NEWS

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The real estate market and the hotel sector

Prospects in italy and abroad

Italy • The real estate market and hotel sector work together in a symbiotic relationship both structurally and economically speaking, the former acting as the "vessel" and the latter as the "contents." In this relationship, the property itself is defined as a sort of infrastructure, a term which highlights its central role in the flourishing of individual industrial entities such as offices, hotels, shopping centers, etc. through its capacity to provide service and function. However, in the Italian hotel sector, it is important that this reciprocal economic and structural relationship be anchored in a clear separation of assets between the two respective sectors and be steered by exceptionally specialized authorities, as it already occurs in other countries.

In the United States, for example, this phenomenon of separation of assets and skillful specialization has been the modus operandi since the 1960's, and it has allowed for the successful adaption of both contractual parties.

Italy has been working to achieve this separation and has seen the following progress:

1. the main hotel development groups were originally the owners of both the real estate asset holdings as well as the individual hotels managed by them;

2. during a second phase, the hotel development groups sold their asset holdings to third parties while still retaining their ownership of the hotels (including the company personnel, licenses, both tangible and intangible assets, and the name brand itself), and the relationship between owner and third party was regulated through lease agreements;

3. we are currently in the third phase, in which leading international hotel development groups have maintained exclusive control of intangible assets (brand name, "know-how," reservation centers, and management and training of personnel) while conceding these rights to individual hotel property managers through franchising or management contracts. In turn, these individual managers create lease agreements with real estate firms, thus striking a sort of three-way partnership between the owner of the property (real estate firm), the local hotel operator, and the international brand name.

Quantitatively, the Italian hotel sector seems equally split amongst these three phases of integration, although there has been a progressive, albeit slow, transition away from the first phase, heavily represented by hotel operators who refuse to concede physical ownership;

towards a second phase, represented by entrepreneurs who manage properties already being leased; and ultimately towards a third phase, represented by a rigorous, three-tiered separation of assets and business activity amongst properties, hotel management, and ownership of international "know-how."

In the international market, each of the three distinct spheres of business transaction are by now dominated by distinct categories of financial and entrepreneurial entities:
1. owners are usually institutional investors with stakes in real estate funds and have clear long-term goals and a medium to high propensity towards risk. They focus on the acquisition of real estate assets for use in the hotel industry as well as the development of a high level of professionalism within all aspects real estate activity, including property, facility, administration, etc.;

2. the national hotel operator, broadly represented by local families with an astute entrepreneurial spirit and a deep-seated tradition of hospitality, through the creation of individual hotel management companies, also known as OPCO or "Operational Company," have been an important factor in the success of this initiative, given their authentic flavor of Italian hospitality as well as their keen knowledge of their local surroundings and its economy;
3. lastly, the big-name international brands serve as sources of international know-how; provide access to global, centralized booking networks, and furnish tools for the training and coordination of hotel personnel.

International hotel operators agree that the Italian market must do everything it can to accelerate the process of integration of a three-tiered separation of assets composed of three distinct entities, each with its own high level of specialization and risk profile. The following brief analysis shows the different legal risks and cash flows deriving from the respective operational entities and their contractual stipulations. Based on the managerial contractual structure of the first phase:

- a single party bears the property risk, including damage and/or deterioration of assets and housing market risks resulting from failure to re-evaluate assets;
- the same party will also bear risks associated with hotel activity, including a decrease in bookings and in room rates, etc.;
- said party will benefit from cash flow derived from bookings but will also be subject to the negative cash flow derived from property management costs (such as IMU, maintenance, and security costs) and from business management costs (such as employee salaries and equipment).

Based on the managerial and contractual structure of the second phase (in which the hotel property owner operates through a third-party):

- the property owner will bear all property risks in full;
- the hotel operator will bear all business risks in full;
- the property owner will benefit from a cash flow deriving from the rent paid by the lessee;

- each party will manage its own negative cash flow deriving from operational costs. In the event that the property owner is also the hotel operator (business owner) and chooses to rent out ("Affitto") to a third-party instead of sub-leasing ("Locazione"):
- the property owner will bear in full all property risks;
- the third-party business and the hotel operator will share the business risks. Therefore, in the event of a financial fallout, the tenant (third-party business) will not benefit from booking profits and the property owner will not benefit from rental costs, leading to feelings of ill will amongst the parties in the long-run. However, in the case that business does flourish, the property owner will benefit from rental costs and each party will manage its own negative cash flow.

Based on the managerial and contractual structure of the third phase (in which a property owner, hotel operator, and international brand are present), the following characteristics are most noteworthy:

- the property owner will bear all property risks in full;
- the hotel operator will bear all business risks in full;
  - the international brand will not directly bear property or business risks, however in the case
- of an eventual fallout by the hotel operator, it will forego returns on any material or immaterial
- investments and most importantly, its reputation will be tarnished;
- the property owner will be able to benefit from a continuous cash flow during the duration of the leasing contract and it will be subject to the usual property costs;
  - the hotel operator will benefit from a cash flow deriving from bookings but will also be subject to business management costs;
- the international brand will receive variegated compensation from the hotel operator based on affiliation with and services rendered by the brand. In other words, the brand will be paid for the right to have its image bared.

In conclusion, two comments regarding future prospects of the three-tiered system in Italy are worth mentioning. The first is that the separation of assets within the hotel sector is bound to lead to a tangible increase in the number of national hotel operators with a heightened awareness of contractual stipulations (particularly within management contracts) and the expectations coming from international brands. The second is that international brands must continue their admirable work in diffusing their 'know-how' of management contracts among national hotel operators, despite the climate of fear and distrust associated with these types of particularly innovative contracts.