RESEARCH

THE POWER OF THE BRAND

DERIVING VALUE FROM INTERNATIONAL HOTEL OPERATORS

Q1 2015

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INCISIVE STRATEGIES, TOTAL CAPABILITY AND A RESEARCH LED APPROACH

As one of the most rapidly developing hospitality markets in the Middle East, recent years of supply expansion have seen an influx of international hotel brands to the Dubai landscape. The impact that a well-recognised brand has on operational performance is well-documented, with competitive advantage achieved through a combination of increased brand recognition, centralised services, efficient operations, and global capabilities. These advantages however, come at the cost of higher fees incurred on the part of the developer, both at the design stage and during operation. How to navigate such fees in order to achieve value maximisation for asset owners will be addressed in this paper.

Current landscape

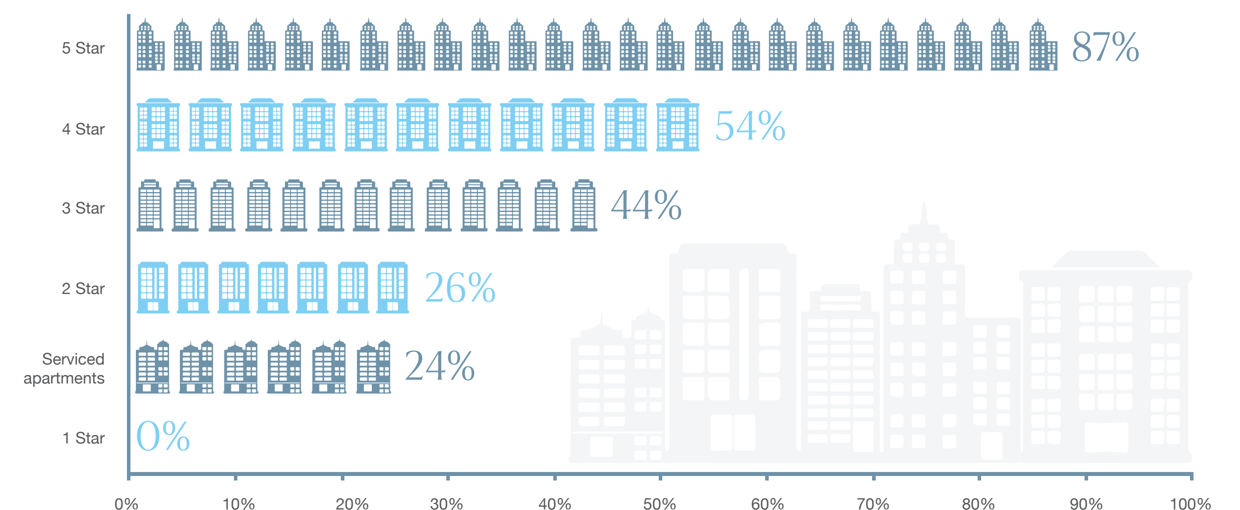
Where is the market gap?

Whereas in immature markets local players tend to dominate the hospitality market, this is not the case in Dubai, where international operators are responsible for operating approximately 61 percent of the aggregate hotel room supply. In the serviced apartment segment however, the figure is much lower; with international brands operating circa 24 percent of the existing supply. (Figure 1)

The strong penetration of internationally branded properties is a sign of a mature hotel market, comparable to that of North America (65 percent) and above Asia Pacific, Africa, Europe and South America which all fall below 50 percent. The majority of internationally branded stock is concentrated in the five-star segment, with progressively lower levels of penetration in the four, three, two and one-star categories, as demonstrated below.

If Dubai is broken down further by area, it is clear that prime locations such as the Palm, Dubai Marina and Downtown have a high penetration of internationally branded properties, whereas older areas such as Deira and Bur Dubai – which account for almost 41 percent of total hotel supply - have the lowest. A noticeable trend in the data is the undersupply of quality branded serviced apartments, not only on a market wide basis, but more specifically in the newer parts of town such as Dubai Marina, Jumeirah Lakes Towers and Barsha.

