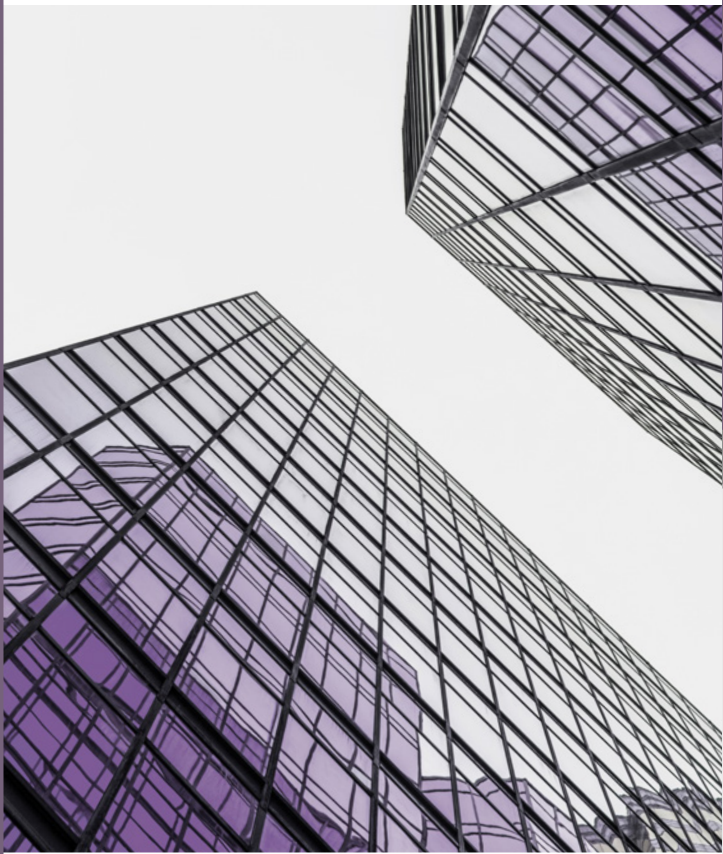

INVESTING, LEASING OR MANAGING?

2017 Development Ideas

The impact of the business model
on the hotel operating statement

CHOPIN AIRPORT
DEVELOPMENT

The Polish hotel market is perceived by most international hotel chains as the most attractive among all CEE markets. This leads to active sales directed to investors who consider any form of partnership with a hotel chain based on a franchise or management contract.
What more, international hotels operators are focused on the market also for great possibilities of its development what increase chances for success of investments in Poland. That is why sector specialisation and separation of functions between specialized industry entities benefits all parties.

Chopin Airport Development as an investor, operator, and franchisee working with the largest global hotel chains, operates on the market in a comprehensive manner and meets a broad spectrum of issues. Hence the idea for this publication, where you will find a case study of four hotels: individual, franchise, managed by the operator, and leased.

Enjoy reading!

GHEORGHE MARIAN CRISTESCU CHAIRMAN OF THE BOARD

PREFACE

The number of branded hotels in Poland has been growing since 1989 when the Marriott Hotel, the only luxury hotel at that time, was opened in Warsaw. In the subsequent years branded chain hotels were developing slowly, which was influenced, among other things, by an unstable economic situation following economic transformations of the 80's and by political circumstances. The real boom was seen after the year 2000 and in the recent years hotel chains have truly dominated the Polish market. Presently, investors are very much interested in cooperation with hotel chains and therefore, in this publications we will indicate differences on the part of income and expenses between a hotel operating under an individual brand and a hotel operating under a hotel chain brand. We will also examine an example of a fictional hotel managed by a specialized entity – a hotel operator and an example of a leased hotel. We will show differences in the impact of those two operating models on the value for both parties to an agreement.

