Bricks v Brains

Rod Taylor is Head of Hospitality & Tourism at Europe Arab Bank plc

Bricks v Brains. If anyone could prove without doubt that they came up with this phrase, they could probably dine out on it for free for the rest of their lives!

But while the phrase came from and why? Historically hotels and many other property assets were both owned and operated by the same entity. The introduction of the concept now accepted as “PropCo” and the “OpCo”, the “bricks and brains”, was an attempt to divide the two distinct areas that make up most property based asset, ensuring that maximum value was generated from each. Just as the phraseology suggests, the PropCo owned the “bricks” with the OpCo looking after the operational aspects and were thereby christened the “brains”.

Some might say that “innovation” was at the heart of the phenomena, others might suggest that it was Marriott and subsequently Host that prompted the wider change. Others might consider it was a natural market progression or that the prime mover was greed. What I think is beyond doubt is that the publicly quoted companies that first embraced the idea were driven to do so by institutional analysts whose job it is to comment on how well a company is performing and recommending investors to invest, hold or sell stock. For the hotel industry some five or six years ago, this pressure grew and the pushed boards to sell assets, reduce capital intensiveness, exit property investment, focus on brand management and return cash to investors. The argument was that a new breed of specialist property owners could make a better fist of generating income from these fixed assets than the hotel company had done.

Some companies brought into this premise quite quickly, some initially argued to the contrary and others sought an “asset light” or “asset right” strategy. But ultimately pretty much everyone of size has, with the exception of Whitbread and thereby Premier Inn, fallen in line. Isn’t it an amazing marketplace where institutional analysts, some just out of business school, probably never having done more than read in their text books about a “recession” have still fundamentally changed the face of property?

It’s also true to suggest that there’s probably no going back although I’ve recently heard mutterings that suggest if property prices really were to fall heavily in the future, then opportunist acquiring by the “brands” might occur. After all, we regularly remind ourselves that we are a cyclical industry. However to be frank, I don’t subscribe to heavily falling prices and so the opportunity is unlikely to materialise.

A central question in the Bricks v Brains, PropCo v OpCo debate is - are these institutional analysts in the future going to be sitting across dinner tables suggesting “I fundamentally changed the hotels property market”, or will it be something best forgotten? My view is that their initial premise, that they could unlock shareholder value, has proven to be a valid one; albeit it might prove to be a one hit wonder. The value of hotels had at the time been rising, the industry was viewed as opportunist by investors, yields vis-à-vis other property classes looked attractive and so money flooded into the sector and the hotel companies or, more precisely, their shareholders benefited. Short term that is!

This phenomenon has brought new investors into the hotel industry and generally speaking, at least for those who invested early, values did rise and happiness prevailed.

These “new to market” investors who were not “dried in the wool” hoteliers have also brought about the development of the new breed of asset management companies who work on behalf of the investor to keep the newly installed “brand owner” on their toes. Because canny investors realise that market sentiment can influence yields and thereby values, they have quite rightly pressed their asset management company to extract maximum cash flow. So the investor is the “bricks” in our equation and the brand is the “brains”.

But what of the “brand” owners, the “brains” alluded to in my introduction. Historically portfolio expansion was relatively benign, in part because “hotels” are hugely capital intensive and even a publicly quoted company only has a finite amount of free cash.

Nowadays, post Bricks v Brains, PropCo v OpCo the international brands can have development teams across the world, as investment capital is not an issue as this will be provided by the investment partner.

The “brands” can now, by way of example, consider India, China, Eastern Europe or wherever. They don’t even need to source the site; the investor does that for them. Little capital is required, a choice of sites, an expanding pipeline and eventually another name over the door, coupled with semi guaranteed medium term cash flows for the “brains” - Heaven personified?

But, I’m a banker so I have to introduce a “but” at this point. So, “but” we should be asking what happens to the “brands” or let’s keep it simple and refer to them as the “brands” when all the choice sites have gone. How many Inter Continentals will be needed in India? How many Marriott in China? How many Sofitals in the Czech Republic? We are obviously many years away from saturation but at sometime in the future it will come.

Has “asset light” helped to develop the marketplace in the construction of hotels - well, yes! A prospective owner in, let’s say Libya would not in the past have found it easy to obtain development finance but now, with Inter-Continental, Marriott or Sofitel etc entering into a lease or management contract then all is possible. It might also be true to suggest that had these brand owners been asked in the past to put their investment capital into the same hotel in Tripoli then it might not have been built or at least it is unlikely it would have been at the top of their agenda.

There is an old maxim about bankers giving you an umbrella when the sun shines and, taking it away when it rains. In many ways that’s like traditional guarantees by brand owners. They’ll guarantee a hotel which is stunningly well sited and avoid doing so in uncertain locations. Am I being unfair to bankers, or perhaps brand owners or both?

