

Merger Boom in the Hotel Industry: Impact on Hotel Owners

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According to the predictions of hospitality experts, other hotel chains may be contemplating the same over the next few years in order to equal the capabilities of the larger players and better compete in the market.

Whilst the consolidation of some of the biggest hospitality companies is exciting news, this may not necessarily be good news for hotel owners. Whilst there has been discussion in the industry press with respect to the impact of the mergers on the companies involved and on consumers, the potential impact on hotel owners have been mainly left unaddressed and we now offer our thoughts.

This article further explores possible scenarios of how mergers of large hotel companies may impact hotel owners, in respect of hotels both in operation and under development.

Change or repositioning of a Brand

Following a merger, the portfolio of brands of the newly merged company may be extensive, with potential overlap or duplication of brands within the same segment. As a result, the company may need to consider repositioning, rebranding, or retiring one or more of the brand. This will be the case particularly if it is considered that due to similarities between certain brands, some of them are no longer viable or may create competition with other brands now comprised in the same portfolio, or which may be simply too expensive to maintain as part of the enlarged portfolio.

Any such changes to the brand will impact a hotel owner whose hotel bears such brand, and we therefore need to consider how this is regulated in a hotel management agreement (“HMA”).

It is usually the case that standard provisions of the operators’ HMAs do not provide any protection for an owner in respect of future repositioning or change of a brand. The result of this is that, unless there has been specific negotiation in the HMA to provide an owner with flexibility and options where the brand of its hotel is repositioned or changed, the hotel owner may find that its hotel must carry a different brand name from that originally contracted for in the HMA. The imposition of this on an owner may not necessarily be well received, particularly if the new branding results in a substantial change of the brand concept, standards, and positioning (which may impact the hotel’s market segment and financial performance). A change and/or repositioning of the brand may also bring opportunities to expand into a new market segment, or to achieve greater flexibility to increase revenue, however, any such change is likely to require significant expenditure from the owner to adapt its hotel in line with the new branding requirements, which may negatively impact the owner’s return in the short term.

In respect of hotels already under operation pursuant to an HMA which does not provide sufficient protections for an owner, the changes required resulting from the brand repositioning will ultimately need to be implemented in the hotel. However, for new hotel projects whose HMA is still under discussion, it

may be possible to negotiate a certain level of flexibility and protection for the owner.

Another issue for owners to consider is the exclusivity arrangement under the existing HMA, since usually exclusivity arrangements are structured to give protection only to the brand of hotel. Therefore, where there is a future change of the brand name of that hotel, the exclusivity protection under the HMA may no longer exist which could leave an owner exposed to unexpected competition should the operator take over management of other hotels now bearing the same brand as the owner's hotel and which are located in close proximity. In this respect, achieving as much protection as possible of an owner's interests, during negotiation of the HMA is essential.

Unification of Brand Standards

Another consequence of a merger of hotel operators will be the potential unification of brand standards, including IT standards. Such unification will apply to all hotels within the portfolio of the merged companies, regardless of whether any particular hotel brand is repositioned, changed or retired, following the merger.

Eventually, every hotel owner will be required to comply with the unified brand standards, and the key questions for an owner in this respect would be "when" "how" and "at what cost"?

It is often the case that the standard terms of an operator's HMA will not provide any protection to an owner in the event of changes to brand standards, and the owner will ordinarily be required to adhere to the implementation of such changes. As a result, unless an owner has specifically negotiated certain provisions in respect of implementation of brand standard changes to provide some comfort and protection for the owner, the owner will be exposed to the mandatory implementation of all changes, regardless of the amount of additional expenditure required to fund such changes. If there is insufficient revenue generated by the hotel to fund the implementation of changes (which might especially be the case if the changes take place during the initial operational years when the hotel business is still achieving stabilisation), the owner may have to seek debt financing.

Although operators will usually provide a phasing-in period for implementation of changes to brand standards (particularly where the costs of same must be funded by the owner's own capital), unless flexibility is agreed in the HMA to protect the owner's position the period of time for implementation can be defined by the operator at its own discretion. This can give rise to a conflict between operator's interest in benefiting and regularising the brand, and the financial performance of the hotel and the owner's additional expenditure requirements.

Therefore, for developers of new hotel projects, it is essential to seek protection and flexibility in the HMA, in case of a change of the brand standards in the future, particularly as the bottom line is that all hotels of the brand will have to comply with the changes, and non-compliance would not only put the owner in breach of its obligations under the HMA, but may result in an outdated hotel which is not able to compete at the level of other hotels of the same brand. A balance is achievable and an owner should look to minimise, so far as possible, the impact of its implementation of brand standard changes, through agreeing in the HMA a suitable grace period to implement the changes, with the aim that the costs of change be covered from profit generated by the hotel business rather than from the owner's equity.

Change to centralised operator services and loyalty programs

In most cases, the mandatory centralised services that will be provided by an operator is not exhaustively set out in an HMA, with the result that amendment of mandatory services may be made at the operator's discretion. Additionally, the charges for centralised services as set out in an HMA (including reservation fees and guest loyalty program costs) will not be fixed for the duration of the term of the HMA, and will be subject to change to reflect increases in the cost of providing such services.

Therefore, hotel owners are under an obligation to allow the hotel to participate in such centralised

services and loyalty programs, regardless of changes to the services or the cost of same.

However, an upside of a merger between hotel operators will be the benefit gained through increased economies of scale and buying power of an enlarged operating company, and therefore hotel owners should benefit from reservation systems now having a wider reach, a merged database of customers loyal to the brand, and greater bargaining strength over third party suppliers and service providers to procure more favourable terms and conditions (including pricing).

What to expect next?

Given the current and envisaged consolidation of operators and brand portfolios within the hotel industry, developers and owners may encounter less flexibility from an operator on certain provisions of the HMA in its negotiations. This arises as a result of the need to achieve unification and consistency across the operator's business and brand portfolio, leaving less possibility for variation to its terms and conditions. There will always be exceptions for "anchor" hotel developers, where the property in question will provide an operator with a strategic point of entry or a portfolio of hotels in a region or country having little or no existing brand representation, especially if the region in question is a new and/or emerging market for the hotel operator, but these remain relatively rare opportunities.

It will be interesting to see whether the approach of hotel developers and owners changes going forwards, given the anticipated large-scale mergers and consolidation of the market, particularly in already well established locations where competition between brands is high. It may be that owners will seek a unique differentiation for their future hotels, and as a result, may consider the smaller players in the market, subject to whether this suits the project and its anticipated market. As a result, smaller hotel operator companies may be provided with an opportunity to deal with owners who are now looking for flexibility and a strategic partnership, and who may have overlooked such operators previously. However, even then, hotel owners should keep in mind that consolidation of operators within the market remains a constant option, and therefore, protection for an owner against such future consolidation should be always sought during negotiation of the HMA, in order to achieve a balance of interest between the operator and owner.