HOTEL FRANCHISE

The success of a hotel is a product of many factors, mainly a product-market fit, appropriate location or experienced management staff. A hotel brand may facilitate better results but it is not a guarantee of such results. In most cases, the hotel brand only will not be enough to compensate for the lack of the aforesaid factors that are fundamental for the success of a hotel. The main advantage of international brands is their standardization and confidence put in them by hotel guests. It is said that when entering a chain hotel a guest has confidence in it only because the hotel belongs to a chain, while the specific hotel may only weaken or damage such confidence. On the other hand, when entering an independent and unknown hotel a guest does not have confidence in it, so the hotel has to build the confidence from scratch. A very significant and measurable benefit that a hotel derives from a brand are guests using loyalty programs of a given chain. In very many hotels the percentage of loyalty guests is significant and the percentage of total income generated by loyalty guests can exceed 30%. That is a very big advantage and at the same time a loss for independent hotels.
However, it needs to be remembered that operation within a chain generates expenses, which are often significant, and limits the freedom of the facility's activities. Local marketing activities are very limited and many aspects of the business should be consulted with hotel chain representatives, who decide whether the activities proposed match the strategy of the entire brand.

Summing up, there is no single and easy answer to the question of whether a hotel should operate under an individual brand or under a brand of hotel chain. Below is presented a list of factors that may predestine a given hotel to join a franchise chain:

EXTERNAL ASPECTS:

- **a large number of chain hotels in the near vicinity** - hotels very often have to join a chain to cope in a competitive environment
- **a large percentage of foreign business and tourist guests in a given location** – foreign guests prefer chain hotels due to their recognisability and certain quality of services
- **a proximity of an office district/congress centre/industrial district** – a possibility to attract corporate guests who have signed contracts with a given chain
- **a prestigious location –** a brand of hotel chain may help to achieve higher ADR levels in prestigious locations

INTERNAL ASPECTS:

- **the lack of hotel owners' experience in running the hotel business** – joining a franchise chain will facilitate sales processes in a hotel
- **high costs of acquiring business due to high share of reservations made through OTA's** – access to clients through reservation systems and loyalty programs may positively affect costs

Below are presented fictional operating statements in two hotels – an individual hotel and a hotel operating under a brand of international hotel chain. This comparison is not targeted at recommending specific solutions but at pointing to differences in income and expenses that often appear between hotels operating under an international/ domestic brand and under an individual brand.

CHOPIN AIRPORT DEVELOPMENT

ASSUMPTIONS:

- **Number of keys:** 120
- **Analysis period:** from the hotel opening up to stabilized year
- **Inflation:** not included
- **Accounting standard:** USALI

YEAR	1	%	2	%	3	%	4	%
Days open	365		365		365		365	
Rooms available (capacity)	43 800		43 800		43 800		43 800	
Rooms sold	21 462		27 156		31 536		32 412	
Guests served	27 901		35 303		40 997		42 136	
Occupancy rate (%)	49%		62%		72%		74%	
ADR - Average daily rate	220		239		253		260	
RevPAR -Revenue per available room	108		148		182		192	
DEPARTAMENTAL REVENUES	**6 632**	**100,0%**	**9 206**	**100,0%**	**11 414**	**100,0%**	**12 056**	**100,0%**
Rooms	4 722	71,2%	6 490	70,5%	7 979	69,9%	8 427	69,9%
Food and Beverage	1 711	25,8%	2 449	26,6%	3 070	26,9%	3 243	26,9%
Other departments	199	3,0%	267	2,9%	365	3,2%	386	3,2%
DEPARTAMENTAL EXPENSES	**2 593**	**39,1%**	**3 378**	**36,7%**	**3 912**	**34,3%**	**4 132**	**34,3%**
Rooms	1 275	27,0%	1 694	26,1%	2 011	25,2%	2 124	25,2%
Food and Beverage	1 283	75,0%	1641	67,0%	1842	60,0%	1 946	60,0%
Other departments	35	17,6%	43	16,1%	59	16,2%	63	16,3%
DEPARTAMENTAL INCOME	**4 039**	**60,9%**	**5 828**	**63,3%**	**7 502**	**65,7%**	**7 924**	**65,7%**
Undistributed expenses	**2 089**	**31,5%**	**2 191**	**23,8%**	**2 397**	**21,0%**	**2 532**	**21,0%**
Administrative and General	630	9,5%	644	7,0%	685	6,0%	723	6,0%
Sales and marketing	497	7,5%	552	6,0%	628	5,5%	663	5,5%
Property operation and maintenance	464	7,0%	460	5,0%	514	4,5%	543	4,5%
Utilities	497	7,5%	534	5,8%	571	5,0%	603	5,0%
GOP – Gross operating profit	**1 950**	**29,4%**	**3 637**	**39,5%**	**5 105**	**44,7%**	**5 392**	**44,7%**
Fixed expenses	**252**	**3,8%**	**394**	**4,3%**	**571**	**5,0%**	**603**	**5,0%**
Property taxes (real estate tax, perpetual usufruct)	133	2,0%	157	1,7%	171	1,5%	181	1,5%
Insurance	53	0,8%	53	0,6%	57	0,5%	60	0,5%
Reserve for Replacement	66	1,0%	184	2,0%	342	3,0%	362	3,0%
NOI – Net operating income	**1 698**	**25,6%**	**3 243**	**35,2%**	**4 534**	**39,7%**	**4 789**	**39,7%**

