Hilton Terminates Las Vegas Franchise

By Olga N. Grogan and Mahmood A. Khan

Introduction

Hilton Worldwide, Inc. is one of the world's largest hospitality chains. It includes 10 brands ranging from the luxury Conrad to the economy Hampton Inn with a few specialty brands such as Homewood Suites by Hilton and recently launched Home2 Suites by Hilton. At the height of the commercial real estate market in 2004-2006, Hilton launched asset disposition program selling over 20 of its most prestigious properties including the Las Vegas Hilton. Most of the properties sold retained Hilton's name through franchising agreements.

The Las Vegas Hilton was built in 1969. When it opened, the property with its 2,956 rooms and 305 suites was the largest in the world. Over its 40 plus year history the hotel changed ownership and management numerous times. The latest owner, Colony Capital LLC, who acquired the Las Vegas Hilton in 2004, faced an aging property in need of reconstruction, sliding customer demand, a massive $252 million loan, and steep franchising fees. In 2004-2007 the owner undertook a renovation of the hotel lobby and other public areas as well as two of the four hotel towers. However, mounting problems led to financial losses and rapidly declining customer ratings. In mid-summer 2011 Hilton Worldwide announced that the Las Vegas Hilton franchising license would be terminated as of January 1, 2012.

Overview: Hilton Hotels & Resorts

Hilton Worldwide, Inc. (HW) (formerly known as Hilton Hotels Corporation) is a global hospitality company that is ranked the 4th largest in the world. It was founded by Conrad Hilton in 1919 and now owned by Blackstone Group, a private equity firm. As of July 2011 Hilton brands encompass 3,750 hotels with over 600,000 rooms in 85 countries. Hilton is ranked as the 36th largest private company in the United States by Forbes. Hilton Hotels became the first coast-to-coast hotel chain of the United States in 1943.

The Hilton family of brands includes the following names: 1) Hilton Hotels & Resorts, 2) Conrad Hotels & Resorts, 3) Waldorf Astoria Hotels & Resorts, 4) Doubletree, 5) Embassy Suites Hotels, 6) Hampton Inn, Hampton Inn & Suites, 7) Hilton Garden Inn, 8) Homewood Suites by Hilton, 9) Home2 Suites by Hilton, 10) Hilton Grand Vacations. (Hilton Worldwide, 2012) This study focuses on the main brand, Hilton.

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Hilton hotels are either owned, managed, or franchised to independent operators by Hilton Worldwide. Hilton Franchise Holding LLC (HFH) is a Delaware limited liability corporation that was formed on September 12, 2007, and began operations on October 11, 2007, to be a franchisor of the Hilton family of brands within the United States. HFH is a wholly owned subsidiary of Hilton Worldwide, Inc.

Today, there are over 540 Hilton branded hotels across the world in 78 countries across six continents. As of December 31, 2010, there were a total of 256 Hilton or Hilton Suites branded hotels operating in the US (not including its Territories or Possessions). Of these, 244 were mature, i. e. were open before January 1, 2009 and were in operation on December 31, 2010. 60 or 25 percent of the mature hotels were company-managed and 184 or 75 percent were franchisee-managed. (Hilton Franchise Disclosure Document, 2011)

Franchising Mission Statement and Principles

Franchise is a form of business organization in which a firm that already has a successful product or service (the franchisor) enters into a continual contractual relationship with other businesses (franchisees) operating under the franchisor's trade name and usually with the franchisor's guidance, in exchange for a fee.

Positive relationship between a franchisor and its franchisees is an important element of a successful franchise company. A franchisee/franchisor relationship requires an ongoing commitment, with each party expected to uphold its end of the bargain through active communication, common goals, and mutual respect. Both the franchisee and the franchisor need to understand and carry out their respective roles under the agreement. The ability to do this revolves around sharing a vision, maintaining professionalism, support, training, and open communication.

