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Case Study

Maritim, 2018: To cease or not to cease the lease

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Wednesday, February 14, 2018. The frozen roads surrounding his office in Bad Salzuflen, Germany, were the last concern of the Gerd Prochaska. The CEO of Maritimv had an important decision to make on Hotel Düsseldorf, one of its most important and profitable hotels. The hotel group has an acquisition right on the property that expires in late 2019 and Mr. Prochaska knew that one false step could not only put his position at stake, but also severely damage the performance of the group and the reputation that it gained over the last six decades. Maritim currently pays a rent of €10m per year for the hotel in Düsseldorf and the request from the group was for Deutsche Bank to structure an acquisition financing of the Düsseldorf hotel that, taking into account all costs, is cheaper than the sum of the current interest expenses and the €10m of rent paid every year.

Marriott, Intercontinental, Hilton and other high-end global hotel chains operate most of their hotels with "asset-light" operating models (**Exhibit 1**). In 2016, *Maritim Hotelgesellschaft mbH* (Maritim), a private hotel chain, operated 45 hotels worldwide, considerably less than its global public counterparts. Nevertheless, it has an impressive €121m of PP&E sitting in its balance sheet and relies on high capex levels to operate those hotels. In 2001, the group embarked on the acquisitions trail in its bid to continue its growth strategy outside Germany. The then spokesman for Maritim, Christian G. Windfuhr, said that the goal was to acquire good quality hotels in famous holiday destinations. The fact that the group was entering unchartered territory and that it had high growth plans, meant that the chain faced a very high cost of capital to compensate for the operational risk.

The pipeline was now different. The acquisitions were to take place in Germany where the group was already the operator. Maritim considered exercising the acquisition rights it had for several hotels where the group was a tenant. Mr. Prochaska was, however, particularly concerned with the one that could have the biggest impact in the group: the right to acquire the

hotel in Düsseldorf for €150m. Back in February 2018, Mr. Prochaska requested *Deutsche Bank* (DB) to structure an acquisition financing of the hotel. For him, the financing conditions of such operation could make or break the decision of adopting an operating model based on property ownership versus an “asset-light” one.

About the group

The Maritim group is family-owned. Dr. Monika Gomolla, one of the owners, serves as Chairman of Supervisory Board at *Maritim Hotelgesellschaft mbH* and as an Executive Director of HMS International Hotel GmbH. The company attributes its early success to the fact that it has been present at prime locations in the Federal Republic of Germany since the opening of the first hotel in the late 60’s and to the fact that it offers extensive congress and event capacities. The group has a sound name in the industry and has been known for many years as one of the best German hotel chains. The comprehensive hotel portfolio includes hotels located in city centres, airport hotels, sport-focused hotels and resorts. The market segments of "business travelers" and "meetings and congresses", which are of prime importance for Maritim, accounted for 62.9% of the turnover and 55.8% of the occupied rooms.

Besides the brand licencing and the sourcing of hotel management agreements, Prochaska’s strategy of expanding the portfolio of Maritim operated hotels is also based on the acquisition of existing hotels and on the construction of new ones. Some of the acquired or built properties are sold to infrastructure investors and then leased back. Others are sold and managed thereafter with an Hotel Management Agreement (HMA). In 2017, Maritim Hotelgesellschaft mbH operated 45 hotels with a total capacity of 14,844 rooms in the financial year of 2016. Out of the 45 hotels, 7 were run as through HMAs, 8 through franchise agreements, 15 as leased properties and another 15 as owned properties **(Exhibit 2)**. Of the 22 hotels that Maritim operates as tenant or manager, 3 are owned by companies in which Maritim has a significant

stake. In 2016, a total of €15m was invested in the acquisition, maintenance and improvements of properties managed under Maritim's brand **(Exhibit 3)**.

Hotel chains worldwide face pressure from shareholders to turn their business into an asset-light one and substitute hotel ownership for leases[1], HMAs and franchising models. The question that the management of the hotel chain often comes up with is not whether a model is better than another but whether a given model for a given hotel makes sense. The operating company (Opco) *Maritim Hotelgesellschaft mbH* currently pays €28m in a Triple Net[2] 20-year agreement to the 15 property companies (Propcos), the entities that own the hotels. In addition to the €28m in annual lease payments, the opco also pays €1-2m per year in maintenance costs.

Recent developments

The onboarding of this German hotel group to *Deutsche Bank* (DB) started in April 2016, when DB was asked to provide financing for the purchase of an hotel in Magdeburg, in the south of Germany. The purchase price for the hotel that had negative EBITDA was €56m. Ultimately, Mr. Prochaska and his team decided against buying the hotel and instead acquired a 14% stake in the holding company of the property, which was later increased to 21%. In 2018, Deutsche Bank was asked to provide financing for the purchase of the hotel in Köln. The purchase price for this hotel was €180m, 14x rent.

