



# Seeking operational excellence: consolidation of third-party management companies

Prominent in North American lodging markets, third-party management companies provide daily property and operational management services as well as year-round financial and accounting support for hotel owners, while marketing the hotel brand through a franchise agreement.<sup>35</sup> Improving hotel fundamentals globally and increased access to capital have led investors to seek out this operational expertise to maximize investment on both newly acquired and existing hotel assets.

By providing a value-add strategy for companies to leverage scale and rapidly achieve growth initiatives, third-party management platforms have driven M&A within the hospitality industry in recent years. Investment funds, foreign buyers and existing management companies are all looking to capitalize on expected industry growth – and they are increasingly investing in these in-demand third-party management companies.

Third-party management companies are far more mature in the US, a country that is a leader in the sector's M&A activity, which has surged in the past five years.<sup>36</sup> Transactions in the US have included some of the country's largest third-party operators. As of year-end 2013 in the US, 18 management companies each operated a portfolio of 50 or more hotels, with the top 15 each managing a portfolio in excess of 8,000 rooms.<sup>37</sup>

The same trend is making its way throughout the world, but on a smaller scale. Europe and Latin America are estimated to be 5 to 10 years behind the US in terms of transaction activity in the sector but are, however, experiencing significant growth in the creation of third-party management companies. In the Middle East and Asia, the presence of third-party operators is limited and transaction activity is minimal as investors favor the franchise model, and manage properties themselves, while brands continue to develop and become fully integrated into the market.

For investors, acquiring proven management companies that can expand is attractive because they can achieve relatively higher returns given the prevailing low cost of capital on a risk-return spectrum. Consolidation in the industry has become an effective way to grow and diversify portfolios by providing opportunities for geographic expansion and to rapidly

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35. *Hotel Investments Handbook*, Chapters 19 to 21, HVS.com, 2008.

36. "Third Party Management Companies: Key Trends and Issues," *Hotel Analyst*, 22 January 2014.

37. "2014 Hotel Management Survey," [hotelmanagement.net](http://hotelmanagement.net), March 2014.



penetrate markets that align with strategic initiatives. Investors are finding opportunities to enhance bottom-line performance by gaining expanded market penetration and operational strength, as well as buying power for various operating systems to better compete in the market.<sup>38</sup>

Key drivers in recent transactions have illustrated that investors particularly value operationally sound third-party management companies with established infrastructure, which can bring them access to new deals and lucrative operating platforms. In addition, investment firms are specifically targeting companies with strong relationships and experience within the real estate and hospitality industries, which also can provide access to prospective transactions and significantly increase deal flow.

Management companies are also using outside investment as an alternative means to finance strategic growth initiatives. Capital partnerships often provide opportunities to leverage resources that would not otherwise be at the company's disposal, which can significantly improve market share and economies of scale. Consolidation provides opportunities for management companies to form new relationships and create synergies in infrastructure, procurement, reservations, sales and revenue management, and other technology systems.

In addition, the increasingly competitive environment in the sector has made management companies more inclined to offer key money or sliver equity in order to secure new contracts.<sup>39</sup> With equity participation anticipated to continue in coming years, the demand for capital partnerships is expected to continue to grow.

Third-party management consolidation also continues to support the hospitality industry's strategy toward an asset-light model. By constructing a hotel business with an asset-light structure, it allows the business to separate itself from owning the bricks and mortar of real estate while providing the brand the ability to capitalize on its operating strengths.<sup>40</sup> The asset-light strategy allows management companies to enter and exit markets with less risk and more flexibility and to achieve increasing returns with each new contract due to economies of scale. Investors, therefore, gain quicker access across borders, oftentimes with local management expertise.

Market indicators point to robust transaction activity in the sector through 2015 and onward. The US is expected to remain the leader in M&A activity as the third-party operator model continues to mature throughout other parts of the world. Investors and third-party managers have significant opportunities to fuel growth through consolidation, particularly in emerging markets, which will lead to an active trading environment in the sector in 2015 and likely beyond.

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38. "Interstate Maintains Strong Growth Here and Abroad," Hotel Management, [www.hotelmanagement.net/operator-owner/interstate-maintains-strong-growth-here-and-abroad-29159](http://www.hotelmanagement.net/operator-owner/interstate-maintains-strong-growth-here-and-abroad-29159), accessed 13 October 2014.

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39. "Hotel Management Companies and Equity Contributions: Benefits and Risks," HVS, August 2014.  
40. "Third Party Management Continues Consolidation," Hotel Analyst, 30 July 2014.