CHAPTER 18

Hotel Franchises

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¶ 18.01 INTRODUCTION

A hotel franchise is essentially an agreement between a hotel chain (franchisor) and a hotel owner (franchisee) wherein the hotel chain allows the owner to make use of the chain's name and services (e.g., a central reservation system and defined operational procedures) in return for which the hotel owner pays the hotel chain a franchise fee. Under such an agreement, 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 made up of company-owned properties. Over time, they develop a concept, image, and brand name that prove successful in attracting customers. Specific operational procedures (known as the mode of operation) are established that produce a profitable level of efficiency. When the lodging product thus developed becomes successful, and it can be demonstrated that hotel owners using the brand name and mode of operation of the company will also be successful, the hotel company is able to franchise its concept and procedures.

One of the first franchise agreements in the hotel industry occurred in 1907 when Caesar Ritz allowed his famous name to be used on hotels in New York City, Montreal, Boston, Lisbon, and Barcelona. Modern hotel franchising started during the 1950s, when hotel construction resumed after the end of World War II. Hotel chains, realizing that their name, image, goodwill, established patronage, mode of operations, and reservation system all had value, turned to franchising their brand names and modes of operation as a rapid, inexpensive, and profitable means of expanding their holdings. Hotel developers were drawn to this idea because it gave a new hotel an immediate identity and a set of established systems and procedures that provided both lenders and investors with confidence that the property would be financially successful.

Some of the hotel chains that first offered franchises were Holiday Inns of America, Inc.; Howard Johnson's Motor Lodges; and Ramada Inn Roadside Hotels. The first Holiday Inn was a company-owned motel that opened in Memphis, Tennessee in 1952. By 1954, Holiday Inns started to franchise, and within a few years, franchises represented the bulk of the properties with which the company was involved.

Howard Johnson, a successful restaurant company that was founded in 1925, started franchising motor lodges in 1954. These were generally rooms-only facilities constructed in conjunction with freestanding Howard Johnson restaurants. The motor lodges and restaurants were often separately owned and operated.

Ramada Inn started out as a chain called Flamingo Motor Hotels in 1952. The name was later changed to Ramada Inn Roadside Hotels in 1958 when the company started successfully franchising.

Hotel franchising flourished during the 1960s and 1970s when a building boom, fueled by financing made available through real estate investment trusts (REITs), spurred the development of thousands of new hotel rooms. When the benefits of a chain affiliation became apparent to sophisticated hotel investors, particularly mortgage lenders, either a franchise or a first-tier management contract became almost a standard requirement of any development or acquisition deal. At present, very few hotels are developed as independents.

¶ 18.02 ADVANTAGES FOR FRANCHISORS

[1] Inexpensive, Rapid Expansion

Hotel companies that seek to become major chains often use franchising as a growth vehicle, because doing so generally requires a relatively modest capital investment compared with developing or acquiring properties on their own. In addition, franchising does not require the extensive management structure that is needed to operate a hotel management company. Depending on the up-front cost of a central reservation system, the capital required to start a franchise chain can be as low as several hundred thousand dollars for legal expenses, promotional material, and start-up costs. The bulk of the expenses for a franchise company consists of the advertising and promotional efforts needed to sell franchises and obtain the critical mass of franchisees required in order to have an economically viable chain.

Another cost-saving aspect of a franchise system is that development responsibilities are shifted to individual property owners. Because these parties typically have first-hand knowledge of local real estate and business markets, they are usually in a better position than a franchisor to acquire the best sites and to handle the overall development process.

The capital that makes a franchise organization grow comes from the owners of the individual hotels in the form of fees. Franchisees assume the major portion of the financial risk associated with opening a new hotel, but in return receive most of the economic rewards.

[2] Profitable Source of Revenue

The revenue generated by a hotel franchise chain typically starts with initial fees paid by franchisees when they join the franchise system, along with ongoing royalty fees. In addition, some franchisors require additional payments for services that they provide, such as marketing, advertising, reservations, frequent traveler programs, and training.

The expenses incurred by franchisors that are chargeable against these fees are generally for services provided by the franchisor and are usually minimal. Many of the services provided by franchisors generate fixed fees (e.g., centralized reservation systems, chain directories, and various administrative functions), so a franchise chain must have a sufficient number of properties under contract in order to be profitable. Once the number of franchisees reaches this level (the "critical mass"), the franchise company typically grows to become extremely profitable. Depending on the nature of the services provided by the franchisor and the fees charged the franchisees, this critical mass of properties can range in number from twenty to fifty.

Because many franchise companies also own hotels or operate properties under management contracts, franchising offers a means of spreading the fixed operating costs of the owned or managed facilities among franchised properties, thereby achieving the necessary critical mass in a shorter period of time.

[3] Customer Recognition and Brand Loyalty

Customer recognition is an important attribute for a hotel chain. While recognition can be created through advertising and promotion, one of the best methods of developing a known hotel brand name is to have a product for people to see and use. Having hotels in both popular destinations and in the cities en route to the destinations (known as feeder cities) provides potential customers with the opportunity to see or hear about the chain before selecting their overnight accommodations. Most people are very particular in their choice of sleeping facilities; product knowledge (either first-hand or second-hand) is an important factor in the selection process.

The rapid growth potential offered by franchising accelerates the essential process of creating customer recognition. Once customers recognize a hotel product and have been satisfied after using it, brand loyalty develops, which results in repeat patronage along with positive word-of-mouth promotion.

[4] Income From Brand Name, Trademarks, Image, and Goodwill

Most hotel companies that offer franchise affiliations started in the industry by developing or acquiring properties that they owned or managed. Over time they created a brand name and trademarks that in turn developed consumer image and goodwill. Further development of the companies included a mode of operation consisting of a home office management structure, operating systems and procedures, and in most instances, a central reservation system and marketing network.

This entire package, particularly the established consumer image and goodwill, has special value for an independent hotel in need of identity and image. Franchising converts this intrinsic value into income for the franchisor. There often is a direct relationship between a hotel chain's consumer image and goodwill and the volume of franchise fees generated on a per-property basis.

¶ 18.03 DISADVANTAGES FOR FRANCHISORS

[1] Loss of Operational Control

The operating responsibility for a franchised hotel lies with either the hotel's owner or the owner's agent (i.e., a management company). The franchisor exerts very little influence over the day-to-day operation of the property. Although franchise chains attempt to control the quality and image of each individual hotel through rules and regulations and periodic property inspections, the persistent fact that the franchisor does not really have basic control over an operation can sometimes result in lower standards of quality and service than the franchisor wishes to maintain. When this occurs, the guests who experience the substandard level of quality service form an incorrect image of the entire chain, which can easily have a detrimental effect on repeat patronage or word-of-mouth promotion.

For this reason, chains such as Hyatt and Westin did not franchise until just recently, citing for years their concern with the risk of losing the operational control of a hotel. Marriott has franchised for a number of years, but has attempted to maintain only a select few management companies that Marriott believed would maintain the levels of quality and service that it requires. Generally speaking, lodging chains associated with the higher classes of facilities are less likely to franchise than those that provide a lower level of service, because they are more concerned with the need to maintain operational control. Two exceptions to this include Motel 6 and Red Roof Inns, although it appears that Motel 6 is anticipating offering franchises in the near future.

Franchise chains attempt to exert operational control by periodically inspecting each property to see that the facilities are well maintained and the hotel is operating at the prescribed standards. Backing up these inspections are extensive operating requirements contained in the franchise agreement. Objective standards set by franchisors, such as requirements that the hotel accept American Express credit cards, that the restaurant be open from 6 A.M. to 10 P.M., or that all guestrooms have a color television, are relatively simply enforced. Subjective standards are more difficult to evaluate and enforce. For example, determining whether an operator complies with regulations stating that a hotel must, at all times, be clean and well maintained or that an operation must be "first-class" can be difficult.

The ultimate penalty franchisors can wield in order to enforce their various regulations and standards is the termination of the franchise. Unfortunately, the time it takes to actually terminate a franchise, particularly if the franchisee is uncooperative, can range from several months to one or more years. The termination process becomes even more difficult if litigation is involved and the dispute involves a subjective regulation.

Perhaps the greatest loss of control for a hotel franchisor is the prevention of its expansion by franchisees concerned about the impact of new hotels being developed in their area that are affiliated with the same brand. For a hotel company that does not offer franchises, the decision to have multiple properties in a given market is made purely in-house on a corporate level. However, because the franchisee does not expect to compete either with the parent lodging company's own brand or with other brands that are owned by the company, franchisors must prove that such development would not impact the existing franchisee.

