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Hotel Franchise Agreements Can't Be Negotiated. Is That True?

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Key Take: Brands themselves and industry participants describe hotel franchise agreements as non-negotiable, though in reality, with experienced legal counsel and strategic/financial advisors, there are several key terms that can be negotiated.

Negotiation of Hotel Franchise Agreements

The form hotel franchise agreement comes directly from the brand's lengthy Franchise Disclosure Document (FDD). Brands are reluctant to make changes to their form. With legal counsel, JF Capital has successfully negotiated over 125 hotel franchise agreements, and in each, we received concessions beyond the basic form. This was a function of knowing what is achievable in negotiations, and when those negotiations must take place. It is also driven by location, size, and profile of the hotel and the strategic and financial importance to the brand. We will examine some of the negotiated deal points that we regularly achieve, which differ from the franchise forms.

Royalty Fees on Rooms and on Food and Beverage Revenue for Selected Brands

It is usually possible to achieve what is referred to as a ramp up in the percentage of royalty fee percentages paid over the first few years of the franchise agreement, reducing the burden as the hotel is launching and stabilizing. For those brands that also charge a royalty on food and beverage revenue, it is sometimes possible to receive an annual dollar amount cap on that specific fee.

Radius Restriction/Area of Protection

Franchise agreements will often have a defined Area of Protection (AOP) specifying that for a certain number of years, the franchisor will not open another branded hotel within a specified radius or geographic area. The radius will vary greatly as the radius or distance in Midtown Manhattan will be substantially smaller than in suburban New Jersey. It is critically important to understand that the AOP offered will almost always be specific to the sub-brand, such that if negotiated for a Sheraton hotel, part of the Marriott brand family, the AOP would not apply to Marriott, Westin, Residence Inn, Le Meridien, Renaissance, or other Marriott brands.

Guaranty

The franchise agreement is guaranteed. If the specific guarantor is not negotiated upfront, the franchisor will generally assume and take the position that it is the sponsor or their affiliate, essentially a warm body with liquidity and net worth. If structured upfront, it is generally possible to have the property owner LLC or LP as the guarantor such that it is effectively non-recourse.

Loan to Value Limitations on Debt Financing

Some form franchise agreements have a limitation on the LTV on debt financing (often 75 percent LTV). It is possible to increase this or to remove the requirement entirely.

Right of First Offer/Right of First Refusal

Some franchisors have introduced Rights of First Offer (ROFO) or Rights of First Refusal (ROFR) on a proposed asset sale, benefitting the franchisor. It is sometimes possible to remove these encumbrances and simply provide a notice of any marketing or sales process.

Specific Window for Termination With Reduced or Minimal Fees

While rarer to negotiate, for newer brand launches and rollouts there is greater uncertainty in how successful the brand will be. With newer brands, it is sometimes possible to negotiate a “free” or discounted termination with minimal liquidated damages, after or during a certain window.

Select Situation Specific Transfer/Assignment Provisions

Each form license agreement has several pages on transfers. Often, they fail to address deal structures commonly utilized for hotel ownership and development. It is possible to insert specific transfer provisions that would facilitate a joint venture buy/sell or put/call provision, or readjustments of equity within the franchisee ownership.

Key Money

Key Money is widely misunderstood. Usually, Key Money is advanced as an unsecured loan with a franchisee guaranty. The Key Money loan has no interest rate and is coterminous with the franchise agreement. The franchisor will generally forgive a ratable portion of the Key Money loan each year so that by the end of the franchise term it is fully forgiven. Many are surprised that the funds are generally not advanced until after opening of the property, or completion of the detailed capex work. On sale or agreement termination, the balance of the Key Money loan must be repaid.

PIP — Property Improvement Plan

For an existing hotel, each franchise agreement will require a Property Improvement Plan (PIP). The PIP is issued as a scope document of work to be done and related timing, but without any financial estimates. The PIP is an exhibit to the franchise agreement and is guaranteed. The PIP can be up to 25 pages of scope items, including some which simply say “Replace” or “Make like new.” It is important to heavily negotiate the PIP prior to signing the Franchise Agreement. Working with an experienced operator, project manager, and contractor can facilitate an efficient negotiation of the PIP and can lead to large financial savings and minimize future challenges.

Conclusion

Working closely with experienced legal counsel and strategic advisors that regularly negotiate with the hotel brands, and doing so early in the process — at the term sheet stage, prior to submitting a franchise application — can yield surprisingly good results. While 95 percent of the text of the franchise agreement shown in the FDD doesn’t change, the few items that may are material and can drive substantial value.