Gaining Maximum Benefit from Franchise Agreements, Management Contracts, and Leases

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Gaining Maximum Benefit from Franchise Agreements, Management Contracts, and Leases

Abstract

[Excerpt] As the owner of a hospitality property, you can be your own manager, as discussed in Chapter 17. But that chapter also outlined common ownership structures that are intended to maximize the value of your investment by involving various partners. I view these structures as a web of relationships that create and enhance value to all stakeholders.

Hotel and restaurant investors have long recognized that separating the real estate from the brand and from management of a hotel can create value. In fact, today it is difficult to find publicly listed firms that do all three. Firms like Host Hotels and Resorts (NYSE: HST) or Hospitality Properties Trust (NYSE: HPT) are hotel owners that contract with other companies, such as Marriott International (NYSE: MAR) and Accor (PA: AC), which provide brand and management services. In the discussion in Chapter 17, you read about ownership structures that included management contracts, leases, and franchise agreements. In this chapter, I discuss how these contracts provide you with a set of ownership, brand, and management services to help you achieve your investment and ownership objectives. As a start, let's build on the outline of structures in Chapter 17. The examples I give here provide a context for this discussion of contracts and leases.

Keywords
Cornell University School of Hotel Administration, hospitality management, hospitality industry, franchise agreements, contracts, leases

Disciplines
Finance and Financial Management | Hospitality Administration and Management

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Gaining Maximum Benefit from Franchise Agreements, Management Contracts, and Leases

Jan A. deRoos

As the owner of a hospitality property, you can be your own manager, as discussed in Chapter 17. But that chapter also outlined common ownership structures that are intended to maximize the value of your investment by involving various partners. I view these structures as a web of relationships that create and enhance value to all stakeholders.

Hotel and restaurant investors have long recognized that separating the real estate from the brand and from management of a hotel can create value. In fact, today it is difficult to find publicly listed firms that do all three. Firms like Host Hotels and Resorts (NYSE: HST) or Hospitality Properties Trust (NYSE: HPT) are hotel owners that contract with other companies, such as Marriott International (NYSE: MAR) and Accor (PA: AC), which provide brand and management services. In the discussion in Chapter 17, you read about ownership structures that included management contracts, leases, and franchise agreements. In this chapter, I discuss how these contracts provide you with a set of ownership, brand, and management services to help you achieve your investment and ownership objectives. As a start, let’s build on the outline of structures in Chapter 17. The examples I give here provide a context for this discussion of contracts and leases.

Let's start with the structure where the owner of the hotel, the franchise, and the hotel management are separate entities (number 5 in Chapter 17). In this case you own the hotel, another firm owns the franchise brand, and a third firm manages the hotel (see Figure 19.1). So if you're a developer with a great site but limited hotel experience, you should see investment returns maximized when specialized management and brand services are used.

You might be able to operate a hotel yourself, especially if it's a relatively small property. If you're an experienced operator, you might purchase a franchise so that your property operates under an established brand. Some hotels and many restaurant operators do this. While the independent owner-operator is common throughout the world, the franchise model is common in the United States.
Many of the largest or best-quality hotels are owned by an institutional owner or real estate fund. Those owners generally sign an agreement with a branded operator, such as Four Seasons, Westin, or Hyatt. These branded operators will not separate their brand from their management services. In some cases, hotel owners lease their properties to the branded hotel operators. In this case, the lease is the only agreement between the two. This is common around the world but not so much in the United States.

As you read in Chapter 17, the restaurant industry uses leases far more than management contracts. Tenants take a similar role to that of operators under a management contract, but they also take on significantly more business risk (see Figure 19.2).

One scenario that we didn't discuss in Chapter 17 was one in which the brand owns the restaurant and then signs both a lease and a franchise agreement with a local operator. As an operator, the reason that you might sign such an agreement is that you are set up in a location selected by a successful national brand, and you have a proven operating system with the franchise. McDonald's uses this approach for its local franchisees, for instance. As the local operator, you earn your return by operating the restaurant efficiently so that there is excess cash flow after paying both rent and franchise fees.

However, if you own a site, you might work with a company like Buffalo Wild Wings. This firm owns its brand, operates its restaurants, and signs leases with property owners, becoming tenants in
community shopping centers or neighborhood centers. As tenant, they keep all of the restaurant's cash flow after paying the rent.

