation should be evaluated carefully to determine whether the price/value relationship is favourable to the hotel owner and whether that relationship shows promise for long-term stability.

From our research, we note that a franchise may cost in the region of 4-6% of total revenue, although we emphasise that this number is based on a select sample and should be treated as a broad indication only. The potential franchisee must be confident that the franchise will deliver benefits that outweigh the costs.

Taking on a franchise is a complicated investment. Selecting an appropriate franchise for a property entails exhaustive research and investigation by an investor/owner. The information presented here provides some general insight into franchise fee structures and should not be relied upon other than as a preliminary resource.

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About the Authors

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About HVS

HVS is the world's leading consulting and services organisation focused on the hotel, restaurant, shared ownership, gaming, and leisure industries. Established in 1980 by President, Steve Rushmore, MAI, FRICS, CHA, the company offers a comprehensive scope of services and specialised industry expertise to help you enhance the economic returns and value of your hospitality assets.

Steve Rushmore began his career in the 1970s as a consultant in the hospitality division of a prominent New York City real estate firm. Through that experience, he noted the limited body of knowledge available to assess the value of hotels and motels, taking into consideration both the business and real estate components. Rushmore's first book, The Valuation of Hotels and Motels, quickly became the definitive work on the subject and, soon after, HVS was born. The HVS method of providing an economic study and appraisal for hotels immediately became, and continues to be, the industry standard.

Over the past three decades, HVS has expanded both its range of services and its geographical boundaries. The company's global reach, through a network of 30 offices staffed by 300 seasoned industry professionals, gives you access to an unparalleled range of complementary services for the hospitality industry.

Our clients include prominent hotel owners, lending institutions, international hotel companies, management entities, governmental agencies, and law and accounting firms from North America, Europe, the Middle East, Asia, Latin and South America, and the Caribbean. Our principals literally 'wrote the book' on hospitality consulting, authoring numerous authoritative texts and hundreds of articles. HVS principals are regarded as the leading professionals in their respective regions of the globe. We are client driven, entrepreneurial and dedicated to providing the best advice and services in a timely and cost-efficient manner. HVS employees continue to be industry leaders, consistently generating a wide variety of articles, studies, and publications on all aspects of the hospitality industry.

HVS is the industry's primary source of hotel ownership data. Our 2,000+ assignments each year keep us at the forefront of trends and knowledge regarding information on financial operating results, values, management contracts, franchise agreements, compensation programmes, financing structures, and transactions. With access to our industry intelligence and data, you will have the most timely information and the best tools available to make critical decisions about your hospitality assets.

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