BOYADJIAN & ASSOCIATES

PROJECT FINANCE & MANAGEMENT CONSULTANTS

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Franchising: A Tool for Global Growth

Franchising is a quick way to grow the hotel room numbers without eroding capital earmarked for investment in must-have destinations or opportunistic deals. Major hotel groups are increasing the proportion of their portfolios under franchising both as part of expansion of their networks and conversion of existing owned or managed properties. While franchising offers higher returns than direct control as well as reduced capital requirements, the franchisor's exposure to risk is increased. The key to successful franchising programmes includes selecting the right properties and business partners, on-going relationship management with those business partners, strong agreement terms and conditions and a commitment to enforcing the franchising rights. Franchisors need proactive monitoring programmes to ensure that quality is maintained to protect the brand and minimise financial risks such as revenue leakage.

Proportion of Hotel Rooms under Franchise:

Hotel Company	Rooms
Accor	19%
Cendant	100%
Choice	100%
IHG	76%
Marriott International	46%
Hilton Hotels	70%
Starwood	34%

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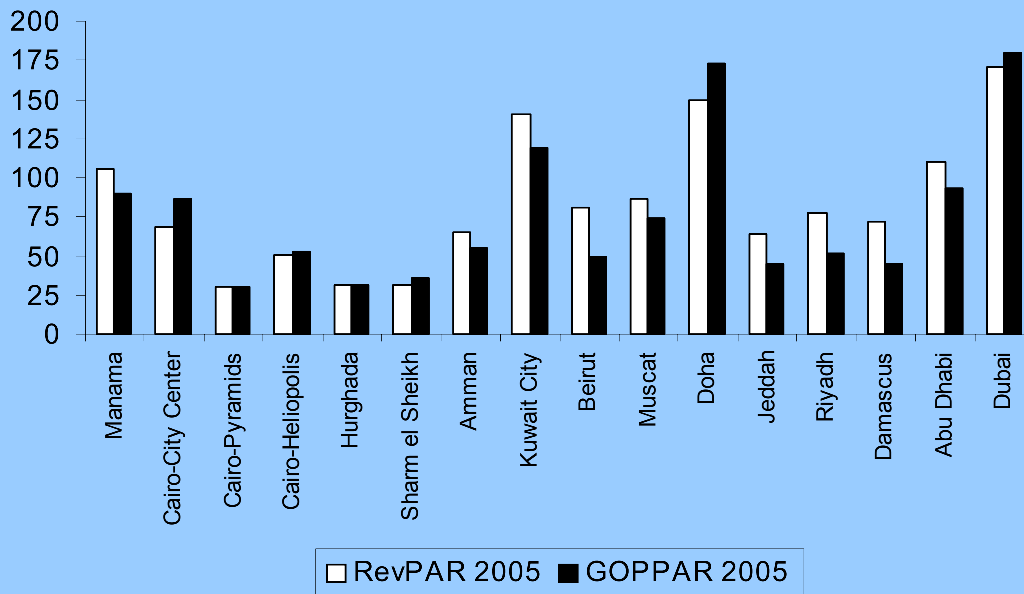
RevPAR and GOPPAR Trends 2005 (US$):



The strong trading performance of hotel markets in the Middle East in 2004 was followed in 2005 by skyrocketing double-digit growth. This was driven predominantly by growth in average room rate (approximately 18%) and an occupancy rate of 70%.

The hotel markets in the region have historically been underpriced in comparison to other international markets. However, such a situation is coming to an end. A rigid pricing strategy was implemented simultaneously across the region in 2005, a move triggered by increased liquidity in the region and sustainable levels of demand. The strong purchasing power of the GCC consumers, together with the sustained levels of corporate and leisure demand in the region, successfully absorbed the rise in room rate. The price elasticity of the hotel markets was further facilitated by the steady appreciation of the euro against the US dollar.

"Why do we need to conduct a review of our franchisees? We trust them!" This is all too often the response from companies when an examination is suggested. Of course it is desirable that the franchisor and franchisee should have a good working relationship, which will involve mutual trust and respect. But this does not mean that decades of statements should be accepted without question. After all, most companies place trust in their employees but still check their expense claims.

One consequence of this sentiment is that a large number of brand owners are failing to monitor agreements adequately and are losing millions of dollars as a result. The key to ensuring that the correct royalties or licence fees are being reported lies in the following steps:

- Ensuring that the agreement terms (i.e., net room revenue, allowable deductions) are clearly and concisely defined;
- Ensuring the agreement allows for a thorough and unrestricted examination to be conducted;
- Exercising these rights regularly; and
- Maintaining regular contact with the franchisee.

Clear and concise agreement terms

Crucially, any deal is only as good as the agreement underpinning it. Large discrepancies arise after an agreement has been signed over what seems like little issues during the negotiation. A great deal of time and effort is spent determining the royalty or

fee rate but little consideration is given to some of the other financial terms and conditions.

When negotiating an agreement, it is vital that both the franchisor and the franchisee are clear as to exactly what the terms and conditions state and the parties agree that the clauses say the same things. If such clarity is not established at the outset, discrepancies in interpretation will often mean disputes further down the line, as the franchisor does not receive the income it was expecting or the franchisee is asked to pay out more than it believes is fair.

