CHAPTER 19

Property Management

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¶ 19.01 INDIVIDUAL MANAGERS VS. MANAGEMENT COMPANIES

The financial success of any lodging facility is largely dependent on the skill and ability of on-site management. Hotel operators face a number of unique problems, ranging from booking convention business to running a high-energy lounge to installing night audit financial controls. While the skills needed to handle such problems can be acquired through college-level training and operational experience, it is the type of system used by management that usually determines how successfully personnel can apply their skills.

Historically, hotel owners have either hired individual on-site managers to operate their properties or have engaged the services of professional hotel companies through hotel operating agreements such as property leases or management contracts.

The employment of individual managers is the less expensive approach, but there are serious drawbacks to such arrangements. In terms of supervision of staff, overall management skill, and effective operational methods, management companies are frequently superior to individual managers.

[1] Supervision

All the employees of a lodging facility should be supervised to ensure that the integrity of the facility's financial control system is maintained. An individual general

manager often cannot provide the necessary level of direct supervision, whereas the structure of a hotel management company generally provides several layers of control over this aspect of the business. Furthermore, an individual general manager can be abruptly hired away by a competitor, or may quit because of a dispute. A hotel management company, on the other hand, can provide the back-up staff, logistical support, and uninterrupted supervision that is essential for a 24-hour-a-day, 365-day-a-year business. Unless ownership can assume total operational responsibility for the hotel on short notice and for extended periods, an individual general manager is often not a viable alternative for property management.

[2] Expertise

Many professional hotel management companies offer a range of expertise and experience that individual general managers cannot match. Management companies can assist hotel owners with property development, acquisition, and operation by providing such services as national advertising and reservation systems, interior decorating, and property engineering. Management companies are often also able to provide counseling and representation for labor negotiations, permit and license applications, and zoning and property tax proceedings.

[3] Verifiable Past Performance

A successful hotel management company should be able to document its past performance and provide references regarding its operations currently under contract. Verifiable information of this kind provides hotel operators with a basis for selecting a qualified operator. Individual managers, on the other hand, generally cannot document the effect of their management on a particular hotel. As a result, the selection of a qualified general manager usually must be made with very little assurance that the individual will be capable of successfully operating the property. At the least, poor selection results in confusion and loss of momentum until another manager is located and brought in to take over the operation. While vulnerable to the same problem, a management company is better able to handle a transition between general managers because it can provide trained interim personnel who can quickly assume necessary responsibilities within an established system, permitting continuous operation of all essential controls and procedures.

[4] Established Methods and Procedures

The major advantage in hiring a management company is that it can provide established, functional methods and procedures that constitute a complete system capable of handling the complex job of operating a lodging facility. In instances in which a takeover must be made rapidly, established management companies can bring in top-level management staff from other properties to train local personnel and implement proper operating systems and controls. For new lodging facilities, management companies can often provide valuable advice in the layout and design of the physical plant, and once the facility is completed, can institute their mode of operation and quickly bring on-line a fully functioning lodging facility. This experience and expertise saves time and reduces costly mistakes.

Most hotel management companies have developed procedure manuals and

training programs that cover all of the aspects of lodging facility operations. When nothing is left to chance and set methods are established for handling all foreseeable problems, the element of human error is greatly reduced and hotel guests receive a consistently high level of service.

The benefits of retaining a professional hotel management company usually far outweigh the alternative of employing an individual general manager, particularly when a hotel owner does not have the ability or desire to provide a high level of supervision. As a result of many investors reaching this conclusion, the number of hotel properties managed by third-party operators has grown significantly over the past twenty-five years. This trend is further substantiated by hotel lenders, underwriters, and rating agencies, who typically require that a competent hotel company be included in the project team.

