HOTEL FRANCHISING: HOW TO BE A SUCCESSFUL FRANCHISEE

Hotel owners must know what they are getting into before signing that franchise agreement

Stephen Rushmore, CRE, MAI, CHA and Sabena Arora

One of the most important decisions a hotel owner must make is the selection of an appropriate franchise affiliation. A hotel franchise provides a property with instant identity, an image, actual reservations, and other benefits. It often has a direct impact on the ultimate financial success or failure of a hotel property. Since the cost to acquire and maintain a franchise over a 10-year period can amount to hundreds of thousands of dollars, the prospective franchisee must understand the various issues involved in the selection process.

Background

A hotel franchise is an agreement between a hotel chain (franchisor) and the hotel owner (franchisee) whereby the hotel chain allows the owner to make use of the chain's name and services, such as a central reservation system and defined operational procedures. In return, the hotel owner pays the hotel chain a franchise fee (and sometimes other expenses). The chain has no ownership or financial interest in the hotel and is not directly responsible for its economic success.

Hotel companies involved in franchising generally start off as small chains composed of company-owned properties. Over time, they develop a concept, image, and brand name that proves successful in attracting patrons to their properties. In addition, specific operational procedures (known as a mode of operation) are established that produce a profitable level of efficiency. When the lodging product becomes successful, and it can be demonstrated that hotel owners using the brand name and mode of operation will also be successful, the hotel company is able to franchise its concept and procedures.

Stephen Rushmore, CRE, MAI, CHA is president and founder of HVS International, a hotel consulting and valuation firm with offices in Mineola, NY; San Francisco; Miami, Florida; Boulder, Colorado; Vancouver, B.C.; and London. Sabena Arora is a consultant and valuation analyst in the Mineola, NY office of HVS International.

EXHIBIT 1 HOTEL FRANCHISE FEES—ECONOMY HOTEL CHAINS (EXPRESSED AS A PERCENTAGE OF ROOMS REVENUE)

Budget Host	0.9%
GuestHouse Inns	3.3%
Best Inns	4.1%
Passport Inns	4.9%
Scottish Inns	4.9%
Downtowner Inns	5.4%
Rodeway Inns	5.4%
Red Carpet Inns	5.4%
Sundowner Inns	5.5%
Key West Inns	5.6%
Master Hosts Inns	5.9%
Shoney's Inns	7.0%
Villager Lodge	7.2%
Budgetel	7.2%
Motel 6	7.2%
EconoLodge	7.8%
Microtel Inns	8.2%
Super 8	8.2%
Fairfield Inns	8.4%
Hampton Inns	8.4%
Shoney's Suites	8.5%
Sleep Inns	8.5%
AmericaInns	8.8%
Travelodge	8.9%
Thriftlodge	8.9%
Ramada Limited	8.9%
Comfort Inns	9.3%
Holiday Inn Express	9.3%

EXHIBIT 2 HOTEL FRANCHISE FEES—MID-RATE HOTEL CHAINS (EXPRESSED AS A PERCENTAGE OF ROOMS REVENUE)

Best Western	1.7%
Inn Suites	4.5%
Park Inns	6.1%
Mainstay Suites	7.2%
Candlewood Suites	7.5%
Quality Inns	7.7%
Country Inns	8.0%
Holiday Inns	8.5%
Comfort Suites	8.7%
Howard Johnson	8.7%
Ramada Inns	8.7%
Wingate Inns	8.7%
Holiday Inn Sunspree	9.0%
Days Inns	9.0%
Courtyard	9.5%

Caesar Ritz was one of the first hotel franchisors when in 1907 he allowed his famous name to be used on hotels in New York City, Montreal, Boston, Lisbon, and Barcelona. The first modern-day franchisors were Holiday Inns of America, Howard Johnson's Motor Lodges, and Ramada Inn Roadside Hotels. These chains flourished during the 1960s and the 1970s, when a building boom fueled by real estate investment trusts spurred the development of thousands of new hotel rooms. When the benefit of belonging to a chain became apparent to sophisticated hotel investors, particularly mortgage lenders, a franchise affiliation was made a standard requirement for most development or acquisition deals. Today, very few hotels are developed as independents.