For these reasons, loss of operational control can be a significant deterrent for a hotel chain that is evaluating the potential of franchising. Not only is it difficult for a franchisor to enforce its standards, but the process of terminating a franchise can be time-consuming. The potential liability is a substandard hotel that could tarnish the image and goodwill of the entire chain.

[2] Difficulties With Owners

A hotel franchise company generally has to work with many property owners and management companies. The hotel industry is largely ego-driven, so the chances are good that the objectives of a franchise company will not always mesh with the motivations and styles of all of the individuals with which it works. In fact, franchisees often band together and form a franchise association that represents their interests when disputes with their franchisor arise.

In any case, the end result of maintaining a number of business relationships is that hotel franchise companies often have to spend a considerable amount of time and money attending to their franchises in order to keep their system functioning in an efficient and orderly manner.

[3] Liability Without Control

When a franchised hotel is involved in litigation, particularly in suits involving liability claims, the franchisor is often named as a defendant. Even though the hotel chain is often found to have no control over the incident and therefore to bear no liability, the cost of legal defense can often be considerable. Occasionally, franchisors are found to be liable even though they do not have direct control over the operation of a hotel. This liability exposure can be and generally is limited through insurance, which in itself can represent a considerable expense.

[4] Quality, Service, and Cleanliness Control Problems

As described earlier, controlling the level of quality, service, and cleanliness at individual properties is not easily accomplished by franchisors. Because these subjective elements are always open to different interpretations, property owners are sometimes able to get by with lower standards than those intended by the franchisor.

Periodic property inspections followed by counseling with on-site management are the usual steps taken by franchisors seeking control of a property. Some chains offer extensive training programs and operating manuals that describe the various operating procedures that must be used to maintain the standards that they set. In any event, maintaining acceptable levels in these areas can often involve a large amount of effort and expense on the part of a franchisor.

[5] No Control Over Pricing

Another element beyond the control of a franchisor is the establishment of uniform room rates and pricing policies for individual franchisees. For some types of lodging chains, particularly those catering to price-sensitive travelers, a uniform pricing strategy is highly desirable. Uneven pricing from one hotel to another can confuse customers and adversely affect the image of the entire chain.

[6] Costly Start-Up

When a hotel chain first begins franchising, the company generally experiences a negative cash flow until the number of its properties reaches the necessary critical mass. Cash flow should turn around when the critical mass is reached, but the franchisor must have sufficient funds set aside to provide the necessary services to the franchises it has on board during the build-up period.

[7] Mandatory Disclosure Document

All forms of franchising are strictly regulated by both the federal government and certain state agencies. Aimed at protecting the small investor from risking life savings on fraudulent franchise schemes, these regulations require full disclosure of many of the important business aspects of a franchise investment. This level of disclosure eliminates the possibility of franchisors creating individual agreements for each potential franchisee and adjusting terms through negotiation. As a result, most terms of a franchise agreement are fixed and are not subject to alteration.

The Federal Trade Commission (FTC) is the primary governmental overseer of franchising in the United States. In order to offer (sell) a franchise, potential franchisors must first file with the FTC a disclosure document known as a Uniform Franchise Offering Circular (UFOC). While this document does not receive either an approval or disapproval from the FTC, it must be accurate and current. The following list contains the major items that must be addressed in a UFOC.

1. *Introduction.* Brief introduction and warnings that the material should be read carefully and that a lawyer or an accountant should be consulted. Notice from the FTC that even though the offering circular has been filed with that agency, the agency has not checked it and does not know whether it is correct.
2. *The franchisor and any predecessor.* Description of the franchisor and the franchised business. Date when the franchisor started the business, its business address, any previous owners. An overview of the franchised business, its concept and strategy.
3. *Identity and business experience of the persons affiliated with the franchisor; franchise brokers.* Biographical sketches of the directors, principal officers, and other executives who have management responsibility in the franchisor's business.
4. *Litigation history.* Description of any past or present litigation involving the franchisor or the persons affiliated with the franchisor described in Item 2.
5. *Bankruptcy.* Fifteen-year bankruptcy history for the franchisor, its predecessor, or any of the persons affiliated with the franchisor described in Item 2.
6. *Franchisee's initial fee or other initial payment.* Description of the initial fee paid by franchisee to acquire the franchise. Description of the franchisor's expenses that are paid from the initial fee.
7. *Other fees and expenses.* Description of the other fees and expenses payable by the franchisee during the term of the franchise, which typically include royalty fees; accounting and auditing fees; advertising fees; expansion fees; initial leasehold construction fees; furniture, fixture, and equipment fees; insurance fees; ongoing maintenance fees; refurbishing fees; telephone reservation referral fees; transfer fees; and training fees. Statement of whether these charges and fees are to be paid to the franchisor, or expenses are to be paid to other parties (e.g., contractors, furniture and equipment dealers, and accountants).
8. *Franchisee's estimated initial expense.* A broad estimate of the major expense categories involved in developing and starting a lodging facility typical of what will be franchised.
9. *Obligations of the franchisee to purchase or lease from designated sources.* Terms of any requirement for franchisee to purchase or lease anything from either the franchisor or suppliers designated by the franchisor.
10. *Obligations of the franchisee to purchase or lease in accordance with specifications or from approved suppliers.* Terms of any requirement for franchisee to use either approved specifications or suppliers when purchasing.
11. *Financing arrangements.* Terms of any agreement by franchisor to provide any financing to the franchisee.
12. *Obligations of the franchisor.* Other supervision, assistance, or services. List of the services and obligations of the franchisor, which are generally subdivided into pre-opening obligations and continuing obligations.
13. *Exclusive area or territory.* Details of any exclusive areas or territories granted by the franchisor.

14. *Trademarks, service marks, trade names, logotypes, and commercial symbols.* Description of the various marks and trade names owned by the franchisor and available to the franchisee. Description of any known infringement or agreements limiting the use of these marks.

15. *Patents and copyrights.* Description of any patents and copyrights owned by the franchisor. Terms of issuing and maintaining operating manual supplied to franchisee, including any provisions regarding confidentiality.

16. *Obligations of the franchisee to participate in the actual operation of the franchised business.* Rules pertaining to whether the franchisee must actually operate the hotel or can hire a professional management company. Restrictions, if any, regarding the conduct of other hotel business activities and the diversion of business to other hotels are also described.

17. *Restrictions on goods and services offered by the franchisee.* Definition of what goods and services can be offered by the franchisee at the franchised premises.

18. *Renewal, termination, repurchase, modification, and assignment of the franchise agreement and related information.* Various aspects of the franchise terms including length of initial term and renewal term; termination by franchisee; termination by franchisor, with and without notice; obligations upon termination or expiration; franchisee's interest upon termination or non-renewal; transfer of interest by franchisor; transfer of interest by franchisee; transfer upon death or mental incapacity; franchisee sale of its securities; corporate transfers; non-waiver of claims; covenants not to compete; and modifications of agreement.

19. *Arrangements with public figures.* Description of any public figures involved with the franchise.

20. *Actual, average, projected, or forecasted franchise sales, profits, or earnings.* Any statement or projection of sales, profits, or earnings, made by the franchisor.

21. *Information regarding franchises of the franchisor.* Data relating to the number of franchises currently in existence and the projected franchise sales for one year.

22. *Financial statements.* Recent audited financial statements of the franchisor.

23. *Contracts.* Complete copy of franchise agreement and other contracts that must be executed by the franchisee.

24. *Statement of prospectus accuracy.* Representation by franchisor that prospectus is accurate.

25. *Acknowledgment of receipt by a prospective franchisee.* Statement by prospective franchisee noting the date of receipt of the UFOC.

The UFOC must be given to a prospective franchisee at the earlier of the first "personal meeting" or "the time for making disclosures." The FTC defines the "time for making disclosures" as ten business days prior to the earlier of (1) the execution by a prospective franchisee of any franchise agreement imposing a binding legal obligation or (2) the payment by a prospective franchisee of any consideration in connection with the sale or proposed sale of a franchise. In addition to the FTC disclosure requirements, several states impose additional franchise regulations, some of which are more stringent than the federal rules.

The ultimate effect of this level of disclosure is to establish uniformity in franchise structures, requirements, and fees, and thus eliminate any advantage a franchisor may have over a franchisee in terms of bargaining power.