¶ 19.02 TOTAL PROPERTY LEASES

The practice of using professional hotel companies to manage lodging facilities for property owners began in the early 1900s. During this period, hotels became larger and more complicated to operate and the benefit of chain identification became an important competitive factor as the general population gained mobility. Hotel chains such as Hilton, Statler, Manger, and Albert Pick began to expand throughout the United States, operating both their own properties and hotels owned by others.

At first, the most common method by which hotel companies furnished management services was through total property leases. Essentially, a total property lease is an agreement between a hotel company and a hotel property owner whereby the hotel company leases the hotel (land, improvements, and sometimes the furniture, fixtures, and equipment) from the property owner. The hotel company thus becomes the tenant and assumes all operating responsibilities, as well as the financial obligations of funding, working capital, operating expenses, and rent. The landlord-owner is passive with respect to all operating decisions and is not responsible for working capital or operating expenses. The hotel company receives the residual net income after all expenses, including rent, are paid.

Under a total property lease, the financial burden is placed on the hotel company, which enjoys some benefits if the property is successful, but suffers all of the losses when operating performance is not adequate. Because of the popularity of management contracts, hotel operating leases have all but disappeared. Only recently, with the resurgence of real estate investment trusts (REITs), have operating leases been reestablished.

[1] Rental Formulas

Many types of rental formulas were devised for total property lease agreements. In a typical arrangement, known as a "25, 10, and 5 lease," the rent was based on the total of the percentages of various revenues realized by the property. See Exhibit 19-1.

Under such an arrangement, the landlord, as owner of the land and improvements, was responsible for payment of real estate taxes. The tenant owned the personal property and paid all of the operating expenses incurred by the hotel. Sometimes the rental agreement also provided the landlord with a minimum rent to cover the debt service on any mortgages on the property. If such was the case, the tenant paid the greater of the minimum rent amount or the rental formula, such as that for a 25, 10, and 5 lease.

Exhibit 19-1 25, 10, and 5 Leases

	Percentage of Total
Rooms Revenue	25
Beverage Revenue	10
Food Revenue	5
Other Income	20

[2] REIT Structures

The use of real estate investment trusts (REITs) as an alternative for hotel acquisition, financing, and portfolio expansion has resulted in the increased popularity of hotel operating leases. To qualify for favorable REIT tax advantages, the owning company may not operate the properties—it must "lease" the hotels to an independent lessee. Typically, the lessee in turn contracts third-party management, in which management fees are subordinated to the minimum base fee paid to the company. Rents typically include a base and percentage fee or are the greater of the two. In these scenarios, the lessee assumes a majority of the downside risk and is often related to the chosen operator, effectively creating a total property lease.

As a result of REITs competing in the same arena as other fixed income securities, the life of a real estate investment trust fluctuates with the rise and fall of interest rates. For this reason, hotel operating leases may be limited to the few hotel-specific REITs created during periods of low interest rates.

[3] Advantages and Disadvantages of Property Lease Agreements

A property lease agreement contains advantages and disadvantages for both parties. A property owner realizes the following advantages:

1. The owner retains title to the property, which provides possession and creates residual value when the term of the lease expires.
2. The financial risk to the owner is minimized, particularly if the hotel company is creditworthy and has guaranteed a minimum rent.
3. The owner has no operational responsibilities.

The property owner faces the following disadvantages:

1. The operator has little incentive to maintain the property in top condition as the lease term nears its expiration date. For this reason, many hotels are returned to the owners in poor physical condition, as well as with a tainted reputation. Furthermore, because much of the existing business is often diverted to other hotels managed by the operator, few reservations are on the books for the owner or new tenant.
2. A hotel lease places the owner in a passive position. Under such an agreement, the owner has no input in the operations of the hotel or control over the hotel management. Little can be done if the property is not operated

in a profitable and appropriate manner unless the terms of the lease are violated.

3. If the hotel is extremely successful, the property owner does not participate in the financial rewards to the extent of an owner/operator. Thus, the potential for profit is somewhat limited.
4. Leases are difficult to terminate. Unlike a management contract, which is an agency agreement, a lease creates an encumbrance on the real estate that gives the tenant specific rights of possession.