Services Provided by the Franchisor

Every hotel franchisor offers a wide array of services to the hotel owner. During the franchise selection process, the prospective franchisee needs to evaluate which services will be useful and their ultimate cost. The following list contains many of the services normally provided by a hotel franchisor:

- National marketing and advertising (national and global)
- Consumer brand recognition
- Reservation system
- Referrals between properties
- Proven mode of operation
- Technology and proprietary software
- Training
- Design plans and specifications
- Financing
- Site selection and market analysis
- Development and construction assistance
- Publicity and promotion assistance
- Public relations support
- Standardized signage
- Quality assurance standards
- Impact policies
- Group purchasing benefits
- Frequent traveler programs
- Tie-ins with other marketing programs developed by airlines, for example

One of the key benefits of a hotel franchise affiliation is the instant recognition and image created by a known name. Travelers seek out known quantities for overnight lodging, where they can be assured of a uniform standard of quality. A hotel franchise also transfers an established image to a property that uses its affiliation. For example, Days Inns tend to attract senior citizens. Holiday Inn has a strong commercial following. Hilton is highly successful in the group market. If a hotel needs to penetrate a particular market segment, the appropriate franchise can significantly increase its chance of success.

Franchise Fees

When evaluating a potential hotel franchise, one of the important economic considerations is the structure and amount of the franchise fee. Second only to payroll, franchise fees represent most hotels' largest operating expense. Since many of these fees are tied to performance, the more successful a hotel becomes, the more fees they will likely pay.

Hotel franchise fees are the compensation paid to the franchisor for the use of the chain's name, logo, identity, image, goodwill, procedures and controls, and marketing, as well as its referral and reservation systems. Franchise fees are normally formulated starting with an initial fee paid upon making the application for the franchise, plus continuing fees paid periodically during the term of the franchise.

The initial fee typically takes the form of a minimum dollar amount based on a hotel's room count. This fee is paid upon submission of the franchise application. It covers the franchisor's cost of processing the application, reviewing the site and market potential, evaluating the plans or existing layout, inspecting the property during construction, and providing services over the preopening or conversion phases.

The payment of continuing franchise fees commences when the hotel assumes the new franchise affiliation, and the fees are paid monthly over the term of the franchise 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 traveler program and other miscellaneous fees.

Sometimes the franchisor offers additional services for a fee. These services may include any of the following: consulting, purchasing assistance, computer equipment or satellite communication equipment rental, optional training programs, on-site opening assistance, or additional advertising services.

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

In order to provide a preliminary comparison of hotel franchise fees, HVS International has developed a model that calculates the total fees paid to a hotel franchisor over a 10-year period. These fees include the initial as well as the continuing fees and expenses. The model expresses the total fees paid as a percentage of the hotel's projected rooms revenue. Exhibits 1, 2, and 3 show how various franchises are ranked based on the percentage relationship of the total projected franchise fees to the total projected rooms revenue.

The franchise fee tables show a wide variance of fees ranging from a low of 0.9% for a Budget Host to 10.0% for a full-service Marriott. The Marriott affiliation appears to be the most expensive, and Marriott is currently the only franchisor whose continuing fees are based on a percentage of the combined rooms and food and beverage revenues. Marriott's frequent traveler award program also contributes to the average cost of this affiliation. However, few would argue with the success of Marriott's proven operating abilities, as well as

EXHIBIT 3 HOTEL FRANCHISE FEES—FIRST-CLASS HOTEL CHAINS (EXPRESSED AS A PERCENTAGE OF ROOMS REVENUE)

Clarion Hotels	5.1%
Omni Hotels	6.9%
Westin	7.2%
Doubletree Hotels	7.4%
Residence Inns	7.5%
Hawthorne Suites	7.6%
Embassy Suites	7.7%
Towne Place Suites	7.8%
Four Points Hotels	8.0%
Sheraton Hotels	8.0%
Radisson Hotels	8.1%
Homewood Suites	8.1%
Crowne Plaza	8.5%
Hilton Suites	8.6%
Hilton Garden Inns	8.6%
Hilton Inns	8.6%
Marriott Hotels	10.0%

EXHIBIT 4 TYPICAL LIQUIDATED DAMAGE PROVISIONS FOR TERMINATING A FRANCHISE

Microtel
Based on occupancy rate for 12 months preceding termination
- Less than 50% occupancy, no damages
- 50% to 59.9%, 12 months of fees
- 60% to 69.9%, 24 months of fees
- 70% and greater, 36 months of fees

Best Inns
50% of franchise fee that would have been earned during the remainder of the term

Days Inns
24 months of fees but no less than $2,000 per room

Hilton
Franchisor shall be entitled to recover all losses, costs, expense and damages

Promus
Franchise fees for past three years

Radisson
An amount equal to all actual and consequential damages

HFS Affiliations
Varies with each franchise, but generally the fees paid during the preceding 24 or 36 months

Motel 6
Average monthly payments of royalty fees, marketing and reservation system contributions for 36 months preceding the default.

its favorable customer image and goodwill. Often a direct relationship exists between a hotel's goodwill and potential for asset value enhancement. Therefore, while affiliating with this franchisor will be comparatively costly, it may well be prudent and feasible.