¶ 18.04 ADVANTAGES FOR FRANCHISEES

[1] Instant Recognition and Shortened Start-Up Period

The primary benefit of a franchise affiliation for a hotel is the instant name recognition that it provides. Hotel patrons traveling to new destinations often look for a lodging facility with a recognizable name and image because they want to know that the quality of the accommodations and service at the hotel they choose will meet the expectations they have that are based on prior experience with (or recommendations of) the same product. Although an independent hotel without a chain identity may well develop its own reputation and patronage, the period of time needed to penetrate the market in this fashion may extend over many years. Another decided advantage for new hotels with a recognizable affiliation is that they generally experience a faster build-up of patronage. This shortens the normal start-up period, so that a hotel with a chain affiliation will reach a stabilized occupancy level more quickly than would a new, non-affiliated hotel.

[2] Attraction of Different Market Segments to Different Franchises

Over time, hotel chains develop specific images in various market segments. For example, Marriott Hotels, Hyatt Hotels, Westin Hotels, Sheraton Hotels, and Hilton Hotels generally achieve high penetration in the meeting and convention market segment. Courtyard by Marriott, Embassy Suites, and Doubletree Hotels have a strong following in the commercial segment, while Holiday Inns, Hampton Inns, and Comfort Inns have strong followings in the leisure market. Residence Inn by Marriott, Homewood Suites, Villager Lodges, and Studio Plus Suites are oriented toward extended-stay guests.

The market strengths of each lodging chain can directly benefit the hotels that take on their franchises, so a hotel owner looking for a franchise affiliation should thus be aware of the market strengths of each available franchisor and determine which affiliation will make the best use of both the available market and the subject property's contemplated or existing facilities.

[3] Proven Method of Operation and Product Merchandising

Successful, established hotel chains generally allow potential franchisees access to the manuals and training programs that they have developed as internal guidelines for their mode of operation and product merchandising. By reviewing these materials, a franchisee can be certain that the franchisor has tried and proven systems and procedures that will increase the chances of franchise success.

New franchise companies typically have several company-owned hotels that serve as laboratories for developing systems and procedures. Prospective franchisees, lenders, and investors look at the operating results of these properties and use them as a means of confirming the ability of the franchisor to run viable, profitable hotels.

¶ 18.05 DISADVANTAGES FOR FRANCHISEES

[1] Excessive Cost if Incorrect Franchise Is Chosen

The selection of a franchise is one of the most important decisions that a hotel owner must make. Choosing the wrong franchise almost always adversely affects operating results. For example, an affiliation with a luxury-quality, convention-oriented lodging chain will negatively affect a hotel that, based on local market conditions and characteristics, should be oriented toward the budget-rate, leisure market segment. Some of the costs that can result from selecting the incorrect franchise include:

- Operating losses during the period the ineffective affiliation is in use;
- Cost of acquiring a new franchise;
- Cost of purchasing new identity items such as signs, logos, and monogrammed items; and
- Operating losses during the initial occupancy build-up period under the new franchise.

[2] No Guarantee of Success

Hotel franchisors typically have no financial interest in the properties they franchise and make no representation that a particular franchise will be an economic success. In fact, franchisors occasionally set operating standards that may in themselves be costly to the franchisee, such as requiring a hotel to upgrade its facilities even though such upgrades may not have a direct impact on the operating profitability of the hotel.

Even though franchise offerings are regulated by the FTC and some state agencies, franchise salespeople have occasionally resorted to unethical practices in order to sell new franchises. The compensation received by many of these salespeople is based on the number of franchises they sell, so without strict supervisory control, some salespeople may attempt to sell franchises either to unqualified owners or to projects that have no economic feasibility. Such conduct was partially responsible for the overbuilding that took place during the early 1970s.

As discussed previously, hotels spend anywhere from .75% to 9.34% of total revenues to affiliate with a national lodging franchise. This percentage is often the largest single expense incurred by a hotel after payroll and typically makes up the largest expense in the hotel's marketing budget. As with any substantial cost or investment, purchasers of a service like to see the benefit that they are receiving for their money.

With regard to the economic benefit of hotel franchise fees, we are provided only with the claims and promises provided by the franchisors themselves. Some franchise companies refuse to provide performance statistics of any kind, fearing that such claims would constitute guarantees which if not achieved would leave them open to ridicule and perhaps litigation. Other companies provide statistics such as system-wide reservation contributions, but these statistics are closely guarded and vary from chain to chain as to what is considered a reservation and/or denial. Furthermore, in comparing the gross delivery of reservations for a given period, many of which are composed of room-nights booked months and sometimes years in the future, against the actual occupied rooms in that period can be quite misleading.

Initiated by the University of Denver School of Hotel, Restaurant and Tourism Management, Richfield Hospitality, one of the largest independent hotel management companies, used this model as a basis to survey forty-three of its hotels, which operate under thirteen different franchises. The model attempted to quantify three areas of franchise performance:

1. The benefit of programs and services offered by the franchise;
2. The consumed reservation room night contribution of the reservation system; and
3. The drive-by value of the franchise name.

The findings enabled Richfield to rank the various franchises based on these three categories as shown in Exhibit 18-1.

Exhibit 18-1 Franchise Rankings

Hotel Franchise Portfolio	Franchise Programs and Service	Reservation Contribution	Drive-by Value
A	1.0	3.0	4.0
B	7.0	4.0	6.0
C	10.0	1.0	1.0
D	5.0	2.0	7.0
E	3.0	13.0	11.0
F	8.0	6.0	9.0
G	12.0	10.0	13.0
H	2.0	5.0	5.0
I	13.0	8.0	3.0
J	9.0	9.0	2.0
K	11.0	11.0	10.0
L	4.0	4.0	12.0
M	6.0	6.0	8.0

The franchises surveyed include Best Western, Clarion, Comfort Inn, Days Inn, Hilton, Holiday Inn, Howard Johnson's, Knights Inn, Quality Inn, Radisson, Ramada, Sheraton, and Travelodge. The survey results indicated that each franchise offered different benefits to the hotels that operate under their flag. Several of the best performing franchises in terms of their actual room night contribution were viewed by many general managers as not very effective in their programs and services provided. Similarly several franchises that did not contribute significantly to the hotel's occupied rooms through their reservation service were perceived by the general managers to provide strong benefit in terms of the flag's drive-by value.

Although it is not known whether the University of Denver model and the Richfield study adequately quantified all of the aspects of return on investment, the relative rankings of the different chains provide insight into the substantial differences in performance that can be expected on the basis of property type and location relative to the particular affiliation. HVS is currently taking this study to the next level by rolling it out on a national basis.

The goal is to quantify the benefits offered by all the major national franchises and analyze the information to see how these benefits relate to the size, type, location, and competitive situation of a particular hotel. The success of the survey is of course contingent on the contribution of the independent owners and management companies from which the survey information is polled. Although such information may be available from the franchises themselves, we believe that the owners and operators themselves will provide the most objective and pertinent information available. After all, it is not the value of a particular franchise to the franchise company itself that is being assessed; it is the value of the franchise to the franchisee that poses one of the biggest questions in the minds of hotel owners and operators in the lodging industry today.

[3] Nontransferable Franchises

Some hotel franchisors do not allow existing owners to freely transfer a franchise to a new owner in the event of a sale. Some of the transfer restrictions typically imposed by franchisors include:

- Payment of a transfer fee;
- Approval of new owner by franchisor;
- Application for an entirely new franchise;
- Refurbishment of hotel to meet current franchise standards; and
- Right of first refusal on transfer.

Ultimately, the risk posed to the seller by these transfer restrictions is that the franchise may not be renewed or that it can be renewed only for a price. For example, a transfer may require spending hundreds of thousands of dollars in order to bring a hotel up to current standards. Anything that could inhibit the transfer of a valuable franchise could also adversely affect the market value of the property.

[4] Short Term of Franchise

Franchisees and potential buyers face the risk that the reversionary value of an investment in a hotel will be discounted if its franchise cannot be renewed or extended. Since the economic lives of hotels generally span thirty to forty years, and franchise terms typically range from ten to twenty years, continuation of a favorable franchise affiliation is important. A change of name and image midway along a hotel's economic life can result in severe marketing and financial difficulties. For this reason, first-tier hotel management companies typically require contracts that extend beyond twenty years in order to preserve the name integrity of the chain.