There are several advantages in a property lease agreement for the hotel operator:

1. The operator has total control of the hotel during the term of the lease with very few approvals required from ownership.
2. A profitable hotel creates a leasehold value that can sometimes be mortgaged by the operator. If the terms of the lease permit a transfer, the leasehold value can also be realized through a sale.
3. The upside profit created by a successful hotel will solely benefit the operator, who receives whatever money remains after operating expenses and lease rental have been paid.

The disadvantages for a hotel operator are as follows:

1. The hotel operator loses possession of the property when the lease term expires.
2. The leasehold loses its value as the term of the lease expires.
3. The financial risks of operating the hotel are borne by the hotel company, so the operator must have a net worth great enough to be able to incur the exposure.
4. Leasehold interests create contingent liabilities on corporate balance sheets that can adversely affect the value of stock in publicly traded companies. Of course, because of the requirements for real estate investment trusts, hotel operating leases are a necessity.

¶ 19.03 DEVELOPMENT OF HOTEL MANAGEMENT CONTRACTS

Hotel management contracts came into use between 1950 and 1960. During that time, more and more Americans started traveling abroad, and foreign governments that were interested in attracting American tourists began encouraging U.S. hotel companies to develop hotels in their countries.

The concept of a worldwide lodging chain was appealing to a number of hotel companies, but many were reluctant to expose themselves to the development and operating risks associated with owning or leasing a hotel in a foreign country. Many factors, including governmental instability, fiscal uncertainty, and a lack of skilled labor led hotel companies to develop a replacement for the property lease that would shift the financial burden from the operator to the owner. The result of the hotel companies' efforts was the hotel management contract.

A management contract is essentially an agreement between a hotel management company and a hotel property owner whereby the management company takes on the responsibility of managing the hotel and its facilities. The owner, unless stipulated

otherwise, assumes a passive position with respect to operating decisions, while assuming responsibility for all working capital, operating expenses, and debt service. The management company is paid a fee for its services and the owner receives the residual net income after all expenses.

Unlike a property lease, the financial burden under a management contract is placed entirely on the owner, who enjoys the upside benefits of a successful property, but suffers the downside losses if the operation is not profitable. Under this arrangement, American hotel companies were eager to expand overseas because the foreign country assumed the financial risk for the benefit of developing tourism and the management company provided operational expertise and name recognition. Chains such as Hilton International, Hyatt, Sheraton, Western International (Westin), and Inter-Continental were among the hotel companies that used management contracts to expand their bases of operations worldwide.

Once hotel companies discovered that they could make almost as much money with a management contract as with a property lease without assuming any of the financial risks, they started to change their modes of operation.

¶ 19.04 PROPERTY LEASES VS. MANAGEMENT CONTRACTS

Exhibit 19-2 illustrates the shifting of financial risks between the property owner and the hotel operator, using both a property lease and management contract structure. Two scenarios are set forth for a proposed 300-room, first-class hotel: one assumes a new property (Hotel *A*) with a normal occupancy build-up and the other assumes a new property of the same description but with a lower starting occupancy and a longer and slower build-up (Hotel *B*).

Exhibit 19-2 Assumed Occupancy and Average Room Rates

	Hotel *A* (Normal Occupancy Build-up)		Hotel *B* (Low Occupancy Build-Up)	
Year	Occupancy	Average Rate	Occupancy	Average Rate
1	58%	$ 95.00	45%	$ 95.00
2	65	101.65	48	101.65
3	70	107.75	50	107.75
4	73	113.14	52	113.14
5	73	117.66	53	117.66
6	73	122.37	54	122.37
7	73	127.26	55	127.26

As shown in Exhibit 19-2, Hotel *A* starts with a 58 percent occupancy in Year One and reaches a stabilized level of 73 percent in Year Four. Hotel *B* starts with an occupancy rate of 45 percent in Year One that grows slowly and stabilizes at 55 percent in Year Seven.