Now, with one of the most important acquisitions rights expiring relatively soon, Prochaska wanted to be sure that the €150m acquisition right for the hotel in Düsseldorf was worth exercising. The group had other cards on the table such as the option to extend the current

[1] Under the German GAAP, a rental expense under an operating lease is currently recognised as a P&L item on a straight-line basis over the lease term and the contracted leasing as an off-balance sheet item. However, from January 2019 onwards, companies covered by the IFRS 16 are required to record operational leases as a liability and the "right to use" the asset as a depreciable asset, even if the company does not own the asset. Nevertheless, according to a study made by HVS, a variable lease payment contract or a one-year leasing with extension clauses avoids that the lease is reported as a liability, which might allow this operating model to survive in the European Union.[x]

[2] Leasing contract that stipulates that the tenant shall bear the costs related to the leased asset, in addition to the rental fee.

leasing agreement and the possibility to negotiate an HMA or find a third-party operator (TPO) and, at the same time, negotiate a franchising agreement with the owner. Mr. Prochaska had the objective of knowing whether it was possible to structure an acquisition financing that made owning an hotel the best choice when compared to other existing operating models. After all, by owning the property, the hotel group instead of paying annual leases, can partially or wholly finance a hotel with debt, with a financing structure that increases the free cash flow of the group by having a new annual debt service lower than the sum of the lease payments and the current debt service[3] **(Exhibit 4).**

In the financial year of 2017, the 33 Maritim hotels located in Germany were able to increase their operating profit by 5.8%, the average room rate from €131.60 to €139.20, the average occupancy rate from 63.5% to 65.3% and the turnover from €375m to €385m **(Exhibit 5)**. The total turnover of all hotels managed under the brand name Maritim also improved to €472m[4] when compared to the previous year. A positive development is particularly evident in the "Turkish Riviera" / Belek region. In the Egyptian destinations on the other hand, no increased booking volume is noticeable. In Egypt and Turkey, Maritim is either a franchisor or operates the hotels through management contracts since the hotel chain considers that the real estate sector is too volatile in the region. The Maritim hotels in Mallorca, Tenerife and Mauritius achieved a particularly good result in 2017.

The average room rate at Maritim has improved by €2.48 compared to the previous year and stands at €98.35. Room occupancy in 2016 increased by 4.76% and the RevPAR[5] increased by 7.47%. Before that, in 2016, the hotel chain had a comprehensive renovation across the hotel portfolio. Examples include the general refurbishment of Maritim Hotel Stuttgart completed in August 2016 and the renovation of the hotel in Ulm in April 2016 costing €8.3m and €7.4m,

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[3] Includes the repayment of principal.
[4] This turnover figure is consolidated under *HMS hotel management services international* and includes revenues from non-German hotels.
[5] *RevPAR* or revenue per available room, is a performance metric in the hotel industry that is calculated by dividing a hotel's total guestroom revenue by the room count and the number of days in the period being measured.

respectively. As of February 2016, the Hotel in Königswinter underwent a complete renovation that was completed by May 2017. All these remodeling and renovation works were carried out while the business was running.

The hospitality industry

One of the factors that affects the choice of the hotel operating model is the forecasted demand growth of the sector. If a very cyclical demand is anticipated, franchise and management agreement will be preferred over leases and property ownership-based models. Following the financial crisis, enormous growth of investment projects has taken place in the German hotel industry. Better conditions in the financial markets, a recovery in hotel performance and the VAT reduction for hotel accommodation in the beginning of 2010 released a previously unknown investment power in the German hotel industry, which manifested itself in 2016 with a new peak. In 2016, 5,665 investment projects were recorded in Germany. According to the IHA hotelmarkt 2017 report [i], the average German hotel industry's RevPAR in 2016 was €66 in 2016, slightly above the European average of €65. According to the latest *Meeting and Event Barometer 2015/2016*[6], Germany continues to rank at the top as the conference destination with more popularity among the surveyed organizers worldwide.

Despite this, Mr. prochaska was worried about a new type of competition and he had reasons for that. Airbnb, a leading online platform for hospitality services, started a partnership with a real estate developer to launch its own branded-apartments whereby the real estate developer, who owns the property, will rent out the apartments to private tenants[ii]. Unlike hotel operators, Airbnb will not manage the operations in the property nor is charging the real estate operator (Newgard) for the use of its brand. According to Financial Times[iii], the online platform is expected to take 3% of the nightly room rates, the exact same commission it currently charges

[6] *The Meeting & Event Barometer* is a study that examines the event and conference market in Germany on an annual basis.

hosts through its platform. The real estate developer will take 25% of the same room rate, with the rest going to the tenants who are in charge of subletting the apartments. The platform seems to be quite optimistic in being successful with such strategy, given that they want to take home-sharing to everywhere in the US. If the expansion strategy is indeed successful, it should be a matter of time until they start selecting attractive neighborhoods in Europe. Despite overcapacities and the resulting cutthroat competition, the willingness to invest in hotel projects in Germany remains high. In its industry report 2017, the International Hotel Association points out that the focus of the planned investments in new hotel projects in 2016, as in previous years, was in the 3- and 4-star segment. In total, 85,115 new hotel rooms in Germany are planned within the next three years, of which a total of 38,092 rooms are in the 4-star category. In the 3-star segment, 22,997 new rooms are currently being planned. This additional occupancy potential of 61,089 rooms will further intensify competition in the 3- and 4-star segment.

Financial position and financing proposal

Even though the group had high PP&E in its balance sheet, the group was not over levered. On the contrary, the opco *Maritim hotelgesellschaft mbH* had €38m **(Exhibit 6)** of debt in 2017. With cash standing at €40m and an EBITDA of €43m, the firm was levered at Net Debt/EBITDA ratio close to 0x. Even with this almost non-existent leverage, the group was still paying an average interest rate of 5.0%. In 2017, this resulted in interest expenses of €1.2m. The rent of the 15 internally leased hotels is currently transferred to the international holding company in order to support the debt service of the holding. This junior debt, usually referred to as holdco debt, is a mezzanine piece. This is a subordinated debt element structurally subordinated to the debt sitting at the opco and propco levels (at the operating entity and property levels, respectively) and has a risk premium[7] of 620bps. The indebtedness of the HMS

[7] Difference between the junior interest rate and senior interest rate.

holding was €320m in 2017. With a cash amount of €48m and an EBITDA of €75m, the holdco had a net leverage of 3.6x.

