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Hotel development and ownership:

Franchising, Referral associations and Management contracts

Advantages and disadvantages

A Project

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Abstract

The majority of hotels operate under a global brand either owned by the operator, leased by the operator, run by the owner (or its manager) under franchise or run by an operator on behalf of the owner under a management agreement. Many global operators have pursued asset-light strategies over the past decade, and franchise and management agreements have now become the preferred type of contract.

Franchising is a popular business endeavor for entrepreneurs. Not all franchises, however, do well. Many people want to become the next Donald Trump, but many laypersons do not recognize that a "franchise is a system of business operations that, more often than not, will permit a person who operates the franchise properly to succeed in achieving a reasonable profit." Therefore, potential franchisees should consult an attorney on all matters involving the franchise. And, possibly hire an accountant. In addition, potential franchisees should thoroughly investigate their investment. Taking these necessary steps is the only way to make good business decisions and also to limit litigation.

Introduction

If you are thinking about buying into a franchise system, it is important that you understand exactly how franchising works, what fees are involved, and what is expected of you from the franchise company.

An individual who purchases and runs a franchise is called a "franchisee." The franchisee purchases a franchise from the "franchisor." The franchisee must follow certain rules and guidelines already established by the franchisor, and in most cases the franchisee must pay an ongoing franchise royalty fee, as well as an up-front, one-time franchise fee to the franchisor. Franchising has become one of the most popular ways of doing business in today's marketplace. In most states you cannot drive three blocks without seeing a nationally recognized franchise company.

I Franchising

I.1 The History of Franchising

Franchising began back in the 1850's when Isaac Singer invented the sewing machine. In order to distribute his machines outside of his geographical area, and also provide training to customers, Singer began selling licenses to entrepreneurs in different parts of the country.

In 1955 Ray Kroc took over a small chain of food franchises and built it into today's most successful fast food franchise in the world, now known as McDonald's. McDonald's currently has the most franchise units worldwide of any franchise system. In the 1970s, the Ritz-Carlton name was licensed to the builders of a new hotel in Chicago. The Ritz-Carlton Chicago opened in 1975 in a tower atop Water Tower Place. It joined the Four Seasons Hotels chain in 1977, as there was no Ritz-Carlton chain at the time. Confusingly, it remains part of Four Seasons and has no association with the current Ritz-Carlton chain, though it uses the name and the iconic logo.

I.2 Franchising in hotel business

Franchising is the practice of using another firm's successful business model. The word 'franchise' is of Anglo-French derivation - from *franc* - meaning free, and is used both as a noun and as a (transitive) verb. A system of permanent relations between a franchiser (hotel chain) and a franchisee (hotel property) based on which all the knowledge, marketing & promotion programs, brand image and success are used in return for mutual satisfaction of interests. For the franchisor, the franchise is an alternative to building 'chain stores distribute goods that avoids the investments and liability of a chain. The franchisor's success depends on the success of the franchisees. The franchisee is said to have a greater incentive than a direct employee because he or she has a direct stake in the business. The best-known names in the hotel industry, Holiday Inn, Hampton Inn, Courtyard by Marriott, Sheraton, Ramada, etc., are not directly in the lodging business. They are franchising companies. Names such as JHM Enterprises, White Lodging, Starwood, Sunburst Hospitality and many others that are seldom recognized by hotel guests, are actually hotel companies. This is the nature of franchising, and it creates an opportunistic relationship between hotel companies and their franchisors.

Hotel owners are in the business of leasing hotel rooms. For the use of a room, they charge a room rate. Their related businesses may be entertainment, dining or other services offered to guests.

In the hotel business, a company's revenues and profits depend on the frequency with which they rent rooms (occupancy) and the rate at which those rooms are rented (average rate).

The hotel company's most visible assets are the real estate it owns and operates. So, one of its missions is to build real estate value. Travelers (guests) are the customers of hotel owners.

Hotel franchising companies are in the business of leasing a brand name to operating hotels. For the use of that brand name, they charge a percentage of revenues. Each franchising company also operates related businesses, such as reservation systems and purchasing services, which they provide to their franchisees for a fee. In the franchising business, a company's revenues and profits depend on distribution, or the number of hotels, which carry its brands. A franchising company's most visible assets are the brand names I towns. So, one of its missions is to build brand recognition.