[5] Little Control Over Other Franchisor Affiliations

Most franchise agreements are not overly restrictive regarding the number of new hotels in the market area with which the franchisor can be affiliated. Occasionally, a franchise will grant a property owner an exclusive area for a specific period of time. In most cases, however, a franchisor is free to add a new product to a market whether it is another franchised hotel or a property managed or owned by the franchise company. With the recent trend in product segmentation, franchisors sometimes claim that adding a product to a market area that caters to a different market segment or price classification will not adversely affect an existing franchisee. While this may have been true during the late 1980s, when demand for accommodations was extremely high, many hotels located in the same market area that formerly targeted different segments of the traveling public found themselves competing directly for business during the lean years of the early 1990s. Proliferation of new brands virtually stalled as new development of hotels became a nearly impossible task. However, with the strong operating performance of most hotels from 1994 through 1996, many new brands targeting specific segments are set to come on line during the latter half of the 1990s.

[6] Adherence to Chainwide Standards

The various regulations and standards developed by franchisors are designed to cover all the hotels in the chain and ensure uniform mode of operation and image. Occasionally, these standards may be inappropriate for a specific property, or unsatisfactory to a particular owner, but franchisors generally do not allow any deviation from their system. The chainwide standards that can negatively affect individual hotels include:

- Required year-round operation;
- Set operating hours for restaurants, lounges, and room service;
- Minimum staffing level requirements, such as 24-hour door attendants and bell hops;
- Participation in chain advertising and frequent traveler programs; and
- Required amenities (e.g., a swimming pool, a restaurant, room service, a lounge, or free parking).

Property owners who would be adversely affected by these standards are sometimes able to work out exemptions with franchisors before signing an agreement.

[7] Benefits Dependent on Number of Properties in Chain

Just as a franchise chain has a critical mass for the franchisor at which franchise revenues cover the costs of licensing and maintaining franchises, so too does a franchise chain have a critical mass for the franchisee, at which the economic benefits of the franchise affiliation exceed the cost of acquiring and maintaining it. The benefits of a franchise affiliation that are directly related to the number of properties in the chain include:

- Reservation referrals from other properties;
- Word-of-mouth referrals from patrons with favorable experiences;
- Advertising and marketing assistance;
- Additional chain services; and
- Sophisticated central reservation system.

A potential franchisee should evaluate the price/value relationship of joining a hotel chain, particularly in light of the fact that some new franchisors will reduce initial and continuing franchise fees during their start-up period to reflect the reduced level of benefits that they provide compared with an established chain.

[8] Lack of Control Over Chain Quality and Image

Individual franchises have little control over any of the operating policies of the franchisor that adversely affect the overall quality and image of the franchise chain, and so are essentially at the financial mercy of the franchisor. An analysis of the hotel franchise organizations that started during the 1950s and the 1960s yields examples of chains that faded in popularity and others that increased in strength because of their ability or inability to maintain efficient operating policies. Necessary policies for a franchise company include:

- Mechanism for terminating franchises that do not maintain an appropriate level of quality and service.
- Mechanism for removing hotels from the system that are not functionally up-to-date.
- Periodic update of marketing strategies and chainwide customer image.
- Consistent product and unified image.

A twenty-year franchise commitment will typically expose the owner of the affiliated hotel to at least one complete turnover in the management of the franchise company. New policies and management outlook evolve on a continual basis, and this may or may not be a positive influence on the entire lodging chain.

¶ 18.06 SERVICES OFFERED BY FRANCHISORS

Like any other long-term financial situation, a hotel franchise has certain risks and benefits. Hotel owners can minimize the possibility of an unpleasant experience by carefully reviewing the services offered by individual franchisors and dealing only with reputable franchise companies.

[1] Site Selection and Market Analysis

Hotel franchise chains often help prospective franchisees to select a suitable hotel site and analyze the characteristics of the surrounding market area. In this regard, however, their assistance is reactionary in that franchise companies generally only comment on a potential site chosen by the franchisee; they do not actually seek out suitable locations.

Franchisors also typically recommend independent hotel appraisers who can perform market analyses for potential franchisees. Franchisors are also often able to assist appraisers by providing important data such as the room rates and occupancy levels of competitive lodging facilities, the number of fill nights at other chain properties in the market area, and reservation data regarding the amount of satisfied and unsatisfied lodging demand in the immediate area.

[2] Provision of Plans and Specifications

Hotel chains that seek to have a uniform image or character for their properties generally provide prototypical architectural plans to the franchisee that can be modified and adjusted to fit a particular site. The benefit of these plans to the franchisee is twofold: they often reduce development cost, and they assure a well-conceived, functional property. Some franchisors also provide detailed specifications for construction and furnishings in order to maintain the quality standards of the chain. Potential hotel developers should realize that most hotel chains have strict guidelines concerning plans and specifications for constructing and furnishing their facilities. Consequently, developers should make no significant expenditures for architectural plans until a franchise has been selected and the required specifications have been obtained.

[3] Development Assistance

Hotel franchisors are often able to provide assistance during the construction of a hotel. At the minimum, a hotel chain usually wants the opportunity to approve plans and specifications prior to construction and to inspect for compliance during development and after the project is completed. Some franchisors, however, have in-house development experts who will provide extensive support in all phases of the development process. The cost of these services is generally an additional charge over the normal franchise fees.

[4] Assistance in Obtaining Financing

Franchisors generally do not secure financing for franchisees, but they do sometimes assist in assembling loan packages for lenders. A good hotel chain typically develops relationships with the various financial components necessary to obtain financing, which include firms that perform market studies and appraisals, mortgage bankers and brokers, construction lenders, permanent lenders, real estate investment trusts, mortage conduits, and investors. In addition, large hotel companies such as Marriott, Promus, Choice, and HFS offer potential franchisees direct financing of their own. This was a necessary vehicle created by these companies during a period in which the economics for expansion were present but the financial sources for hotel construction were not. As traditional third-party financing has returned to the market in recent years, these programs at the major hotel companies have been scaled back.

Because financing is an important aspect of a hotel development or acquisition, more franchisors can be expected to take an active role in obtaining funds in the future. A franchise package that offers not only the normal franchise benefits but some form of financing commitment is an unbeatable combination for attracting franchisees.

[5] Publicity and Promotion Assistance

Generally, hotel chains that sell franchises have prepared professional advertising and promotional campaigns that include logos; trademarks; signs; property; billboards; and print, radio, and television ads. Franchisees can usually obtain these advertisements and promotional materials from the franchisor and immediately use them in the proper media.

[6] Centralized Purchasing

Many franchisors offer centralized purchasing services that are able to take advantage of quantity discounts available to large volume buyers, passing these savings on to the individual franchisees. Not only can the financial benefits of centralized purchasing be substantial, but the ease of ordering, receiving, and accounting is often greatly simplified. Vendors, realizing the purchasing power of an entire organization, are also more likely to provide better service. Centralized purchasing not only reduces the cost of buying products such as furniture and operating supplies but decreases the price of such services as advertising, accounting, and legal counsel. Centralized purchasing is generally a voluntary service; in most instances, the franchisee is free to purchase supplies, furnishings, and equipment from any vendor in the market as long as the specifications of the item purchased meet the franchisor's approval.

Another advantage gained by the buying power of a lodging chain is that individual franchisees are able to receive reductions in credit card commissions.

[7] Referrals Between Properties

One of the primary benefits of belonging to a lodging chain is the referral of business between the properties within the chain. In effect, each property in the chain functions as a marketing office that creates room-nights of demand for other hotels throughout the chain. For example, when a patron is checking out of one hotel, the front desk personnel should determine whether the traveler requires a reservation at the next destination. If so, a sale should occur, and a reservation should be made with another franchisee in the chain. Similarly, when meeting and convention groups have been satisfied with the service and accommodations they received by one hotel in a chain, they should be referred directly to other chain hotels for future meetings. Individual franchisees benefit by keeping hotel patrons "within the chain" through property level referrals.

Hotel owners who are prospective franchisees should investigate whether a franchisor actively encourages referral activity between properties, and if so, whether there is chain representation in the feeder cities where this type of reservation activity would originate.

[8] Centralized Reservation System

Another major benefit of a franchise affiliation is the centralized reservation system that ties the entire chain together. Most hotel chains offer a reservation system consisting of a central reservation office with a toll-free telephone number. Staffed by trained personnel, the central reservation office takes all reservation requests and records the following information:

- The hotel within the chain that is the most convenient destination to the caller.
- The availability of accommodations at the requested hotel on the desired date(s).
- Available room rates.
- A reservation, if the caller so chooses.
- Guarantee of the reservation, if necessary.
- Any special request.
- Information about the caller (e.g., name, address, and telephone number).

