

Manchises – Nothing is more powerful than an idea whose time has come

In brief

This time last year we authored a newsletter entitled "[How do hotel owners and operators consummate their legal relationships](#)" That article featured a comparative analysis of the three most common ways that owners and operators engage legally being management agreements, franchises and less commonly, leases. The article also analysed manchises in comparison to the three other ways in which hotel owners and operators could contract with each other for the operation of a hotel.

Introduction

In late October 2023, we once again hosted our Masterclass at the HICAP hotel investment conference in Singapore. Baker McKenzie colleagues Dora Stilianos (Melbourne office) and Graeme Dickson (Sydney office) were joined by three of the top leaders in the industry in an exciting panel line-up - Patrick Finn, VP , Development, South East Asia and Korea, IHG Hotels and Resorts; David Simpson, Managing Director, Axsia HTL and Karen Wales, Head of Hotels Australia, Transaction Services, Colliers with Dora serving as the moderator. The panel enthusiastically discussed the potential for manchises to act as an enhancement to the traditional contracting methods by combining management agreements and franchises.

In our view there are strong arguments for owners and operators to seriously consider the use of manchises. In this newsletter we provide our views in support of this opinion as well as dealing with the potential shortcomings of a manchise.

The views expressed in this newsletter are those of the writers only and not any other member of Baker McKenzie nor are they to be taken as an expression of the views of the HICAP Masterclass panellists.

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What is a manchise and how could it work?

- A manchise, as its name suggests, is a fully negotiated and executed management agreement with an option to convert to a fully negotiated franchise agreement during the life of the management agreement. The franchise normally is an annexure to the management agreement (however can also be addressed in other ways). The need to have a fully negotiated franchise agreement is to ensure to the greatest extent possible that the option works as seamlessly and mechanically as possible without any need for further negotiation. In Australia, the franchisee/owner has the benefit of the Franchising Code of Conduct (e.g.,, cooling off period, initial and ongoing disclosures). The Code makes things a little more complicated but should still allow the option to be exercised either by co-operation between the parties or, as a last resort, by referral to a binding expert determination.
- The option to convert can be available to both parties or only to one party. However, we would envisage that it would be more commercially palatable if it is only exercisable by the owner. For the purposes of this newsletter we will assume that the option is only exercisable by the owner.

- The option can be exercisable from the date of execution of the management agreement or a later date. In our opinion it would be more commercially palatable for the option to be exercisable once the hotel ramp up period has come to an end and trading has stabilised – perhaps around year three or four. We will also assume that the option is only exercisable from year four.
- From the time that the option is capable of being exercised, the window of opportunity available to the owner may be drafted narrowly (e.g., a three month once and only window) or broadly (e.g., a number of years terminating, say three years prior to the termination of the management agreement). This window will depend on the importance of the conversion option to each party. In our view, a longer exercise period may provide greater flexibility for the owner however may not be acceptable to an operator who may prefer a limited exercise period for greater certainty around its long term planning and strategic goals for that hotel and the surrounding area.
- If the option is exercised then the term of the franchise agreement can be the same date that the management agreement would have otherwise terminated or drafted to extend the contractual relationship for a longer period. We will assume that the management agreement has a term of 10 years and that the franchise has the same term.
- The availability of a franchise also opens up the possibility of removing clauses from the management agreement that typically create negotiating tension between the parties (e.g., performance based termination provisions).
- The option to convert can be available to any owner during the term of the management agreement or available specifically to the initial owner.
- There is also the question of whether the owner should be required to pay a fee to the operator in consideration for the right to exercise the option and/or the actual exercise of the option. In our view, having this conversion option may be valuable to an owner and therefore should be associated with a fee payable to the operator. This of course will need to be considered against a number of factors including whether the option to convert lies with both parties or only one party.

What are the advantages of a franchise over a management agreement?