Hotel owners are the customers of hotel franchisors.

Top 10 des groupes hôteliers mondiaux au 1er Janvier 2013
Top 10 of worldwide hotel groups as of 1 January 2013

RANG - RANK 2013	2012	GROUPES - GROUPS		HÔTELS - HOTELS 2013	2012	CHAMBRES - ROOMS 2013	2012	NOMBRE GROWTH	% EVOL. GROWTH
1	1	IHG	GB	4 602	4 480	675 982	658 348	17 634	2,7%
2	2	Hilton Hotels	USA	3 992	3 861	652 378	631 131	21 247	3,4%
3	3	Marriott International	USA	3 672	3 595	638 793	622 279	16 514	2,7%
4	4	Wyndham Hotel Group	USA	7 342	7 205	627 437	613 126	14 311	2,3%
5	6	Choice	USA	6 198	6 203	497 023	502 460	-5 437	-1,1%
6	5	Accor	FRA	3 515	4 426	450 199	531 714	-81 515	-15,3%
7	7	Starwood Hotels and Resorts	USA	1 121	1 076	328 055	315 346	12 709	4,0%
8	8	Best Western	USA	4 024	4 018	311 611	295 254	16 357	5,5%
9	9	Home Inns	CHI	1 772	1 426	214 070	176 562	37 508	21,2%
10	10	Carlson Rezidor Hotel Group	USA	1 077	1 077	166 245	165 802	443	0,3%

Source : Base de données MKG Hospitality - **Mars 2013** | *MKG Hospitality database* - **March 2013**

Franchise advantages:

- Coherent and clearly defined concept
- Functional business strategy
- Optimized and measurable financial and promotional results
- Business safety and sustainability
- Working tools and procedures with a high and guaranteed productivity
- Competitive marketing and sales programs
- Global distribution and sales systems, already tested and generating additional guest flux to the franchisee

Franchise disadvantages:

- Franchises can be costly to implement. Also, many franchises charge ongoing royalties cutting into the profits of franchisees.
- Franchisors usually require franchisees to follow their operations manual to a tee in order to ensure consistency. This limits any creativity on the part of the franchisee.
- Franchisees must be very good at following directions in order to maintain the image and level of service already established. If the franchisee is not capable of running a quality business or does not have proper funding, this could curtail success.
- Sometimes franchisors may be lax on their commitment to support the franchisee. Also, they may make poor decisions that would have an ill effect on the franchisee. Therefore, it is important to research any franchise concept thoroughly before signing any agreements.

Secrets and conditions of the franchisee's success:

To be successful in a franchise right from the start, the hotel should:

- Integrate efficiently in the franchise network

- Adapt to and acknowledge its new professional status
- Understand and comply with the particularities and functions of the chosen franchise network

Around 70% of those franchisees who do not respect the franchiser policy generate losses to their own business.

Affiliation is an investment, with important consequences. Previously, the hotel owner must gain and assimilate the knowledge, competences and abilities necessary to guarantee the correct decision.

II Management contract

II.1 Franchise vs Management Agreement

Innovation can also be seen in the context of eco-friendly policies. Today's consumers are increasingly environmentally aware and expect the brands they affiliate with to be likewise engaged.

The combination of regulatory pressures and guest requirements for sustainable and value for money options make the hotel industry extremely challenging. Implementing sustainability policies across a portfolio of franchised hotels is particularly demanding for hotel operators and achieving the right blend of eco-friendly brand, with commercial realities and local regulatory compliance is no mean feat.

Towards the back of this guide we also consider other areas of innovation that may yet impact on the hotel industry and what this might mean for franchised hotels.

Theme	**Franchise Agreement**	**Management Agreement**
What is granted?	Hotel owner is licenced a package of IPRs, essentially relating to the 'brand' of the hotel operator. These IPRs are to be used in the management and operation of the hotel. Centralised marketing, advertising and reservation services are provided for a further fee (see below). Management and operation of the hotel remains the obligation of the owner.	Operator will: Manage and operate the hotel on behalf of the owner; • Provide technical services (eg in relation to the design and development of the hotel); • Licence its brand; and • Provide centralized adver tising, marketing and reservation services. Clearly under this structure the hotel benefits from the 'hands on' experience of the operator.
What are the	Whilst overall management of the	Although management and operation

