

EVALUATING HOTEL FRANCHISE & CHAIN AFFILIATION PROGRAMS

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Given the dollars involved in purchasing and maintaining a franchise or affiliation, the decision to be a franchise or chain affiliated hotel is one of the most critical decisions in a hotel investment. For many hotels the costs associated with purchasing and maintaining a franchise represents the second largest (after labor) expense category.

With the cost of a typical franchise or chain affiliation program representing six to eight percent or more of revenue, and given that the hotel industry in general is bringing approximately 22-24 cents of every revenue dollar to the net income (after reserves and before debt service) line, franchise and /or affiliation fees can potentially account for the equivalent of over 25% of a hotel s bottom line.

While for many hotels, affiliation can represent the difference between financial viability or failure, affiliation does not ensure successful financial performance. And in fact, certain types of hotels, depending upon their market positioning and segmentation, perform much better as independents.

Historically, franchise and chain affiliation decisions were often driven by lending requirements. The need to have an affiliation to secure financing evolved out of a very real concern (by lenders) about a property s having access to a reservation system and the need for many hotels to tie into national marketing and promotional programs to generate business.

And since in the past these services were not readily available on a stand alone basis, a franchise or affiliation was often routinely required as a prerequisite for financing. Today, however, there are several cost-effective alternatives (to franchising or chain affiliation) available for a hotel to tie into an independent reservations systems/services, and for purchasing direct sales and/or trade show representation services, advertising and public relations expertise etc. on a "stand alone" or ala carte basis.

Complicating the decision of whether to become a franchise or chain affiliated hotel is the sheer number of alternative programs available. Today, it is estimated that there are over eighty (80) different program alternatives available to an owner.

And, although there are general "rules of thumb" to consider, unfortunately there is no single or "best" approach or established criteria for evaluating affiliation alternatives.

DECISION METHODOLOGY

How then does one go about evaluating the cost vs benefits of affiliation and/or the merits of one franchise or affiliation program versus another?

It is important to keep in mind that different affiliation programs have the potential to generate greatly varying types and volumes of business for different types of hotels. Additionally, the cost of a franchise or affiliation can also vary substantially depending upon the scope of services and benefits provided. While the average cost of a typical franchise normally is between 6 and 8%, the range of the actual cost of various programs is much greater, with programs available costing anywhere from less than 1% to well over 10% of revenue.

Thus the cost versus benefits of affiliation can vary dramatically, depending upon both the volume of business generated by and the cost of a particular franchise or chain affiliation program.

To evaluate the costs versus benefits of various affiliation programs one needs to 1) assess the potential of different affiliation options to generate incremental (or business that a hotel could not otherwise generate on its own) business for a particular hotel and 2) to determine the total potential costs of affiliation.

Evaluating the Potential of a Franchise to Generate Incremental Business

Evaluating the merits of a franchise or affiliation should begin with a comprehensive analysis of the customer or business mix of the hotel. Hotels do not compete with all hotels for all types of business. Rather, a particular hotel competes with certain hotels for specific types of business. The size, location, facilities, level and scope of services, ambiance or character, physical characteristics, and condition of a hotel will dictate which market segments a hotel may potentially attract.

Different market segments or customer profiles often require very different marketing strategies and well as different sales and promotional programs. For example for group business, regional and/or national sales programs may be necessary to supplement a hotel's direct sales effort; for wholesale business, relationships with major operators could be expected to be an important factor; for corporate business a frequent or honored guest program might be an important marketing component etc. Thus to evaluate the potential of a franchise or affiliation program to generate business for a hotel one needs to begin with a solid understanding of the hotel's business mix.

An analysis of the business mix should include :

- An identification of the TYPE(S) of business a particular hotel is targeting (to try to maximize financial performance)
- An understanding of WHY guests are staying at the hotel (versus at a competitive hotel!)
- An understanding of WHERE the business is coming from (local, regional or national etc.)
- An understanding of WHO is booking the business (is business being booked by on site staff, via a chain or franchise organization's sales force or via intermediaries i.e travel agents, wholesalers etc.)

- An understanding of HOW the business is being booked (is business being booked by direct sales staff, via an on site reservations department or via a chain or franchisor s 800# or via the internet etc.)

The analysis of the business mix is essential to serve as the basis for evaluating the potential for a given franchise to generate specific types of business for a particular hotel. In assessing the potential for a franchise or chain affiliation to generate business for a hotel it is important to keep in mind the concept of "incremental" business, or the need to focus on the potential of an affiliation to generate business that a hotel couldn't otherwise generate on its own.

Often there is potential overlap in the accounting for the actual "generation" of business. For example group business that might be booked directly by on site staff yet individual meeting attendees call a chain 800# to make their actual reservation. A franchise or chain organization might account for this business as part of its contribution since it came through its reservation system, yet in reality the business was actually generated by the hotel directly.

Determining the Costs of Affiliation

Traditionally, the cost of a franchise has been defined in terms of initiation, royalty, marketing and reservation fees. However, expenses involved in both maintaining the affiliation (such as complying with system standards, providing amenities, signage, costs of utilizing proprietary software etc.) and promoting the affiliation (such as honored or frequent guest promotional programs) should also be accounted for in estimating the total costs, to the extent that they represent costs that a hotel wouldn't otherwise incur on their own (without the affiliation).