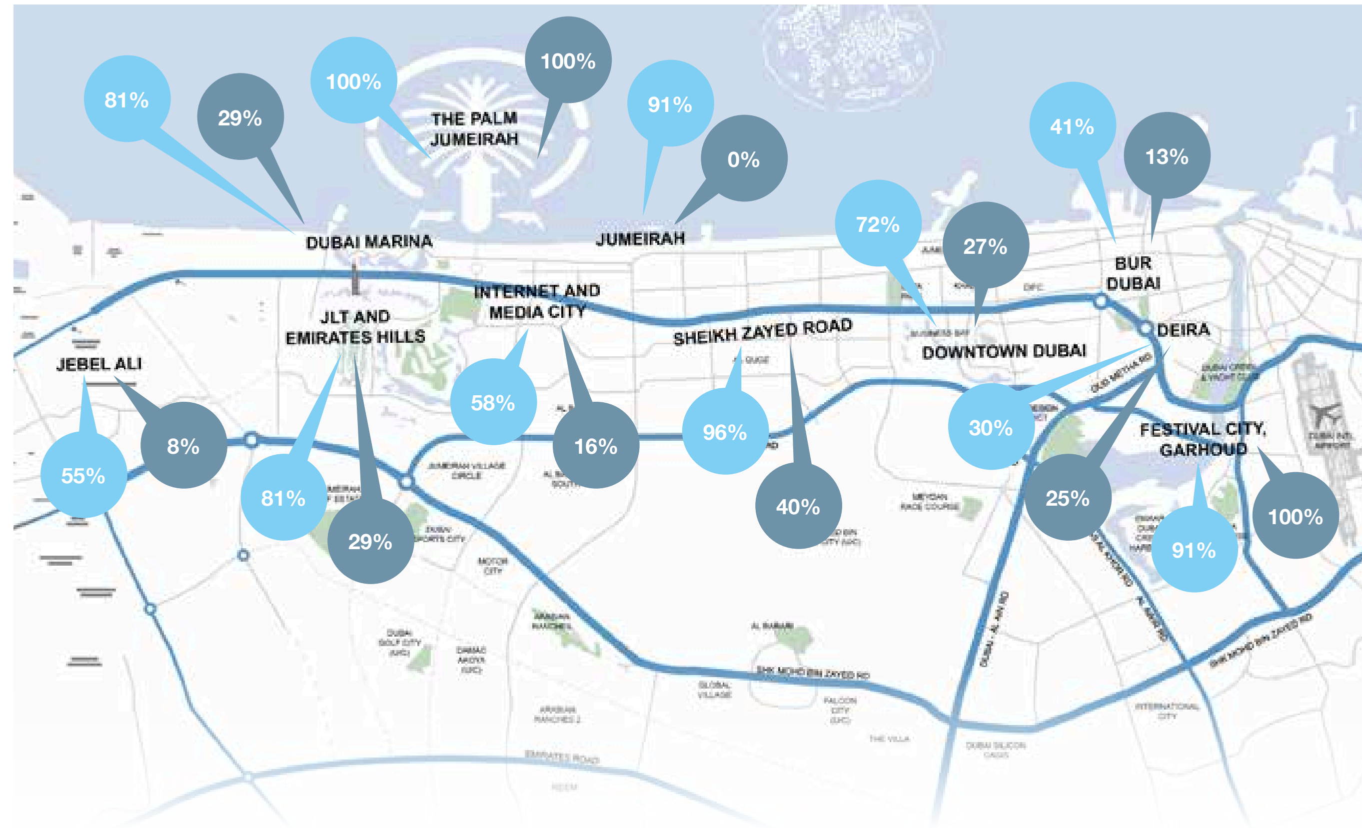
FIGURE 1
Hotel and serviced apartment brand penetration