Seven-year projections of income and expense for each hotel based on these occupancy and average rate assumptions are shown in Exhibits 19-3 and 19-4. The data for operating ratios for controllable expenses have been adjusted to reflect differing levels of occupancy; fixed expenses such as property taxes and insurance have been

held constant except for inflationary increases. A basic management fee of 3.0 percent (based on total revenue) has been deducted as well as a 4.0 percent reserve for replacement (also based on total revenue) to provide a fund for the replacement of furniture, fixtures, and equipment.

A property lease and a management contract structure is assumed for each scenario in the Exhibits. The terms for these structures are based on typical provisions found in the marketplace. It should be noted that, beyond their use in REIT structures, hotel property leases are no longer common and therefore the assumed terms are based on the historic use of these instruments.

As stated previously, the rent paid under hotel property leases has typically been determined by the "25, 10 and 5" lease. The actual dollar amounts yielded by this formula for both hotels are shown in Exhibit 19-5.

Usually, under such an agreement the landlord owns the land and improvements and is responsible for the payment of real estate taxes. The tenant owns the personal property and pays all operating expenses.

Exhibit 19-6 shows how the net income realized by Hotel A is divided between the hotel company (tenant) and the property owner (landlord) under a property lease.

The net income realized by the tenant starts with the net income from the projection of income and expense. The landlord pays the real estate taxes out of the rent, so the amount deducted for real estate taxes can be added back to the net income. The rent is deducted from the net income and is calculated using the rental formula set forth above. The result of these calculations is the net to the tenant.

The net to the landlord is based on the previously calculated rent minus the property tax obligation. Because the tenant is assumed to own the furniture, fixtures, and equipment, a reserve for replacement has not been deducted from the net to the landlord.

The terms of the management contract assume a basic management fee of 3 percent of total revenue plus an incentive fee equal to 10 percent of house profit (income before fixed charges) after deducting the 3 percent base fee. Exhibit 19-7 shows how the net income for Hotel *A* is divided between the hotel company and the property owner under a management contract.

The net to the management company is the total of the basic management fee plus the incentive fee; the net to the owner is equal to the residual net income remaining after deducting the total management fee.

A comparison of each structure is made for Hotel *A* in Exhibit 19-8 by totaling the income to each party over a seven-year period assuming both a lease and management contract.

Hotel *B* has a lower starting occupancy and a longer and slower income buildup and as a consequence produces much different results from Hotel *A*. Exhibit 19-9 shows how the net income of Hotel *B* would be divided between the hotel company (tenant) and the property owner (landlord), assuming a property lease. As can be seen, the net income realized by the tenant is actually negative for the first four years, while the landlord, on the other hand, realizes a positive cash flow.

Exhibit 19-10 assumes a management contract structure for Hotel *B* and shows how the net income is shared between the hotel company and property owner. Exhibit 19-11 compares each structure by totaling the income to each party over the seven-year period.

In this scenario, the hotel company would want to operate the hotel with a management contract, while the property owner would realize more income from a lease. In fact, if the transaction were structured as a lease, the hotel company would have a cash flow shortfall of almost $4 million during the first seven years of operation. For many of the smaller hotel companies, this degree of exposure is not acceptable.