Table 1. Operating statement of a 120-key hotel operating under an individual brand (PLN 000s)

Source: *CAD projections*

YEAR	1	%	2	%	3	%
Days open	365		365		365	
Rooms available (capacity)	43 800		43 800		43 800	
Rooms sold	24 090		30 222		35 040	
Guests served	31 317		39 289		45 552	
Occupancy rate (%)	55%		69%		80%	
ADR - Average daily rate	240		270		280	
RevPAR -Revenue per available room	132		186		224	
DEPARTAMENTAL REVENUES	**8 307**	**100,0%**	**11 607**	**100,0%**	**13 741**	**100,0%**
Rooms	5 782	69,6%	8 160	70,3%	9 811	71,4%
Food and Beverage	2 276	27,4%	3 099	26,7%	3 518	25,6%
Other departments	249	3,0%	348	3,0%	412	3,0%
DEPARTAMENTAL EXPENSES	**3 155**	**38,0%**	**4 103**	**35,3%**	**4 501**	**32,8%**
Rooms	1 457	25,2%	1 967	24,1%	2 315	23,6%
Food and Beverage	1 662	73,0%	2 076	67,0%	2 111	60,0%
Other departments	36	14,4%	60	17,2%	75	18,2%
DEPARTAMENTAL INCOME	**5 152**	**62,0%**	**7 504**	**64,7%**	**9 240**	**67,2%**
Undistributed expenses	**2 824**	**34,0%**	**3 053**	**26,3%**	**3 202**	**23,3%**
Administrative and General	789	9,5%	813	7,0%	824	6,0%
Sales and marketing	789	9,5%	871	7,5%	934	6,8%
Property operation and maintenance	665	8,0%	696	6,0%	756	5,5%
Utilities	581	7,0%	673	5,8%	687	5,0%
Franchise fee	173	3,0%	326	4,0%	392	4,0%
GOP – Gross operating profit	**2 155**	**25,9%**	**4 125**	**35,5%**	**5 646**	**41,1%**
Fixed expenses	**316**	**3,8%**	**497**	**4,3%**	**687**	**5,0%**
Property taxes (real estate tax, perpetual usufruct)	166	2,0%	197	1,7%	206	1,5%
Insurance	66	0,8%	67	0,6%	69	0,5%
Reserve for Replacement	83	1,0%	232	2,0%	412	3,0%
NOI – Net operating income	**1 839**	**22,1%**	**3 628**	**31,3%**	**4 959**	**36,1%**

It is possible to get higher ADR and occupancy rates compared to competitive non-chain hotels, full operational capability is reached faster

The structure of sources of booking is different. Non-chain hotels sell mainly via OTA channels (even up to 70-80%). Chain hotels have a significant percentage of loyalty guests (20-35%), who make bookings via direct channels (web direct, hotel direct)

The share of expenses of the room department in the total income from that department is lower as a result of a lower share of OTA bookings and lower expenses on fees for intermediaries

The share of marketing expenses is higher due to marketing fees to a hotel chain and fees for loyalty points, global e-commerce activities, etc. The share of expenses of property operation and maintenance department may be higher as it is necessary to maintain computer network and internet systems.