The Hilton franchising mission statement is, "When you develop a Hilton Hotels Corporation franchise, you are not just developing a hotel, but a relationship with our entire family of hotels. Advantages like our friendly, responsive corporate staff, franchising expertise across all market segments and competitive fees make this a hotel company you will want to stay with for a long time." (Hilton Franchise LLC, 2010)

Table 1

Hilton Monthly Franchise Fees

Monthly Royalty Fee	5% of monthly Gross Rooms revenue
Monthly Program Fee	4% of monthly Gross Rooms revenue
Monthly Food & Beverage Fee	3% of monthly Gross Food & Beverage revenue
Technology Fee	0.75% of monthly Gross Rooms revenue

What franchisees should expect from Hilton Worldwide:

- Hilton will protect the value of its brands.

In the final analysis, Hilton brands are what distinguish Hilton from the competition and are the reason Hilton's guests keep coming back to HW. Hilton will not compromise on the quality of its brands and hotels.

- Hilton is committed to delivering outstanding service to its franchisees and to helping them to maximize the value of the system.

Hilton franchisees are Hilton customers. HW goal is to deliver the same, common-sense service levels that Hilton would expect for itself.

- Hilton Worldwide will work hard to maintain the superiority of its brands.

Hilton will continuously monitor and research trends and standards within each brand's competitive set and introduce on a periodic basis what Hilton believes are the best cost-justified changes in standards and policies. (Hilton Franchise LLC, 2010)

What Hilton Worldwide expects from its franchisees:

- Uphold brand value, product and service quality standards, and Hilton's culture of complete guest satisfaction.
- Total commitment to building customer loyalty.
- Ensure that a franchisee's employee team members are well-trained and focused on delivering on Hilton's commitment to product and service quality.

The long-term health of Hilton brands depends on this commitment. In the guest's mind, a brand is only as strong as its weakest property. Rigorous enforcement of standards helps both Hilton and its franchisees.

- Tell directly how Hilton can better serve and support you.

HW invites its franchisees to communicate openly and regularly to provide input to improve Hilton brands and relationships, and will seriously consider all ideas and points of view that benefit the brands and franchisor-franchisee relationships.

- Take a proactive role in building new Hilton brands in your markets.

HW expects and encourages its quality franchisees to be the most aggressive developers of Hilton brands, and HW will try to help them in that effort. (Hilton Franchise LLC, 2010)

As the above principles show, Hilton makes strong emphasis on protecting the value of its brands, building customer royalty, and will not compromise on quality.

Overview of Franchise Fees

Initial Franchise Fee or Development Service Fee

When a franchisee submits their license application for a Hilton franchise, it pays the HHC an initial fee based upon the number of guest rooms in the prospective hotel. The initial fee is currently $85,000 for the first 275 guest rooms or suites plus $300 for each additional guest room or suite, with a minimum fee of $85,000.

Other initial fees include: Product Improvement Plan Fee, Construction Extension Fee, Renovation Work Extension Fee, Designer and Engineering Fees, Pre-Opening Training. It is estimated that an initial investment for a new 300 room hotel is between 53 to 93 million dollars.

Source: http://www.hiltonfranchise.com/Scripts/FD.asp?http://www.hiltonfranchise.com/Marketing/Fees/FeesOvrvwHHB.asp.

Other Fees

Other Fees include various guest assistance and quality assurance fees; frequent customer, affiliation and distribution programs fees; management fees; transfer, relicensing and financing fees; conferences and training; remedies and damages fees. (Hilton Franchise Disclosure Document, 2011).

Las Vegas Hilton

The hotel, designed by architect Martin Stern, Jr. was built in 1969 by Kirk Kerkorian and opened as the International Hotel. When it opened, the International was the largest hotel in the world. Barbara Streisand was the opening-night performer, along with Peggy Lee performing afterwards in the hotel's lounge. In 1969, right after Streisand's engagement, Elvis Presley performed for 58 consecutive sold out shows, breaking all Vegas attendance records.

The International Hotel was sold to Hilton Hotels Corporation in 1970 and renamed the Las Vegas Hilton in 1971. In 1998, Hilton Hotels

Corporation split their properties and stock into two different companies (Hilton Gaming, and Hilton Hotels). Shortly after the split, Hilton Gaming Company merged with Bally Entertainment Corporation (owners of Bally's Hotel). The company was re-named Park Place Entertainment. In 2000, Park Place Entertainment purchased Caesars World (All Caesars Casinos). In 2003 Park Place Entertainment changed their name to Caesars Entertainment. In 2004, CaesarsEntertainment sold the Las Vegas Hilton to Colony Capital LLC for $280 million. Colony Capital, a Los Angeles-based private equity firm, then transferred the property to its subsidiary Colony Resorts LVH Acquisitions LLC.