Comparing the economic benefits to the hotel company under a lease with those under a management contract, it becomes apparent that the potential upside benefit

Exhibit 19-3 Hotel *A*—Projection of Income and Expense

	Year #1		Year #2		Year #3		Year #4		Year #5		Year #6		Year #7	
Number of Rooms	300		300		300		300		300		300		300	
Occupancy	58.00%		65.00%		70.00%		73.00%		73.00%		73.00%		73.00%	
Average Rate	$95.00		$101.65		$107.75		$113.14		$117.66		$122.37		$127.26	
Days Open	365		365		365		365		365		365		365	
Occupied Rooms	63,510		71,175		76,650		79,935		79,935		79,935		79,935	
	Total $	**% Gross**	**Total $**	**% Gross**	**Total $**	**% Gross**	**Total $**	**% Gross**	**Total $**	**% Gross**	**Total $**	**% Gross**	**Total $**	**% Gross**
Revenue														
Rooms	6,033	54.9	7,235	56.4	8,259	57.3	9,044	58.0	9,405	58.0	9,782	58.0	10,173	58.0
Food	3,212	29.2	3,624	28.3	3,980	27.7	4,271	27.3	4,442	27.3	4,620	27.3	4,804	27.3
Beverage	1,285	11.7	1,450	11.3	1,592	11.1	1,708	10.9	1,777	10.9	1,848	10.9	1,922	10.9
Telephone	248	2.3	285	2.2	316	2.2	342	2.2	355	2.2	370	2.2	384	2.2
Other Income	214	1.9	229	1.8	243	1.7	256	1.6	267	1.6	277	1.6	288	1.6
Total	10,992	100.0	12,823	100.0	14,390	100.0	15,621	100.0	16,897	100.0	17,571	100.0	17,571	100
Departmental Expenses														
Rooms	1,505	24.9	1,631	22.5	1,745	21.1	1,845	20.4	1,919	20.4	1,996	20.4	2,075	20.4
Food and Beverage	3,562	79.2	3,833	75.5	4,082	73.3	4,305	72.0	4,478	72.0	4,657	72.0	4,843	72.0
Telephone	169	68.1	182	63.9	194	61.4	205	59.9	213	60.0	222	60.0	231	60.2
Other Income	134	62.6	141	61.6	147	60.5	154	60.2	160	59.9	166	59.9	173	60.1
Total	5,370	48.9	5,787	45.1	6,168	42.9	6,509	41.7	6,770	41.7	7,041	41.7	7,322	41.7
Departmental Income	5,622	51.1	7,036	54.9	8,222	57.1	9,112	58.3	9,476	58.3	9,856	58.3	10,249	58.3
Operating Expenses														
Administrative and General	953	8.7	1,022	8.0	1,087	7.6	1,145	7.3	1,191	7.3	1,239	7.3	1,288	7.3
Management Fee	330	3.0	385	3.0	432	3.0	469	3.0	487	3.0	507	3.0	527	3.0
Marketing	572	5.2	613	4.8	652	4.5	687	4.4	715	4.4	743	4.4	773	4.4
Franchise Fees	241	2.2	289	2.3	330	2.3	362	2.3	376	2.3	391	2.3	407	2.3
Property Operations and Maintenance	623	5.7	668	5.2	710	4.9	748	4.8	778	4.8	809	4.8	842	4.8
Energy	554	5.0	582	4.5	610	4.2	637	4.1	663	4.1	689	4.1	717	4.1
Total	3,273	29.8	3,559	27.8	3,821	26.5	4,048	25.9	4,210	25.9	4,378	25.9	4,554	25.9
House Profit	2,349	21.3	3,477	27.1	4,401	30.6	5,064	32.4	5,266	32.4	5,478	32.4	5,695	32.4
Fixed Expenses														
Property Taxes	349	3.2	363	2.8	378	2.6	393	2.5	409	2.5	425	2.5	442	2.5
Insurance	121	1.1	126	1.0	131	0.9	136	0.9	142	0.9	147	0.9	153	0.9
Reserve for Replacement	440	4.0	513	4.0	576	4.0	625	4.0	650	4.0	676	4.0	703	4.0
Total	910	8.3	1,002	7.8	1,085	7.5	1,154	7.4	1,201	7.4	1,248	7.4	1,298	7.4
Net Income	1,439	13.0	2,475	19.3	3,316	23.1	3,910	25.0	4,065	25.0	4,230	25.0	4,397	25.0

