Asset-light: common sense or construct impossible?

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IN THE SPRING issue of Hospitality Magazine, the Institute of Hospitality’s periodical, the question was put “whether the ‘bricks and brains split’ [between ownership and operation, RvG] was such a good idea in the first place: Is an end to ‘asset-light’ in sight?” Katherine Doggrell asked.

Looking in the rear-view mirror
Most large international hotel chains started out as property companies. The Hilton story in particular is well-documented: Conrad Hilton grew his brand in the US by stringing together, from 1919, one hotel property after another. More recently, in the 1990s, Barry Sternlicht used a hotel real-estate-investment trust to build Starwood into the global player it is today with brands such as Sheraton, Westin and St. Regis. The first instances of what later became widely known as management agreements occurred when Hilton International was able to find local investors, especially in developing countries, willing to take on the full risk of ownership of hotels run by Hilton. Since then, this has evolved into the much wider trend of international hotel chains separating hotel ownership from operations. Especially during the ‘high times’ of the mid-noughties, these chains succeeded in selling properties at very favourable prices and closing management agreements on equally good terms. The rationale behind this—the cash generated from the sale would generally be earmarked for investment in growing the brand—and the business risk of owning a hotel now resided with the new owners.

The result is that most international chains now only own or lease the real estate of a very limited number of the hotels that bear their brand. Very ‘light’ are Marriott, which owns six (of a total of 3,400) and Intercontinental (15 owned; it manages 628 and is franchisor of a further 3,800). Somewhat more ‘asset-heavy’ is Starwood, owning 62 of ‘their’ 1,041 properties. French hoteliers Accor pursue a slightly different strategy, one they label ‘asset-right’ rather than light. Even though they have sold and are still divesting hundreds of properties, the resulting portfolio will still include some 40 percent of owned and or leased hotels.

Financial focus
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On July 11, Southern Cross went into administration. This British care-home provider was organised according to the ‘opco/propco’ (operating company/property company) model, meaning it did not actually own the real estate of the homes, choosing to specialise in their operation. When Southern Cross did not manage to keep its growth in revenue in line with that of its lease payments, the model was blamed as one of the major reasons for the collapse.

The hospitality industry, by nature very property-intensive, has its own version of the opco/propco model, often called ‘asset-light’: many hotels are not owned by the companies that actually run them. In this article Rob van Ginneken highlights some of the potential problems inherent in the model and explores what the future may have in store for this hotel ownership structure.
Food for thought

One oft-cited argument against the viability of the asset-light model, more specifically the management contract is the difference in focus of owners and operators. The latter wish to expand and grow their brand (and its value) but, in doing so, prefer to not tie up their own capital in real-estate property. This equates to a rather fundamental ‘difference in agenda,’ where the long term financial performance of individual properties cannot automatically be assumed to be the top priority of the operator. (Asset-light strategies achieved through sale-andleaseback arrangements do not result in a separation of profit-and-loss ownership and operation and are not discussed in this article.)

This could easily lead to different views on the desirability of certain capital-budgeting expenditures. Some go beyond this and say the agency problem inherent in management agreements will continue to lead to disputes and in some cases even court cases, such as the notorious Woolley versus Embassy Suites and Woodley Road versus ITT Sheraton rulings. These judgements established that the owner has the right to terminate management agreements in case they feel (or rather, can prove in court) that the operator has not lived up to its duties as an agent of that owner. For completeness’ sake it should be mentioned here that the Woodley Road case, in which the owners were awarded $51.8m in damages, both actual and punitive, was later appealed, and largely successfully so, by Starwood, ITT Sheraton’s successor.

One might argue cases such as these pertain to ‘old’ management agreements, and that more contemporary contracts are more ‘foolproof’ because of increased professionalisation of all stakeholders involved. However, it should be noted that some of the properties involved would still have been operating under the contracts had there not been a falling-out (e.g. the Woodley Road contract term was 1979–2030). Thus, many legacy contracts from days of yore are still in place.

As recently as 2010, an arbitrage panel settled a dispute between Broadreach Capital Partners (BRCP), owner of the Four Seasons Resort Aviara in Carlsbad, California, and Four Seasons. Reportedly, Aviara staff even threw up barricades to prevent BRCP from moving in new management. The arbitrage panel awarded Four Seasons compensation from BRCP for terminating the contract. Four Seasons was not found to have breached the agreement or its fiduciary duties to BRCP, but both parties were found to have ‘contributed to the demise of the business relationship.’

Meanwhile, another party has entered the stage. Asset managers, hitherto primarily focused on the more technical aspects of managing real estate, are...
Increasingly employed by owners to help improve operational results. In a case where the hotel is already operated by a management company, this triggers the question how many mouths can actually be fed from a single hotel’s P&L? Or, from the owner’s point of view: to what extent can operator and asset manager work in unison to actually put more food on the table?

What’s in the stars, post-crisis?
If we are indeed moving out of the recession, more investors may be willing to consider adding hotel real estate to their portfolio, or expanding existing ones. Availability of equity capital has never been higher, if you believe some pundits. Possible investors include HNWIs (high net worth individuals), private equity funds and institutional investors alike. Especially for the higher-end of the market, this may very well lead to a resumption of the asset-light trend that more or less came to a halt after 2007 and a commensurate increase in property values.

However, availability of debt capital is still limited. In fact, these last few years have been heaven for those investors not dependent on leverage, who could pretty much cherry-pick the properties of their choice. If debt financing remains hard to come by, this would only serve to strengthen the trend of investors and banks requiring the brand to share part of the risk and co-invest. The result would be more, rather than fewer bricks on operators’ balance sheets.

Increasing competition for properties from which to fly the brand flag will at least to some extent put the brakes on the asset-light trend. Marriott’s recent acquisition of the Berners hotel in London has been mentioned by many industry experts as another example of a chain (temporarily) not adhering to the asset-light strategy. In this case it would appear Marriott is using its balance sheet in order to build the brand in a desirable market where availability of hotel real estate is limited, if only to sell and manage back the property within a few years.

In the mid-market segment where, increasingly, the operators aim to fly their secondary or even tertiary brand flag, competition from brands not encountered in the higher-end market could mean operators having to invest.

Finally, for some of the large chains, the (relatively) limited number of properties they still own contrib-
ute disproportionately to their bottom-line. For them, both the upside and the downside business risk are higher for these owned hotels than for the ones they merely manage for a fee. In that perspective, it remains to be seen what operators will do with their owned properties. Do they opt for a continuation of the asset-light strategy, perhaps succeeding in repeating what they did in the middle of last decade, or sit out the ride up and benefit, as owner-operators, from the recovery themselves? Perhaps it is not only the economy that follows a cyclical pattern, but also strategic behaviour.

References
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