Owner perspective

- A franchise agreement gives the owner the opportunity to have operational control of the hotel once the ramp up period has ended without losing the other benefits that a management agreement provides (e.g., the brand, centralised services such as reservations and bespoke technical assistance). There are many reasons an owner may wish to adopt this course including:
 - (a) the desire to control the day to day operations of the hotel, particularly when the operator and/or the brand is new to the market. This however will need to be carefully considered particularly in circumstances where the owner has minimal operational experience or expertise which may in turn adversely impact hotel operations and therefore performance;
 - (b) the owner considers that the operator is not performing to its expectations and there are significant or insurmountable issues in exercising a performance based termination provision; and/or
 - (c) the owner would prefer to engage a "White Label" manager (i.e a manager which possesses operational expertise but does not have its own brand and hence is, for practical purposes, invisible to hotel guests and other members of the public). The costs of any "White Label" manager will need to be carefully considered against the management fees of the operator to ensure this is a commercially beneficial option.

- In circumstances of operator underperformance, the option to convert obviates the need to trigger a performance based termination provision in the hotel management agreement and avoids the potential to be drawn into costly and time consuming negotiation or even litigation if the owner and the operator cannot agree that the termination provision has been validly exercised. There is also the added risk that any relevant dispute settlement authority (e.g., expert, arbitrator or court) finds in favour of the operator and orders the management agreement to be reinstated or imposes a substantial damages award upon the owner.
- There is a potential to reduce the overall fee stream payable to the operator under a franchise agreement as compared with a management agreement, though this must be balanced with the additional fees and costs associated with any "White Label" manager or any internal costs (such as wages, training and development costs and increased administrative costs) should the owner decide to manage the hotel itself.
- If it is the case that franchises are a superior legal basis for the relationship between the owner and the operator then this should ultimately enhance (perhaps substantially) the sale value of the hotel.

Operator perspective

- The opportunity to operate another hotel within the area of restriction contained in the management agreement (franchises typically do not have such restrictions).
- The prospect of an additional fee or fees for granting to the owner the right to convert to a franchise and/or the exercise of such right. In our view, a fee or other valuable consideration should be payable to the operator for granting this right to the owner.
- If the term of the franchise is the same as or longer than the management agreement, the fee stream generated by the franchise potentially will be greater than a management agreement alone – not to mention the impact on profitability.
- In circumstances of operator underperformance, the risk of termination for poor performance is significantly reduced or eliminated (in the latter case, if the trade-off for entering into the franchise is the removal of any performance based termination provision in the management agreement). This then removes the potential of:
 - (a) the entire fee stream from the management agreement being prematurely eliminated by giving the operator the opportunity to earn franchise fees in lieu of management fees; and/or
 - (b) costly and time consuming litigation as mentioned above.
- The operator will not need the same level of corporate resources as the owner will be responsible for management.
- The operator's discount rate on franchise fees are typically lower than on management fees and, as above, the cost to deliver services is lower. Together this enhances the operator's return.
- If franchises enhance the sale value of a hotel then any operator who is prepared to contract on this basis arguably should, in our view, have enhanced prospects to obtain other hotel engagements from that owner as well as other owners in comparison to those operators who are not prepared to do so.

What are the disadvantages of a franchise?

Owner perspective

- The operator may be reluctant to allocate the best executive and/or operational staff to the hotel due to the potential that the owner may elect to convert to a franchise.
- The additional cost and time incurred in undertaking a full management agreement negotiation and a full franchise negotiation. However, typically negotiation of franchises is relatively simple, straight forward and

significantly less costly than management agreements. Additionally, there are other options to negotiating a full franchise agreement at the same time as the management agreement negotiations.

- The owner will need to demonstrate, either directly or through a third party manager or asset manager, that it has the requisite skills and experience to meet the franchisee's obligations under the franchise agreement (i.e. to operate the hotel in accordance with the Brand Standards).
- Potentially the cost of a franchise plus White Label management could be more costly.

Operator perspective

- The prospect of a conversion to a franchise may inhibit long term planning with respect to the hotel and also surrounding hotels managed by the operator depending on the significance of the hotel.
- The potential for a reduction in the fee stream. However as mentioned above this may not be the case.
- The additional legal and other costs and time incurred in negotiations as referred to above. However again, as mentioned above, this can be alleviated.
- To date, operators have shown a willingness to franchise in non-core locations and/or lower rating brands. There are some examples of larger CBD properties which are franchised but this is quite limited.