owner's obligations?	hotel remains with the owner, the owner is required to: • Adhere to the operator's 'brand standards manual' in terms of both the brand and the standards applicable to that brand; • Participate in group marketing and advertising; • Participate in the group's reservation system; • Where the hotel is being constructed or renovated, obtain the operator's approval for the relevant plans and specifications; • Open the hotel on the specified date (some operators may require 'grand opening event(s)'; • Prepare and maintain records and accounts to be shared with the operator; and • Comply with all legal requirements and provide the operator/franchisor with protection against any claims.	of the hotel is provided by the operator, the owner will remain responsible for: • Compliance of the hotel with the operator's brand standards (and the cost of renovations associated therewith); • The cost of maintenance and repairs; • Insurances; • The employment of non-management employees; • Obtaining regulatory licenses for hotel operation, such as liquor licence etc; • Real estate issues, such as lease renewals,zoning requirements, etc; • Although not an obligation per se, owners will often seek the right to approve annual budgets, capital and FF&E budgets, approve key personnel positions, review the hotel's accounts, apply performance tests and for a reasonable non-compete restrictive covenant.
What is provided by the operator?	The operator will typically provide: • Training on the operation of the hotel according to the 'system' (some training may be incorporated in the fees, some may involve additional charges); • Providing and updating the brand standards manual(s); • Occasionally pre-opening services (which may form part of the fee structure or could be payable separately); • Access to the operator's marketing, advertising and	The operator will typically: • Operate the hotel according to the Brand Standards; • Include the hotel in the operator's marketing, advertising and reservations system; • Have authority to conduct day-to-day operation of the hotel including purchasing goods and services, conducting litigation, managing staff etc; • Provide technical services relating to the design and development of the hotel (this is often subject to a separate technical services agreement

	reservations system; and • Technical services may be provided on other areas albeit this is likely to be for additional fees.	and fee).

What are the fee structures?	A typical fee structure involves:
	
	• An initial fee (this is often linked to the size of the hotel). In some cases this fee is non-refundable;
	• Continuing or royalty fees – this is based on room revenue. Typically this is between 3% and 5% of room revenue;
	• Advertising/marketing contribution – again commonly based on room revenue. This fee generally goes towards a fund for group (not necessarily local or regional) marketing. Typically between 2% to 4% of room revenue;
	• Reservation fee(s) (can be combined with above) – supports cost of operator's reservation and/or loyalty system(s). Rates and calculation vary between different operators and the systems they operate.
		A typical fee structure involves:
		
		• 'base fee' – typically between 2% to 4% of gross revenue;
		• 'Incentive fee' – typically around 10% of gross operating profit;
		• Technical services fees – lump sum or payable on a time and materials basis for relevant services;
		• Centralized services fees – often made up of:
		  •
		  ○ Marketing fees – typically in the region of 2% of room revenues;
		  ○ Reservation fees – calculated per room or against room revenue;
		  ○ Loyalty and other programmes provided.

Standards applicable	Hotel operators commonly have a brand standards manual or operating manual. Compliance is key.	Brand standards manual. Again compliance is key.
Applicable restrictions	Whilst post expiry/termination restrictive covenants can be enforceable in a franchise agreement, the underlying principle is that the restriction must be reasonable. In the context of an asset run as a hotel it is difficult to consider a situation where it would	HMAs typically contain a restriction on the operation of similar hotels within a prescribed area.

	be reasonable to place such a restriction on the hotel/ owner.	
Personnel	As management and operation of the hotel remains with the owner, the owner will employ all people associated with the operation of the hotel.	Operator will usually provide key management personnel (at a cost to the hotel). Most operators will require that the owner remains the employer of the remainder of hotel staff.
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Legal requirements	Franchising is a regulated activity in a number of countries and the franchisor or brand owner is commonly required to disclose detailed information about the franchise it offers. See overleaf for more detail in relation to European disclosure requirements.	The HMA is a contractual document that is not regulated by specific laws, however, local laws will apply notwithstanding the governing law of the HMA.
Multiple operations	Whilst it is common for operators to offer a 'direct franchise' (ie between hotel owner and operator), franchising also offers the potential for operators to grant third parties with a 'master franchise' or 'development rights' for a specific territory.	
Term	Typically between 5 to 15 years but can be more. Often includes options to renew.	HMAs are typically between 15 to 25 years and often incorporate renewal provisions.