Source: Knight Frank

FIGURE 2

Hotel and serviced apartment brand penetration by location



Location	International brand penetration		% of Total room supply
	Hotels	Serviced apartments	
Bur Dubai	41%	13%	14%
Downtown	72%	27%	7%
Deira	30%	25%	27%
Dubai Marina	81%	29%	9%
Festival City, Garhoud	91%	100%	5%
Jebel Ali	55%	8%	2%
JLT & Emirates Hills	70%	41%	2%
Jumeirah	91%	0%	3%
Palm	100%	100%	5%
Sheikh Zayed Road	96%	40%	9%
Internet and Media City	58%	16%	15%
Other	57%	0%	2%
Total	**61%**	**24%**	**100%**

Source: Knight Frank

Benefits of a well-recognised brand

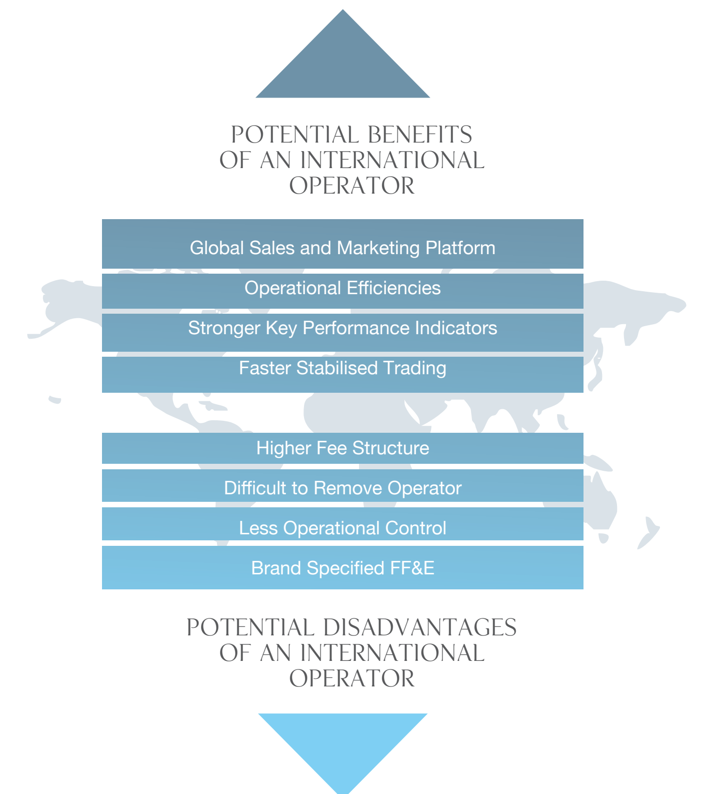
From the guest's perspective, the advantages of choosing a hotel or serviced apartment property managed by an internationally branded operator are lower perceived risks and search cost. In this sense, a customer familiar with a particular hotel brand will know what to expect from a property before even coming in contact with it.

From an owner's perspective there are several benefits of choosing an international operator. Stronger occupancy and Average Daily Rate (ADR) performance are primary benefits – and these have a direct and measurable impact on property value. However, there are also other implications such as access to a global sales and marketing platform, increased resilience through economic cycles and a compressed timeframe between hotel opening and stabilised operating performance.

Furthermore, owners are able to leverage from the experience of international operators in the form of operational efficiencies both at the property level, and also at the group level in terms of centralised distribution and procurement.

FIGURE 3

Advantages and costs of internationally branded operators



Source: Knight Frank

Four components of brand equity

The components of hotel brand equity that international operators are able to leverage from fall into four key components: brand awareness, brand loyalty, perceived quality and brand image as shown in Figure 4.

Brand awareness

Characterised by brand recognition or recall, brand awareness is likely to be high for internationally branded properties which have global market penetration and multiregional sales and marketing campaigns. As a central driver of brand equity, brand awareness represents a core component of international operators' competitive advantage.

FIGURE 4

Four components of brand equity

Source: Kim & Kim (2005)

Brand loyalty

Signalled by repeat purchasing behaviour, customers who have high brand loyalty will be less likely to switch to competitors and are the most frequent, high value guests a property may have. International operators are able to offer loyalty schemes and reward programmes in order to maintain their customer base in a way that locally branded properties cannot.

