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TO OPERATE OR NOT TO OPERATE YOUR HOTEL RESTAURANT YOURSELF…THAT IS THE QUESTION

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LEASING A HOTEL RESTAURANT TO A THIRD PARTY CAN BE PROFITABLE – BUT THERE ARE TRAPS FOR THE UNWARY

A New York City hotel owner found himself planning a renovation of his property – as many owners have in the recent boom years. How do you prioritize the renovation? One obvious and appealing answer was to upgrade the hotel restaurant. A premium restaurant can do wonders for both the brand and the topline. With that in mind, the owner leased his restaurant to a prominent, well-regarded third-party operator.

The result was a nightmare. The restaurant operator was unhappy because the deal required the venue to be open during unprofitable times such as breakfast and weekend lunches. The hotel owner, on the other hand, thought that the combined revenue and profit wasn't nearly enough to compensate for difficulties in supporting catering and room service, and the quality of both was substandard. The legal dispute escalated from there. In a short time the parties were arguing over nearly every detail of the agreement – lease terms, revenue and profit sharing, service obligations and performance, labor costs. The dispute took months – and high fees – to unravel. At the end of the day, the hotel owner was left with this question: would he have been better off running the restaurant himself?

During the economic downturn, upscaling your restaurant was probably the last thing on your mind. But for hotel owners who have cash on hand as a result of a healthy economy, and who are looking to upgrade services, the restaurant is a natural item in a renovation project.

Quality food service is of course integral to a well-run full service hotel. But a premium hotel restaurant can serve as more than just a center for food service operations and a source of additional revenue. The best hotel restaurants are a draw in their own right – they attract customers who might not otherwise visit the hotel; but once they are aware of it and visit in large numbers, they add a spark of energy. Restaurant traffic is a sign that the hotel is booming – and customers can recommend the hotel to friends and colleagues who will become guests. And a quality restaurant lends an air of prestige that can help build the hotel's brand.

The hotel and the restaurant are different businesses that can easily wind up in conflict

But upgrading the restaurant isn't an easy matter. To put it in stark terms – restaurants don't work the way hotels do. The economics are different, as are the labor market, the terms of employment, the unions and the pace of operations. From the restaurant operator's perspective, a hotel restaurant isn't just a restaurant – if it houses the only kitchen in the building, it often has to meet obligations such as room service and event catering that aren't usually part of the life of a stand-alone restaurant. These may or may not fit well with the restaurateur's talent and business plan. The two businesses – hotel and restaurant – can wind up in tension, or even in conflict. Operating a hotel restaurant can lead both parties – the hotel owner and the restaurant operator – outside their comfort zones. But a hotel owner who decides to avoid the partnership risk and instead take on running the restaurant directly can wind up outside the comfort zone as well.

It's tempting to run your own restaurant. But do you know the restaurant business well enough to succeed?

How do you manage a successful restaurant upgrade? The conundrum starts with the first decision you have to make: operate the restaurant yourself, so that you have complete control over the venue? Or bring in an outside operator via a lease, license or franchise, or management agreement? There are arguments in favor of each option – and an equal number of arguments against.

Many hotel owners are tempted to run their own restaurant operation. The reasons are understandable. They maintain complete control over their venue, and don't have to give up revenue or profits.

The problem with this scenario is that while the owner's vision of the restaurant is accurate, the execution is not. It can be severely problematic. True, there are potential synergies – room service and event food-and-beverage service, for example. But in practice, the workload involved in managing the restaurant detracts from the hotel's real business of selling rooms. The difficulties of restaurant operations – quality control, managing the restaurant's labor force, handling its marketing – can be a severe distraction. But the harm isn't just to the hotel. Oftentimes, distracted ownership results in the restaurant's being neglected, which leads to employee turnover or poor service and can cause the restaurant to become even more of a distraction in an ongoing negative feedback loop.

If the hotel is in a prime location, you can succeed – and draw traffic – with a restaurant that you own and control

But just because this can and does happen doesn't mean it has to. Sometimes, direct control over the restaurant works out wonderfully. Usually, this has to do with location – the hotel is situated in a high-traffic venue where the restaurant can stand on its own and draw not just from the hotel but also from the neighborhood, or even beyond. Hotels in New York's Meatpacking District and at several venues in Southern California are succeeding with restaurants that serve as powerful attractions in their own right. Revenue benefits and so does the brand.