From this table it can be seen that management agreements generate more revenue per hotel for the operator. However, the costs associated with managing hotels, particularly on an international basis, is an awkward fit with the rationalized, lean model which is currently preferred.

This said, there are still many instances when management agreements are preferable. Flagship hotels, new and emerging brands and hotels in emerging markets are more likely to flourish under the tighter brand controls offered by a management agreement.

II.2 Franchise Financing

Many prospective franchisees will need to finance part or all of their purchase of a new franchised business. Traditional lending sources are available but the restrictions related to financing any new business startup, even a franchised business, are stringent.

When researching how to finance a franchise, the best source of information about financing options is the franchisor. This is an issue that the franchisor has addressed numerous times with other franchisees and they will have a great deal of information about the practical options that are available.

In today's market, most traditional lending sources and programs are simply not available for new franchise startups. This is true regardless of the credit rating or score of the borrower and/or the type and amount of collateral that a person might have to secure the loan. In such a climate, the financing options are usually limited to one of the following approaches:

How to evaluate a hotel franchise:

- Based not only on the franchise costs, but especially on the concept, services and return on investment granted for those costs
- Calculation formula of the access cost, which is different from the cost of functioning within the network
- Franchiser's criteria of choosing the right of access
- Negotiation of the right of access and fees
- Negotiation of costs for the services and materials provided by the franchiser
- Evaluation of publicity (advertising) costs
- Variation of tariffs from one franchiser to another

The Retirement Plan Option

If you have significant balances in your IRA, 401K or other retirement plans, there are programs you can establish that allow you to access these funds to invest in starting your own new franchise business. This funding solution, which is performed by a handful of experienced and qualified professional organizations across the country, is a combination of a retirement plan and a corporation.

In this type of program, your retirement account invests by buying stock in a new corporation you set up to own and operate your franchise business. As your franchise becomes profitable, your retirement account will realize gains based on its stock ownership, on a tax deferred basis.

This financing tool allows you to purchase a franchise without applying for or obtaining a loan. It also saves you the paperwork and overhead associated with creating debt from a traditional source, keeping your overhead low and allowing your franchise to prosper at a higher level. Your Fran Choice consultant can refer you to a number of companies that set up such plans in complete compliance with the ERISA Act of 1974 and IRS regulations.

Local or Regional Bank Option

There are a number of local or regional banks that still occasionally make new business start up loans. Realistically, you will need to have a stellar credit history and rating plus fantastic collateral before they will even consider you, but that still beats the national banks which simply are not making such loans at this time.

If you wish to pursue this option, focus on creating or building a relationship with an individual banker. In today's climate you need someone within the bank that will be your "champion" in terms of arguing in favor of the loan. If you don't already have a banker relationship you can use, then you should leverage your local contacts in order to get referrals to bankers from other people who do have such a relationship. If you are introduced to the banker as a great person by someone the banker already knows and respects, it will go a long way toward helping you find your champion.

Last but not least, beware that this process is potentially very frustrating. Due to the nature of the beast with banks in this market, you should plan to develop multiple potential sources to pursue all at once. Most likely, majority of them will turn you down regardless of your qualifications – and you'll want a back-up or two.

Angel Financing

Another avenue you might explore is to find an “Angel” investor or lender that will provide the funds you need for your business startup. Even though the economic times are very tough, there is a great deal of money in the market sitting on the sidelines looking for a decent place to be invested.

If you can find an individual with such resources, and if you have strong credit and great collateral, it is a relatively straightforward process to pitch a loan proposal with success. Your best source for finding such a person is probably a referral from someone you know. Ask your attorney, accountant, banker and other professional advisors for referrals to such a person.

The Partner Option

The first step to finding a partner to help finance your business startup is to ask yourself if you know someone, a friend, relative or acquaintance, that would potentially be willing to back you with the resources needed to start a business. If you think of someone that is a possibility, discuss this idea with them and determine the circumstances under which they would be willing to participate and the amount of resources they might be willing to invest.

This option will enable you to pursue a franchise opportunity right away since you can add your partner’s assets to your own in order to meet the minimum standards necessary to pursue the business. The disadvantage is that the partner will usually own part or even the majority of the resulting business since they put up the money.