Perceived quality

Although there is a physical element to the hospitality industry, much of the perceived value is driven by the quality of service which feeds through to the customer experience. Perceived quality drives brand equity by assigning value to the guest experience, and in this way international brands have a clear advantage through established standard operating procedures.

Brand image

Brand image is a product of a guest's brand associations or perceptions that have been shaped by experience. While branded properties would generally have a positive brand image, as guests would have likely encountered them before in a different property or even country, locally branded or stand-alone properties would not be able to benefit from a brand image to the same degree.

Internationally branded **hotels** in Dubai achieve RevPAR premiums of **21-36%**

Calculating the premium – brand value

In order to quantify the premium, Knight Frank have taken the achieved Revenue Per Available Room (RevPAR) of a sample of internationally branded properties, and compared them to an unbranded/locally branded competitive set. Care was taken in selection to have a comparable sample both in terms of location and quality, the results of which are shown in Figure 5.

While the premium in RevPAR performance can be seen across segments, research indicates that internationally branded properties in the five star segment are able to drive the highest premium over locally branded hotel stock. While there are some exceptions to this trend - such as The Address - this generally applies across the emirate and highlights the importance of an international operator at the top end of the market.

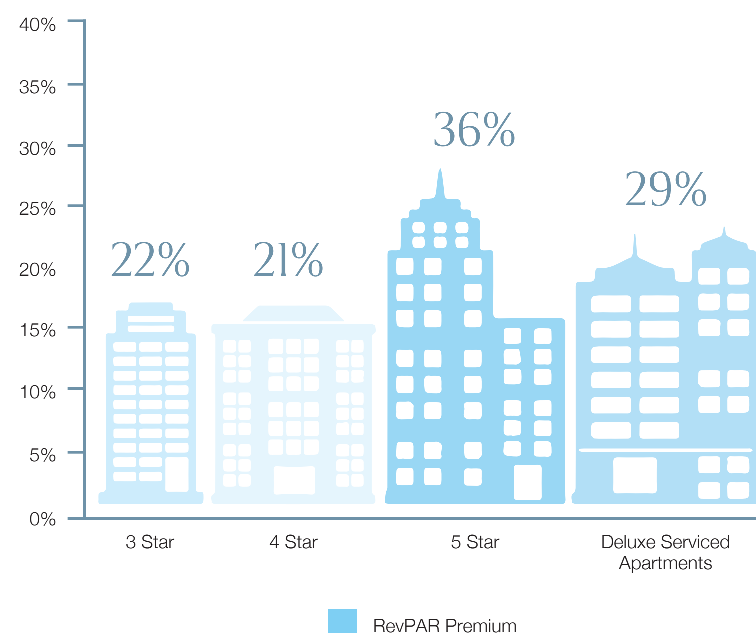
Although developers are often reluctant to engage international operators for serviced apartment developments, partially because they are seen to be less complex than full service hotels (due to lower guest turnover, lower staff to room ratios and fewer F&B outlets among other reasons) this belief may be misguided – particularly since internationally branded serviced apartment properties are able to outperform their locally branded counterparts by a significant margin.

Looking at the three and four star segments in which international brand penetration is modest, the RevPAR premium remains significant, indicative of the value that international operators can bring regardless of categorisation.

What are the costs, and where can developers save?

Although the premium on attainable RevPAR for internationally branded properties may range from 21 to 36 percent in Dubai, these benefits come with additional costs. Quantifying these costs depend on the type of owner-operator agreement and may differ depending on whether a franchise agreement, lease agreement, or management agreement is in place. Although franchise agreements have made their way to the Middle East - for example with recently signed Holiday Inn and Staybridge Suites in DWC - the most common form of deal structure in the region is the management contract which typically has the following main operational cost considerations.