Let's examine the contractual tools mentioned in these examples: franchises, license agreements, leases, and management contracts. These contractual obligations shape property rights in the hospitality industry, and if you understand how to price and how to use property rights, you are at a competitive advantage.

**Franchise and License Agreements**

The United States Federal Trade Commission defines a franchise using the following three elements. The franchisor must: (1) promise to provide a trademark or other commercial symbol; (2) promise to exercise significant control or provide significant assistance in the operation of the business; and (3) require a minimum payment of at least $500 during the first six months of operations. To prevent deception and abuses of franchisees, the U.S. government requires all franchisors to provide prepurchase disclosures in a 23-item Franchise Disclosure Document. As a franchisee you purchase the right to use a concept created by the franchisor, and for your royalty fees, you are granted a license to use the franchisor's trademarks and other trade dress. Figure 19.3 lists the leading hotel and restaurant franchise systems.

Although you're using the franchisor's system, as franchisee you supply the management acumen for the franchised unit. Meanwhile, the franchisor manages the brand image, marketing, and
product design. As franchisee you have the right to sell goods using the franchisor’s trade name, brand identity, methods of preparation and quality standards, marketing efforts, and distribution systems. Ideally, you would match your business site to the choice of franchise system and promote the local business.

One reason that companies use franchising to grow their system is the financing available from working with many other business operators. While this is undoubtedly true for firms in their initial growth phase, it doesn’t explain why mature firms with a low cost of capital such as Choice Hotels or Burger King continue to franchise, and why many franchisors evolve to become capital providers to their franchisees. Instead, franchising offers the following two incentives—better operating results, and efficiency and cost savings.

**Figure 19.3**

**Top 10 Hotel and Restaurant Franchisors**

<table>
<thead>
<tr>
<th>Top 10 Hotel Franchisors</th>
<th>Top 10 Restaurant Franchisors</th>
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<tbody>
<tr>
<td>1. Marriott</td>
<td>1. McDonald’s</td>
</tr>
<tr>
<td>2. Hilton (Hilton Hotels Corp.)</td>
<td>2. KFC (Yum Brands, Inc.)</td>
</tr>
<tr>
<td>3. Holiday Inn (InterContinental Hotels Group)</td>
<td>3. Subway</td>
</tr>
<tr>
<td>4. Sheraton</td>
<td>4. Burger King</td>
</tr>
<tr>
<td>5. Holiday Inn Express (InterContinental Hotels Group)</td>
<td>5. Pizza Hut (Yum Brands, Inc.)</td>
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<tr>
<td>6. Hampton Inn (Hilton Hotels Corp.)</td>
<td>6. Wendy’s (Wendy’s/Arby’s Group)</td>
</tr>
<tr>
<td>7. Courtyard (Marriott International)</td>
<td>7. Taco Bell (Yum Brands, Inc.)</td>
</tr>
<tr>
<td>8. Comfort Inn (Choice Hotels International)</td>
<td>8. Dunkin’ Donuts</td>
</tr>
<tr>
<td>9. Radisson (Carlson Hotels Worldwide)</td>
<td>9. Domino’s Pizza</td>
</tr>
<tr>
<td>10. Crowne Plaza (InterContinental Hotels Group)</td>
<td>10. Applebee’s (DineEquity, Inc.)</td>
</tr>
</tbody>
</table>


- **Better results.** Franchising heads off such potential problems as uncaring managers and excessive management risk taking. It also reduces what otherwise would be high monitoring costs for a far-flung network. By franchising units, the incentives of owner and operator of a given hotel or restaurant are aligned because they are one and the same, the franchisee. Franchisors do have to deal with the problem of badly behaving franchisees, but monitoring costs for franchisees are lower than in a regional management hierarchy.

- **Efficiency and cost savings.** The division of labor between the franchisor and franchisee makes for operating efficiencies. Successful franchisees excel at site selection and unit-
level management, while franchisors provide efficient distribution and marketing for the brand by combining the purchasing power of the entire network.