This data is stored in the central reservation computer for future statistical analysis and, if necessary, is also transmitted to the property to confirm the reservation and identify the patron.

Hotel franchise reservation systems vary in sophistication. Potential franchisees should investigate the workings of each reservation system to determine which will work best for their particular operation. The aspects of the system that should be analyzed include the following:

- The number of reservations the central system actually generates for the properties within the chain. (The franchisee should trace this data to individual properties that have locations similar to the subject property, and then analyze the reservation data on both a monthly and weekly basis.)
- The number of reservations that represent actual room-nights and the number that result in no-shows.
- The number of reservations that are currently unaccommodated within the potential franchisee's market area, and to what properties unaccommodated reservations are currently referred.
- The identity of the properties in the chain from which the subject property can expect to receive reservation overflow. Reservation system computers are programmed to refer unaccommodatable reservations to another property within the chain, usually the closest based on travel time. This procedure should, however, be verified to ensure that the potential franchisee's hotel will receive its fair share of overflow reservations.
- The identification of the potential franchisee in the reservation system. For example, a hotel might be known as the Sleep-Inn Downtown or Sleep-Inn Convention Center or Sleep-Inn Airport or Sleep-Inn Interstate. Incorrect information conveyed by a name or description could divert reservations and patronage to other properties even if they are less well located to the traveler's final destination.

Hotel franchise companies with centralized reservation systems are generally able to provide franchisees with market analysis based on their reservation data. These reports can provide important market research information to the franchisee. The reports containing this research information that are usually available to franchisees include:

- *Reservation originations.* A listing of where reservations originate, categorized either by zip code or by telephone area code. This information is useful in planning future marketing programs.
- *Reservation denial report.* A listing of the number of potential patrons who attempted to make a reservation at a specific property but, because the property was fully booked, could not be accommodated. This information is important for quantifying unaccommodated demand, which provides an indication of the need to expand a property.
- *Occupancy comparisons.* A report showing how a specific property's occupancy percentage compares with other hotels of the same franchise in the property's market area, state, and region. This information is useful in evaluating operating performance.

A potential franchisee should request to see examples of the different reservation system reports offered by franchise chains in order to determine which offers the most useful information.

[9] Proven Mode of Operation

A franchisor should provide the franchisee with a tried and proven mode of operation that includes all the systems and procedures that are necessary in order to operate the franchise efficiently. In most instances, the information regarding the implementation of the mode of operation is communicated either by training programs or by an operations manual offered by the franchisor.

Some chains offer extensive schools or seminar programs to familiarize management level personnel with the chain's mode of operation and general philosophies. Other franchisors have detailed operating manuals that provide recommended solutions to almost any problem that the management of the property may encounter. While the assistance provided by the franchisor will not substitute for actual hotel operating experience, it is important to use the experience of the hotel chain in order to reduce the number of operational errors and to conform with the chainwide image and mode of operation of the franchisor as well.

[10] Marketing Offices

Most hotel chains, particularly those with a group marketing orientation, maintain national and regional marketing offices that generate meeting, convention, and group business. This service is particularly beneficial for those hotels that anticipate heavy usage in the meeting and convention segments. The time and effort required to establish the marketing infrastructure to effectively penetrate the meeting and convention segment can be overwhelming for an individual hotel; tapping into a chain's database of group business can offer a substantial advantage. The potential franchisee should verify that such information does exist and will ultimately produce meeting and convention room-nights for the subject property.

[11] Property Inspection and Evaluation

Quality assurance is an important activity for franchisors. A hotel chain is only as good as its poorest hotel, so constant inspection and evaluation on the part of the franchisor is necessary to maintain a consistent level of physical and service quality.

Most hotel chains typically inspect their properties two to four times per year. A score is usually awarded based on a 1,000 point system. Franchisees that do not achieve a satisfactory score are usually provided with a set time frame to correct the issues that brought them below the given standard. The purpose of these inspections is to monitor quality standards and familiarize the on-site management with the techniques used to maintain the required level of quality. Because rigid enforcement of quality standards is extemely important for the success of a franchise system, the methods of regulating property level quality should be closely evaluated by potential franchisees.

¶ 18.07 FRANCHISE FEES

When evaluating a possible hotel franchise, one of the most important economic considerations is the structure and amount of the franchise fee. Hotel franchise fees are the compensation paid to the franchisor for the use of the chain's name, logo, identity, image, goodwill, operating systems and procedures, marketing plans, and referral and reservation systems. Franchise fees are normally formulated using an initial fee paid upon applying for the franchise plus continuing fees paid periodically during the term of the franchise.

[1] Initial Fee

The initial fee typically takes the form of a minimum dollar amount based on a hotel's room count. For example, the initial fee may be a minimum of $45,000 plus $300 per room for each room over 150. Therefore a hotel with 125 rooms would pay $45,000 and a hotel with 200 rooms would pay $60,000. The initial 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 pre-opening or conversion phases.

If the hotel is existing and the franchise represents a conversion, the initial fee structure is occasionally reduced. Some franchisors will return the initial fee if the franchise is not approved, while others will keep a portion (5% to 10%) to cover the cost of reviewing the application.

Other costs associated with the initial acquisition of a national franchise may include the cost of signage and any specialized computer software or hardware needed to interface with the franchisor's central reservation system. An existing hotel contemplating an affiliation also bears the possible burden of repurchasing towels, brochures, operating supplies, and paper items imprinted with the national franchisor's logos. It is also possible that the potential affiliate may have to undertake a property refurbishment or renovation (ranging from installing a higher grade of carpeting to enclosing a property's exterior corridors). These costs must be considered when measuring the cost/benefit of affiliation, and varies from hotel to hotel and between the various franchise organizations.

[2] Continuing Fees

Payment of continuing franchise fees commences when the hotel assumes the new franchise affiliation; these 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.

[a] Royalty Fee

Almost all franchisors collect a royalty fee, which represents compensation for the use of the chain's trade name, service marks and associated logos, goodwill, and other franchise services. A significant profit is generally factored into the royalty.

[b] Advertising or Marketing Fee

Chain-wide advertising and marketing consists of national or regional advertising in various media, the development and distribution of a chain directory, and marketing geared toward specific groups and segments. In many instances, the advertising or marketing fee goes into a fund that is administered by the franchisor on behalf of all members of the chain. In this situation, these dollars must be utilized for the purpose of promoting the chain, and do not normally represent a source of profit to the franchisor.

[c] Reservation Fee

If the franchise chain has a reservation system, the reservation fee supports the cost of operating and paying for the central office, telephones, computers, and reservation personnel. Like advertising or marketing fees, the reservation fee is designed to cover the cost of the reservation system, and generally provides little profit to the franchisor.

[d] Frequent Traveler Program

Some franchisors maintain incentive programs that present awards to guests for frequent stays. The programs are designed to encourage loyalty to the affiliation.

[e] Other Miscellaneous Fees

These fees may include fees payable to the franchisor for additional systems or procedures; they are generally minimal in cost and do not represent profit. In addition, those franchisors that provide extensive training programs for their franchisees levy training fees that cover the cost of the instructional programs.

Sometimes the franchisor offers additional services for a fee. These services include consulting, purchasing assistance, computer equipment or satellite communication equipment rental, optional training programs, on-site opening assistance, or additional advertising services. The fees for these services are typically not qualified in the disclosure documents.

[3] Continuing Fee Assessment

Continuing franchise fees are assessed on the basis of several formulas. Royalty fees are generally based on a percentage of rooms revenue (which can vary as much as 1 percent to 6.5 percent). Advertising, marketing, and training fees are generally calculated on a percentage of rooms revenue (ranging from 1 percent to 4.5 percent), but sometimes are based on a dollar amount per available room per month. Reservation fees may also be based on either a percentage of rooms revenue (1 to 8 percent) or a dollar amount per available room per month ($2 to $6) but in some instances are assessed by an amount per reservation sent to the property through the central reservation system ($1 to $5.50). These various formulas may be used by themselves or they may be combined with each other. For example, the marketing fee for a franchise may be the greater of $2.00 per available room per day or 2 percent of rooms revenue. Many also have first-month contingency fees in lieu of recorded revenues (e.g., a royalty fee of $24.00 per room for the first month and then 5% of gross revenues in the ensuing months).