Franchising or licensing a national brand can be a short path to a restaurant upgrade – but the options for customization will be limited

For hotel owners who do not have this location advantage – or who for other reasons don't want to take over full control of the restaurant, what are the alternatives? Two alternatives are franchise or license a national brand, or lease the restaurant to a professional restaurant operator.

The franchise or license option is uncommon. But hotel owners have sometimes successfully licensed or franchised a recognized, brand-name restaurant. The upside has much to recommend it. A recognized brand can help attract business to both the restaurant and the hotel. In addition, there is ease of operation – the turnkey nature of a franchise means that the restaurant is less likely to drain time, attention and resources. Manpower can be better directed elsewhere in the hotel.

But turnkey operation also creates a downside. There is limited if any ability to change formats. And the limitations mean that you may not be able to cater to certain customers whose dietary needs are not met by the fairly limited menu that most franchise restaurants offer.

Many hotel owners opt to lease the restaurant to a third-party operator. There are powerful reasons why this makes sense

The far more common alternative to restaurant ownership is leasing the restaurant space to a professional restaurant operator. Ask hotel operators about restaurant lease arrangements and you'll hear polarized opinions – hotel owners either love the idea of leasing the restaurant or they hate it. This is understandable given the complexities of creating a lease and making it work, as we've seen in our opening example. More fundamentally, hotel and restaurant operators are each entrepreneurs. As such, they each have a vision. The danger is that it's a vision that the other party doesn't share. In spite of this, most hotel executives will agree that they are not the best restaurant operators, and that leasing to a restaurant professional makes sense.

The arguments in favor of leasing are powerful. As discussed, the restaurant operator takes over the restaurant completely – the hotel owner does not need to manage the restaurant. This simplifies the hotel owner's life and eliminates distractions. It can also create positive value. Remember that the restaurant operator's sole purpose is to make money and establish a venue that draws traffic independent of the hotel. If the restaurant succeeds, that can work in the hotel's favor, and not just in terms of shared revenue. A successful restaurant serves as a sort of "bug lamp" that attracts diners to the hotel. Some of those diners are local business owners who, once they are aware of the hotel, may well stage events there and recommend it to their clients, business partners, suppliers and other visitors.

Purely from a revenue perspective, the advantages are straightforward. The costs and risk of loss in the restaurant are covered by the lessee. And the lessee provides a steady stream of revenue in the form of rent, generally with an upside via a percentage of the restaurant's sales.

Among the problems with leasing the restaurant: loss of control and conflicts over operations. What happens when your restaurant operator doesn't like room service?

With all of those points in favor of a lease arrangement, where do the problems come in? There are several. We've reviewed some in our opening scenario, but there are others as well. The most fundamental issue is that the hotel doesn't control the venue. That means that there will be room for conflict – the hotel owner and the restaurant lessee may pull in opposite directions. This is not just a matter of creative differences or creative temperament – there can be operational problems.

How does the operational relationship go sour? Running a hotel restaurant isn't like running a stand-alone restaurant. On a day-to-day basis, service quality may suffer if the restaurant operator doesn't put his or her heart into the task, or if the hotel's food needs put the restaurant operator under an unwanted burden. A case in point: breakfast can be unprofitable for restaurants – but it is critical for the hotel. If the restaurant is half-hearted about breakfast service or if

quality suffers, the hotel's reputation will take a hit. And revenues for both parties will suffer as guests go off-premises to seek out other breakfast options. In a similar vein, restaurant operators may not want to expand point-of-sales systems to cover room service and restaurant meals charged to rooms – but the ability to present guests with a single bill and make food service an integral part of the guest experience is essential from the hotel owner's perspective.

Communications breakdowns can cause problems on both sides

Communications problems – the result of the two parties' unfamiliarity with each other's business realities – can lead to breakdowns as well. What staffing does the restaurant need on a given day? The restaurant operator won't know the answer if the hotel fails to inform the restaurant of the day's census. Perhaps there's a wedding next Thursday morning that will result in peak traffic. If the restaurant is short-staffed, service breakdowns and angry guests will be the result.