While the most common franchise offering is a single franchise, where the franchisee obtains the right to use the franchisor’s intellectual property for a single location, some firms use multiunit franchises. In these arrangements, the franchisee is granted a development territory and commits to open new units on a specific schedule. In a master franchise, usually used internationally, the franchisor licenses to the franchisee the right to subfranchise over a large geographic region. One example is the relationship between the Carlson Companies and Rezidor, which holds a master franchise to Carlson's brands in most of Europe, the Middle East, and Africa.

Services Offered by Franchisors to Franchisees

The many services offered to franchisees by franchisors are all geared to increasing franchisee's success and profitability, although franchises do have some disadvantages (see Figure 19.4). Franchisors may offer the following assistance: determining the best available location using sophisticated geotagged marketing data; prototype plans and specifications that facilitate unit level efficiencies; a standard operating system; and training assistance and materials at preopening and during subsequent operation. They may sometimes provide financing assistance.

Franchise Fees and Major Terms in Lodging

Most hotel franchise costs are structured as follows. An initial fee to obtain the franchise rights, paid at the signing of the franchise agreement, may be a set fee or a per-room charge. Per-room fees range from $200 to $500 per room, and minimum payments are typically around $25,000. Then, the franchisee pays a royalty fee, usually 4 to 5 percent of gross revenues, for use of trade name, service marks, goodwill, and other franchise services. Other fees include a marketing contribution fee, a reservation fee, a loyalty programs fee, charges for hardware and software, travel agent commissions, training fees, data and communications fees, and the costs of attending the annual conference. These fees and charges are equivalent to 3 percent to 6 percent of gross revenues.

Franchise agreements generally run for 20 years, although I've seen a clear trend to shorter terms. One major franchisor offers a 10-year term. Territorial protection is negotiated on a deal-by-deal basis; some franchisors have a policy of not granting any protections.
Restaurant franchisors’ fees are similar in many ways to those of hotels. The initial fee averages $25,000 to $50,000, and the royalty fee generally runs from 4 percent to 8 percent of gross revenues. The marketing contribution fee is often combined with the royalty, but in any event is paid as a percentage of gross revenues.

Like hotels, restaurant franchise terms have generally run 20 years, but I've seen an increasing use of the 10/10 contract, which involves a 10-year initial term with a 10-year renewal (contingent on both parties agreeing to the renewal). While few franchisors grant territorial protection, some do give the first development rights for new locations to existing franchisees.

Management Contracts versus Leases

As a property owner, assuming you have a choice between a management contract or a lease, your decision may rest on your assessment of the allocation of financial risk and control between owner and operator. Leases generally would provide you with relatively predictable returns from your real
estate, but *once* you sign the lease you have little control over how your lessee treats your building during the term of the lease. In contrast, a management contract gives you greater financial potential on both the upside and the downside. Also, with a management contract you have greater control of your property through contractual asset-management provisions. Beyond that, the decision rests on matters of lease accounting, the legal status of tenants, and local custom. Let's take a closer look at management contracts.

*Hotel Management Contract Negotiation Strategy*

You should not undertake signing a management contract lightly, because it can define a property's identity for up to 60 years. If you've never seen a management contract, you might be surprised by the obligations it imposes on both owners and operators.⁴

As an owner, here are some of the important objectives you might be trying to achieve. Note that some of the goals you have as owner can be at odds with the operator's objectives, and the contract must reconcile those competing agendas. Your chief goals are to achieve a cash flow from your property and make sure that its asset value is preserved. To that end, you might want to insist that the operator bear some financial risk for the success or failure of the operation. This generally occurs through incentive fee mechanisms. You should try to preserve at least some operational influence and control over the hotel by requiring the operator to exhibit appropriate, prudent flexibility in difficult times and not insist on blind adherence to brand standards. You also need transparent systems for monitoring and evaluating your hotel's performance.

For the operator's part, it will seek the exclusive right to manage the hotel without undue ownership interference; the assumption by the owner of most if not all financial risk; indemnification for actions except for gross negligence or fraud; and procedures that require you to provide all funds needed to operate the hotel and to comply with brand standards.

The starting point for discussions over all these points is an agreement between you and your prospective operator regarding the hotel's operating projections. This can take a brief time, but sometimes takes up to a year. If you and the operator cannot even agree on the anticipated financial performance, there's not much point in proceeding with contract negotiations. Your operator may assist you in this process by suggesting ways to optimize the building for minimum costs and maximum revenue.