Each one of these fee structures offers advantages and disadvantages for the individual property. A fee based entirely on a percentage of rooms revenue is favorable for hotels that derive significant income from food and beverage sales. Fees based on an amount per available room are fixed, and tend to benefit hotels with high volumes and penalize properties with lower results. Paying a reservation fee based on the number of reservations received is fair, as long as the reservations equate to occupied room nights and not to no-shows.

Many franchisors are now requiring franchisees to bear their fair share of the costs associated with operating a frequent traveler program. Frequent traveler program assessments are typically based on a percentage of total or rooms-only revenues generated by a member of the program at a hotel (1.0% to 6.5%), or a fixed dollar amount per room occupied by a frequent traveler member ($1.60 to $5.00). Many programs also require hotels to contribute a one-time participation fee of $5.00 to $10.00 per guestroom, while others use a combination of all three methods.

The specific fee structures required by a franchise company must be disclosed in the UFOC that it must file with the FTC, so potential franchisees can evaluate the fee structure of prospective franchise companies and determine whether the price/value relationship warrants the acquisition of a particular franchise. Exhibits 18-3, 18-4, and 18-5, developed from information contained in UFOCs, provide comparisons of the fees charged by various franchise companies. Each table deals with a different class of lodging facility (i.e., economy, mid-rate, and first-class) and the data in them is derived from the operating information in Exhibit 18-2.

Exhibit 18-2 Lodging Facility Class Distinctions

	Economy Hotel	Mid-Rate Hotel	First-Class Hotel
Room Count	100	200	300
Average Room Rate (Year 1)	$35.00	$65.00	$95.00
Room Rate Growth	5% per Year	5% per Year	5% per Year
Occupancy			
Year 1	60%	60%	60%
Year 2	70%	70%	70%
Year 3	75%	75%	75%
Projection Period	10 years	10 years	10 years
Total Room Nights	266,450	532,900	799,350
Total Rooms Revenue During 10-Year Projection Period	$11,794,243	$43,798,356	$96,027,117
Total Food and Beverage Revenue During 10-Year Projection Period	N/A	N/A	$57,616,270
Number of Reservations From Franchisor	15% of occupied rooms	15% of occupied rooms	15% of occupied rooms
Percent of Rooms Occupied by Frequent Travelers	N/A	8% of Occupied rooms	8% of occupied rooms
Percent of Rooms Occupied By Third Party Reservation Travelers	N/A	5% of occupied rooms	5% of occupied rooms
Average Length of Stay	2 nights	2 nights	2 nights

Our model assumes that each affiliation is capable of generating the same portion of occupancy from its reservation system. In truth, some affiliations generate more demand and some contribute less.

The following three exhibits summarize the franchise fee information relating to each franchise affiliation. The first column in each table identifies the name of the franchisor. The second column shows the amount of the initial fee based on the room count assumed for each class of facility. The next five columns represent the continuing fees, which are subdivided into royalty, reservation, marketing, frequent traveler program, and miscellaneous cost. The continuing fees were calculated annually over the ten-year projection period and represent the total ten-year amount that would be paid by the franchisee. The next column represents the sum of the initial and continuing fees. The last column shows the percentage relationship of the total projected franchise fees to the total projected rooms revenue.

A total of fifty-seven franchise groups, in which twenty-six budget, eleven mid-rate, and twenty first-class franchisors participated, were included in the analysis. The trend toward continued franchise expansion and segmentation was exhibited by a 19 percent increase in the number of 1994 study participants.

The Budget Host organization lead the analysis, with only 0.75 percent of its projected ten-year revenue going toward expenses related to franchise fees. Other organizations achieving low percentages included Preferred Hotels at 1.49 percent, Best Western at 1.94 percent, Microtel at 2.70 percent, and Best Inns at 4.12 percent. The percent of rooms revenue figures ranged from 0.75 percent to 9.34 percent in the budget category, 1.94 percent to 8.99 percent in the mid-rate category, and 1.49 percent to 9.91 percent in the first-class category. Low percentage leaders in each category were Budget Host, Best Western, and Preferred Hotels, respectively. The overall range was a low of 0.75 percent to a high of 9.91 percent with a median of 6.57 percent.

Budget Host, Best Western and Preferred Hotels are, technically, not franchises, but rather associations or referral organizations. Because these groups are structured for the benefit of their member hotels, fees are oriented more toward covering operating costs rather than producing large profits. Their percentages are therefore somewhat representative of the actual cost of operating a franchise organization and provide an indication of the margin of profit realized by other chains.

A Marriott affiliation is still the most expensive; 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 above-average cost of this affiliation. However, few would argue with the success of Marriott's proven operating abilities, as well as its favorable customer image and good will. Often a direct relationship exists between a hotel's good will and its potential for asset value enhancement. Therefore, while affiliating with such a franchisor may well prove feasible and prudent, it will be comparatively costly.

As Exhibit 18-6 shows, the overall franchise class average showed steady growth over the past five years. The budget class maintained a three-study average of 5.7 percent, the mid-rate class carried a 6.7 percent average, and the first-class group had a three-study average of 6.4 percent. The budget group exhibited the lowest averages over the past five years, while the mid-rate group logged the highest.

Most hotel lenders believe that to be competitive in today's hotel market, a strong franchise affiliation is essential. Customers want to know the level of quality for which they are paying, and would rather not take the chance of having an unpleasant surprise from a "no-name" lodging facility. Hotel lenders also typically insist on a franchise affiliation of some type because it reduces the perceived investment risk. The big question is whether to opt for a Best Western affiliation at 1.94 percent of rooms revenue or for a Days Inn affiliation at 8.97 percent.

The selection of a chain affiliation should be evaluated carefully to determine when the price/value relationship is favorable to the hotel owner and when that relationship shows promise for long-term stability. One of the tools available to compare the relative cost of a franchise chain affiliation is the preceding analysis. Armed with this information, owners can address additional costs pertinent to their particular properties and determine the overall cost of affiliation.

Exhibit 18-3 Summary Table of Chain Franchise Fees—Budget Hotels

Chain	Total Initial Cost	Total Royalty Costs	Total Reservation Cost	Total Marketing Cost	Total Frequent Traveler Cost	Total Misc. Cost	1994 Total Ten-Year Cost	1994 Total Cost as a % of Total Room Revenue
AmericInn	$20,000	$589,712	—	$235,885	—	—	$845,597	7.2%
Best Inns	13,875	235,885	$117,942	117,942	—	—	485,644	4.1
Budget Host	3,500	51,875	30,000	—	—	$3,500	88,875	0.8
Budgetel	25,000	589,712	117,942	117,942	—	1,000	851,596	7.2
Comfort Inn	40,000	588,918	164,871	255,494	—	9,600	1,058,883	9.0
Downtowner Inns	10,000	471,770	24,000	117,942	—	—	623,712	5.3
EconoLodge	25,000	471,315	164,771	255,295	—	9,600	925,981	7.9
Fairfield Inn by Marriott	37,500	471,770	160,907	294,856	—	6,500	971,533	8.2
Friendship Inn	20,000	352,911	164,471	254,994	—	9,600	801,976	6.8
Hampton Inn	35,000	471,770	—	471,770	—	36,700	1,015,240	8.6
Holiday Inn Express	40,000	589,712	189,582	235,885	35,745	10,600	1,101,524	9.3
Howard Johnson Inns	35,000	471,770	294,856	235,885	—	6,650	1,044,161	8.9
Master Host Inns & Resorts	15,000	530,741	24,000	117,942	—	—	687,683	5.8
Microtel	25,000	294,856	—	—	—	—	319,856	2.7
Nendels	10,000	353,827	216,354	182,500	—	—	762,681	6.5
Passport Inns	10,000	412,799	24,000	117,942	—	—	564,741	4.8
Red Carpet Inns	15,000	471,770	24,000	117,942	—	—	628,712	5.3
Rodeway Inns	25,000	354,211	164,871	255,394	—	9,600	809,076	6.9
Scottish Inns	10,000	412,799	24,000	117,942	—	—	564,741	4.8
Shoney's Inns	25,000	412,799	117,942	117,942	55,000	—	728,683	6.2
Signature Inns	25,000	471,770	412,799	—	—	—	909,569	7.7
Sleep Inn	35,000	471,415	255,395	166,871	—	28,800	957,481	8.1
Super 8	20,000	471,770	—	353,827	—	—	845,597	7.2
Thriftlodge	30,000	471,770	—	508,270	—	—	1,010,040	8.6
Travelodge	30,000	471,770	—	508,270	—	—	1,010,040	8.6
Villager Lodge	15,000	589,712	121,592	117,942	—	—	844,247	7.2