Contract terms – in particular revenue-sharing agreements – create many traps for the unwary

Finally, there are issues to do with economic expectations and contract terms. As a hotel owner, what are your expectations for the restaurant lease? A decision to lease means contracting out a major part of your operation – in effect, the entire food service establishment. This is not like granting other concessions – say, for the newsstand or gift shop. Given the revenue that the restaurant generates, you will probably not be content with a simple rental agreement – you will want to participate in the revenue flow. But what's a fair share? There can be many complexities. Should the revenue share be different for hotel guests? And for the hotel guest, can he or she pay for a meal by charging it directly to the room? Think of the nightmare of linking the restaurant operator's point-of-sale system to the hotel folio. And what about ensuing arguments about just how the accounting was done and monitored by each party? While these may seem simple to work out, they can often cause unwarranted tension between the restaurant operator and the hotel owner.

Of course there are many other terms to consider. As mentioned, the restaurant operator may not want to build out facilities to meet hotel service requirements. But it might also happen that the restaurant operator is the one demanding the costly build out of dining or kitchen space, beyond what the hotel owner wants to subsidize.

Then, there's the possibility that the contract may not balance risk equitably. Often the parties will draw up a contract in which there is little or no base rent, with most of the hotel's revenue coming from a percentage of restaurant sales. This means that the hotel carries most or all of the financial risk for the success of the venue – economic risk without control.

Furthermore, if the restaurant is performing poorly, the hotel may have to forgo rent or even subsidize the tenant so that the venue does not close. The hotel owner clearly does not want a shuttered restaurant – but the resulting imbalance may mean that the hotel owner never fully recovers financially from the restaurant's downturn.

The right answer can be highly individual – even in a prime location, where most hotels will want to operate their own restaurant, a franchise might be effective.

With all of these potential challenges and disadvantages in play, what arrangement makes sense? There are pros and cons for each option, and the right answer may depend on individual factors, such as a prime location that makes it desirable for the hotel owner to own and operate a restaurant. Even here, other approaches may work – your Times Square hotel may succeed better with a Hard Rock Café than with a restaurant you run yourself.

In many cases, bringing in a third party to run the restaurant is the best solution

It will often make sense for the hotel to give up control and find a restaurant operator. And in spite of the challenges, this can be a very healthy solution for all concerned. There has been a string of success stories in which hotels have leased restaurants to third parties.

My own experience bears this out. When I was CEO of The Griffin Group, we leased our restaurant at the Hilton Scottsdale in Arizona to a then-unknown steakhouse. It was called Flemings. The result was not only an association that was financially rewarding for both sides, but also a huge intangible success for both parties. Thanks to the restaurant, the hotel became a well-known location for businesspeople to visit, thus increasing top-of-mind awareness for the hotel in a city with many other hotel alternatives. Success at the Hilton helped build Fleming's brand as well.

Review contract terms with your business advisor – then form your partnership, create your restaurant and build your brand

But given the traps and the complexities involved in leasing the restaurant, how can you succeed? The bottom line is, be realistic. Look at your capabilities, scrub the numbers and make sure your lease terms are good. An experienced business advisor – one who knows the intricacies of both the hotel and restaurant industries – can be an important ally as you formulate your plans and formalize your contract. With an effective and equitable contract in hand, you'll be undistracted and better able to focus on the main task: finding a restaurant operator that will bring something different to your location – one who can add value in a way you can't easily manage on your own. Then form your partnership, draw up your agreement and get ready to reap the benefits of having a first-class restaurant under your roof.

ABOUT THE AUTHOR

Lawrence Cohen is a Partner and the Hospitality Group Leader at Marks Paneth LLP. He rejoined the firm after having served for many years as the President and Chief Executive Officer of The Griffin Group, the investment and management company of the late Merv Griffin.

Mr. Cohen has strong roots in the hospitality industry. The Griffin Group and its affiliates owned and managed properties that ranged from high-end resorts to limited service properties. Mr. Cohen spearheaded all aspects of the business including acquisition, development and redevelopment, financing, management team hiring, supervision of operations and eventual sale.

At Marks Paneth, Mr. Cohen draws on his deep experience and serves his clients as a business ‘‘coach.’’ For mature companies, he will advise entrepreneurs, CEOs and CFOs on strategies to reposition their companies in the current business environment. For start-up companies, he will delve into the business plans and advise on the growth of their infrastructure. While Mr. Cohen will usually directly assist in the business plan preparation process and support the money-raising process, he will also often ‘‘roll-up his sleeves’’ and assist with the execution of his advice including negotiating the business points of lender agreements, leases, distribution agreements, etc. as well as hiring and/or terminating employees.

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