Once you and the operator have a mutually agreeable set of financial projections, your next step is to negotiate a letter of intent or "deal sheet" that outlines the major areas of agreement without
negotiating the legal language in detail. This letter, which runs five to 10 pages, is not an exercise in drafting a legal document. Instead, the purpose is for the parties to identify any "walk-away" items and to memorialize the results of the negotiations regarding the specific hotel being considered. One key point might be what happens if you sell the property. While the operator may not want you to terminate the management agreement if you sell the hotel, it might accept termination if you agree to a significant termination fee or other financial benefits.

Here are some of the other points that go into a letter of intent, all of which outline your fundamental agreement:

- The relationship between the parties (principal-agent or personal services).
- The operator's financial commitment to the project.
- Contract length, including renewals.
- Circumstances for contract termination.
- The management fee structure, including operator services that the owner must pay for outside of the management fee structure.
- Territorial restrictions on the operator's right to operate competing properties near your hotel.
- Dispute handling (arbitration or litigation).
- The lender's rights and obligations in the management contract if you cannot make debt service and the lender must foreclose.

Once you have the deal outlined in the letter of intent, the rest of the negotiations involve converting those understandings into a legal document. This is the province of legal teams, but both you and the operator need to keep tabs on these negotiations.

*Important Management Contract Points*

Let's discuss the detailed points that go into a management contract.

**Agency versus Personal Service** This is a contentious matter, because under common law a principal may dismiss an agent at any time, which means an owner can terminate an operator, despite contract language prohibiting such a termination. Yet operators seek (and arguably need) a stable contract term. Court cases supporting agency have changed the playing field and given considerable power to owners. Owners are no longer bound by contract provisions prohibiting termination if they can show that the agency relationship has been violated. In response, you may find that your operator insists that the contract provisions be governed under the terms of Maryland state law. This is because
the state of Maryland passed a law in 2003 that requires courts to interpret contracts under contract law instead of agency law, when the two conflict. This means that the termination provisions of the contract will trump the common law of agency. This potential conflict is the reason that you and your operator must consider your relative negotiating power and positions prior to agreement or rejection of an agency relationship.

**Operator's Financial Commitment** Many owners ask operators to co-invest in the project or otherwise make a financial commitment. As you may guess, this serves as an indication of the operator's commitment to the project, and it provides you with needed capital. I've found such financial commitments in less than half of contracts that I have reviewed. To begin with, the amount of capital involved is relatively small, generally less than 10 percent of the capital needed to acquire or build a hotel. The commitments take one of the four following forms (from the most desirable for the owner to the least desirable):

1. **Key money.** An up-front rebate of management fees provided as a cash payment to the owner. The operator usually demands a rebate of the key money if the contract does not run full term or if the owner sells the hotel within a specified, short period.

2. **Loan.** Generally structured as a mezzanine loan. This type of loan is subordinated to the main mortgage and is not secured by the real estate.

3. **Operating guarantee or cash flow guarantee.** An operator guarantee of a certain level of hotel cash flow in the project's initial years. If the hotel does not produce the guaranteed cash flow, the operator must "cure" the deficiency (make up the difference). This payment is usually subject to a claw-back mechanism that repays funds advanced under a guarantee out of future cash flows. The cash flow guarantee provides the lender with the assurance that the operator will provide sufficient funds to operate the hotel and cover debt service during the opening years of a hotel project.

4. **Equity.** A partnership arrangement in which the operator contributes funds to the venture. Most owners wish to avoid this, because they don't like the idea of the operator as partner. If your operator is an equity partner you can't terminate the contract, because one cannot terminate one's partners, and the relationship between the owner and operator becomes significantly more complex.

**Contract Term and Renewals** In general, chain operators are able to obtain terms significantly longer than independent operators as a result of their greater negotiating power. The average term for
A chain operator is a 10-year initial term with two 5-year renewal terms at the operator's option. Leading chains obtain substantially longer terms. For independent operators, the initial term is five years with one 3-year renewal term, again at the operator's option. Independent operators are able to significantly extend their initial terms and renewals if they provide key money or another financial contribution.

**Contract Termination** Assuming that agency is not provided in the contract, owners usually have the right to terminate the contract if the operator consistently underperforms, based on a two-pronged test. First, the hotel must have financial performance that is below the budgeted performance (typically, less than 90 percent of budget) and, second, the poor results must not be the result of poor economic conditions that affect all hotels in the market (often referred to as force majeure).

