THE RISE OF HOTEL FRANCHISES

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In the ever-evolving landscape of hospitality, hotel franchising remains a compelling avenue for hoteliers, entrepreneurs and investors seeking to capitalise on established brands and industry expertise. By carefully weighing the benefits, challenges, and emerging trends, stakeholders can navigate the complexities of hotel franchising and unlock opportunities for long-term success. In this article, Wisefields Partner, Bilal Ambikapathy, shares his insights on the rise of franchises in the region, and why this model may be one to become the new norm.

Historically, hotels across the Middle East have been managed by international operators pursuant to the terms of a hotel management agreement. Hotel management agreements place legal risk and responsibility of the hotel business on the hotel owner, while retaining operational control and management with the international operator.

Hotel staff are all employees of the hotel owner and both operating and employment liability remain with the hotel owner despite the owner having no operational control or management. The operating licenses are held in the hotel owner's name.

This approach to the apportionment of risk has long been of concern to hotel owners and the implementation of control mechanisms and oversight into a hotel management agreement remain the central focus of negotiations prior to execution of that agreement.

With the growth of portfolios of hotels held by single owners and the advent of sophisticated asset management teams within the corporate structure of hotel owners in the region, the application of the franchise model to hotel operations has become more viable and a number of international operators are now actively promoting hotel franchises across the Middle East, in particular in Saudi Arabia and Egypt.

The hotel franchise works best when the hotel owner has an experienced team of asset managers and hotel staff under its employment that can themselves perform the operational function of the hotel without the supervision and control of the international operators.

This gives the hotel owner the freedom to set their own annual budget, recruit and manage hotel staff, control FF&E expenditure and capital improvements, implement more aggressive bad debt and credit control policies and importantly control bank accounts and withdrawal from those accounts.

In turn, the franchise agreement shifts the focus away from management and instead deals extensively with intellectual property, brand and brand standards, access to the operator's booking and marketing systems, training and support, reporting and disclosure of financial information and fees.

Because of the disclosure requirements mandated by franchise laws in the region, international operators are required to disclose in full at the outset, prior to execution of the franchise agreement, the entirety of their fee structure.

This level of transparency helps hotel owners evaluate the true extent of the cost of the franchise over the life of the franchise agreement. This exercise is often difficult to achieve with hotel management agreements as not all hotel operators disclose the full extent of their fee structures until sometime after the hotel management agreements are signed.

Franchising also allows hotel owners with a portfolio of hotels to better cluster and centralise certain hotel level services and staff, including for example the HR, administrative, accounting and executive functions, across different brands, without the restrictions otherwise imposed in hotel management agreements when dealing with brands from different hotel operators.

To transition seamlessly into a franchise model, some international operators are offering hotel owners "manchise agreements" pursuant to which the international operator manages the hotel for a 5-to-7-year period following which the hotel owner and international operator have the option to terminate the management agreement and "flip to franchise" by replacing the hotel management agreement with a franchise agreement. This allows hotel owners sufficient time to build the necessary internal capabilities and knowledge to operate the hotel themselves and then move to a franchise when they are ready to do so.

From a financial perspective, a key difference between the hotel management agreement and franchise agreement is that the incentive fee structure (a fee based on gross operating profit) under the hotel management agreement is no longer charged under a franchise agreement. However, note that the base fee (a fee based on gross revenues) is often twice as high as is a hotel management agreement, and as such careful consideration needs to be given to the economic outcome of each structure and its ultimate impact on the hotel's IRR over the lifetime of the agreement.

In some cases, international operators will not offer hotel management agreements for smaller hotels below a certain key count. In those circumstances, the international operator may insist that the hotel owner also appoint a third-party manager to manage and operate the franchise. If that is the case, then the third-party manager will charge an incentive fee which may, in some circumstances, diminish the economics of one form of agreement over the other.

Ultimately, regardless of the operating model one selects, consideration needs to be given to both the economic outcomes for the hotel owner and guest experience. One should not result in the compromise of the other, given that both are interdependent and cannot excel on their own.

Bilal Ambikapathy
bilal.ambikapathy@wisefieldslaw.com

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