Practical experience

With all the advantages manchises seem to possess over management agreements and franchises you would expect their roll out to be flourishing. This could not be further from the truth.

In Australia, we are aware of only one instance (although there may be others) of a documented manchise, and that was a special case. It was a US based owner contracting with a US based operator. The parties had a pre-existing relationship in the US so when it came to the Australian hotel, they merely transplanted a US negotiated manchise and only changed it to accommodate the specifics of a change of jurisdiction from the US to Australia. The option to convert could only be exercised after a significant number of years after the execution of the management agreement and on only sale by the purchaser of the hotel. The franchise agreement was not annexed but was to be in a form reasonably acceptable to the operator based on the operator's Asia Pacific then current form conversion franchise agreement. Unfortunately, we did not get the opportunity to see how the manchise would operate in practice as the hotel was sold.

Realistically there are a number of reasons why the take up of manchises has been less than spectacular.

Arguably, manchises are more attractive to an owner than an operator when compared to a management agreement or a franchise – particularly if only the owner can exercise the option to convert.

The process of selecting an operator for a specific hotel can be very time consuming and complex. As part of this process operators usually shape the expectations of the prospective owner which includes the proposed contractual arrangement – which traditionally has been management agreement or franchise. The potential to add a manchise into the mix arguably further complicates this process and can lead to greater cost and time spent negotiating and finalising the deal. Given the scarcity of manchises in the Australian market, significant time and cost may also be required to educate a specific party on how a manchise would work in practice and in assessing the risks around this contracting model.

This is where we see a role for savvy commercial negotiators (who usually are also highly experienced hotel asset managers) engaged by a prospective owner to steer such owner through the negotiation process. As their experience and expertise in dealing with an operator is usually far greater than the prospective owner (particularly in the case of a

first time owner), it is our view that it is incumbent upon such commercial negotiators to consider the appropriateness and, if considered appropriate, raise the prospect of a franchise with the prospective owner as early as possible in the negotiation process.

Interestingly one very well respected US hotel industry expert commented after seeing a draft of this newsletter "What is being discussed in Australia [in regard to franchises] is so prevalent here in the US it barely rates a mention". To finish this section with a little war story, we are aware of one instance where a prospective owner of a new hotel elected to engage an operator for the hotel even though the owner had operational control of other hotels (and therefore significant operational experience and expertise). We suggested to the owner to consider a franchise rather than a management agreement on the basis that in our view a time would come, rightly or wrongly, when the owner would wish to takeover operational control of the hotel. That time came and there was a prospect that the parties would be off to court as relations soured. Ultimately, reason prevailed and the parties agreed to terminate the management agreement and enter a franchise. This process would have been far easier, less time consuming and certainly less costly if the parties had gone down the franchise route in the first place.

Summary and conclusion

"Change is inevitable. Growth is optional." (John C Marshall)

The hotel industry is forever changing. However to continue to attract new capital from a sometimes fickle but always demanding investment community (including sovereigns, institutions, private equity players, high net worths and others) and the lenders they rely on, it needs to grow. By that we mean it needs to aim to make investment in the hotel industry increasingly attractive in comparison to the plethora of other investment opportunities in property (e.g., commercial, industrial and residential) alternative investments and more broadly.

We consider that franchises assist greatly in the process of making hotel investment more attractive by making available another viable contractual alternative to management agreements and franchises. In fact in our view franchises have benefits as explained in this newsletter which arguably make it more attractive to the investment community than either a management agreement or a franchise.

We also consider for this reason that owners and the major international hotel management companies should strongly embrace franchises. The more investors there are with the intent to invest in hotels the more opportunities there are for owners to maximise sale price and for operators to grow their footprint and fee streams – perhaps exponentially.

Franchises – nothing is more powerful than an idea whose time has come. We could not have put it any better than Victor Hugo.

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