The tenor of the current financing package for the 15 propcos of the group varies between the respective loans, but in the year of 2018 €28m of debt was outstanding, resulting in a net debt ratio of –0.6x based on 2016's EBITDA. In case the acquisition is the chosen route, Maritim clearly has the capacity to leverage at the propco level.

The group does not have cross default[8] nor cross acceleration[9] covenants in its current financing structure. Therefore, the consequences of a contract breach[10] would have little impact on other affiliates, apart from the potentially damaged brand and from the impossibility to operate the hotel where the breach happened. To finance the purchase of the hotel in Düsseldorf, Deutsche Bank estimated a financing volume of up to €180m, of which €150m (15x rent) correspond to the purchase price and €30m to 20% of the purchase price for fees and other costs. This amount does not include the replacement of the existing financing on the hotels in own possession of around €28m. Mr. Prochaska was, thus, seeking a financing amount of €208m from DB. With a pro-forma EBIDAR of €48m, this financing would result in a gross adjusted ratio of 4.3x[11].

A traditional standalone financing would not work since the acquisition price is higher than the current market value of the property.

This estimated financing volume is divided into a senior and a subordinated tranche. The senior tranche bears an interest rate of around 3% and the structurally subordinated tranche bears interest rate of around 9%. The exact amount of savings that result from the refinancing and top-up financing depends on the acquisition price. Nonetheless, the increase in interest expenses is not proportional to the increase in the financing amount given that, in this case, the weighted

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[8] C*ross default covenant* is a non-financial covenant that triggers the default of all of the group if any of the controlled subsidiaries defaults.

[9] C*ross acceleration covenant* is a non-financial covenant that allows a lender to require the group to repay all of the lender's outstanding debt. It differs from the cross-default covenant since the group does not enter into technical default.

[10] Such as the inability to pay leases to the hotels where the group is the lessee.

[11] (Bank debt + Factoring + Operational Leases + Provisions) / EBITDAR

average interest rate is not the same for all financing amounts. For a given collateral value, the maximum amount of senior debt is a fixed percentage of the collateral. Therefore, the bigger the financing above this maximum value, the bigger the junior tranche and, thus, the increasingly lower the savings.

To fulfil Prochaska's request in the best possible way, Deutsche Bank proposed a structure in which the owned hotels and the hotel in Düsseldorf are combined in a ring-fenced[12] propco structure to serve as collateral. This ring-fenced structure would allow the financing of the acquisition as well as the refinancing of the existing financing of the hotels in own possession with annual interest payments of approximately €9m. To get a mortgage lending value of the real estate, a rent multiple of 10x[13] was estimated[14]. In this case, the average rent of the leased properties as a percentage of EBITDAR is 83.3%, which yields a collateral value of €258.3m[15], given the €19m 2016 EBITDA of the owned properties and the €10m of annual leasing payments of the Hotel in Düsseldorf. With 60% being the maximum senior LTMLV[16], if 60% of the collateral value is higher than the total financing, this deal could be financed entirely with senior debt. Therefore, the bigger the rent multiple and the estimated total rent, the bigger could be the savings.

All collateral would be valid at the level of the Opco as well as at the level of the Propco. This meant that all the hotels required priority and subordinate land register entries. For the above considered €208m of financing, the senior tranche (60% of the collateral) is €155m and the subordinated tranche €53m. With a cash balance of €40m and an EBITDAR of €31m, this resulted in a net leverage of 5.4x and in a weighted average interest rate of 4.5%. Individual

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[12] *Ring-fencing here* is defined as a requirement from the lender to limit the transfer of cash and other assets within a certain perimeter of a group of companies. In this case, the transfer of assets is limited between the collateralized hotels and the other hotels and/or entities of the group.

[13] The adopted multiple was based on internal information from previous transactions in the sector in the DACH region.

[14] Since the collateralized hotels are owned by the group, a "fictitious" rent value has to be estimated. In real estate valuation, rent is an industry standard base multiple for hotel valuation purposes. Given that hotel lessors require a certain yield for a given location risk (cyclicality, environmental, etc.), rent is usually a feasible indicator of profitability.

[15] Collateral = rent multiple * (Düsseldorf annual lease + estimated rent of remaining hotels) .

[16] *Loan to Mortgage Lending Value.*

assets could be sold if the LTMLV after the transaction was not above a threshold of 80%. If this were the case, part of the sale proceeds would have to be used for debt repayment, so that the LTMLV could be below this threshold. Moreover, a majority stake sale of the group would not necessarily lead to a repatriation or refinancing of the loan. This gave Prochaska some room for maneuver and the CEO just wanted to make sure that at the opco level, the remaining EBITDA from franchised and managed properties could be used to raise additional capital without being subject to this LTMLV threshold.

The shares of Maritim's opcos and propcos would be pledged[17]. This covenant, very used in the UK as a lender protection, cannot, however, be "used" to its full potential under German law[18], given that Deutsche Bank can only sell the pledge shares once the company is under administration in court. The bank would, therefore, be exposed to volatility in the share price until the process is settled. Other financial covenants would include Debt Service Coverage Ratio, Debt/Market Value, Debt/Lending Value and Net Debt/EBITDA. A cash sweep covenant[19] would be used as a metric for a potential additional repayment. Mr. Prochaska was now in position to evaluate the pros and cons of the acquisition.

