Pandox—A Hotel Owner-Operator's Smorgasbord of Options

By Rob van Ginneken

Introduction

"You book a room on the website of a famous international hotel chain. As you arrive to check in, its reassuring brand name is above the door. Its logo is everywhere: on the staff uniforms, the stationery, the carpets. But the hotel is owned by someone else—often an individual or an investment fund—who has taken out a franchise on the brand. The owner may also be delegating the running of the hotel, either to the company that owns the brand or to another management firm altogether. The bricks-and-mortar may be leased from a property firm. […] Welcome to the virtual hotel." (The Economist, 2009)

The above introduces, in plain language, the wide variety of ownership, operating and branding configurations in the hotel industry, which could be said to be increasingly vertically disintegrated (Roper, 2013).

This case aims to enhance students' understanding of this important topic, using the example of Pandox, an important player in the European hotel industry. The data presented in this case study have been collected mostly from publicly available sources, such as the company's website and annual reports, and industry news websites. In addition, the Senior Vice President, Director of International Operations, was interviewed in the fall of 2015.

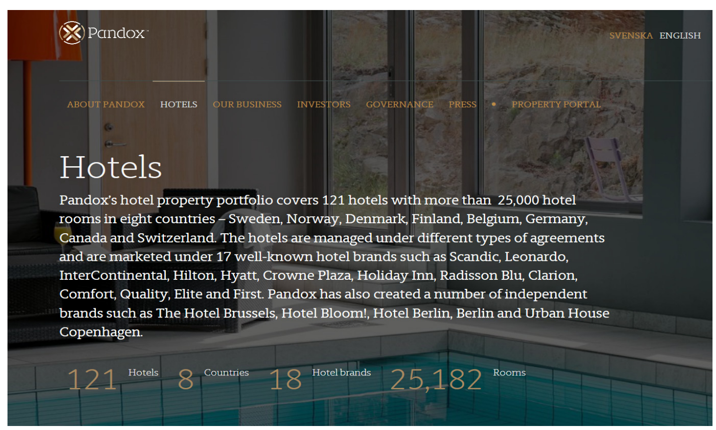
Having grown from a base portfolio of 18 hotels in Sweden in 1985, at the end of 2015 Pandox owned 121 hotels (more than 25,000 rooms) in eight countries (Pandox 2016a). Most of these (89 hotels, or 81 percent of the total number of rooms) are situated in the Nordic region (Sweden, Norway, Denmark and Finland); the balance are in Germany, Belgium, Switzerland and Canada. Growth has not always been on a 'one hotel at a time' pace: buying, but also selling entire portfolios of hotels can be considered to be part and parcel of the Pandox business model. An important growth spurt took place in 2010, when it bought Norgani Hotels, or 73 properties, all in Scandinavia and Finland. As a result of this acquisition, the company increased in size by 160% to 120 hotels, becoming one of Europe's leading hotel companies. At the beginning of 2016, Pandox announced the completion of the acquisition of 18 Leonardo hotels in Germany. The company is not just a buyer, but also a seller of hotels: in 2014, a portfolio of 14 Swedish hotels was sold, followed by another sale of 8 (again Swedish) hotels in 2016.

Rob van Ginneken *is affiliated with NHTV University of Applied Sciences.*

The guiding principle for Pandox to either acquire or divest of hotels is to establish a portfolio of larger, full-service hotels, in the upper-medium to high-end segments, and in markets which attract business as well as leisure demand. Another element of the Pandox business model is to acquire underperforming hotels, and invest in them by means of refurbishments or repositionings. Sources in the industry familiar with Pandox often applaud the company for its ability to do so. For example this developer of a large international hotel company: "What Pandox does very intelligently, they buy hotels that are badly positioned, make a fantastic turn-around there [...]. Very smart, what these guys are doing!" (Anonymous, personal conversation, 2014).

Figure 1

Screenshot company website – Portfolio Overview



The company is split in two segments. Property Management owns 103 hotels which it leases out to tenant-operators. Well-known tenants include Scandic, Choice Hotels and Rezidor. The second segment, Operator Activities, operates the remaining 18 hotels, either as a franchisee of brands such as Crown Plaza, Hilton and Holiday Inn, or independently, such as The Hotel and Hotel BLOOM! (both in Brussels) and Hotel Berlin, Berlin in (indeed) Berlin. In Operator Activities are also the two hotels Pandox acquired in 2007 and 2008 in Montreal, which are subject to a management agreement with Intercontinental and Hyatt, respectively.