The Las Vegas Hilton is now Colony Resorts anchor property, with their corporate office located on the second floor of the east tower. The hotel, next to the Las Vegas Convention Center, has 2,956 rooms and 305 suites and a 74,000-square-foot casino, with a dozen restaurants and the Hilton Theater showroom. (LVH – Las Vegas Hotel & Casino, 2012)

Hilton Terminates Las Vegas Franchise

Termination of a franchise agreement is frequently contested by both franchisors and franchisees if it is not carefully written and understood. The most common reasons for termination are:

- Failure in paying any monies owed to franchisors
- Failure to follow terms agreed upon in the agreement
- Failure to maintain the quality control standards set by the franchisor
- Continuous violation of any law, rule, or regulation of any governmental agency
- Improper use of the proprietary marks of the franchisor
- Certain condition of bankruptcy and insolvency. (Khan, 1999)

In mid-summer 2011 Hilton Worldwide notified the owner of the Las Vegas Hilton of its plans to terminate its franchise license agreement by the end of the year. Hilton Worldwide said that as of January 1, 2012 its franchise agreement with Colony Resorts LVH Acquisitions LLC, owner and operator of the Las Vegas Hilton, will have been terminated, forcing the off-Strip hotel to give up the Hilton name and loyalty program.

"We have been in discussions with other major hotel brands and may re-engage with Hilton in the coming months regarding a new franchise agreement," said Owen Blicksilver, a spokesman for the Las Vegas Hilton. "We expect to announce an affiliation with a major hotel chain before year's end." Blicksilver said Hilton's notification would not "impact the management, ownership, operations, employees, vendor or guest services at our hotel." (Sieroty, 20111)

"Pursuant to the license agreement, either party may terminate the agreement without cause at any time after Jan. 1, 2011. Unless the parties reach an agreement otherwise, the effective date of the termination will be Jan. 1, 2012," according to a Colony Resorts filing with the Securities and Exchange Commission.

"Neither Hilton Worldwide nor Colony Resorts would comment on the reasons for terminating what will be an eight-year business relationship at the end of the current contract. The current three-year license, signed in 2009, gives Colony Resorts the right to use the Hilton brand, and it links the property to Hilton's Honors loyalty program." (Sieroty, 20111)

Las Vegas Hilton Financial Hardship

The Las Vegas Hilton has struggled since the economic downturn and is located on the north end of the Strip, an area suffering from unfinished projects, empty lots, and the recent closing of the Sahara hotel.

Colony Resorts lost $3.3 million on net revenue of $52 million in the first quarter of 2011, an increase from the $2 million loss, on $54 million in net revenue, in the same quarter of 2010. The 2,950-room Paradise Road hotel-casino lost $8.86 million in the second quarter vs. a loss of $9.85 million in 2010's second quarter. Amid tough competition and an oversupply of hotel rooms in Las Vegas, net revenue of $45.5 million in the second quarter of 2011 was down from $47.5 million in the same quarter of 2010. Casino revenue of $14.2 million declined 9.1 percent, the Hilton reported. Hotel room revenue was steady at about $19.3 million, while food and beverage revenue fell 8.6 percent to $14.4 million. (Green, 2011)

Colony Resorts LVH also reported that it chose not to make monthly interest payments totaling $3.5 million for June, July and August of 2011 on its $252 million term loan "in order to conserve liquidity for operating and other needs." The loan represents a majority of the company's $296 million in debt and liabilities. The term loan lender is Goldman Sachs Commercial Mortgage Capital L.P. A Goldman Sachs affiliate is also an investor in Colony Resorts LVH and this was not the first time the term loan has been in default, with the last default resolved in July 2010.

