OAK INVESTMENT MANAGEMENT GROUP

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The Real Estate of Hotels

Hotels are a specialised area of real estate. This is because hotels are beholden to their occupiers (operators) like few other parts of the real estate world. A good brand can make a success of a location or a building where an average one would struggle. In the right circumstances, as a single 'occupant' of a hotel, an operator can hold a landlord to ransom. Trends are as fluid and fast changing as retail but with capital decisions as slow as the rest of real estate.

Hotel landlords can either collect the rent from a hotel operator (generally known as a leasehold contract) or they can go into partnership with a hotel operator (generally known as a management contract). Barring a leasehold contract with group parental guarantee from a very solvent company the landlord of a hotel can never be fully immune from the operational performance of the underlying hotel asset. As a result it is usually very important for an investor in hotels to fully appreciate the operational performance in the target hotel.

Owning the freehold of a hotel which is granted to an operator on a leasehold basis requires the normal due diligence on covenant, ability to pay and trajectory of the group as a whole. Owning the freehold of a hotel which is granted to an operator on a management basis and / or with a turnover element to the rent requires an enhanced and specialised level of due diligence. The landlord with a management contract in place exposes themselves to a higher level of risk and should expect a higher return than one with a leasehold contract in place.

What drives a good hotel investment? Like any property specifically or any business generally pricing power is key to operational performance. If an operator can command a higher average daily rate (ADR – which is the key metric of the hotel industry), then all things being equal a landlord can charge a higher rate. The proportion charged needs to keep pace with the ability of an operator to pay as well as the volatility of cash flows that can naturally or exceptionally occur.

Ascertaining the right amount of capital expenditure to keep the property fresh, competitive and ahead of the competition is a decision make with any property. In the case of a hotel there is a tension between short term investment (affecting the profit and loss side of the business) and long term investment (affecting the balance sheet side of the business). Usually an operator wishes to maximise the former and a landlord wishes to maximise the latter. These can work hand in hand to everyone's benefit – but sometimes not.

Hotels can generate brand recognition and loyalty by themselves. This is intimately connected with guests' experiences and recommendations. As such the responsibility of delivering value in hotel property will always reside primarily with the operator. A landlord can help by setting the framework of success and motivation for the operator, as well as an understanding of their requirements – but an operator is the fundamental source of value.

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