'Asset-Light' — Managing or leasing?

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Abstract

This paper looks at the factors that hotel operators consider when shifting their real estate off their balance sheets.

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INTRODUCTION

The last six years has seen a growing trend for operators to seek to dispose of their real estate assets of their hotels while keeping the hotels within the operator's stable of brands. This trend has been driven by a number of factors:

- Recognition of hotels as an asset class for property investors.
- Increasingly high prices paid due to both cheap debt and a large surplus of demand over supply for more traditional commercial property investments.
- Shareholder demands for owner/operators (especially listed companies such as InterContinental, Hilton and Accor) to release capital from their balance sheets to return to shareholders and improve return on capital employed.

Sale and lease-backs have long been used as a way to release value from a real estate investment and hotel companies are certainly not the only sector where this is common. Such transactions are often used for pubs, retail premises and non-real estate assets such as ships, aircraft and even films.

Sale and manage-backs have only really become common in the last few years as part of the disposal programmes of the big owner/operator chains that have been moving towards their 'asset-light' strategies of becoming hotel management companies rather than owners of real estate.

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WHY A MANAGEMENT AGREEMENT NOT A LEASE?

One of the main advantages of a sale and manage-back for an operator selling hotels is the reduced risk. The management agreement reduces their exposure to the fluctuations in profitability of the underlying business. Under a lease structure, the operator has all the operational business risk and the obligation to pay the rent.

A seller of a portfolio is in a good position to dictate the basic terms of the management agreement such as term, fees and performance testing. This gives operators a long-term secure income stream. A management agreement, with that associated income stream, is an asset, whereas a lease, with its obligation to pay rent, is a liability. This has an effect on the way investors value the operators' shares. There can also be some tax and accounting advantages.

For these reasons, it appeared for a while that sale and lease-backs were going out of favour. The high-profile case of Le Méridien might well have accelerated that view. Shortly after a sale and lease-back to The Royal Bank of Scotland (RBS), Le Méridien's business suffered from the effects of an economic downturn, 9/11 and SARS. It could not meet its rent payments on, among others, The Grosvenor House and The Waldorf hotels, and RBS took back the leases.

More recently the Swallow Hotels collapse has highlighted the risk of a badly structured sale and lease-back strategy. In that case, at risk of slightly over-simplifying the facts, Swallow bought the hotels, put in place high-rent leases and then used the rental yield to sell the hotels again at ever higher prices. This worked as long as the continuing profits on sale exceeded the losses caused by the shortfall of gross operational profit needed to pay the rents.

LEASE-BACK COME-BACK?

Although the advantages of a management agreement seem to be clear, a number of operators still favour a lease-back model. And it does still have its advantages, especially if it is structured to avoid the risks.

The biggest risk is that if profitability drops, the operator will not be able to meet the rent payments. There are two ways in which this risk can be mitigated or avoided:

- Set rents at a manageable rate.
- Use turnover rents that reduce if business drops, with or without a minimum base rent.

These would seem obvious, but in some cases can be difficult to implement. For an operator that is already highly geared, it may need to raise a fixed amount of capital from the sale. If it sets the rent lower, it will not achieve the required sale price. Setting a variable rent requires the purchaser landlord to assume some exposure to the operational business risk. Ironically, it is the very success of sale and manage-backs that has made hotel real estate investors more comfortable with assuming a certain level of business risk.

The other advantages of a lease arrangement are that the operator retains all the benefit of the operational turnover and profit, rather than

just taking a small percentage of both. It can also be easier to market and sell. There are more investors willing to buy real estate with a rental yield than there are investors willing to assume the complete business risk of a hotel's operations.

Finally, a lease gives an operator much more control and freedom to run the operations as it thinks fit. Not so with a management agreement.

CONVERGENCE?

A number of operators looking for disposals still favour the sale and lease-back model. Accor has recently sold large portfolios across the UK, Germany and the Netherlands and Permira's Principal Hotels Group has also sold its portfolio on a sale and lease-back basis. Menzies Hotels was looking at a sale and lease-back before its owners decided instead to sell the whole group and MacDonald Hotels was marketing a sale and lease-back of 24 hotels before deciding to sell effectively with vacant possession.

In some ways, the two models are converging. A turnover rent lease places some of the business risks onto the landlord; more so if there is no minimum base rent. Management agreements have been seen with guaranteed or priority owner's return taking some of the risk away from the owner. It is becoming more common in both models to see both the owner and the operator sharing the operational risk — the only significant difference being the balance of that risk.