Since 18 June 2015, Pandox' B shares have been listed on Nasdaq Stockholm. Owners of these have one vote for each share. The company's

Table 1

Portfolio Overview by Segment and Geography (Values in Millions of Swedish Crowns, or MSEK)

Property Management	No. of hotels	No. of rooms	Property value	Property value in % of total
Sweden	50	9,519	13,193	42.0%
Norway, Finland, Denmark	33	6,515	7,396	23.6%
International	20	3,721	4,473	14.2%
Total	**103**	**19,755**	**25,062**	**79.7%**
Operator Activities				
Sweden	2	358	269	0.9%
Norway, Finland, Denmark	4	894	843	2.6%
International	12	4,183	5,262	16.7%
Total	**18**	**5,435**	**6,375**	**20.3%**
Total owned properties	**121**	**25,190**	**31,437**	**100%**

Adapted from the year-end report January-December 2015 (Pandox, 2016a)

A shares (three votes to each share) are not publicly traded; the majority of these are held by three long-time corporate shareholders. Pandox is part of the FTSE EPRA/NAREIT Global Real Estate Index. This index tracks the share price performance of listed real estate companies. Companies in this index must derive at least 80 % of their revenue from real estate directly, for example from rent received from tenants. For that means no more than 20% of its revenue can come from hotel operations.

Recent developments

In November 2014, Pandox became the lessee-operator of the Grand Hotel Oslo (Hotel Management, 2014). This particular arrangement is quite exceptional: the hotel is owned by one of Pandox' majority shareholders, and the lessee status is not one that Pandox will actively seek for other properties. Yet the number of hotels in Operator Activities has increased in perhaps more fundamental ways. In the first few weeks of 2016, the company announced it would take over operation of a number of owned hotels of which the lease had expired, and an extension could not be negotiated with the lessee-operator (Browne, 2016). The effect of these 'reclassifications' of hotels from Property Management to Operator Activities is that rental income will transform into net sales from operating those hotels.

A relatively minor source of revenue is Asset Management services provided to the owners of another 8 hotels.

Theory and practice of hotel operating models

As will be clear from the introduction of Pandox, hotel ownership and operation are often separated. From the point of view of a company that is (primarily) an owner, such as Pandox, two questions pose themselves:

1. are we going to operate the hotel ourselves, or are we going to contract a third-party to do that – either through a lease or a management contract?
2. are we going to affiliate the hotel, either through a franchise contract with a brand or through another type of affiliation, such as becoming the member of a consortium?

The large international (very often U.S.-based) hotel companies (IHCs) most people are familiar with, such as Hilton and Marriott, pose themselves similar but subtly different questions. Rather than the question "To operate [the hotels we own] or not?", the question for them is "To own [the hotels we operate] or not?" Two separate but related theoretical concepts may provide useful insights for interpreting these choices made by owners and operators: that of 'agency' and 'modal choice'.

Agency theory is concerned with relationships where one party, the agent, acts on behalf of another, the principal (Kruesi, 2015). As the goals, risk appetite and interests of agent and principal may not always be aligned, such a relationship may prove to be problematic. In the hotel industry where, as we have seen above, hotel ownership, operation and branding are often separated, two possible agency challenges present themselves. Kruesi (ibid) discusses agency issues in franchising (where the franchisee (agent) is expected to operate a branded business in line with the interests of the franchisor (the brand owner principal). Other studies (e.g. Panvisavas and Taylor, 2008; Turner and Guilding, 2010) explore agency issues that are the result of the separation of hotel ownership and operation, where the hotel owner is the principal of hotel companies that manage the owner's property as their agent.

In hospitality research, a number of papers (see e.g. Contractor and Kundu, 1998; Gannon and Johnson, 1997) address the second

Table 2

Overview of Pandox' Shareholders

	A shares	B shares	Capital %	Votes %
Eiendomsspar Sverige AB	37,314,375	7,314,375	29.8	39.8
Helene Sundt AB	18,657,188	3,657,187	14.9	19.9
Christian Sundt AB	18,657,187	3,657,188	14.9	19.9
12 other large owners	371,250	42,370,285	28.2	14.3
Other owners		18,000,992	12.2	6.1
Total	**75,000,000**	**75,000,000**	**100**	**100**

Company website (Pandox, 2016b)

theoretical concept of 'modal choice'. These studies explore how hotel companies have grown and whether there is one 'best way' for them to expand, whilst retaining control over brand standards, key personnel and other intangible assets deemed to be proprietary. In practice, many hotel companies started out as hotel owners, but developed, over the years, into quite a different breed of companies, often employing 'multi-modal' or 'plural-form' (Brookes and Roper, 2012) organizational structures. In the industry, they are referred to as (different degrees of) 'asset-light' companies. This term is used to describe (most but not all) IHCs which have disposed of most of their hotel real estate, focusing on hotel operations. "Sale and lease-back" and "sale and manage-back" denote two ways of achieving this. In the former, hotel companies sell their properties to a third party, only to then lease the building back from the new owner, and continue to operate it. In the latter, the original owner will also continue to operate the hotel, but this time on the new owner's behalf. Of these two, the sale and manage back option is preferred by most IHCs, as the lease-back option would create a long-term rent liability for the operator. This liability, in combination with uncertain hotel income, still leaves a lot of risk with the operator. In summary, most IHCs can be said to operate on a fee-based model, where they prefer to grow, faster than they could if they were to own or lease, by signing management and / or franchise agreements for hotels owned by a third party.