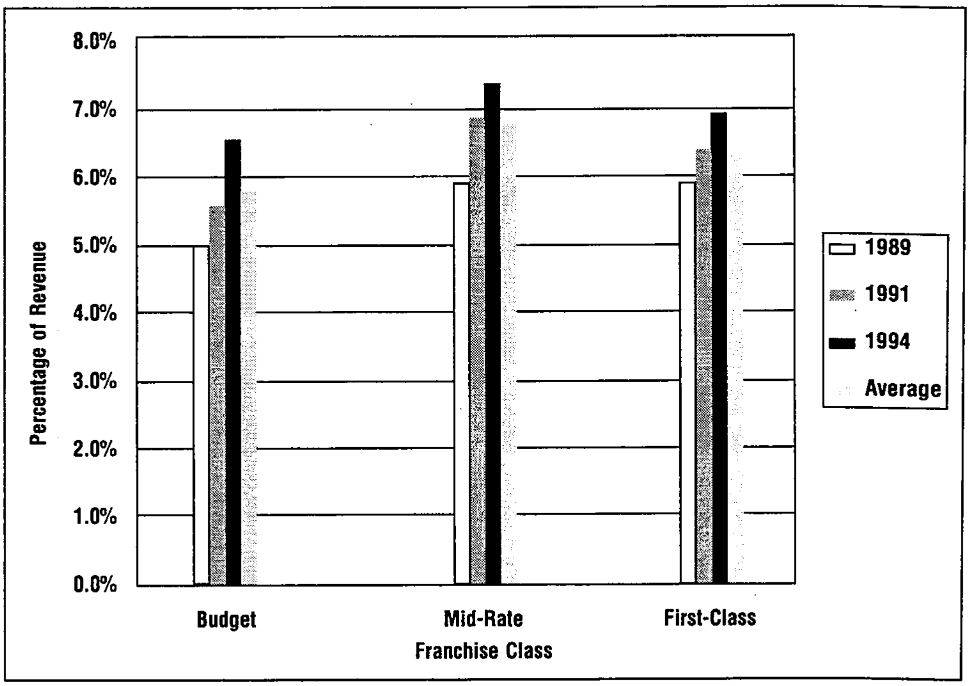
Exhibit 18-4 Summary Table of Chain Franchise Fees—Mid-Rate Hotels

Chain	Total Initial Cost	Total Royalty Costs	Total Reservation Cost	Total Marketing Cost	Total Frequent Traveler Cost	Total Misc. Cost	1994 Total Ten-Year Cost	1994 Total Cost as a % of Total Room Revenue
Best Western	$42,000	$ 46,160	$311,593	—	—	$449,865	849,618	1.9%
Comfort Suites	60,000	1,751,934	523,746	$772,294	—	9,600	3,117,574	7.1
Country Lodging by Carlson	20,000	1,268,043	439,643	2,144,010	—	—	3,871,696	8.8
Courtyard by Marriott	80,000	2,126,572	501,656	875,967	—	52,000	3,636,195	8.3
Days Inn	80,000	2,846,893	1,007,362	—	—	4,750	3,939,005	9.0
Holiday Inn	80,000	2,189,918	584,764	656,975	$227,911	13,350	3,752,918	8.6
Howard Johnson	70,000	1,751,934	1,094,959	875,967	—	6,650	3,799,510	8.7
Park Inn	31,000	1,740,807	3,650	870,487	—	—	2,645,944	6.0
Quality Inn	60,000	1,757,734	523,946	772,694	—	9,600	3,123,974	7.1
Quality Suites	60,000	1,751,934	523,946	772,694	—	9,600	3,118,174	7.1
Ramada	70,000	1,751,934	—	1,970,926	—	6,650	3,799,510	8.7

Exhibit 18-5 Summary Table of Chain Franchise Fees—First-Class Hotels

Chain	Total Initial Cost	Total Royalty Costs	Total Reservation Cost	Total Marketing Cost	Total Frequent Traveler Cost	Total Misc. Cost	1994 Total Ten-Year Cost	1994 Total Cost as a % of Total Room Revenue
Clarion	$90,000	$2,866,409	$1,084,972	$1,552,090	—	$9,600	$5,603,073	5.8%
Doubletree	30,000	2,880,814	3,360,949	—	—	—	6,271,763	6.5
Doubletree Club	30,000	2,880,814	3,360,949	—	—	60,000	6,331,763	6.6
Doubletree Suites	30,000	2,880,814	3,360,949	—	—	—	6,271,763	6.5
Embassy Suites	150,000	3,841,085	120,034	3,360,949	—	—	7,472,068	7.8
Guest Quarters Suites	30,000	2,880,814	3,360,949	—	—	—	6,271,763	6.5
Hawthorn Suites	120,000	3,841,085	2,400,678	—	—	—	6,361,763	6.6
Hilton Garden Inn	55,000	4,801,356	1,920,461	960,271	584,371	—	8,321,459	8.7
Hilton Inn	55,000	4,801,356	1,920,461	—	584,371	—	7,361,188	7.7
Hilton Suites	55,000	4,801,356	1,920,461	960,271	584,371	—	8,321,459	8.7
Holiday Inn Crowne Plaza	120,000	4,801,356	1,178,691	1,920,542	502,341	19,600	8,542,530	8.9
Homewood Suites	90,000	3,841,085	—	3,841,085	—	53,700	7,825,870	8.1
Marriott	90,000	7,487,115	359,708	960,271	614,574	—	9,511,667	9.9
Omni	50,000	2,880,814	—	3,360,949	—	—	6,291,763	6.6
Preferred Hotels	19,000	390,000	1,008,285	—	—	12,950	1,430,235	1.5
Radisson	45,000	3,841,085	419,659	3,760,624	389,683	139,886	8,595,937	9.0
Sheraton	60,000	4,801,356	1,199,519	960,271	385,599	284,768	7,691,514	8.0
Sheraton Suites	150,000	5,761,627	1,043,436	960,271	384,099	254,793	8,554,226	8.9
Westin	50,000	4,801,356	960,271	1,920,542	623,493	90,000	8,445,662	8.8

Exhibit 18-6 Summary Percentages Over the Past Five Years



¶ 18.08 HOTEL FRANCHISE SELECTION PROCESS

The selection of an appropriate franchise affiliation is one of the most important decisions to be made during the entire hotel development or acquisition process. The chain affiliation of a hotel affects the property's image, market orientation, ability to benefit from referral business and a central reservation system, ability to compete in the local market, potential for future competition, and ability to generate profits. A poor choice of franchise can seriously affect the competitiveness of a hotel and its ultimate profitablility and financial success.

[1] Market Study and Appraisal

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 study and appraisal. As described earlier, a market study and appraisal is an evaluation of the market potential of the subject area. Based on the locational and competitive factors determined to be influencing the subject property, recommendations are made in the study regarding market orientation, types of facilities required to cater to this orientation, and the appropriate class or level of quality for the facility. Once these characteristics have been determined and the highest and best use established, appropriate franchise affiliations can be investigated on the basis of their ability to complement and create demand for the subject property.

Developers should evaluate the important factors regarding franchises before proceeding to the next step in the selection process. The first factor that should be considered is that a hotel chain will not consider granting a franchise that will be directly competitive with another lodging facility that it owns, manages, or has franchised in the same market area unless there is sufficient existing and unaccommodated room-night demand. The presence of a competitive property within the market 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. However, the presence of another property in the same market area should alert the hotel owner to research other franchise opportunities.

The second factor to be considered is whether or not a franchisor has any properties in the 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.

[2] Analysis of Suitable Franchise Affiliations

Once several suitable franchisors have been found, the prospective franchisee should contact the appropriate franchise salespeople and request a copy of their company's UFOC. This document will contain a wealth of information, but additional investigation will probably be necessary. The following checklist contains questions that the prospective franchisee should ask in order 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 two, five, and ten years from now?
- ☐ How many properties are owned, managed, or franchised by the chain?
- ☐ Has the product or concept been market tested?
- ☐ How many franchises were terminated over the last five years?
- ☐ What were the reasons for terminating these franchises?
- ☐ What are the names, addresses, and phone numbers of franchisees that can be contacted for references?
- ☐ What percentage of the chain's properties are up-to-date in design, and what percentage are currently being refurbished?
- ☐ 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?