Time to make a choice on Düsseldorf

The clock was ticking for the hotel group. Mr. Prochaska needed to know whether the acquisition was the best strategy to adopt in order to operate the hotel. At first sight, given the considerably lower needed capex, an asset-light model seems to be more attractive from a relative return perspective when compared to an asset-heavy one. However, a number of asset-light companies from several industries are opting for a "not so light" model. UBER, for

[17] *Share pledge* can be understood as a non-financial covenant that, depending on what is contractually agreed, allows the lender to sell a certain number of shares - usually just enough to cover the outstanding principal.

[18] According to Mayer Brown, a global law firm, under German law, the lender must apply for foreclosure measures at the relevant court. A forced sale can only be achieved by way of auction upon enforcement of the land charge. Enforcement of land charges will be carried out by the lender in accordance with the German foreclosure law (Zwangsversteigerungsgesetz, ZVG) by way of a forced auction (compulsory sale) of the property (Zwangsversteigerung).

[19] *Cash sweep* is the mandatory use of a certain amount free cash flow to repay part of the outstanding debt.

instance, is now buying 24,000 XC90s Volvo cars to implement the autonomous driving technology that it has been developing to compete with WAYMO[20] and Tesla[iv]. Amazon acquired Whole Foods in 2017, increasing considerably the PP&E in its balance sheet. Farfetch, one of the leading premium fashion e-commerce companies is looking to open its first branded physical stores with the project "store of the future". Flixbus, a leading low-cost inter-city bus service used to rent all of its buses until recently when they started to buy the vehicles to include in the fleet. In the hospitality sector, it is not clear whether the advantages of not owning any properties overcome the generally lower profit upside potential.

Moreover, with DB's proposed financing, Maritim would save about €2.5m annually over the term of the loan of 7 to 8 years. If one-time costs and prepayment penalties are added to the new financing expenses, the total cash-flow savings would be approximately €15m over 8 years. If after these 8 years the group manages to be refinanced, a similar amount of annual savings should be expected.

For the owned hotels, a market and mortgage lending valuation would have to be prepared in order to finalize the financing structure. Other advantages of the refinancing included having a lender that could proactively follow the business model and that is aware of future projects, thereby avoiding conflicts among different creditors and Maritim. One alternative to owning the hotel would be extending the leasing contract and continue operating it under a leasing agreement. The tenant, Maritim, could then choose to either operate directly the hotel or subcontract operations through a third-party operator. Infrastructure investors and private investors usually do not have the expertise to operate a hotel, and thus, they decide to hand over the operations and receive instead a more stable cash flow: the rent. This cash flow is, however, less stable than what one may think since hotel operators can always try to negotiate the conditions of the lease.

[20] Waymo was formerly known as *Google self-driving car project.*

"Personally with leases I have bad experiences. When it's very good, it's very good, but when it's bad the operator tends to come to you to renegotiate the lease." [v]

Edward Wojakovski - CEO of Tonstate Group Ltd

HMA and franchising agreement as alternatives for Düsseldorf

"Although asset-heavy business models, such as owner-operated hotels, allow tighter control over hotel operations, the managed and franchised models offer quicker growth due to lower capital investments. However, they require strong relationships with third-party hotel owners."

– IHA Annual report 2017[i]

An HMA was seen as an alternative by Mr. Prochaska for the current lease of Düsseldorf. On the one hand, Maritim would keep the exact same operations and stop paying the rent. On the other hand, Maritim would stop receiving the full revenue of the hotel and would start receiving a fee that is a small percentage of those same revenues. This fee is composed of a management fee that, in most of the cases, is around 2% of the revenue and an incentive fee equal to a percentage of any increase in revenue over the previous year **(Exhibit 7)**. Nevertheless, some operators try to win management contracts by having fees substantially below the industry average.

The fact that the hotel manager is in charge of the operations does not preclude the owner from bearing the operational risk. In fact, in an HMA, it is usually the owner that bears such risk (including staffing/human resources). For an HMA to be as symbiotic as possible, it is important to have an alignment of interests, which in reality does not always exist. The misalignment can exist at two levels: economic value added and profit margin. If the managing entity is compensated with a fee entirely based on revenues, there is a risk that the marginal ROIC is

inferior to the cost of capital of the owner and that unnecessary operational expenses incurred to have small increases in the top line plunge the profit margin.

Another alternative for Mr. Prochaska is finding a third-party operator ("TPO") for the hotel and at the same time trying to negotiate a franchise agreement with the current owner of hotel in Düsseldorf. With regards to the franchise model, the owner of the property, who is also the franchisee, would have the right to use Maritim's brand, the distribution network and other intellectual property of Maritim. In contrast with the HMA, in the franchising agreement the owner retains control[21] of the property. Nevertheless, the owner could always choose to have a third party who is usually owner-facing (i.e. profit maximizer) to operate the hotel. This third-party operator (TPO) can be essential if the owner has limited experience, given that the TPO can bring a rigid budgeting strategy and be more efficient. As with the HMA, the franchising agreement requires careful consideration when negotiating the fee structure.

[21] *Control* in this context means being responsible for the hotel operations.