FIGURE 5
Premium of internationally branded properties



Source: Knight Frank

Incentive fee

Taken as a percentage of Gross Operating Profit or Adjusted Gross Operating Profit (which is usually defined as GOP after Base Fee), incentive fees are usually a major point of negotiation between hotel operators and owners. These fees may be static or dynamic, and in many cases developers can negotiate a sliding scale depending on GOP profit percentage which helps align the interests of the property owner and hotel operator. For example, it is not uncommon to negotiate an incentive fee to increase as profitability ratios increase and fall (sometimes to as low as zero) as profitability ratios fall. There are also other mechanisms that owners can negotiate such as operator guarantees which can benefit developers and reduce their exposure to risk; however, these are almost never seen in standard hotel management agreements.

Base fee, licence fees & royalty fees

Typically calculated on total revenue, base fees can range from 1-3 percent depending on the hotel operator and asset class under consideration. Some hotel operators will only charge a base fee, while other may split the fees into base, licence and royalty fees.

Marketing fee

These are payable to hotel operators over and above the sales and marketing expenditure at the property level. They are generally used to cover operator head office and marketing costs, and therefore are typically difficult to negotiate. They may be calculated either as a percentage of rooms revenue or total revenue.

Reservation fee

While some hotel operators charge a flat fee on room revenue as a reservation fee, others charge a fee depending on what channels bookings may come through. Although this may seem favourable to hotel owners, such a fee structure does carry risk in the sense that the owner does not have control on how an operator may channel its reservations.

FIGURE 6
Typical commercial terms of hotel management agreements in the Middle East

Fee	Typical Fee Structure
Incentive fee	6%-9% of AGOP/GOP
Base fee	1%-3% of Total revenue
Marketing fee	1%-3% of Total revenue/rooms revenue
Reservation fee	0%-1% rooms revenue

Note I: GOP – Gross Operating Profit – Revenue minus Departmental Expenses and Undistributed Expenses. AGOP – Adjusted Gross Operating Profit – Revenue minus Departmental Expenses, Undistributed Expenses and Base Fee.

Note II: Base Fees typically include Royalty and Licence Fees, although some operators may charge them separately.

Source: Knight Frank

The brand equity associated with international hotel brands stemming from awareness, loyalty, perceived quality and brand image underscores the value that developers can achieve through partnering with international hotel operators. Although the fee structure of hotel management agreements may have a significant impact on profitability at the property level, there are many other aspects of such contracts that go far beyond these financial terms. Such examples include the contract term, performance tests, reciprocity, owner approvals, non-compete clauses and termination clauses, each of which may require extensive negotiations between developers and operators.

The strength of branded properties in Dubai are clear, with owners being able to achieve RevPAR premiums between 22 and 36 percent over locally branded and owner operated properties. Although there are certain costs involved with such partnerships, it is important to understand the terms of the contract and negotiate terms that align the interests of owner and operator.

Looking at other markets in the GCC such as Oman, Abu Dhabi, Saudi Arabia and Qatar, which have a lower brand penetration ratio than Dubai, it is worth noting that the benefits of internationally branded operators are applicable on a regional level. The key to driving value in such partnerships lie not only in negotiating the commercial terms, but also in examining the non-financial elements of hotel management agreements which may only come into play when properties are fully operational.

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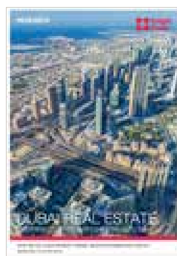

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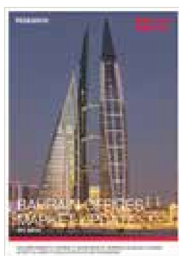

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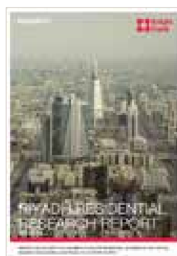

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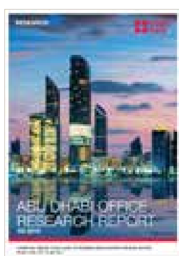

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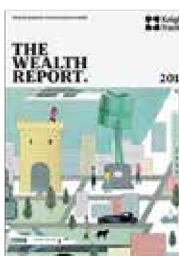

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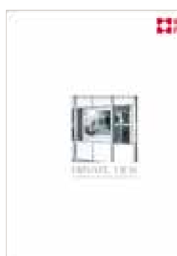

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