Table 2

The Las Vegas Hilton Financial Summary

	1 quarter 2010	2 quarter 2010	1 quarter 2011	2 quarter 2011
Net Revenue	$54.0M	$47.5M	$52.0M	$45.5M
Profit (Loss)	($2.0M)	($9.85M)	($3.3M)	($8.86M)

While the lender is entitled to exercise various remedies due to the default, in August 2011 Colony Resorts LVH said it's "currently in discussions with its lender to negotiate a restructuring of its debt, the outcome of which is uncertain." This means the second default could again be resolved on friendly terms unless there are disputes with the other main investor, Colony Capital LLC. (Sieroty, 20112)

On September 2, 2011 a notice of foreclosure was filed against the Las Vegas Hilton. Attorneys for lender Goldman Sachs Mortgage Co. and majority owner Colony Capital LLC have agreed to have veteran gaming manager Ronald P. Johnson take charge of the entire operation. He has overseen everything but the casino since his December 13 appointment as receiver by Clark County District Court Judge Elizabeth Gonzalez. The idea is that Johnson will maintain operations in the near-term, including paying suppliers on time and avoiding layoffs. (Sieroty, 2012)

Las Vegas Hilton Compromised Quality

As the evidence suggests, it is likely that deepening financial problems were at the root of the problems leading up to Hilton Worldwide's decision to terminate the Las Vegas Hilton franchising license. When a hotel does not produce enough income and subsequently experiences financial loss, all expenses including those directly affecting service are likely to be trimmed. These cost-saving cuts trigger deterioration of a property, customer service quality, and guest satisfaction. In case of continual losses, a property may enter a state of extreme negligence that may then require a substantial investment to ameliorate the property. Hilton Worldwide did not comment on these conclusions. Additionally, precise information regarding this aspect of the franchise relationship is not publicly accessible.

The last known substantial renovation project, at the cost of $100 million, was undertaken in 2004-2007 shortly after Colony Resorts purchased the property. During the renovation process, about half of the rooms were upgraded with new beds and various technological accessories such as 37-inch plasma televisions, wireless Internet access and ports for MP3 music players. Additionally, the lobby, casino, and the porte cochere were renovated and sports book expanded. (Knightly, 2007) However, despite these renovations and upgrades, the property was frequently described by customers as "tired" and showing its age, suggesting that either the renovations were insufficient or that another renovation project was well overdue.

Customer reviews of the Las Vegas Hilton in the last couple years of the franchise's existence had been predominantly negative, with about three quarters of reviewers rating the Las Vegas Hilton as below average. Moreover, the majority of positive reviews received during that time emphasized the affordability of the hotel, which frequently offered a $30-60 nightly rate, as the main redeeming factor. Below are three representative customer reviews of the property submitted right after the Hilton Worldwide announced the termination of the franchise contract. The reviews provide primary evidence for the assumption that one of the reasons for the franchise license termination was severely compromised quality of customer service at the hotel, which was likely a direct by-product of the hotel's cost-saving measures implemented during a time of overarching financial difficulty.

> "I am a HH Diamond member and this is the worst Hilton property I have ever stayed in. I waited in the check-in line for nearly 40 minutes and then, at 6:15 in the evening, they told me my room was not ready yet. I waited until 9:00 PM to finally get into my room. Now, the staff was great; friendly, courteous and the like but no matter how busy you are, it's disappointing that it should come as a shock to a LV-based hotel. Next time, I will choose another non-Hilton property."
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> - Submitted by Frank on October 24, 2011.

> "The only reason I stayed here was that I arrived too late in the evening to have the energy to move somewhere else. The next morning I moved first thing. I had a "suite" which was actually two non-connected rooms. I don't know why they advertised this as a suite. The problems: dirty and old. The furniture looked like it came from a garage sale - surfaces very dirty and stained - you don't want to sit anywhere in this room. I actually felt uncomfortable taking my shoes off from the stains on the carpet. Walls literally had some peeling wallpaper. TV remote was disgusting. Windows had large visible forehead and finger grease stains. The shower is designed for a 4 foot tall person (oh yea these still exist at this hotel). Also, REALLY Expensive! Why in

the world would you pay more to stay here???? By the way, if you want to be close to the convention center - everything is close to convention center in Vegas and there are trams, taxis, and free valet (at the Hilton convention center) to get you to the conference center. I even have a loyalty card at this Hilton and could not get outta there fast enough. Even with the cancellation fee, the Venetian was cheaper and soooooo soooooo much nicer. I have stayed in 1-2star Ramada Inns that were nicer than this place. Do not stay here!!"