When an agreement is being drafted, there are a number of areas that have the potential to cause difficulties. If it is decided that the license fee is to be made on a royalty basis, should this be based on gross room revenue, net room revenues or some other calculation? Whatever is decided has to be very carefully defined. If it is net room revenue, for example, does net mean money actually received from room sales, less sales, use, exercise, value added, tourist or other taxes or government imposed surcharges on such room use or room occupancy less standard industry deductions?

It is clear that if these definitions are not set out in the agreement, the franchisor will think there are no restrictions or qualifications, while the franchisee will want to do everything possible to keep payments down. If the parties are in different countries with different languages, different cultures, different standards and business practices, the issue is only exaggerated. But, if all parties are in agreement from day one, there is little room for uncertainty.

Audit access clauses

On some occasions our attempts to conduct examinations have been hampered by poorly worded agreements which give the franchisor only restricted rights, for example, "audit all the information which the franchisee has used in preparing the license fee statements." This is of little value because it is precisely the information, which has not been used which is of most interest. The wording above allows us to verify accuracy but not the completeness of the statements. A well-worded agreement is the foundation for a successful examination and should give any firm appointed by the franchisor complete and unfettered access to all the books and records in the custody or control of the franchisee, including electronic data.

Exercising audit rights regularly

Research to date across all industries indicates that around 8 in 10 licensors do not have a formal compliance programme. Specific data is not presently available for franchisors. However our

Selected MENA Hotel Valuation Index Per Room 2006 (US$):

Country	City	Value Per Room (USD)
Bahrain	Manama	270,000
Egypt	Cairo-City Center	260,000
	Cairo-Pyramids	114,000
	Cairo-Heliopolis	180,000
	Hurghada	110,000
	Sharm el Sheikh	130,000
Jordan	Amman	190,000
Kuwait	Kuwait City	280,000
Lebanon	Beirut	230,000
Oman	Muscat	230,000
Qatar	Doha	400,000
Saudi Arabia	Jeddah	180,000
	Riyadh	250,000
Syria	Damascus	130,000
UAE	Abu Dhabi	290,000
	Dubai	450,000

As of January 2006, The average regional hotel value per room stand at around US 230,000. The region has good potential to experience uplift in values over the next few years, which will help to further stimulate the transaction and lending markets.

Tourism Development and Investment Trends in the MENA Region

The current volume of investment in proposed hotel assets reached USD 15 billion. More than 60,000 hotel rooms are currently under construction in the region. The number of up-market, boutique and lifestyle brands entering the MENA markets has increased. Brands such as W, Banyan Tree, Mandarin Oriental, and Trump, and The Stein Group have entered (or are in the process of entering) the market. The level of investment in 'trophy' assets (the Trump Hotel Palm Jumeirah, the Emirates Palace Abu Dhabi, the Philippe Starck Design Hotel in Beirut, and various properties in Saudi Arabia) is increasing. The development of limited service hotels and serviced apartments continues to be noticeable across the region, as is the formation of specialist local operators/brands or hotel business lines such as Shaza, Refad, and Centro by Rotana.

The strong trading performance of the hotel markets, together with increased liquidity in the region, has triggered the creation of various, specialised hotel investment vehicles. We estimate that more than US$1.4 billion worth of capital was being raised in 2005 by newly established specialised hotel investment funds/vehicles. Such vehicles specialise in investing in specific asset classes within the hotel industry in the Middle East and North Africa (the remainder of the investment arena is dominated by high-net-worth individuals and institutional investors, which are on a par in terms of distribution).

Some of the main transactions and large developments that took place in the region in 2005 and early 2006 include the acquisition of Yotel (the design-led budget brand) by IFA Hotels and Resorts, the Initial Public Offering of Kingdom Hotel Investments (KHI), the establishment of the Armani brand (and fund) as well as the inauguration of Nakheel Hotels and Resorts.

impression is that the majority of major franchisors have a programme although the breadth and depth of geographical coverage and frequent varies significantly. Some variety would be expected due to the different arrangements, network size and systems. A best practice programme will contain a number of elements.

Monitoring

Monitoring of the franchisee by the franchisor on a regular basis is essential. This should include timely follow-up of missing or incomplete returns and robust enquiry into unusual items. This should also include basic checks and balances. Reconciliation of returns to actual payments received is also needed particularly where cash received and monitoring are separated functions.

Monitoring should also include review of franchisee auditor certificates normally submitted annually in arrears to the monthly franchisee submitted returns. Where appropriate the returns should also be reviewed with audited financial statements. Franchisee auditor certificates also need careful review particularly for complex operations. Some are comprehensive reports based on specifically commissioned exercises, however others may not focus on detecting misreporting at their client, may not meet requirements set out in the contract and contain heavy caveats.

Benefits

In addition to identifying compliance issues with franchisees, a proactive approach to licensing management encourages franchisees to improve future reporting, increases the licensor's predictability of future payments and, for both parties, identifies areas for improvement in drafting of future agreements. A well publicised programme may act as a deterrent to deliberate misreporting particularly where this is backed penalties and recovery of audit cost clauses. Similarly, such visits are more widely accepted when thought to be "normal" best practice behaviour rather than seen to be snooping.

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