- ☐ 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?
- ☐ Does the franchisor sell franchises only to individuals it considers qualified?

[3] Negotiation of Final Terms

Because a franchisor is generally required to amend the UFOC whenever any important terms of a franchise agreement are changed, most hotel chains will not negotiate variances to their standard agreement. Occasionally, however, some additions and modifications such as the following can be obtained.

Exclusive territory. Sometimes franchisors will grant exclusive territories to franchisees who promise to develop a certain number of properties in the area within a specific period of time. Having franchise control over a geographic region often creates value for the holders of these exclusive territories, who can sometimes sell the franchise rights to others.

Protected areas. Franchisees are sometimes able to negotiate an agreement by which the franchisor cannot own, manage, or franchise another property within a specified geographic area for either a certain period of time or until a certain level of operating performance has been achieved at the franchisee's property (e.g., occupancy over 70 percent for two consecutive years). A protected area is an important benefit if it can be obtained from a franchisor.

In regard to the final selection of a franchise company, potential franchisees should strive to make their choice as early as possible in the development or acquisition process. Because most franchisors have specific requirements for layout, design, quality, and furnishings, it is advantageous to involve the franchisor before any architectural plans or specifications are made. The franchisee should always ask for an exclusive area, since this technique is an effective means of prohibiting new competition. If the franchise chain that is chosen is new, the franchisee should ask for reduced fees until the chain reaches a certain size. Finally, since the reservation system is one of the key elements to a franchise affiliation, the franchiser should try to obtain some guarantee that the system will be effective and generate actual room-nights for the facility.

¶ 18.09 FRANCHISE AGREEMENTS

Once an offer to grant a franchise has been made by the franchisor and accepted by the franchisee, a contractual agreement is drawn up that details the responsibilities of the two parties. The general provisions of franchise agreements typically provide an overview that attempts to make the franchise system and concept appear to be unique so the franchisor can consider the license it grants (the franchise) to be proprietary. Most licenses for franchises are granted for a specific location, so the franchise agreement should include a description of the exact location of the hotel. If the franchisor allows a restricted area, the details of this area should be contained in the agreement.

[1] Term of Agreement

Hotel franchise agreements typically range from ten to twenty years. Sometimes they provide extensions at the option of the licensee. Franchisees should seek a term for as many years as possible if they have the ability to freely terminate the franchise should the benefits it generates not measure up to expectations of the franchisee. If there is a cost associated with termination, the franchisee should ask for short terms with several options to extend. Most lenders want franchise terms to extend over the life of the mortgage on the property. In addition, lenders generally want the right to either terminate or take over the franchise for the remaining term in the event of a foreclosure. Mortgagee provisions of this kind are known as "comfort letters."

[2] Proprietary Information

Most franchisors consider all of the publications and written material that they generate for the benefit of their franchise holders to be proprietary. These include operations and training manuals, educational material, conferences and seminars, methods, techniques, formats, specifications, procedures, architectural plans, and so forth. Franchise agreements generally stipulate that this information must be treated confidentially and that its disclosure must be limited.

[3] Relationship of Parties

All parties to a franchise agreement are considered independent and are not able to bind each other. To limit liability, most franchisors stipulate in their franchise agreements that signs be posted at the front desk stating that the hotel is independently owned and operated under a license with the franchisor. Franchisors generally require indemnification from their franchisees for any claims or actions brought against them.

[4] Hotel Image and Operating Standards

One of the most important sections of a franchise agreement is the one containing provisions regarding the maintenance of a hotel's image and general operating standards. These provisions relate to franchisor control over not only the physical quality of a lodging facility, but also the level of service and guest satisfaction. Franchisors generally require contract provisions that allow them to monitor the condition and appearance of the hotel and to establish standards for grading compliance. Some chains insist on requirements that hotels that hold their franchises be upgraded at regular intervals so that they remain in conformance with company standards. If alterations are to be undertaken or if the hotel must be rebuilt after a casualty or condemnation, the franchisor will generally want the right to approve plans and specifications. In order to control the quality of furnishings, equipment, and supplies, franchisors also often develop strict specifications that must be followed when purchasing, including the use of approved vendors. Operational procedures are controlled by setting forth requirements in the agreement that the franchisee follow the standards established in the operating manuals provided by the franchisor. Operating standards also generally include restrictions regarding the franchisee's operating competing hotels, diverting business, employing company personnel, and working for another franchisor. Insurance coverage is another important operating standard for franchisors, so they include provisions related to the amount and types of insurance that must be carried by the franchisees in the agreement.

[5] Training and Guidance

Hotel chains generally require some form of training or orientation for senior level management in order to familiarize personnel with the various systems, procedures, programs, and policies developed by the franchisor. The franchise agreement should specify the nature of this training, which can range from regular classes conducted by the franchisor at an educational facility to simple training manuals. A certain amount of ongoing guidance and consulting is also normally provided, but if the time involved in these activities becomes excessive, the franchisor will usually require a fee.

[6] Reservation Systems and Advertising

Most franchised hotel chains offer some form of reservation or referral system that is paid for either by the continuing franchise (royalty) fee or by a separate reservation fee that is stipulated in the franchise agreement. A reservation fee can be assessed on the basis of a percentage of rooms revenue or on some other formula related to the number of reservations received. Some hotel chains establish advertising funds to be used for such activities as national or regional advertising and specialized marketing. Most of these funds are established and administered by the franchisor, but are funded by the individual hotels within the chain.

[7] Fees

As noted previously, most franchises require prospective members to pay an initial license application fee. The amount and details of the fee should be set forth in the franchise agreement. The license application fee is generally payable upon application and is considered earned by the franchisor when the application is approved. The agreement should specify the procedure to be followed if the franchise is not approved. For example, a percentage of the fee may be retained by the franchisor to offset the cost involved in processing the application.

[8] Reports, Inspections, and Audits

Most franchise agreements establish the right of the franchisor to inspect the books, records, and financial reports of the franchisee, particularly if the franchise fee is based on a formula tied to the financial operating results of the franchisee. Provisions relating to the types and timing of reports that must be submitted to the franchisor are set forth in this part of the agreement.

Franchisors periodically inspect the properties in their chains to determine whether the standards set forth in their franchise agreements are being maintained. If it is necessary to verify the accuracy of the financial data, a franchisor usually has the right to conduct an audit.

[9] Assignment

A franchise can be assigned by either the franchisee or the franchisor, and while both parties will generally want the right to freely transfer the franchise, usually, only the franchisor has the ability to do so. The franchisee must request approval in accordance with the franchise agreement.

Naturally, the primary concern of the franchisor is to maintain the chain's level of quality, so a new franchisee must be closely reviewed. Franchise agreements generally set forth the basis for approving an assignment as well as the procedure for notification. Some franchisors require that a property be brought up to current standards before it can be assigned, which can entail a substantial expenditure and thus make the property more difficult to transfer. Most franchisors want the right of first refusal in the event they might desire to acquire the property upon a contemplated transfer.

[10] Termination

Most franchise agreements do not permit the franchisee to terminate the agreement before the end of the term. If the agreement is terminated, the franchisee generally has to pay damages to the franchisor that usually amount to two to three times the franchise fee paid over the past year. Since the cost of terminating a franchise can be expensive, it is important for franchisees to make a good initial selection in order to reduce the chance of an early termination.

Most franchise agreements grant the franchisor extensive rights regarding franchise termination. Some of the more common termination provisions include failure to open the property; failure to operate the property; failure to have proper moral character; violation of a law or ordinance; bankruptcy; failure to maintain insurance; failure to pay franchise fees; and failure to comply with franchisee agreement. In most instances, the franchisee has a right to cure the default before the franchise is terminated.

Franchise agreements generally establish certain obligations on the part of the franchisee in the event that the franchise is terminated or expires. Some of these obligations are: payment of all monies owed to the franchisor including liquidated damages, if appropriate, and removal of signs, systems, marks, and identity items. Some franchise agreements even require that the telephone number of the hotel be returned to the franchisor.

The selection of an appropriate franchise affiliation affects a property's ability to compete in the local market, generate profits, achieve a certain image or market orientation, and benefit from referral business. Because the success of a hotel is predominantly based on the cash flow it generates, owners and lenders must quantitatively measure the benefits and services of a national affiliation against the total cost of such a commitment.

Continued brand recognition, consistency, and franchisor staying power also are important factors in an owner's or lender's decision to add or change a franchise affiliation.