A franchise fee is usually calculated on the base of revenues from room department or revenues from room department + revenues from breakfasts

Table 2. *Operating statement of a 120-key hotel operating under a brand of hotel chain (PLN 000s)*

Source: *CAD projections*

HOTEL MANAGEMENT AGREEMENT

Most hotels in Poland are managed by their owners. However, that has been changing recently and investors have increased opportunities to cooperate with a specialized management company. The investors may decide to cooperate with an entity that is also a franchiser e.g. chains: Hilton Worldwide, Marriott International, Intercontinental Hotel Group, Hyatt, Rezidor Hotel Group, etc. In such case the hotel chain manages a hotel and makes its brand available to the same. Such agreements are usually concluded by large full-service hotels, operating in the 4*+ standard. Another type of management company is an individual operator. Individual operators often sign trilateral agreements under which a hotel owner also signs a franchise agreement with a hotel chain.

Primary responsibilities of a management company include:

- staff recruitment, training and supervision
- management of all operating departments in the hotel
- hotel management in accordance with the accepted operating budget and provisions of the management agreement
- preparation of monthly and annual operating reports for the hotel owner
- purchases
- planning, oversight and execution of capital expenditures (upon approval of the owner)
- revenue management, etc.

There are two standard types of fee applied in the hotel management agreement: a base fee and an incentive fee. The base fee is the main fee charged by a management company. It is usually calculated as % of the total income of a hotel (typically 2-4%). There is one big disadvantage of such solution i.e. the operator is dependent on the maximization of income and not the optimization of the entire business. The other fee – incentive fee addresses the aforesaid problem of maximization of the entire business of a hotel. It is usually calculated on gross operating profit or net operating income of a given facility. The methods to determine the amount of the fee are different, a standard market rate is 8-12% on the GOP level. If, in addition to that, a decision is taken to operate under a brand of an international chain, the owner has to calculate additional costs connected with granting the franchise i.e. a franchise fee (it may be reduced due to management expenses), marketing fee or booking fees and loyalty programs. The market practice shows that the aforesaid fees are frequently not the only ones charged to the hotel owner.

If a decision is taken to cooperate with an international hotel chain, an investor may expect fees for:

- mandatory staff training
- internal audits organized by the chain
- pro-quality activities
- systems that integrate chain hotels
- accounting systems, IT systems, etc.

In the case of a management agreement, the hotel business risk lies with the hotel owner. The hotel owner is required to pay current obligations and employ the staff.

ASSUMPTIONS FOR THE ANALISYS:

- **Number of keys:** 180
- **Analysis period:** from the hotel opening up to stabilized year
- **Inflation:** not included
- **Accounting standard:** USALI
- **Basic management fee:** 3% of total departmental revenue
- **Incentive fee, the level of which is dependent on the GOP level in relation to total income:**

  GOP<35% - 5%*GOP level

  35%<GOP<45% - 8%*GOP level

  GOP>45% - 10%*GOP level

YEAR	1	%	2	%	3	%
Days open	365		365		365	
Rooms available (capacity)	65 700		65 700		65 700	
Rooms sold	35 478		44 676		49 275	
Guests served	46 121		58 079		64 058	
Occupancy rate (%)	54%		68%		75%	
ADR - Average daily rate	230		250		275	
RevPAR -Revenue per available room	124		170		206	
DEPARTAMENTAL REVENUES	**10 905**	**100,0%**	**14 626**	**100,0%**	**17 363**	**100,0%**
Rooms	8 160	74,8%	11 169	76,4%	13 551	78,0%
Food and Beverage	2 444	22,4%	3 078	21,0%	3 395	19,6%
Other departments	301	2,8%	379	2,6%	418	2,4%
DEPARTAMENTAL EXPENSES	**3 904**	**35,8%**	**4 811**	**32,9%**	**5 438**	**31,3%**
Rooms	2 203	27,0%	2 915	26,1%	3 415	25,2%
Food and Beverage	1 662	68,0%	1 847	60,0%	1 969	58,0%
Other departments	39	13,0%	49	12,9%	54	12,9%
DEPARTAMENTAL INCOME	**7 001**	**64,2%**	**9 815**	**67,1%**	**11 926**	**68,7%**
Undistributed expenses	**3 435**	**31,5%**	**3 481**	**23,8%**	**3 646**	**21,0%**
Administrative and General	1 036	9,5%	1 024	7,0%	1 042	6,0%
Sales and marketing	818	7,5%	878	6,0%	955	5,5%
Property operation and maintenance	763	7,0%	731	5,0%	781	4,5%
Utilities	818	7,5%	848	5,8%	868	5,0%
GOP – Gross operating profit	**3 566**	**32,7%**	**6 334**	**43,3%**	**8 279**	**47,7%**