The Savings Option

As a final option if none of the above are available to you, you can save your way to success. If you don't have the funds necessary to purchase a franchise, but are very interested in someday doing so, you need to start preparing today by saving everything you can. This is the surest method for most people, though it will take discipline and patience on your part.

The key is to build your net worth and asset base so that you have something you can leverage in the future. Go down to your bank and set up a "business ownership" account. The secret to this account is that you won't touch whatever funds you put into it until you're ready to invest in a business of your own. Start the account with all the funds that you currently have available. Next, put a fixed amount of at least $500 into this account from each monthly paycheck (direct deposit would be best). Never miss a deposit.

This may seem like a slow road to travel but it serves two purposes. First, you'll be surprised at how fast the money will grow. Second, it gives you a key piece that you need to begin working with bankers and franchisors to put financing options together.

To get financing, you must have equity, credit or credibility. The first two are obviously missing or you wouldn't be reading this section. Assuming this is true, the third is the easiest to get. After as little as six months to a year of following the savings plan as outlined above, you will have established a track record that shows you are serious about owning a franchise.

II.3 Marketing

Marketing programs offered by franchisors are paid for by franchisees. They differ in terms of the amount of money directed to marketing, the sophistication of marketing programs, quality of advertising, distribution among various media and market segments, and direct yield to the franchisee. While each brand markets to a wide range of market segments, most focus on market segments appropriate for their hotels. For instance, national convention sales efforts would not be appropriate for Econolodge any more than promotions for truckers would be appropriate for Hyatt. Marriott’s marketing for Courtyards is most targeted within the corporate segment. For full service Marriotts, the company targets groups more directly. Hilton’s marketing is known for its effectiveness with groups and executives. Days Inn was historically strong in the Senior Citizen market, but their success has drawn direct competition for these customers in recent years. The best brand for a location has marketing appropriate for the kinds of customers who will be attracted to that specific hotel. Marketing programs differ in other ways as well. Choice’s marketing has been oriented toward television, and has promoted a multi-brand system over individual brands. Cendant brands, which are also clustered within one company, are promoted individually. They focus on different media, depending on the marketing goals of the particular brand.

The basic fees associated with a franchise are:

Royalties– A royalty is the fee charged for the use of a brand name. In the hotel industry, royalties are typically in the range of 3 to 5 percent of room revenues. They vary depending on the value of the brand and some peculiarities of the market. In general, a strong brand commands a higher royalty and commands that royalty in full over the life of the agreement. A weak brand may have a lower royalty, and may negotiate discounts during some part of the term of the agreement. Pricing of royalties reflects more than the simple desirability of a brand. Franchisors consider the speed at which they wish to sell franchises, the cost of the services they provide, the amount of competition from other franchisors for hotels at their product level, and other factors. Since royalties are calculated as a percentage of room sales, the royalty earned per room rented is much higher on a hotel like a Hyatt, with rates well over $150, than on a hotel like a Red Roof Inn, which may have rates under $50.

Costs of Entry– Franchisees pay application and initiation fees at the time they join the franchise system. In addition, among other items, costs of entry include:

- signage
- logo'd items
- architectural details required by the brand (like Holiday InnExpress's clock tower)
- brand specific computer systems
- charges for operating manuals
- charges for training (both sending management to training and paying for franchisor trainers and openers to come to the hotel)

Reservation System Charges– Franchisees pay for the operation of the chain reservation system. Typically, the reservation system is charged back to the franchisee community "at cost", meaning that the franchisor does not book a profit on the system. Reservation system charges generally include a percentage of room sales. There may also be charges per reservation, charges for reservation equipment, and various fees for usage. Travel agent commissions and Global Distribution System charges are also billed through the reservation system. The charges for delivering guests to hotels add up when they include franchise fee (5 percent), reservation and marketing fee (3.5 percent), Global Distribution System charge ($3 to $4 per reservation), travel agent commission (10 percent), etc. For a hotel with a $50 rate, these charges may total over 35 percent of revenue. For a hotel with a $200 average rate they may exceed $40 for a room night. Most hotel reservation systems allocate the costs of the reservation service as a percent of room revenues. This method encourages franchisees to use the reservation system as much as possible because their costs do not increase for heavier usage. The benefit to the franchise company is that the franchise system controls a larger proportion of the total volume of sales at its hotels. Guests also receive the most seamless service because franchisees are likely to make more of their rates and group programs available through the reservation system. The alternative system allocates a larger share of the cost of the reservation system to the hotels that use it most heavily by charging a fee per reservation booked, in addition to a base fee. Under this system, some hotels keep special programs, like group bookings, off the national reservation system and require group guests to book directly with the hotel. In general, taking full advantage of the reservation system is beneficial to hotels.

