In this first Devil's Advocate column, hotel industry consultant **MELVIN GOLD FHCIMA,** who has also agreed to be chairman of Hospitality magazine's editorial board, discusses the recent trend of splitting asset ownership from the hotel operation.

RIGHT *or* WRONG

The big story in the hotel sector over the past few years, at least at the 'large corporate' level, has been the split of asset ownership from the hotel operation. A variety of mechanisms and business models have been deployed which have seen 'sale and lease back', 'sale and manage back', 'public to private' and 'joint venture' arrangements come to the fore in the sector. It seems that everyone has been doing it. But is it the right thing to do and what are the possible long term consequences?

It would be hard to criticise any hotel company that has gone down this route in the current business environment. There has been a huge amount of money seeking to find its way into the sector, thus values have been high and shareholder value (in both public and privately owned companies) has typically been enhanced by such transactions. Of course the reduced asset intensity and the return of capital to shareholders or reinvestment in new opportunities has underpinned the rationale. So following the crowd wasn't wrong.

Or was it?

Let's look at the downside. What might go wrong? A good starting point for that is to look at some of the key characteristics of the hotel sector – service orientated; capital intensive; needing to keep up-to-date with the latest trends; customer focused; cyclical; disposable product; and having a diverse range of operations within a building. Delivery of a hotel operation under a split structure, therefore, means that there will be an element of discussion between the parties in order to accomplish the business' objectives. That invariably means that the operator will seek to justify the capital that it requires to spend to achieve the business' objective while the owners – pride themselves on expertise in property asset management and creativity in financial structuring – will require convincing that the money really needs spending. Perhaps even more so they will require some assurances that the operator will actually improve the hotel's performance. Such assurances may be hard to gain and harder to believe, particularly since the market circumstances may not be entirely positive or, in the face of new competition or historic under-investment, that the expenditure may be so-called defensive expenditure (in other words important to retain market position but not necessarily earnings enhancing).

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So conflict could result. If the investment takes place then the operator will be under huge pressure if the results don't follow. If it doesn't take place then the operator will feel they are operating a less than optimal hotel, and management/staff morale could fall, contributing, in itself, to a worsening performance.

Thus, for this situation to work itself out to a satisfactory conclusion, correct and credible decisions will need to be made at the outset, and the planned outcomes will need to be achieved. In a volatile world that is a situation with its own risks. (The counter-argument, of course, is that each party brings its own expertise to bear on the situation which brings more robust solutions and more rigorous procedures which benefits the business, its finances and, hopefully, the customers).

What if it all goes wrong? There are a number of possibilities of course. The hotel ends up under-invested, the management company could end up with an under-invested asset that doesn't fit its brand standards, the owning company could decide to

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change management companies and the owning company may also find itself unable to achieve the levels of return required which, if highly leveraged, may mean that they have to also negotiate with their debt providers. None of these are palatable options.

Then there is the corporate situation. Companies selling their assets and distributing the realised funds to their shareholders are actually shrinking in size. They may well drive higher return on capital but the actual profit amount will be lower. Thus in order to grow they need to achieve a higher number of hotels under management and in order to achieve that they need to demonstrate that they have a stronger brand and better operational ability than their competitors. Brand is important, hence the appointment to senior roles in hotel companies of management from consumer goods companies with strong brand names. Of course the big get bigger and the rest get taken over. So, among others, we've seen the failure of Le Meridien which has ended up in the Starwood portfolio, Hilton International being taken over by Hilton Hotels Corporation, and Whitbread's full service portfolio being operated by Marriott in a joint venture pending its sale.

If the big get bigger then how does that affect the rest, and how does it affect the consumer?

One of the recent trends, although arguably it started just before the trend to the so-called split of 'bricks and brains', was the rise of the boutique or designer hotel. It is interesting to view the two trends together. The boutique/designer operators were seen as innovative upstarts operating within small companies. They were nimble in their approach and quickly gained popularity with consumers and huge attention from the media. Their success caught the attention of the bigger players in the sector and they attempted to replicate the trend but with only limited success, Starwood's W brand being the most notable. In most cases (but not all) the boutique hotels continue to retain their popularity, in part as a reaction against the 'sameness' and corporate anonymity of some of the product offerings from the larger chains. Now, with a different operating structure, a greater focus on brand building, and of course the need to satisfy the requirements of their new financial partners, the big players are likely to have less focus on innovation, not more.

The consumer reaction is likely to be mixed. Individuals love innovative products and freedom of choice, but equally they love the benefits of recognition and loyalty schemes offered by the big companies. Corporate buyers also enjoy the scale of the big players since economies of scale and centralised purchasing make life easier for them.

Where will it all end? Certainly there will be winners and losers. Not all the companies participating in this trend will end up winners but not all will be losers either. Chances are that we will see the hotel industry, which is fundamentally a long term industry, be affected by shorter term investment cycles. The newer investors are likely to see typical periods of investment as three to five years and that may make it difficult to obtain the long-term capital that hotels require. Equally, the aspirations of such investors may not match the cyclicality of the hotel sector and some may get caught out. It is to be hoped that the exit of some of the current investors heralds the arrival of long-term financial institutions as a second-phase investor, for they will tend to be longer-term players.

From the operator perspective, the concerns will be about meeting the targets of their new investors, growing their brand coverage and being able to properly up-keep and enhance their properties.

Ideally, the outcome of all this will be positive for the hotel sector, creating a more robust industry and, one would assume, having some positive impact for consumers. At this stage the achievement of such an outcome is far from clear and the consumer appears to be furthest from anyone's thoughts. ■

CALLING CONTRIBUTORS

HOSPITALITY MAGAZINE will be inviting a series of contributors to write this column in the future. The idea is that we pick a current trend in the industries we cover and our contributor puts some of the counter-arguments against the trend. Playing Devil's Advocate. Naturally in doing so the views expressed may not fully represent the person's own views, but will demonstrate an understanding of the topic and hopefully be thought provoking for our readership.