You probably won't be able to obtain the right to terminate the contract without cause, but even if you do you'd have to pay a termination fee in the range of two to five times the most recent annual management fees. The termination fee would decline as a contract approaches maturity.

Chances are that you will be able to negotiate the right to terminate the contract if you sell the hotel, but that probably will be subject to a termination fee. Chain operators often obtain the right of first offer to purchase the hotel if you do plan to sell. In the event that you cannot cover debt service, the typical contract gives the lender the right to terminate the management contract in the event of foreclosure, again subject to a termination fee.

**Fee Structure** The dominant fee structure in the industry is that the operator earns a base fee based on total revenue, plus an incentive fee based on hotel profitability (see Figure 19.5). Over the past 20 years, contracts have increased the emphasis on incentive fees, which is seen by owners as aligning the interests of the owner and operator. As you see in Figure 19.5, three incentive fee structures are common. Historically, the incentive fee was based on a profit measure called income before fixed charges (IBFC); sometimes a sliding scale is used, with higher payments based on increasing the operating margin. This incentive fee structure remains common in Europe and Asian contracts. A more recent provision is an incentive fee based on cash flow after an owner's priority (or preferred) return. This provision pays the operator a bigger percentage, but it's based on a figure that is more volatile than IBFC. This incentive fee structure is common in North American contracts. In distressed hotel situations, the incentive fee may be based on the improvement in IBFC; the operator is rewarded for improving the situation even if the IBFC remains negative. As I said before, in addition to the basic and incentive fees outlined, a contemporary management contract provides for payment for a variety of operator provided services, known as system reimbursable charges.
Other Terms: Protected Territory, Dispute Resolution, and Lender’s Rights

If you’re new to the hotel business you might be surprised to find that your operator would want to open a competing hotel down the street, but most operators seek expansion with multiple brands. The negotiations here must balance your wish to have some territorial protection for your hotel against the operator’s wish to have some freedom to expand operations in growing markets. This expansion comes in two potential forms. The operator will want to add brands that do not compete directly with your property, and if you’re in a growing market, the operator will want to add competing properties. Your agreement should specify the following: the definition of the restricted area, which brands are excluded from the restricted area, the time period of any restriction, and conditions for adding properties within the restricted area.
With any luck you and your operator will not have major disagreements, but you must decide in advance what dispute resolution mechanisms you will use. In particular, you may want to provide for formal alternatives to litigation. You might use an owner-operator committee with mandated mediation to handle disputes prior to bringing them to arbitration. Then, any arbitration clause should state clearly whether all contract provisions should be subject to arbitration or whether arbitration should be limited to specific disputes such as budget matters, management-fee calculations, operator system-reimbursable expense allocations, determination of unfavorable economic conditions for operator-performance provisions, and disputes about repair and maintenance, reserve for replacement, and capital improvement allocations.

Finally, your contract will have provisions regarding the lender's rights should you default on your loan. The lender wants to be able to terminate existing obligations when taking over a property in foreclosure. That would remove from the lender all of the rights and obligations of the (now departed) owner. However, recent contracts have given rise to the subordination, nondisturbance, and attornment agreement (SNDA), a form of nondisturbance agreement that has the effect of removing the lender's right to terminate under the existing management contract after a foreclosure. Lenders will be increasingly reluctant to grant an SNDA in the future as a result of lessons learned in the 2008—2010 downturn.

**Hotel Leases**

Most hotel brand operators prefer management contracts to leases, because accounting rules require that fixed lease payments be disclosed as a debtlike operator liability and capitalized. No such balance sheet effect exists for management contracts, because the contract creates no debtlike liability.

A lease innovation that makes disclosure moot is an agreement in which the lease payments are 100 percent variable, based on room revenues, as there are no fixed debtlike obligations. This innovation has brought about a change in attitude toward leases on the part of operators, who now see leases as a risk-sharing device. The absence of a fixed lease payment makes the owner and operator both at risk for the business's success.