Marketing Assessments

Franchisees pay for the national marketing programs of their brand. These programs are officially not-for-profit to the franchisor. There is a suspicion in the franchisee community that franchisors use marketing and reservation system money to offset other costs of company operations. For this reason, many franchise systems have a committee of franchisees with some authority to review the expenditures of the marketing and reservation funds. There is generally a base marketing assessment that is a percentage of sales. In addition, there are charges for:

- special programs
- listings with some travel consortia
- rooms rented to guests through select promotions (for instance Holiday Inn hotels pay a fee for each room rented to a Priority Club guest)
- participation in regional marketing programs (marketing collectives of hotels within a chain are now prevalent, for instance, Days Inns in Florida have a franchise-sponsored collective that identifies specific marketing programs and funds those programs in addition to their national franchise marketing assessment)
- Various Charges– Incidental other charges are a common part of the franchise relationship. Some costs associated with a franchise would be incurred by an independent hotel as well, and may be less expensive for a franchisee. Management education is a good example. Without programs provided by a franchisor, it is difficult for a hotel operator to find training programs that are cost effective and specifically designed for a given type of property. Various charges include:

- fees for attending national conventions, regional meetings and required training sessions
- mandatory fees for franchisee councils
- computer support arranged through the franchise company for franchise-specific software and hardware
- miscellaneous fines for non-compliance
- required upgrades of computer systems and other technology (like adding a satellite dish to communicate with the chain, or purchasing a specific computer for staff training)
- required chain standard items (adding irons and ironing boards to all guest rooms, for instance, or adding continental breakfast to allhotels, or creating "senior citizen" rooms to support a national marketing effort)
- signage changes (Holiday Inn changed its "Great Sign" to its current signage standard some years ago, Best Western, Howard Johnson, Hilton and Choice brands, among others, have also changed their signage)
- complying with changing facilities standards
- purchasing insurance to protect the franchisor against a possible loss of revenue in case of a problem with the hotel

Sticking Points

Most of the time, most franchisees and franchisors get along. Most of the time, both parties make money and both parties are reasonably happy. But not always. These are the common sticking points.

Impact (Called Encroachment in Other Industries)

Impact is probably the most contentious issue between franchisees and franchisors, in all industries. Impact occurs when a new hotel in the chain takes business away from an existing hotel. It's a troubling topic because every $100,000 in lost revenue to the franchisee means a loss of only $10,000 to the franchisor (royalties, reservation and marketing fees total approximately 10 percent of room revenues). Meanwhile the new hotel may represent a $100,000 to a million dollars annually in new revenues to the franchisor. The franchisor stands to earn a substantial net benefit from impacting the franchisee.

Impact is particularly threatening when the franchisor is also the owner and operator of the new hotel. In these situations, the franchisee generally is concerned that his hotel will take second place in the reservation system, and in marketing programs. Concern about conflicts of interest in terms of data use and concern about retribution also become more prevalent in these circumstances. In general, there is no protection from impact for the franchisee within the franchise agreement. To the contrary, most franchise agreements specifically reserve the right for franchisors to add units at any location. Instead, some hotel franchisors provide “Impact Policies” specifying the level of protection they offer. Unlike franchise agreements, impact policies can be changed at any time. Impact policies offer one of two forms of protection.

Area of Protection – is a protected territory around the franchisee hotel in which the franchisor agrees not to license new properties. The trouble with areas of protection is that markets change. Over the course of a 20 year franchise agreement, the bounds of a reasonable territory might grow or shrink by ten miles in any direction. Recognizing this problem, franchisors confine areas of protection to small sub-markets. The adjoining sub-market then becomes fair game for a competing hotel in the same franchise, and that new hotel may be on the border of the existing area of protection.