Exhibits

Exhibit 1 – Hotel portfolio of global chains discriminated by operating model

		Owned & Leased		Managed		Franchised		Total
	Year	Rooms	% Portfolio	Rooms	% Portfolio	Rooms	% Portfolio	Rooms
Marriott	2014	9,879	1.4 %	303,341	42.4 %	401,545	56.2 %	714,765
IHG	2014	3,190	0.4	192,121	27.0	514,984	72.5	710,295
Hilton	2013	61,670	9.1	150,318	22.2	466,642	68.8	678,630
Accor	2014	186,468	38.7	162,171	33.6	133,657	27.7	482,296
Starwood	2013	15,900	4.7	189,900	56.0	133,400	39.3	339,200
Hyatt	2013	28,039	19.4	84,919	58.8	31,441	21.8	144,399
Rezidor	2014	17,538	22.9	41,339	54.0	17,732	23.1	76,609
Total Rooms		**322,684**	**10.3 %**	**1,124,109**	**35.7 %**	**1,699,401**	**54.0 %**	**3,146,194**

Source: HVS research, Annual Reports

Exhibit 2 – Financing scope of the acquisition of the hotel in Düsseldorf

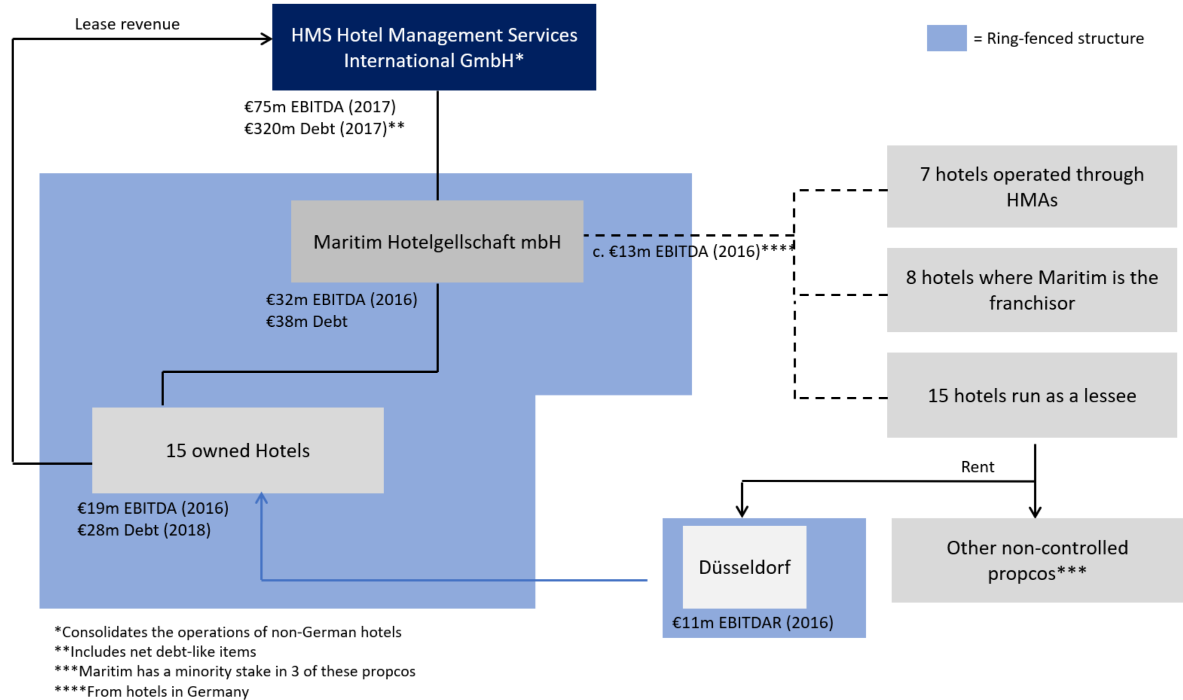

Exhibit 3 – Consolidated cash flow statement of Maritim Hotelgesellschaft mbH

Cash Flow Statement

thousand €	**2017**	**2016**	**2015**
Cash flow from operating activities	33,139	21,508	21,231
Cash inflow / outflow from investing activities	-13,609	-15,032	5,847
Cash inflow / outflow from financing activities	-5,196	696	-27,626
Changes in cash and cash equivalents	**14,334**	**7,172**	**-548**
+ Cash and Cash equivalents at the beginning of	25,937	18,765	19,313
= Cash and Cash equivalents at the end of the period	**40,271**	**25,937**	**18,765**

Exhibit 4 – Opco debt repayment - Status quo vs DB Scenario

Status quo											
€m	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**
Propco debt	24,5	23	26,3	21,5	15,9	11,3	4,6	3,1	1,9	0,7	0,1
Interest	4,8%	4,9%	4,7%	4,7%	4,7%	4,7%	4,7%	4,7%	4,7%	4,7%	4,7%
Interest payment	1,2	1,1	1,2	1,0	0,7	0,5	0,2	0,1	0,1	0,0	0,0
Düsseldorf Lease	10,0	10,0	10,0	10,0	10,0	10,0	10,0	10,0	10,0	10,0	10,0
Total costs	11,2	11,1	11,2	11,0	10,7	10,5	10,2	10,1	10,1	10,0	10,0
Debt service				15,8	16,3	15,1	16,9	11,6	11,3	11,2	10,6

Deutsche Bank scenario									
€m	**PF 2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**
New debt (previous debt + acq. cost)	206,3	202,2	198,0	193,9	189,8	185,7	181,5	177,4	173,3
Senior trache	166,8	163,5	160,1	156,8	153,5	150,1	146,8	143,4	140,1
Interest	3,0%	3,0%	3,0%	3,0%	3,0%	3,0%	3,0%	3,0%	3,0%
Interest payment	5,0	4,9	4,8	4,7	4,6	4,5	4,4	4,3	4,2
Junior tranche	39,5	38,7	37,9	37,1	36,3	35,6	34,8	34,0	33,2
Interest	9,0%	9,0%	9,0%	9,0%	9,0%	9,0%	9,0%	9,0%	9,0%
Interest payment	3,6	3,5	3,4	3,3	3,3	3,2	3,1	3,1	3,0
Upfront fee	5,2								
Prepayment	3								
Overall cost	**8,6**	**8,4**	**8,2**	**8,0**	**7,9**	**7,7**	**7,5**	**7,4**	**7,2**
Savings	**-5,5**	**2,6**	**2,5**	**2,5**	**2,3**	**2,4**	**2,6**	**2,7**	**2,8**