Hotel Franchise Selection Process

Selecting the appropriate hotel franchise affiliation requires an analysis of the local competitive market, review of the available affiliations, quantifying the benefits and costs, and negotiating the final terms. Each one of these steps is reviewed in the following sections.

Market Analysis and the Determination of Available Affiliations. Selecting a hotel franchise is essentially a matter of first identifying what sort of hotel represents the highest and best use of a property and then determining which hotel chain affiliation would best complement the type of hotel chosen. The key to determining the highest and best use of a property is a thorough market analysis. Given the locational and competitive factors determined to be influencing the subject property, the property's market orientation, the facilities needed to cater to this orientation, and the appropriate class or level of quality for the facility can be established. These characteristics will then point to the appropriate franchise affiliations that will complement and create demand for the subject property.

Care must be taken if the franchisor has existing properties in the same market, particularly if the franchisor has an ownership interest in a competitive property. This could create a potential conflict of interest that could be detrimental over the long run. The presence of a competitive property of the same affiliation within the market, however, should not deter a potential franchisee from investigating whether the franchisor will consider a franchise application. In some cases, a franchisor may be considering the termination of a franchise, which could mean an available opening for a new property.

Another factor to consider when identifying potential franchises is whether or not a franchisor has any properties in feeder cities to the subject's market area. It is important from a marketing point of view that a franchisor have representation in the cities that will provide demand to the subject property's market area. Familiarity with a product often influences the selection of a lodging facility.

Quantifying the Benefits and Costs of a Franchise Affiliation

While selecting the appropriate hotel franchise can sometimes be a complicated process, the federal and state governments have made the data collecting phase significantly easier. Unlike many business transactions (such as entering into a management contract) franchising in the US is highly regulated, and franchisors must make full disclosure of all elements involving the contemplated franchise relationship. The document containing all this important information is called a Uniform Franchise Offering Circular or UFOC for short. Before you are allowed to sign a franchise agreement you must be given ample time (10 days) to review the content of the UFOC. Most hotel UFOC's are highly detailed and fairly lengthy, but are written in easy-to-understand language. They contain a wealth of information about the history and business dealings of the franchisor as well as explanations of the benefits and obligations involved with the pending franchise relationship.

The following is a summary of some of the important disclosures contained in a typical UFOC:

- *History of the franchisor and identity and business experience of its management personnel.* A hotel franchise is no better than the quality of the executives managing the franchise organization. Look for experience in areas such as marketing, sales, reservation technology, and hotel operations. Be wary of organizations that are top-heavy with executives who are merely franchise sales people.
- *Franchisor's litigation history.* How many and what types of lawsuits does the franchisor have outstanding? While litigation does not necessarily indicate wrongdoings, it does represent some level of dissatisfaction with the franchisor. A prospective franchisee should carefully evaluate the types of pending litigation and whether there are recurring disputes that could reflect internal problems. In some circumstances it might be helpful to discuss the background of the litigation with one or both parties.
- *Estimate of all fees and expenses of entering into and maintaining the franchise.* Along with the initial and continuing fees previously described, the UFOC will also provide a broad estimate of the major expense categories involved in developing and starting a lodging facility of what will be franchised. Known as a "liquidated damage clause," it also sets forth how much it will cost to terminate a franchise before the end of its term. A franchisee must be aware that if the wrong franchise is selected, it will generally cost between one and three times the last year's franchisee fee to relinquish the affiliation. Exhibit 4 shows the cost of terminating a franchise for several of the major chains.
- *Obligations of the franchisee to purchase or lease from designated sources.* Some franchisors require franchisees to purchase supplies from certain suppliers or use specific products or identity items. Some franchisors license suppliers using what is called a preferred vendor agreement, which allows them to receive fees based on the volume of sales made to the franchisees. This form of kickback arrangement is usually described in the UFOC.