Impact Study – is an estimate of the revenues the existing franchisee will lose if the additional hotel is licensed. Franchisors with impact study policies generally have a hurdle such as 3 percent of occupancy or 5 percent of room sales. If the estimate is higher than the hurdle, the new franchise is denied. The measure of impact is generally defined as the amount of franchise-generated business that would be lost and could not be replaced, if a hotel of the same brand is opened, rather than a hotel of a comparable brand. Three percent seems like a hurdle that would be readily exceeded, but the definition is so narrow that the hurdle is hard to reach. Particularly since the studies do not always measure the difference in impact if no new hotel is developed, which would be likely to be much higher. Further, under these policies, the franchisee may have to defend a hotel by purchasing an impact study every six months, if the franchisor is aggressive about adding distribution in a market.

So far, a satisfactory formula for compensating a franchisee for revenues lost due to impact has not been established. Franchisors and franchisees continue to propose new compromises.

Franchise agreements are contracts with a specified term, generally twenty years in the hotel industry. A franchisee who chooses to leave the system is, by contract, commonly liable for the present value of estimated future franchisee fees through the end of the contract term, unless otherwise specified. For a full service hotel, liquidated damages can run into the millions of dollars (for instance liquidated damages could be the present value of 8.5 percent of gross room revenues for ten or more years). They can exceed the market value of the hotel itself. A twenty year agreement with extensions is fine, when the franchisee keeps up the standards of the hotel and the franchisor continues to perform.

II.4 Working Relationships

Whatever the legal aspects of a franchisee-franchisor relationship, franchising is proliferating. Franchising works in today's market. It provides a means for an individual to own and operate a business in a complicated world. It makes it possible for lenders to mitigate their risk when they lend to inexperienced operators. It provides national brand marketing for businesses owned by individuals. Franchising is growing because it is a very good idea. Good working relationships between franchisee and franchisor make the best franchise systems effective. Those relationships are based on the concept that an improvement in the franchisee's business is good for the franchisor, and the matching concept that an improvement in the franchisor's brand is good for the franchisee. The actual interaction in these relationships takes place in several ways.

Franchise Services

Franchisors have a staff of professionals dedicated to the betterment and operation of the hotels within a brand. Those franchise service professionals:

- Inspect hotels, develop product improvement plans, and generally make sure that the quality of the product in the system is up to standard
- Provide marketing support through direct corporate and group sales, telemarketing, representation at trade shows, design services, marketing planning, representation to travel consortia, providing listings in directories and networks, developing packages and special promotions, advertising, etc.
- Operate the reservation systems
- Advise operators on their marketing and operations

- Develop training programs for hotel staff (both in conferences and training materials to be used at hotels)
- Bring additional hotels into the system (identify locations that would be desirable for brand distribution and sell franchises)

Hotel franchisors have shown a real interest in maintaining a positive relationship with their franchise communities. In general, the franchisor staff that deals with franchisees is accommodating and works to provide services to their franchisees.

Franchisee Advisory Boards

Most chains have advisory organizations comprised of franchisees. The structure of the franchisee organizations, and their mandate, is significantly different from one system to another. Choice and Cendant are examples; each system has its own version of an advisory group.

In Choice Hotels, the organization is called the "IOC" and is purely advisory; the Choice Board of Directors has veto power over the IOC. The IOC has regional boards as well as a national committee, which encompasses sub committees for education, technology, awards, audit and other functions. All of Choice's brands are represented through committees in the IOC. There are corporate (franchisor) representatives on the IOC voting committee.

Cendant has a separate franchisee group for each of its brands. For instance, "Rina" is Ramada's organization. It includes representatives of the franchisor, and is restricted against actions that would be detrimental to the franchisor (for instance, it cannot reduce franchise fees). However, it is available as a means of communication and discussion between franchisee and franchisor.

For franchisees, active participation in the franchise advisory committee of a chain is an effective way for franchisees to keep up to date with the system. It is also important as a way of protecting franchisee interests within each system.

For franchisors, the advisory committee is a means of communicating with the franchisee community, and a way to gather information about the concerns of their franchisees. Since franchisees tend to be small businesses and vulnerable in comparison to their franchisors, many will not express their concerns or business needs to the franchise company. The advisory committee becomes a conduit for this information. Advisory committees can also provide valuable input for marketing direction and product planning. The franchisor's corporate staff benefits from feedback about practical ways to implement or modify their strategies.