KPIs									
EBITDAR (Opco)	34,9	34,9	34,9	34,9	34,9	34,9	34,9	34,9	34,9
Rental Income	27,8	27,8	27,8	27,8	27,8	27,8	27,8	27,8	27,8
Net operating costs	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Capex	1,0	1,0	1,0	1,0	1,0	1,0	1,0	1,0	1,0
Interest senior	5,0	4,9	4,8	4,7	4,6	4,5	4,4	4,3	4,2
Interest junior	3,6	3,5	3,4	3,3	3,3	3,2	3,1	3,1	3,0
Principal repayment senior		3,3	3,3	3,3	3,3	3,3	3,3	3,3	3,3
Principal repayment junior		0,8	0,8	0,8	0,8	0,8	0,8	0,8	0,8
Debt service	**8,6**	**12,5**	**12,3**	**12,2**	**12,0**	**11,8**	**11,7**	**11,5**	**11,3**
Savings	**-5,5**								

Savings Sensitivity

		Collateral multiple						
Acquisition cost	14,9	8,5	9	9,5	10	10,5	11	11,5
	165	13,7	17,8	22,0	26,1	30,3	34,4	38,6
	170	10,0	14,1	18,3	22,4	26,5	30,7	34,8
	175	6,2	10,4	14,5	18,7	22,8	27,0	31,1
	180	2,5	6,7	10,8	14,9	19,1	23,2	27,4
	185	-1,2	2,9	7,1	11,2	15,4	19,5	23,6
	190	-4,9	-0,8	3,3	7,5	11,6	15,8	19,9
	195	-8,7	-4,5	-0,4	3,8	7,9	12,1	16,2

Acquisition cost	180,0
Collateral	278,0
Senior tranche (in % of LTMLV)	60,0%
Düsseldorf lease	10,0
Interest senior	3,0%
Interest junior	9,0%
Amortization senior	2,0%
Amortization junior	2,0%
Fees	2,5%
Savings	**14,9**

Exhibit 5 – Consolidated income statement of Maritim Hotelgesellschaft mbH

Income statement

€	**2017**	**2016**
1. Sales	385,990,736.94	374,892,973.32
2. Increase in holdings of unfurnished properties for sale	335.105,72	29.861,24
3. Other own work capitalized	124,539.03	113,069.17
4. other operating income	6,005,926.90	7,147,433.75
Total revenue	**392,456,308.59**	**382,183,337.48**
5. Cost of materials		
a) Expenses for goods	31,789,365.59	31,183,408.90
b) Expenses for purchased services	335,105.72	29,861.24
Sub-total	**32,124,471.31**	**31,213,270.14**
Gross Profit	**360,331,837.28**	**350,970,067.34**
6. Personnel expenses		
a) Wages and salaries	101,814,632.59	100,346,053.45
b) Social Security and Pension Expenses	20,525,993.58	20,138,237.69
Sub-total	**122,340,626.17**	**120,484,291.14**
7. Amortization of intangible assets and property, plant and equipment	13,233,575.31	10,082,299.74
8. Other operating expenses	195,243,913.69	199,205,186.81
Total SG&A	**330,818,115.17**	**329,771,777.69**
EBIT	**29,513,722.11**	**21,198,289.65**
9. Income from investments	706,136.46	1,046,208.91
thereof affiliated companies	703,810.13	683,297.66
10. other interest and similar income	620,794.50	1,123,616.95
thereof affiliated companies	211,510.06	261,334.73
11. Interest and similar expenses	6,138,523.16	6,572,690.58
of which interest accrued	301,683.94	433,715.20
12. Taxes on income	8,423,807.01	5,817,553.35
thereof from the change in deferred taxes	-1,641,519.00	-1,414,758.00
13. Earnings after taxes	16,278,322.90	10,977,871.58
14. Other taxes	2,389,641.09	2,419,167.68
15. Expenses from partial profit transfer agreements	139,300.00	165,140.00
16. Net income	**13,749,381.81**	**8,393,563.90**
17. Profit carried forward	33,194,939.60	24,801,375.70
18. Retained earnings	**46,944,321.41**	**33,194,939.60**

Exhibit 6 - Consolidated balance sheet of Maritim Hotelgesellschaft mbH

Balance sheet

€ **Assets**	**31.12.2017**	**31.12.2016**
A. Fixed assets		
I. Intangible assets		
Industrial property rights and similar rights acquired for a consideration and licenses to such rights	224,485.00	210,715.00
II. Property, plant and equipment		
1. Land, land rights and buildings, including buildings on third-party land	181,398,733.00	184,172,588.00
2. other equipment, operating and office equipment	3,779,544.00	3,729,375.00
3. Advance payments and assets under construction	251,231.18	61,352.75
Sub-total	**185,429,508.18**	**187,963,315.75**
III. investments		
1. Shares in affiliated companies	7,636,654.49	6,859,996.81
2. Loans to affiliated companies	28,827,024.26	25,478,472.26
3. Participations	9,970.19	11,937.73
4. Loans to companies with which an equity interest exists	1,539,870.30	2,784,072.00
5. other loans and shares in cooperatives	7,550.00	7,800.00
Sub-total	**38,021,069.24**	**35,142,278.80**
Total fixed assets	**223,675,062.42**	**223,316,309.55**
B. Current assets		
I. Supplies		
1. Land intended for sale with unfinished buildings	414.911,56	79.805,84
2. Goods	2,694,070.21	2,540,138.15
3. Advance payments received	-364,966.96	0.00
Sub-total	**2,744,014.81**	**2,619,943.99**
II. Receivables and other assets		
1. Trade receivables	13,296,540.89	12,777,585.38
2. Receivables from affiliated companies	21,421,411.39	21,899,175.31
3. Receivables from companies with which an equity interest exists	4,334,253.75	3,851,136.68
4. Other assets	13,226,580.63	10,886,520.02
Sub-total	**52,278,786.66**	**49,414,417.39**
III. Cash on hand, bank balances and checks	40,270,789.44	25,937,331.40
Total current assets	**95,293,590.91**	**77,971,692.78**
C. Prepaid expenses	732,833.45	820,213.60
Total assets	**319,701,486.78**	**302,108,215.93**