MANAGEMENT FEE (BASIC FEE)	**327**	**3,0%**	**439**	**3,0%**	**521**	**3,0%**
GOP after management fee	**3 239**	**29,7%**	**5 895**	**40,3%**	**7 758**	**44,7%**
Fixed expenses	**593**	**5,4%**	**1 150**	**7,9%**	**1 713**	**9,9%**
Property taxes (real estate tax, perpetual usufruct)	218	2,0%	249	1,7%	260	1,5%
Insurance	87	0,8%	102	0,7%	104	0,6%
Management fee (incentive fee)	178	5,0%	507	8,0%	828	10,0%
Reserve for Replacement	109	1,0%	293	2,0%	521	3,0%
NOI – Net operating income	**2 646**	**24,3%**	**4 745**	**32,4%**	**6 045**	**34,8%**
Total fee for the hotel management company	**505**	**4,6%**	**945**	**6,5%**	**1 349**	**7,8%**

Table 3. *Operating statement of a 180-key hotel operating under a management agreement (PLN 000s)* ***Source:*** *CAD projections*

DISCOUNTED CASH FLOWS FOR THE HOTEL MANAGEMENT COMPANY AND THE HOTEL OWNER, ASSUMPTIONS:

- **analysis period:** 10 years
- **Assumed discount rate:** 7%
- **Assumed capitalization rate:** 8%
- **Indexation:** none

YEAR	1	2	3	4	5	6	7	8	9	10
Cash flows for the operator	505	945	1 349	1 349	1 349	1 349	1 349	1 349	1 349	1 349
									RV	16 860
Discounted cash flows	472	826	1 101	1 029	962	899	840	785	734	9 257
										16,904 mln

Table 4. *Discounted cash flows for the hotel operator under a management agreement (PLN 000s)* ***Source:*** *CAD projections*

YEAR	1	2	3	4	5	6	7	8	9	10
Cash flows for the owner	2 646	4 745	6 045	6 045	6 045	6 045	6 045	6 045	6 045	6 045
									RV	75 563
Discounted cash flows	2 473	4 144	4 935	4 612	4 310	4 028	3 765	3 518	3 288	41 485
										76,557 mln

Table 5. *Discounted cash flows (hotel value) for the hotel owner (PLN)* ***Source:*** *CAD projections*

LEASE AGREEMENT

The essence of a lease agreement in the hotel industry lies in cooperation between two entities, under which the lessor (investor/owner) is required to build a hotel facility, and usually equip the same, using its own funds and the lessee undertakes to conduct hotel business in such facility. Contrary to a management agreement, the risk of operating business lies with the lessee and the lessee pays a lease fee to the owner of the facility for benefits derived from the owner's property. The lessee company employs the entire hotel staff and pays current obligations.

ASSUMPTIONS FOR THE ANALISYS:

- **Number of keys:** 180
- **Analysis period:** from the hotel opening up to stabilized year
- **Inflation:** not included
- **Accounting standard:** USALI
- **Fee to the hotel owner:**
  PLN 17,000 a year for a hotel room in year 1
  PLN 20,000 a year for a hotel room in year 2
  PLN 24,000 a year for a hotel room from year 3 onwards
- It was also assumed that operating results of the hotel will be the same as under the management agreement.

YEAR	1	%	2	%	3	%
Days open	365		365		365	
Rooms available (capacity)	65 700		65 700		65 700	
Rooms sold	35 478		44 676		49 275	
Guests served	46 121		58 079		64 058	
Occupancy rate (%)	54%		68%		75%	
ADR - Average daily rate	230		250		275	
RevPAR -Revenue per available room	124		170		206	
DEPARTAMENTAL REVENUES	**10 905**	**100,0%**	**14 626**	**100,0%**	**17 363**	**100,0%**
Rooms	8 160	74,8%	11 169	76,4%	13 551	78,0%
Food and Beverage	2 444	22,4%	3 078	21,0%	3 395	19,6%
Other departments	301	2,8%	379	2,6%	418	2,4%
DEPARTAMENTAL EXPENSES	**3 904**	**35,8%**	**4 811**	**32,9%**	**5 438**	**31,3%**
Rooms	2 203	27,0%	2 915	26,1%	3 415	25,2%
Food and Beverage	1 662	68,0%	1 847	60,0%	1 969	58,0%
Other departments	39	13,0%	49	12,9%	54	12,9%
DEPARTAMENTAL INCOME	**7 001**	**64,2%**	**9 815**	**67,1%**	**11 926**	**68,7%**
Undistributed expenses	**3 435**	**31,5%**	**3 481**	**23,8%**	**3 646**	**21,0%**
Administrative and General	1 036	9,5%	1 024	7,0%	1 042	6,0%
Sales and marketing	818	7,5%	878	6,0%	955	5,5%
Property operation and maintenance	763	7,0%	731	5,0%	781	4,5%
Utilities	818	7,5%	848	5,8%	868	5,0%
GOP – Gross operating profit	**3 566**	**32,7%**	**6 334**	**43,3%**	**8 279**	**47,7%**