- Submitted by Scott on September 29, 2011

"Easy and simple, "it's a dump". Extremely bad hotel in any and every aspect. Check in on a Thursday afternoon, no holiday week, over 1 hour waiting time, only 2 people working on check in. Rooms are super old, nasty. Had to call maintenance twice to get ac filter changed as it had almost an inch of mold underneath it. Hair everywhere - sink, sheets, toilet, shower... this is not only the worst Hilton but probably one of the worst hotels in Vegas. And of course nothing is close by, but that we knew up front. Pool is so old and little, forget it."

- Submitted by Jerry on June 27, 2011

The following are customers' reviews up to two years prior to the Hilton's decision.

"Expected more from Hilton. I stay at Hilton hotels about 40 nights per year and I expected more from their Las Vegas location. I stayed at the Hilton Garden Inn south of the strip and it was better. This hotel is old, the rooms are outdated, the service is lousy and the food leaves much to be desired. This hotel should be renovated or torn down and rebuilt, it only does damage to the Hilton name."

- Submitted by anonymous on May 2, 2010

"Not up to the standard of other Hilton hotels. Pros: Cheaper than other hotels on the strip. $88 per night during early Jan. Cons: We stayed at this Hotel for 2 days out of our 4 day vacation. First we were given a smoking room when we had requested them for a non-smoking room. Secondly the bathroom tap was leaking a lot of water for the entire 2 days we were there. No one seemed to care about it when they came for room service (if at all they did any room service cleaning), since they did not change our towels or vacuum our room when we had requested for it. And someone knocked on our door at 2 in the morning. Their so called heater is more of a cooler, since we felt extremely chilly in the morning after the heater was switched on all night. This place is a definite NO-NO. Best Western or Days Inn would be a better choice if it's for a quick stay, they offer free internet as well unlike Hilton which charges around 15 bucks per day!"

- Submitted by Suzie Q. on January 5, 2010

"The Worst Place Ever! Notice the date. The only good reviews occurred a year ago. Do not stay here! This place was dirty and terrible. It lists several restaurants but really only 1 or 2 are open at a time. The pool area is dirty and not great at all. The rooms are very bare hardly clean at all. Shower was pretty gross. No coffee maker and we were here on business. When you order room service even if you are sharing a pizza they charge 2.50 per person even if you are sharing. They nickel and dime you to death and everyone is rude except the door men they are all very nice and funny. I wouldn't stay here again. Even if my company wants to pay again I will say no. The courtyard Marriott across the street is better than this."

- Submitted by Regina on May 8, 2009. (Google reviews of Las Vegas Hilton, 2009-2011)

Various types of franchises offer examples of an adverse incident in one unit negatively affecting the entire franchise chain. News of such incidents is easily spread through word of mouth and publicized by social media and consumer forums. In the case of the Las Vegas Hilton, customer dissatisfaction appeared to have become the norm in the last couple years as the majority (about three fourths) of the customer ratings labeled the hotel as below average according to expectations set by the Hilton franchise. Although the Las Vegas location was Hilton's second largest property boasting a historic, legendary-like appeal and large exposure to the public, consistently poor quality ratings had tremendously impacted the company's brand image, which is one of the most important assets a company needs to compete in a saturated hospitality market. A tainted brand name frequently leads to loss of the customer base and decreased revenue at not only the struggling unit but also at all other units regardless of their location and prior performance.

Conclusion

Unfortunately, over time and due to a widespread financial crisis the Las Vegas Hilton fell short of delivering the quality service and experience that is expected of the Hilton family of hotels. Since Hilton believes that the brand is only as strong as their weakest property, it was arguably unavoidable for the Las Vegas Hilton to lose their franchising agreement. It can be hypothesized that the Las Vegas Hilton could default on paying the franchising fees; however no evidence to support this conclusion was found. The question is why the iconic property fell so low in customer ratings. Apparently, there was a chain of events that weakened the hotel financially as well as functionally and led to the termination of its Hilton franchise relationship.