For completeness' sake, it should be noted that many non-U.S. hotel operating companies have fewer difficulties with hotel ownership and leasing. Examples include certain Asian luxury hotel groups such as Peninsula Hotels, Oberoi and Mandarin Oriental – although the latter two have, to varying degrees, also made moves in the direction of a more asset-light business model (Dutta, 2015; Gollan, 2015). In many European countries, like Germany and the Nordic countries, lease contracts are much more common than management contracts (Hodari, 2014; deRoos, 2015). Not surprising then, perhaps, that Pandox should originate in Sweden.

A relatively new trend is that some IHCs may be getting more than they bargained for, in terms of becoming asset-light. Increasing numbers of investors have acquired hospitality operations 'savoir-faire' and choose to operate the hotels themselves. Others may perceive their manager's brand interest to not always be aligned with their own, and decide to enlist the services of independent (that is, non-branded) management companies. This trend, if it persists, would lead to a decrease in the number of IHC management contracts, leaving them only the franchisor role, and would in fact transform them into pure branding companies. Figure 2 depicts the various degrees of asset-heaviness, from asset-heavy on the left (where the IHC would own the real estate of their hotels) to very asset-light on the right, where they would only be involved in a hotel operation as a franchisor.

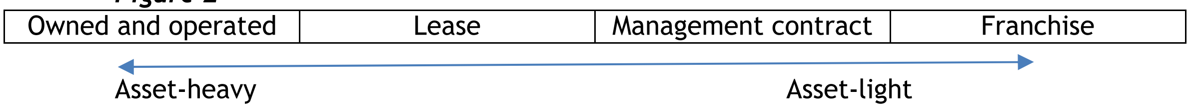
Note that at the level of the ownership and operating structure of an individual hotel, more than one of the agreements represented in Figure 2 may be used in combination. For example, the real estate owner could lease the property to a tenant, who in turn could hire the services of an independent management company to run the hotel on his behalf, and sign a franchise contract with a brand.

Dilemma

The CEO of Pandox, Mr. Anders Nissen, is well-known in the hotel industry as an ardent promotor of the lease model as a way to structure the relationship between a hotel owner and a hotel operator. Put differently, he believes management agreements, even with independent / unbranded operators, do not create an equitable partnership (Nissen, 2014), because in a management agreement "the owner [is] taking 100 percent of the risk while the operator benefits on the upside." (Nissen, 2013:2).

His view on this matter is quite clearly reflected in the company's portfolio, the majority of Pandox' hotels being leased to an operator, compared to only two hotels under management of a major brand. Mr. Nissen believes a lease agreement in which the rent payable to the landlord is variable and depending on the revenue and / or profit of the hotel, is a better way to have owner and operator share the

Figure 2



business risk of owning and operating a hotel. In one of his most outspoken moments, Mr. Nissen (2013:2) commented on his experiences as a panel member during a debate at a hotel investment conference, as follows: "It was particularly apparent that a number of advisors, often London-based – couldn't explain the benefits of a lease agreement and instead recommend investors, who often run a passive investment model, to agree management deals with cunning international hotel operators, resulting in an unequal share of the risk. In my world, this is definitely a subject to revisit."

The Economist (2009) provides a possible argument for Mr. Nissen's dim view of the management agreement. In the case of a recession, for example, the operator of a managed hotel will make less money, but the owner will be hurt much more, financially: "[…] if revpar falls 1% at a hotel, its owner typically suffers a 5% profits fall. But the management fees (which are usually linked to a mix of the hotel's revenues and profits) fall by 3%; and franchise fees (which are usually linked only to revenues) fall by only 1%."

Mr. Aldert Schaaphok, Pandox' Director of International Operations, is at least as critical of the management agreement as his CEO. To him, the combination of a manager who is:

a) rewarded, through the management fees mentioned above, largely on the basis of the hotel revenue;

b) while at the same time claiming full control of the actual operation,

is not a logical one. He strongly feels that management companies can 'make or break' the profitability of a hotel, and their compensation should be much more based on that (the "bottom-line") than on revenue ("the top-line"). On top of that, he believes the management of hotel operations should be separated from branding and distribution services. Owners who decide, for whatever reason, not to operate their hotels themselves, would be better off hiring local and/or independent management companies. And his criticism doesn't stop there: he is of the opinion many large brands are too slow in developing truly innovative hospitality concepts, and that Pandox does much better in that regard, themselves.

Discussion Questions

- How would you characterize the company in a nutshell? Who are Pandox' competitors, or similar hotel businesses? Discuss the rationale (advantages and disadvantages) of Pandox' strategy to use different ownership, operation and branding models.
- To what extent do you agree with the Director of International Operations' assertion that independent management companies are a better option for owners who want to outsource operations management than the large international chains?
- What do you think of Mr. Nissen's assessment of the hotel management agreement as an 'unfair' operating structure?
- Figure 2 represents the asset-heavy – asset-light continuum, from the point of view of an IHC that is a branded hotel operator. Discuss this continuum from the point of view of a company that is primarily a hotel owner.

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