Troubled Relationships

If all franchisee-franchisor relationships were smooth all the time, the participants wouldn't be human and their hotels wouldn't be in a dynamic economy. Within every system there are franchisees that are having a difficult time with their franchisor. Throughout the course of a 20 year agreement, most of these working relationships will endure some easy and some difficult times. Issues like termination, liquidated damages, and litigation can be brought on by a host of factors. Some of these include:

There are franchisees that have a policy of operating hotels at the minimum allowable quality standard. Those hotels, particularly as they age, become a problem for the franchisor.

When a franchisee isn't making money, either because of local market conditions, the economy, financing terms, or the productivity of the brand, it is difficult to pay the franchisor. This is particularly true when the franchisor is collecting significant fees while the franchisee is funding operating losses.

Some hotel locations become obsolete (or were inappropriate for development in the first place). Since the franchise sales process tends to encourage development, franchisees tend to blame their franchisor for poor performance.

Over the life of a franchise agreement, a hotel may change owners or it may be operated by several generations of hoteliers. It may also be operated by one individual who has a stronger interest in the operation at some times than others. In any case, the operation is likely to change from time to time. Although a fundamental part of franchising, that is a difficult situation for a franchisor, who's goal is to provide a consistent product.

Franchisors, some more than others, pursue new locations. Once a brand has broad distribution, many new locations will have some impact on existing licensees.

Over the life of a hotel company, corporate direction may change. The brand may be positioned in the mid market, re-positioned in the economy market, and then re-positioned again. The corporation may chose to focus its energies on other brands. The brand may be sold to a company with different goals and objectives. Each shift is difficult for the franchisee, which may end up owning a hotel for which there is little marketing support, or which is not consistent with the other product in the brand.

With more franchisor control in the relationship, a strong franchisor can control the first four issues better. With more franchisee-friendly relationships, the franchisee can mitigate the risk of the last two issues better.

III Referral associations

Referral associations, e.g. Leading Hotels of the World (LHW), offer to hotels similar benefits as franchising, but at a lower cost. Some hotels choose to become a referral property. This means that the property is being operated as an independent hotel in association with a certain chain. These hotels refer guests to one another's properties and share a centralized reservation system, a common logo, image, or advertising slogan. Hotels pay an initial fee to join a referral association and further fees are based on services required. As the property has already been physically developed, the owner may want assistance only with marketing, advertising, management, or reservation referral. In addition, guests may find more variation among the referral properties as size and appearance standards are less stringent than those in a franchise agreement. However, every hotel is assessed and checked regularly to ensure that it maintains the highest standards.

- Similar benefits to properties as do franchises– but at a lower cost
- Shared centralized reservation system and a common image, logo, or advertising slogan
- May offer group buying discounts to members, as well as management training, and continuing education programs
- Each independent hotel refers guests to each of the other member hotels
- Hotels and motels pay an initial fee to join a referral association

Conclusion

The general conclusion of this study is that the motivation to become a franchisee moves around three clear advantages of the franchise system compared to an independent business:

1) using a trade name which gives the franchisee the advantage of being part of a brand known in the market,

2) working with a business format that has proven to be successful in other locations, and

3) the training provided by the franchisor to the franchisee to learn how to run the business and benefit from the processes and routines developed by the franchisor lower risk of failure associated with the franchise option is another agreed upon reason, but it is probably a consequence of using a known trade name, a proven business format, and the training and support the franchisor gives to the franchisee.

In the hotel industry, the reasons to become a franchisee are the same. Mr. Joe Lavin stated his experience with the Marriott and Choice franchisees as, “Franchisees came to us looking for marketing, which is basically what the franchisee gets from the franchisor. The franchisee is buying the right to use a brand that has the potential to attract customers to the hotel, along with all the marketing assets associated with that brand: the reservation system, the customer loyalty program, the online sales, … ; it is all marketing."

Mr. Jordi Frigola, Senior Vice President Jones Lang LaSalle Hotels in Europe and owner of an independent hotel in Barcelona (Spain), stated that his decision of not taking a franchised brand for his new hotel again highlights the importance of „brand" in the potential franchisee's decision. "The brands that were available were not so attractive; their level of brand awareness was low and not clearly positioned; having a franchised contract has a cost and would not give me additional sales; having a franchised contract will also limit my future possibilities; so I decided to go independent."

As we have seen with this theory and practice review, much remains to be studied about the motivations of franchisees in the hospitality industry, but we hope that with this synthesis, we have contributed to bringing some light to this interesting research topic.

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