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The capital-light continuum

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As hotel companies continue their asset-light strategies, their vacation ownership divisions evolve to continue to grow revenue.

By Jon R. Simon
HNN columnist

The hotel industry has for years adopted asset-light or capital-light strategies in a quest to differentiate holdings or ownership of cash flow streams to different classes of investors. These strategies now are gaining traction on the vacation ownership side of the hotel industry, particularly related to how they can grow revenue for their parent companies.

Capital- and asset-light strategies in the VO industry are among the most talked about and often most misunderstood in their breadth of application.

While often looked at mistakenly, as binary (either the strategy is asset-light or it is not), these strategies are in fact part of a continuum in which the capital required changes based on the services and activities provided. While pure fee-for-service strategies will continue to grow on an industry-wide basis, they are unlikely to ever constitute the majority of revenue for any company in the foreseeable future that seeks to grow its revenue base.

Rather, combinations involving full-scale development, just-in-time inventory transactions, inventory "churn" from existing owners, as well as those who walk away from their ownership of their VO interest, will need to be combined to constitute a reliable supply chain that can grow revenue and earnings over time.

An economic awakening

During the last 20 years, traditional hotel companies had been largely satisfied with their timeshare divisions and related profitability. However, the Great Recession of 2007-2009 awoke most of the brands to the attendant risks of their vacation ownership divisions.

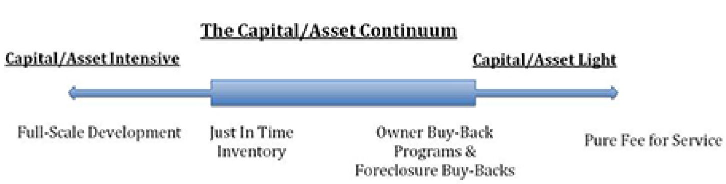
The Great Recession was accompanied with not only an economic slowdown in corporate profits and high unemployment, but was coupled with a devastating almost complete and total evaporation of liquidity in both the private lending markets and asset-backed securitization markets. The VO companies relied on these credit markets much more then their hotel counterparts.

Why? Vacation ownership is traditionally a cash-flow-negative business model in the early years of the development and sales cycles, due to high product, sales and marketing costs, coupled with the fact that most buyers financed the purchase of the vacation ownership interest. In order to bridge the gap, the hotel companies had to monetize the purchase mortgages through hypothecation or securitization. With these lending markets shutting down, the major hotel companies found that they had to literally stop sales of vacation ownership interests to stem the accompanying negative cash flow. It was then that almost all the major brands realized that they had re-entered the asset-intensive environment (in their VO divisions) that they had been exiting over the last 20 years in their hospitality divisions.

The solution was to move back to capital-light or asset-light strategies. But what exactly does this mean in the context of vacation ownership resorts?

The capital-light/asset-light continuum

Mistakenly, many people in and around the vacation ownership industry see capital-light or asset-light as a singular strategy, typically akin to the "pure fee for service" or "PFS" operations of their hospitality sister divisions. In reality, capital/asset-light is part of a continuum of potential development or product acquisition strategies.



There are four major strategies of inventory acquisition/development along the capital/asset continuum. Most of the major vacation ownership companies use two or more of these strategies, described as follows:

• **Full-scale development**: This represents the historical paradigm and is situated on the capital-intensive (left) side of the continuum. Traditionally, all of the major VO companies developed product for sale. This required substantial capital to acquire the land, take the assets through the permitting and entitlement process, take on construction debt and hold the assets through sale. Capital-intensive, full-scale development is the most stable of the supply platforms, and provides the greatest continuity to "brand standards" in terms of the quality of the final product.

• **Just in time inventory**: As one moves to the right to a less capital-intensive strategy, the "just in time" or "JIT" inventory model emerges. A relatively new model for the VO industry, it is less capital-intensive, but only marginally so. In a JIT business model, a third party such as a fee developer or a financial entity becomes the development division of the VO company. The VO company enters into a forward purchase contract to purchase the inventory at specified points in the future and designs the product to meet their brand standards. The forward purchases are guaranteed by the VO company's balance sheet. In terms of benefits, it allows the VO company to outsource the development process, relieving them of the needs to carry large development staffs and land inventory held for future development. Further, the transactions are scheduled to reduce the hold time of the completed inventory on the balance sheet. Theoretically, the goal is to have the acquisition of the VO interest and subsequent sale to the consumer as close as possible. The VO company, with its strong balance sheet, provides the "take-out" money to the fee developer at a specified point in time with a great deal of certainty.

• **Owner buy-back programs and maintenance & financial defaults**: Moving farther to the right on the continuum, the cost of inventory is reduced through the acquisition of re-sales or defaulted inventory. Traditionally, re-sales of inventory by existing owners yielded only a small percentage of the original purchase price. Historically, such owners would either consign their interest to re-sellers or simply walk away from their interest.

• **Pure fee for service**: To the far right of the continuum, we encounter "pure fee for service" or "PFS" strategies. Fee for service today is often confused as the singularity of what capital/asset light strategies entail. When taken to their extreme, they do represent the lightest capital structures available and often entail little direct capital commitment on the part of the VO company. While franchise agreements are not widely deployed in the VO industry, management contracts are and represent a significant form of recurring revenue for most, if not all the major VO companies. The PFS model is largely an outgrowth the Great Recession, where VO companies began to gravitate away from development and its attendant capital requirements.

While vacation ownership companies continue to pursue asset-light strategies to align their businesses with their hotel division counterparts and lessen capital risk, the premise of a pure fee for service vacation ownership company is not likely to emerge anytime in the foreseeable future. In order to continue to grow in a predictable and sustained fashion, vacation ownership divisions and companies will need to develop supply and revenue through the strategic use of all of the capital-light/asset-light continuum.

Jon R. Simon, has a long and accomplished background in the hotels, resorts and vacation ownership industries where he has advised some of the largest U.S. investment funds, hospitality and gaming companies and high net worth individuals. He is currently the Managing Partner for Chasen Capital Advisors, Inc., and heads up their national hospitality practice. He is recognized for his expertise in mergers, acquisitions, capital formations, deal structuring, operations and finance.