EXHIBIT 5 TYPICAL HOTEL FRANCHISE TERMS AND RENEWAL OPTIONS

Marriott Affiliated Hotels
Term: 20 years
Renewal: Non-renewable

Hilton Affiliated Hotels
Term: New Hotels: 10 to 20 years; existing hotels: 5 to 15 years
Renewal: Varies by age, condition and other factors

Holiday Inn Affiliated Hotels
Term: Standard 10 years, new construction up to 20 years
Renewal: Non-renewable

Promus Affiliated Hotels
Term: 20 years, varies with change in ownership or conversion
Renewal: Non-renewable

Doubletree Affiliated Hotels
Term: 10 years for conversion, 20 years for new construction
Renewal: Two 10-year terms if franchisee meets current standards

Radisson
Term: 20 years
Renewal: Non-renewable

Motel 6
Term: 5 to 15 years
Renewal: Non-renewable

- *Obligations of the franchisor.* The UFOC contains a list of services that are available from the franchisor. The prospective franchisee should compare these obligations with the list contained in this article to determine whether the franchisor is offering the full complement of services. In combination with this comparison, the hotel owner should review the previously described franchise fee schedule to determine the ultimate price/value relationship of a particular affiliation.
- *Exclusive area or territory.* Most hotel franchise agreements do not provide franchisees with an exclusive area of operation or territory. Franchisors are essentially free to place new franchises wherever they want to as long as there is no significant amount of adverse impact. Nothing is more devastating than to have to compete with a new property of the same franchise that the franchisor allowed to open in the subject market. A few progressive franchisors solve this potential

conflict up front by negotiating an exclusive territory with the franchisee before the franchise commences. Many franchisors use third-party impact studies in an attempt to quantify the affect of the new competition on the existing franchisee. This latter solution is highly subjective and sometimes unreliable. If the UFOC does not contain a complete discussion of the franchisor's impact policy, the prospective franchisee should request a copy for review prior to entering into a franchise relationship.

- *Renewal and assignment of the franchise agreement.* Most hotel franchises are not automatically renewable or assignable without the permission of the franchisor. When a hotel is sold, the buyer must generally apply for a new franchise and pay an assignment fee. In addition, prior to transferring the affiliation, a franchisor usually requires that the property be physically upgraded to current standards for that particular chain. Exhibit 5 shows the renewal options for various franchises.

Additional Questions. Once the prospective franchisee has reviewed the UFOC, the following additional questions should be asked to properly evaluate a franchise affiliation and make a suitable selection:

- How long has the chain been in business?
- Is the chain growing? How many properties did it have five years ago? How many properties does it have at present? How many properties is it expected to have over the next five years? How many properties are owned, managed, or franchised by the chain? Has the product or concept been market tested?
- How many franchises were terminated during the past five years? What were the reasons for terminating these franchises? What percentage of the chain's properties are up-to-date in design and what percentage are currently being refurbished?
- What is the operating performance of other chain hotels within or near the subject's market area?
- What services are offered by the franchisor? Is there an additional charge for these services?
- What is the chain's reputation among travelers?

The following questions should be asked about the reservation system:

- How many reservations per property does it produce on an annual, monthly, and weekly basis?
- Does it tie into airline reservation systems?
- How effective is the reservation system for other properties in the market area? For similar properties outside the market area?
- What types of reservation reports are available?
- What is the typical percentage of no-shows from the reservation system?

Negotiation of Final Terms. Because a franchisor is generally required to amend and resubmit the UFOC whenever any important terms of a franchise agreement are changed, most hotel chains will not negotiate variances to their standard agreement. However, by carefully reading the UFOC, a potential franchisee can identify areas in which negotiating terms might be a possibility. For example, some UFOCs will indicate that the franchise fees during the first three years of the agreement will range up to say 4%. This means that the franchisee is likely to be able to negotiate lower franchise fees during the first several years, because the disclosure document is not specific on this item. An exclusive territory for a certain number of years is another benefit that sometimes can be obtained before finalizing the agreement. This potential is found in Hampton Inn's UFOC, which says, "Franchisor may in their sole discretion, grant exclusive territorial protection for limited period of time." In addition, prospective franchisees should attempt to obtain what is known as a lender comfort letter, which will automatically transfer the franchise to the mortgage lender in the event the property is taken back through a foreclosure. This provision will make the hotel a more desirable financing prospect.

Conclusion

Franchised hotels account for more than 65% of the existing US rooms supply. Not having some type of brand affiliation can often put a property at a severe competitive disadvantage. The process of selecting an appropriate franchise can be complicated by the many factors that must be considered, among which are the best affiliations for a particular property, what franchises are not being used, what services are provided, what are the fees, and what are the risks and benefits. As with most purchases in life, generally "you get what you pay for," and therefore it usually makes the most sense to go with the best. ■