Franchisors and chain organizations implement programs and/or require standards that meet system needs and make economic sense at a national level. However, national programs and standards may not always meet the needs or make economic sense for an individual property in the system. For example, food and beverage requirements (such as hours of operation, menu offerings etc.) or levels of service (such as voice mail messaging, amenity offerings, etc) may not be necessary given a particular hotel's positioning, customer profile, and/or competitive market.

EVALUATING THE COST VERSUS BENEFITS OF AFFILIATION

Traditionally, one of the primary barometers for evaluating a franchisor's or chain's performance has been the volume or percentage of business generated by the program's reservation center.

While this is clearly an important consideration, it should not be the sole (which unfortunately historically has very often been the case) barometer for evaluating a franchise or affiliation program. And for several reasons. As noted above in the example with group business, a booking through a franchisor or chain organization's 800# may or may not represent business actually "generated" by the franchisor or chain.

It is also important to keep in mind that different franchise and chain organizations may have very

different ways of accounting for reservations (i.e. call volume, conversions, cancellations, gross vs net bookings etc.) activity. It thus can be very difficult to draw conclusions about the performance of one franchise/chain versus another based on this criteria only.

Given some of these shortcomings inherent in evaluating a franchisor's or chain's reservations performance, it is important to identify alternative ways of evaluating the costs versus the benefits of franchise and affiliation programs. Alternative approaches might include:

Assessing the bottom-line versus top-line impact of franchise or affiliation fees. The cost of a franchise or affiliation has traditionally been measured in terms of its top-line impact represented as a percentage of revenue. While this ratio is a reasonable approach for comparing the "absolute" costs of one franchise or affiliation program versus another, it does not take into account the fact that the profitability of different types of hotels can vary substantially. Thus, the impact of franchise or affiliation fees can vary dramatically when fees are evaluated from a bottom versus top line perspective. For example, for a hotel with a 35% net income margin, a 7% franchise fee would be the equivalent of about 20% of the bottom line; for a hotel with a 15% net income margin, however, a 7% franchise fee would be the equivalent of almost 50% of the bottom line !

Estimating the net effective or actual cost of business generated by a franchise or affiliation. The net effective cost is simply the ratio of franchise fees to the percentage or volume of business actually generated by the franchisor or chain organization. For example, again assuming a 7% fee, for a hotel where the franchisor or chain accounts for approximately 35% of a hotel's business then the net effective or actual cost of business generated by the franchisor or chain would be 20% (i.e. 7% fee equivalent to 20% of 35%).

In sharp contrast for another hotel also paying a 7% fee, where the franchisor or chain only accounts for approximately 15% of the hotel's business, the net effective or actual cost of business generated by the franchisor or chain would be almost 50%.

Estimating a "break-even" point that gives one an idea of the volume of incremental business needed to support the cost of a specific franchise or affiliation. Here the objective is to estimate the volume of business that would have to be generated to "break even", or to just cover the cost of a franchise or affiliation. To get a reasonable estimate of a "break even" contribution level of business, one can divide the cost of the franchise or affiliation by the estimated departmental profit per room sold (or the average daily rate multiplied by the departmental rooms profit margin).

OTHER ISSUES TO KEEP IN MIND WHEN EVALUATING FRANCHISE PROGRAMS

It is also important in evaluating the merits of one franchise program versus another to insure that there are no conflicts of interest. Conflicts might arise both "within" a specific brand segment of a chain or "between" brand segments with chains having more than one brand.

Conflicts "within" a brand segment of a chain might involve radius clause or impact issues, regional and/or national sales programs, national marketing and promotion programs and/or quality assurance and control and/or positioning or image concerns.

When chains have more than one brand one should also insure that there are no conflicts in the way the organizations various brands are marketed and promoted. Potential problem areas might include positioning conflicts among brands in the marketplace, multi-brand sales and promotional programs, and multi-brand reservations systems.

THE INDEPENDENT ALTERNATIVE

The decision to align a property with a particular franchise or affiliation is often arrived at by evaluating the merits of one affiliation program versus another. However, part of the decision making process should also include a review of the merits of being an "independent" versus a franchise or affiliated hotel.

In the past there have been few opportunities for independent hotels to tie into a global reservation systems or into national sales and promotional programs. Today, however, there are numerous reservation system alternatives for independent hotels as well as third party direct sales and/or trade show representation services and stand alone advertising and public relations expertise available to independent hotels.

Certain types of hotels can potentially perform better as independents, in particular upper end unique "one-of-a-kind" hotels, specialty boutique style hotels, strong destination based and/or resort hotels.

As a practical matter it is very difficult for chains to develop and implement national positioning, pricing and promotional strategies and programs that meet the specific needs of all properties within their systems. Being an independent hotel can afford an owner greater flexibility in positioning a specific hotel against its competition. As an independent hotel, a property has the opportunity to "customize" its marketing program to promote its uniqueness, specific strengths and special points of differentiation and to specifically target where and how marketing and promotional dollars are spent.

Independent positioning also allows for greater flexibility in establishing rates. As a member of a chain, a hotel s pricing strategy must be consistent with the overall positioning and perception of the chain. It is very difficult for a franchisor or chain organization (in particular for chains having more than one product brand) to develop national pricing strategies that address the needs and objectives of all hotels within their systems.