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Propco versus Opco: Should Private Hotel Operating Companies Acquire Assets to Enhance Shareholder Value?

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If you are a private hotel operating company and have built your company on providing third-party management services, there will come a point in time when you will most certainly question your own strategy and its direction. Can we really build sustaining value if we don't own our hotels? Can we attract and retain quality talent if we don't have a substantial number of hotel assets under long-term control? Is there sufficient margin in the management business to sustain the company for the long term? These are just some of the questions that you will be faced with in exploring your alternatives.

This is a pretty typical conundrum that operating companies face at some stage in the growth of the company.

What's often missing is an understanding of the important distinctions between a pure operating company (opco) and an operating company that incorporates the ownership of real estate (propco) into the structure and design of the company. What's also often missing is the experience to fully evaluate and understand the important issues that need to be addressed.

Let's look at these two fundamental strategic options and how they affect your current circumstances and future opportunities.

The "Opco" Option

Many private hotel companies start out as pure third-party managers. The focus of management is on operations; asset management and investment management are left to the asset manager or owner. The management team is typically from an operations background. Possessing hands-on, on-site experience is critical. The strength of this structure is the P&L; the weakness is the Balance Sheet. Pure operating companies can be run profitably, but they do not build strong balance sheets.

The value of an operating company is typically measured in terms of a multiple of pre-tax earnings or cash flow. The length and quality of the portfolio of management contracts is also an important factor in valuation. Quality is measured in terms of the fee structure, contract terms and the assets in the portfolio. If the portfolio consists of short-term contracts with easy termination and no substantial termination fees, the value of the company will be discounted. On the other hand, if the portfolio consists of contracts with longer terms, where the ability of the owner to terminate without cause is limited, and where the owners in such circumstances will be obligated for substantial termination fees, there will be a premium placed on the value of the contracts, and therefore, the value of the company.

This model can work. With a disciplined focus on operations and a commitment to profitability, value can be realized through cash flow distributions. And, ultimately, value can be recognized for the shareholders through a sale to a larger hotel opco.

The "Propco" Option

The decision to raise capital and acquire hotels inside your operating company structure is complex. For one thing, acquisition and investment require different skills than operations. To make good investment decisions and attract capital, you need an understanding of capital markets, investment structures, and tax and legal capability. Although these are helpful in the operating context, they are not imperative to operating success. And, adding these skills to your team will cost money. If you determine to pursue an acquisition strategy, there is risk that you will have to fund the incremental costs, if the margins from your third party management fee income are insufficient to fund your acquisition team.

When you pursue an acquisition strategy, you will change the character of your company. Whether or not you acquire the assets directly inside the operating company structure or in affiliate partnerships, your focus will shift from the P&L to the Balance Sheet. The company valuation will be based on a combination of two elements – the valuation of your third-party management business as discussed above, plus the valuation of the real estate assets. In relative terms, the contribution to the enterprise value from the assets will dwarf the value contributed by the third-party management business. This reality will change the focus of your business. It will impact how you hire and train your people and how you allocate resources.

An important factor to consider is that you will most likely have third-party investors. This raises all kinds of new cultural and governance issues. The issues and concerns of your investors will be different from the issues and concerns of your third-party owners. How you allocate time, money and talent will become a central concern.

If you pursue this strategic direction, your operating team will need to be trained to think like investors. They will need to achieve a deeper understanding of how you make money on the asset side – how you build value in the asset and not just by creating fee income tied to gross revenues. Decisions on capital expenditures will take on a different perspective. How long will the assets be in the portfolio? Is this a long-term investment strategy or a short-term strategy? What return on investment can we expect on capital expenditures through the intended holding period? These are just some of the questions that you will address. There are many more.

Recommendations

If you have a hotel operating company and are considering pursuing an asset acquisition strategy, consider the following:

- Make sure you have the acquisition and investment skills available to you to enable you to evaluate acquisition opportunities, structure deals and create value;
- Educate your team on the nuances of asset ownership (as compared to third-party management);
- Develop a clear plan on an asset-by-asset basis to build value in the assets – focus on ROI;
- Be disciplined in adding third-party management contracts on a go forward basis. Be careful not to dilute your resources on contracts that do not add enterprise value;
- Try to completely understand the issues and concerns of your investors. To do so requires the presence of a workable governance structure and tools to effectively manage communication; and
- Add to your team only as the P&L permits – do not build a "field of dreams."

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