Equity + Liabilities	**31.12.2017**	**31.12.2016**
A. Equity		
I. Subscribed capital	20,475,000.00	20,475,000.00
II. Capital reserves	3,267,070.70	3,267,070.70
III. Other revenue reserves	32,940,190.52	32,940,190.52
IV. Retained earnings	46,944,321.41	33,194,939.60
Total equity	**103,626,582.63**	**89,877,200.82**
B. Grants to fixed assets	836,110.00	873,857.00
C. Provisions		
1. Provisions for pensions and similar obligations	958,500.00	969,120.00
2. Tax provisions	11,480,410.00	5,336,349.00
3. Other provisions	39,947,899.00	34,545,488.00
	52,386,809.00	**40,850,957.00**
D. Liabilities		
1. Liabilities to banks		
a) Non-current liabilities	38,533,748.03	34,478,584.98
(of which subordinated)	1,389,134.92	2,309,460.28
b) current liabilities	2,323,006.17	6,311,101.25
Sub-total	**40,856,754.20**	**40,789,686.23**
2. Down payments received on orders	11,508,570.85	7,830,286.69
3. Trade payables	19,364,969.14	19,714,312.65
4. Liabilities to affiliated companies	51,509,507.14	53,799,017.97
5. Other liabilities	15,723,524.17	23,060,997.76
(thereof taxes)	1,790,323.36	2,505,156.01
(of which under social security)	27,652.15	28,523.05
(of which subordinated)	6,250,000.00	8,750,000.00
Sub-total	**138,963,325.50**	**145,194,301.30**
E. Prepaid expenses	2,978,852.65	2,760,573.81
F. Deferred tax liabilities	20,909,807.00	22,551,326.00
Equity + Liabilities	**319,701,486.78**	**302,108,215.93**

Exhibit 7 – Typical fee structure in HMAs and TPO agreements

	Branded Operator	Third-Party Operator
Loyalty	To the brand	To the owner
Priority	Top line	Bottom line
Base Fee	2.0-3.5%	1.5-2.5%
Incentive Fee	6-10%	5-8%
Cost of Brand	Included in fees	Additional Royalty Fees
Average Term	15-30 years, plus renewal terms	5-10 years*, plus renewal terms

*Highly negotiable, and can be as low as 1 year.

Source: HVS research, Cornell University

Teaching note

Critical issues

This case study presents the real example of a private hotel chain facing a decision that can heavily impact its competitiveness. Maritim wants to avoid overpaying for the property in Düsseldorf, even though it is one of the most profitable ones. More importantly, this case gives students insights to discuss whether an "asset-heavy" model can be a better choice for private hotel chains like Maritim as opposed to an "asset-light" operating model that is based on Hotel Management Agreements and franchise fees. To achieve a conclusion on what decision is best for an operator like Maritim, a number of factors have to be weighted including the financing context, the geography, the competitive environment and the market.

Use of the case

This case and its questions are particularly relevant for students in the Master in Finance and in the Master in Management who are taking courses that cover financial strategy, operational strategy and M&A related topics such as "Corporate Finance", "Applied Corporate Finance", "Mergers, Acquisitions, Restructuring", "Operations Strategy", "Project Management", "Brand Management", "Strategy" and "Entrepreneurial Finance & Venture Capital". Even though this case requires a limited quantitative analysis from students, it allows them to be immersed in a practical situation wherein a company is faced with a decision on what operational model to adapt. Students should also analyse the financial consequences of the decision, the impact on the group's growth and the impact on its brand.

Discussion questions

1. **On what factors does the choice of an operating model depend on?**

Growth strategy

Maritim has a strategy that relies on international expansion and a triple-digit annual growth goal in the number of rooms. Therefore, even though the revenue per operated room is generally lower for asset-light models, these are the best ones to adopt for a quicker expansion of the brand and increase the number of operated properties given the lower required investment.

Profit per managed room

In contrast with a franchisor, manager and to a lesser extent, with a lessee, a property owner bears all the upside of the operational profit for a given hotel. Many management agreements do not include the reimbursement of costs of operations, be them direct (such as food, electricity, water and gas) or indirect (expenses that do not vary with the level of production, such as insurance and financial obligations related to human resources). For a hotel chain that is not so much focused on growth but rather on the profitability of the current operations, an asset-heavy model based on hotel ownership is more adequate given the tighter control over maintenance costs and overall expenses. Moreover, the more collateral a hotel chain can present when requesting a financing, the lower the interest rates and the better the overall financing conditions.

Ownership

In the hospitality sector, listed companies' shareholders require their firms to constantly improve the return on capital employed. This, along with share buy backs and predictable income from the franchise and management agreements, tends to increase the share price and attract new capital sources. Maritim, by being privately owned and by not having such requirements from the shareholders, relies a lot more on property ownership in comparison to its public counterparts.