Frequent change of ownership/management. The hotel was purchased by Hilton Hotels Corp. in 1970. Since then, the property has changed ownership several times, most recently in 2004, when Park Place Entertainment sold it to Colony Capital for $280 million. While having certain advantages, changes in ownership bear disadvantages as well. Changes of the upper management lead to disturbance of operations, increased uncertainty among lower management, and a decrease in their professional pride and care for the property.

Taking on too much debt. Colony Capital certainly paid premium price for the property in 2004, at the top of the real estate market. At once, the Las Vegas Hilton was hit with not only significant franchise fees, but also with interest expense on the $252 million loan. Serving the loan cut into the share that could be allotted for renovation and maintaining customer satisfaction. Eventually, debt payments took precedence over the maintenance and innovation of the services and experiences the hotel offered to patrons.

Downturn in the US economy starting in 2008. During recession people are less likely to spend on luxury vacations and gambling. If they do, they look for the best value for their money that the Las Vegas Hilton failed to provide.

Thus, it can be argued that the Las Vegas Hilton misfortune was, in a way, a consequence of Hilton Hotels Corporation's asset disposition program that started in 2004. Summarizing its successful efforts to sell selected hotel assets at attractive prices, Hilton Hotels Corporation said that in May 2005 - March 2006 it completed the sale of 20 properties for a combined $1,244 million. Net proceeds after property level debt repayment, minority partner distributions, selling costs and income taxes totaled approximately one billion. All properties, despite having been sold, nevertheless remain in the Hilton system either through long-term franchise or management agreements.

On a combined basis and based on trailing 12-month earnings before interest, taxes, depreciation and amortization (EBITDA) (net of fees), the 20 hotels sold at an EBITDA multiple of 13 times. Including capital that the respective buyers have committed to investing in the properties, the trailing 12-month EBITDA multiple was 14.9 times. After adjusting for a normal replacement for furniture, fixtures and equipment, the implied capitalization rate on the sales was 6.1 percent, and 5.3 percent when adjusted for the additional reinvestment capital. The combined per-room sales price was approximately $132,000 for 11 properties sold in May-July 2005 and $144,000 for nine properties sold between August 2005 and March 2006. (Business Wire. A Berkshire Hathaway Company, 2006)

"Along with adding units to our worldwide system through management and franchise contracts, where we have the industry's strongest development pipeline, selling selected hotel assets at attractive prices and retaining them in the Hilton Family of Brands is an important part of our strategy of becoming a more fee-driven company," said Robert M. La Forgia in April 2006, then Hilton executive vice president and chief financial officer. "The market for selling good hotel real estate continues to be very favorable, as evidenced by the attractive EBITDA multiples we've achieved. We are also very excited that the buyers -- all of whom are well respected hotel owners -- have committed to improving these properties, and we look forward to working closely with them." (Business Wire. A Berkshire Hathaway Company, 2006)

La Forgia added, "With our domestic asset sales program virtually complete, and following the recent completion of our acquisition of the lodging assets of Hilton Group, we are focused on the disposition of certain international hotel properties." (Business Wire. A Berkshire Hathaway Company, 2006; Industry News, 2005)

Apparently, in 2004-2006 Hilton successfully capitalized on the then common sentiment that real estate investment bears no risk. The question is whether the Las Vegas Hilton was just an isolated example or is an early sign of deepening problems of many Hilton's franchisees who acquired Hilton properties in 2004-2006?

Discussion Questions

1. Based on the available data and customer reviews, was Hilton's decision to terminate the Las Vegas Hilton franchise agreement justified? Why or why not?
2. Was there anything that Hilton as a franchisor should or could have done to save its ailing Las Vegas Hilton franchise? If so, during what time frame should necessary actions have been taken and through what general strategies?
3. What are the benefits and drawbacks of a franchise unit ownership change?
4. To what extent does an individual franchisee's performance affect the franchise system as a whole?
5. Discuss possible impacts Hilton's 2004-2006 year asset disposition program may have on the future of Hilton franchising.

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