Fixed expenses	**414**	**3,8%**	**644**	**4,4%**	**886**	**5,1%**
Property taxes (real estate tax, perpetual usufruct)	218	2,0%	249	1,7%	260	1,5%
Insurance	87	0,8%	102	0,7%	104	0,6%
Reserve for Replacement	109	1,0%	293	2,0%	521	3,0%
NOI – Net operating income	**3 151**	**28,9%**	**5 690**	**38,9%**	**7 394**	**42,6%**
Fee for the owner	**3 060**	**28,1%**	**3 600**	**24,6%**	**4 320**	**24,9%**

Table 6. *Operating statement of a 180-key hotel – lease agreement (PLN)* ***Source:*** *CAD projections*

DISCOUNTED CASH FLOWS FOR THE LESSEE AND THE HOTEL OWNER, ASSUMPTIONS:

- **analysis period:** 10 years
- **Indexation:** none
- **assumed discount rate:** 6,5%
- **assumed capitalization rate:** 7,5%

YEAR	1	2	3	4	5	6	7	8	9	10
Cash flows for the lessee	91	2 090	3 074	3 074	3 074	3 074	3 074	3 074	3 074	3 074
									RV	40 985
Discounted cash flows	86	1 843	2 545	2 389	2 244	2 107	1 978	1 857	1 744	23 471
										40,263 mln

Table 7. *Discounted cash flows (hotel value) for the lessee (PLN)* ***Source:*** *CAD projections*

YEAR	1	2	3	4	5	6	7	8	9	10
Cash flows for the owner	3 060	3 600	4 320	4 320	4 320	4 320	4 320	4 320	4 320	4 320
									RV	57 600
Discounted cash flows	2 873	3 174	3 576	3 358	3 153	2 961	2 780	2 610	2 451	32 986
										59,922 mln

Table 8. *Discounted cash flows for the hotel owner (PLN)* ***Source:*** *CAD projections*

SUMMARY

Depending on the risk associated with a given type of agreement, such agreement is attractive to different market players. For entities focused on high returns on investments, a management agreement, which requires an investor to know the hotel industry much better than in the case of a lease agreement, is more attractive. On the other hand, an investor that leases a hotel can expect a much lower risk associated with a given investment, which also translates into lower returns on investment. There is no single and best solution recommended for each market situation and decisions should be taken based on reliable analyses and investor's experience.

AUTHORS OF THE PUBLICATION:

Adam Pilczuk
Director of Strategy and Development

adam.pilczuk@chopinad.pl
Tel.: (+48) 22 650 00 826
Kom.: (+48) 663 382 380

Katarzyna Tencza
Hotel Market Coordinator

katarzyna.tencza@chopinad.pl
Tel.: (+48) 22 650 05 85
Kom.: (+48) 519 749 689

Małgorzata Broniarek
Head of Sales and Marketing Office

malgorzata.broniarek@chopinad.pl
Tel.: (+48) 22 650 01 76
Kom.: (+48) 519 749 681

CHOPIN AIRPORT
DEVELOPMENT

biuro@chopinad.pl
tel.: +48 22 650 08 72
fax: +48 22 650 08 73

CHOPIN AIRPORT DEVELOPMENT SP. Z O. O.
ul. Żwirki i Wigury 1
00-906 Warszawa

KRS 0000047774
REGON 016046030
NIP 5222482605