Freed of the accounting requirement, variable leases offer advantages for both you and your tenant. Operators can generally obtain higher "fees" under a lease than a management contract in many situations because they can keep all proceeds beyond the cost of doing business and the rent (even if that is based on revenues). As a landlord, your rent payments would be more bondlike, since they are based on revenues, not profits. Both are variable, but profits are considerably more volatile.
Most leases provide for guaranteed minimum rents that are typically capped. Without that provision, there is an incentive for the operator to walk away in tough economic times. While good operators create leasehold value at the beginning of the term, this benefit diminishes rapidly over the term of the lease.

**Important Hotel Lease Points**

Although hotel leases are far less complicated than hotel management contracts, they still have important negotiating issues. Legal counsel is essential in helping craft these provisions.

**Rent** If the rent is fixed, does it have a mechanism to index rent to inflation? If the rent is variable, is it based on a percentage of revenues or a percentage of profits? A recent publication estimates that roughly one-third of current contracts feature fixed rents, more than one-third have fixed plus variable rents, 1 in 10 have variable rents, and the remainder are unknown.\(^5\)

**Term** Initial terms are split into three roughly even groups: over 20 years, 10 to 20 years, and less than 10 years. Most leases have two renewal options of five years. Long lease terms benefit the tenant, rather than the landlord.

**FF&E Ownership and Repair (Personal Property)** Generally, the tenant owns and has complete responsibility for replacement and repair of furniture, fixtures, and equipment (FF&E—personal property), but major items such as laundry equipment and kitchen equipment are often negotiated.

**Major Repairs** The owner often takes responsibility for the upkeep and replacement of repair and replacement of the building structure, heating, ventilation, and air-conditioning (HVAC) systems, roof, and other major systems.

**Other Items** You must negotiate the size of any security deposit, insurance requirements, whether the lease is assignable, standards for record keeping, reports to the owner, owner audit, and what portions of the lease are subject to arbitration.\(^6\)

**Restaurant Leases**

Restaurant leases are substantially different from hotel leases, primarily because of the difference in bargaining power between the landlord and the tenant. In restaurant leases, tenants have greatly diminished bargaining power. Whether you’re the tenant-operator or the owner, you are effectively in a partnership that is based on the lease provisions. Make sure that you have the advice of legal counsel.
Rent Landlords generally treat restaurants just as they do other retailers, in terms of the rent formula. Retail leases are structured with a fixed minimum rent and an overage rent that is based on sales. So a restaurant with $3 million in annual sales might have a minimum rent of $150,000 per year plus an overage of 6 percent of sales over $2.5 million (or another $30,000). Thus, the landlord has the comfort of the minimum rent, but shares with the tenant when sales are over the threshold (see Figure 19.6 for customary restaurant lease provisions).

In addition to paying rent for the use of the space, tenants also pay common area charges, which are the tenants' fair share of the operating expenses of the shopping center or building.

Term Initial terms for restaurant leases are generally less than 10 years, and many include a 5-year renewal option. One key provision that protects both the restaurateur and the landlord is a cancellation clause. This terminates the lease should revenues fall below a negotiated level.

Other Items Whether you're the landlord or tenant, you must negotiate language regarding the specific use of the premises. Tenants should expect the landlord to exclude many uses not related to the restaurant business. You'll also need to negotiate security deposit and insurance requirements.

<table>
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<th>Figure 19.6</th>
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<tbody>
<tr>
<td><strong>Restaurant Rents</strong></td>
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<td><strong>Rent as % Sales</strong></td>
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<td><strong>Super Regional Malls</strong></td>
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<tr>
<td>Restaurants</td>
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<td>Food Court</td>
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<td><strong>Regional Malls</strong></td>
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<td>Food Court</td>
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<td><strong>Community Centers</strong></td>
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<td>Restaurants</td>
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<td>Fast Food</td>
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<tr>
<td><strong>Neighborhood Centers</strong></td>
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<tr>
<td>Restaurants</td>
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<td>Fast Food</td>
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</tbody>
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*Source: Urban Land Institute, “Dollars and Cents of Shopping Centers.”*

Closing

As we have seen, separating the real property from the intellectual property in the hospitality industry has created many different opportunities for success. Those who are new to the hospitality industry can enhance their success by understanding the value proposition of various combinations of
property rights. Whether you enter the industry as an operator or a real estate owner, well-constructed agreements with other property rights holders creates a wide variety of strategies for success.