It’s true to suggest that many more hotels are now being developed because of PropCo – OpCo structures and thereby a much larger investment pot of money. So I am of the view that Bricks v Brains, PropCo v OpCo has had some positive benefits.

What is my view of the industry from the investors’ standpoint, the “bricks” in our equation? This becomes more involved because the hotel industry is just a small element of the wider property marketplace. Hotels have seen values rise but from a starting point of yields being ahead of other sub sectors such as offices, warehouses, retail etc. Hotel yields have come in, it could be suggested to unsustainable levels. Indeed there is some evidence coming through to suggest that yields are softening and values have started to slip. Hotels have benefited from the rush to property but not in isolation, it is not a big enough sub sector to be insulated from the overall marketplace.

So if investors in offices or other core sub sectors get cold feet and yields move out, hotels will follow suit. Rather like my earlier suggestion that some institutional analysts have never lived through a recession, so “new to market” hotel investors have never seen hotel values do anything other than rise. Well....this isn’t strictly so, the investors in the original Swallow Hotels concept did experience a downturn in value. It was a cracking idea, as long as the financial balls remained in the air. When the balls did eventually fall to earth it was however found to be a flawed model. The premise behind Swallow was raise some capital, buy some hotels, make modest improvements, throw in a supposed “brand” and enter into an PropCo v OpCo structure. OpCo, the “brains”; enters into a lease with PropCo, the “bricks”, underpinned by a fixed rent at a level that is unsustainable, and seek to on-sell this investment to less well informed, largely private investors.

The outcome, apparently unexpected trading downturn, means that the original Swallow company as the “bricks” can’t pay the rent and goes into liquidation, investor or the “brick” is left with nothing. He has neither the time nor the experience to manage and when he tries to re-let the property finds the previous rent cannot be replicated as it had been set at too high a level. Result the value of the asset falls – so there have been some historic casualties with Bricks v Brains. The “brand” has of course risen from the ashes, has been acquired by new investors and “new” Swallow appears to be trading well.

What this indicates is that investors would be well advised to only enter into a lease or management contract with a real “brand” that is recognised and admired by the travelling public and is also financially robust.

When the PropCo v OpCo debate first started there was a feeling that a “lease” was safe and sound but a “management” contract was suspect. The lease was good for the owner; the management contract suited the brand owner. But experience has shown that both, and hybrids thereof, have a place in the investment marketplace. Management contracts
need previous, internal experience or brought in knowledge. Otherwise you’ll hear the plaintive cry of “this is our standard contract” from the brand owner. Both sides should get a fair deal, a win/win and having an experienced lawyer and a team of professionals steeped in the property industry on your side is a big plus. Being able to say with conviction “you don’t really mean that do you” is an art and could save “bricks” a lot of heartache throughout the term of the contract.

For the “Bricks v Brains” partnership to work long term there must be a shared vision and strategy for the asset.

I’ve considered the thinking behind “Bricks v Brains”, have reviewed the development of new hotels, evaluated the investment barrier and all that remains is to consider “How are the operators, the “brains” shaping up”? Well, Operators/Brands/Brains – they’re actually doing rather well in terms of both income and thereby cash generation from the base fees, incentive fees, marketing fees, advertising fees etc being charged to “bricks”. Here I’d also like to add a plaudit for the new asset management companies whom I suggest have helped drive the “brains” to even greater levels of operating efficiency. The PropCo v OpCo, Bricks v Brains structure has minimised risk for OpCo’s, the “brains” and has as a result generally stabilised their income levels, with increasing profits emanating from their growing, world-wide portfolios. But while I do suggest that OpCo’s might now be sitting pretty, with their growing number of management contracts, what then is the outlook for the “bricks”? It’s great to have new investors, new money coming into any sector, but my primary concern revolves around what happens if property yields soften and move out, values fall and some investors experience burnt fingers. If there is such an effect on the wider property sector, which there currently is, then the hotel sub sector could experience a similar downturn.

To summarise:-

1. Has Bricks v Brains returned cash to shareholders locked into previously average performing hotel stocks – yes.
2. Has it generally helped “brand” owners, the “brains” – yes.
3. Has it helped expand the number of “branded” hotels world-wide – yes and to some limited extent no. Across the UK and other brand conscious European countries like France it has but in Italy, where brand penetration is low, it has had a reduced effect.
4. Have the new breed of investors, the “bricks” benefited from uplift in values – yes, so far.
5. Will “brains” see profits continue to rise in the near future, aided by an expanding pipeline of openings – yes
6. Might “brains” profits plateau as an when the market for new openings is satisfied – yes but we’re still a long way off.
7. Should “bricks” be currently looking to invest – yes, but with caution and with a weather eye at what is happening across the wider property sector.
8. So to all these points I have answered “yes.”
9. Did I come up with the original “Bricks & Brains” slogan – “no.”

A banker always ends with a “no” and I try not to disappoint.