Location

Each location has different risks associated with it. Geopolitical, environmental, and economic risks are factors that influence the cyclicality of the real estate sector and the hospitality demand. For a given location, the more cyclical the real estate, the more difficult it is to estimate a yield on the property. Hotel operators usually only operate within a relatively small yield range, and thus, cannot afford to buy or even be a lessee on such locations. Hotel management agreements and franchising agreements are usually the preferred models for more cyclical and risky locations.

2. What type of agency problems can arise in each model?

The way contracts are structured and negotiated give rise to different agency problems. An owner has to negotiate a budget with the hotel operator on a yearly basis. The initial budget is usually linked to performance metrics such as the RevPAR and Gross Operating Profit. A conflict here is not uncommon since operators will want a higher budget in the cases where some or all the operating expenses are incurred by the owner. With regards to personnel, nor the owner nor the operator want to bear the responsibilities of employment. In Germany, the owner tends to be the legal employer, even though all the training and staff related matters are responsibility of the manager. In relation to capital expenditures, the owner is usually the responsible for the funding of maintenance capex.[vi] It would be straightforward to think that managers would incentivize owners to invest in capex as much as possible, given that managers do not take it out of their pockets. Sometimes, however, capex related projects have a high negative impact on revenue (e.g. having several rooms closed for extensive periods of time).

3. Is there an operating model better than another for Maritim?

Operating a hotel through leases is becoming less appealing and owning it seems to be a more attractive option given the current low market interest rates. Furthermore, being an owner allows the sale of the property later on if needed. Nevertheless, the choice of the operating model of a hotel is not a binary decision. Hotel Management Agreements (HMAs) and franchises are becoming preferred options over leases and ownership-based models by global hotel chains. These models allow a faster brand dissemination and the chance to earn management and franchising fees with a relatively low investment. With regards to upside potential, in most of the cases, both HMA fees[22] and franchise royalties are lower than the profit obtained when the hotel is either owned or leased, given that HMA and franchise fees are usually a percentage of sales[23].

On the other hand, for a hotel generating negative net income, the downside can be very different in each situation. For negative profit levels there are usually no franchising nor management fees[24] but neither there is downside risk[25]. Lessees and owners, however, must still pay the leases and service the debt even if they have a negative EBITDAR and EBITDA, respectively. In this case, the lender will file the hotel for foreclosure, unless no other action is taken by the owner[vii]. The lessee, by not being able to pay the leases, will enter into a contractual default. This may or may not be renegotiated, but the lessee is in risk of losing the contract and, therefore, the operations of the hotel – and eventually other hotels also operated by the lessee that belong to the same owner.

If well negotiated, the management contract, by charging the hotel owner 2 to 5% of the hotel revenues and up to 20% of the net income, seems quite appealing. Furthermore, in case of

[22] Usually this figure is the same as revenues given that under an HMA, direct and indirect costs of operations are usually reimbursed by the property owner.

[23] Sometimes the fee structure also includes a small percentage of profits

[24] Usually only operating costs reimbursements.

[25] Downside risk is here defined as the loss of capital.

negative results, the hotel management entity does not necessarily cease to manage the hotel, unless there is such termination clause in the agreement. Both “asset-light” models generate higher levels of cash for a given investment, and thus, a higher return on capital employed. Even though there are some key differences between the HMA and the franchising model, the main one being the fact that the franchisor Maritim does not operate the hotel in *stricto sensu* but advises on management and operational policies, the fees from both franchising and HMAs seem quite attractive[viii].

Furthermore, in the case of the HMA, there is also a degree of dependence on ownership for project development and capital injections, mainly for maintenance capex. When insufficient capital investment is received, the brand can be negatively impacted due to several reasons including lack of property maintenance. Nevertheless, in the current low interest rate environment, owning a hotel turns out to be, in the majority of the cases, several times more profitable[ix].

With regards to hotels where Maritim is a franchisor, the group does not operate the property. Therefore, when the owner does not possess the necessary skills to do so, TPOs can prove to be an efficient solution given their niche expertise for a given location and segment. Contrary to the general belief that TPOs steal market share from franchisors, these two market players are very complementary given that very often a franchisee is not an industry expert and prefers to have a TPO with local market expertise.

4. Is there such a thing as a perfect combination of operating models that maximizes profitability and minimizes operational and financial risk?

These models are discussed in the optic of Maritim which is considered a branded operator. Ownership based models and leasing are generally more appropriate for use in developed markets, in places with a less cyclical real estate and with stable hospitality demand levels.

These two require higher investments, but they also allow higher profits compared to other models and avoid some of the agency problems discussed above. Franchises and HMAs are good bets in the case the operator is over levered, or in case it has a very reputable and known brand in place. Properties where the owner does not have the expertise to run a hotel might seem an opportunity to put in place an HMA. However, global brands such as Marriott tend to be contacted during the construction phase of the property to brand it, operate it or both. This means that most operator-free properties were not of interest to such brands as the offered terms were probably not appealing. For example, if an owner demands that the operator is in charge of capex investments as well as all direct and indirect costs, the risk-adjusted return decreases considerably.

5. Should the current leasing agreement for the hotel Düsseldorf be substituted by an HMA or franchise agreement instead?

Given that Maritim has successfully operated the hotel for several years, the market risk is considerably lower. If Maritim becomes a simple franchisor, the profit related to this property decreases substantially. The same happens to a lesser extent with an HMA, with the aggravating factor that as a manager, Maritim might still incur some hefty operating costs. Moreover, the fact that real estate has been historically stable for the past 6 decades and that the chain can always sell the property in the future, an ownership-based model for Düsseldorf seems to be the most reasonable choice.

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