Exhibit 19-4 Hotel *B*—Projection of Income and Expense

	Year #1	Year #2	Year #3	Year #4	Year #5	Year #6	Year #7
Number of Rooms	300	300	300	300	300	300	300
Occupancy	45.00%	48.00%	50.00%	52.00%	52.00%	52.00%	52.00%
Average Rate	$95.00	$101.65	$107.75	$113.14	$117.66	$122.37	$127.26
Days Open	365	365	365	365	365	365	365
Occupied Rooms	49,275	52,560	54,750	56,940	56,940	56,940	56,940

	Total $	% Gross	Total $	% Gross	Total $	% Gross	Total $	% Gross	Total $	% Gross	Total $	% Gross	Total $	% Gross
Revenue														
Rooms	4,681	52.8	5,343	54.0	5,899	54.8	6,442	55.5	6,700	55.5	6,968	55.5	7,246	55.5
Food	2,705	30.5	2,935	29.7	3,136	29.2	3,350	28.8	3,484	28.8	3,623	28.8	3,768	28.8
Beverage	1,082	12.2	1,174	11.9	1,254	11.7	1,340	11.5	1,394	11.5	1,449	11.5	1,507	11.5
Telephone	199	2.2	219	2.2	235	2.2	253	2.2	263	2.2	274	2.2	285	2.2
Other Income	202	2.3	213	2.2	223	2.1	234	2.0	244	2.0	253	2.0	263	2.0
Total	8,869	100.0	9,884	100.0	10,747	100.0	11,619	100.0	12,085	100.0	12,567	100.0	13,069	100.0
Departmental Expenses														
Rooms	1,389	29.7	1,472	27.6	1,551	26.3	1,633	25.3	1,698	25.3	1,766	25.3	1,837	25.4
Food and Beverage	3,332	88.0	3,521	85.7	3,699	84.3	3,887	82.9	4,043	82.9	4,204	82.9	4,373	82.9
Telephone	157	78.9	166	75.8	175	74.5	184	72.7	191	72.6	199	72.6	207	72.6
Other Income	132	65.3	138	64.8	144	64.6	150	64.1	156	63.9	162	64.0	168	63.9
Total	5,010	56.5	5,297	53.6	5,569	51.8	5,854	50.4	6,088	50.4	6,331	50.4	6,585	50.4
Departmental Income	3,859	43.5	4,587	46.4	5,178	48.2	5,765	49.6	5,997	49.6	6,236	49.6	6,484	49.6
Operating Expenses														
Administrative and General	905	10.2	956	9.7	1,005	9.4	1,055	9.1	1,097	9.1	1,141	9.1	1,187	9.1
Management Fee	266	3.0	297	3.0	322	3.0	349	3.0	363	3.0	377	3.0	392	3.0
Marketing	543	6.1	574	5.8	603	5.6	633	5.4	658	5.4	685	5.5	712	5.4
Franchise Fees	187	2.1	214	2.2	236	2.2	258	2.2	268	2.2	279	2.2	290	2.2
Property Operations and Maintenance	591	6.7	625	6.3	657	6.1	689	5.9	717	5.9	746	5.9	775	5.9
Energy	545	6.1	570	5.8	595	5.5	620	5.3	645	5.3	671	5.3	698	5.3
Total	3,037	34.2	3,236	32.8	3,418	31.8	3,604	30.9	3,748	30.9	3,899	31.0	4,054	30.9
House Profit	822	9.3	1,351	13.6	1,760	16.4	2,161	18.7	2,249	18.7	2,337	18.6	2,430	18.7
Fixed Expenses														
Property Taxes	349	3.9	363	3.7	378	3.5	393	3.4	409	3.4	425	3.4	442	3.4
Insurance	121	1.4	126	1.3	131	1.2	136	1.2	142	1.2	147	1.2	153	1.2
Reserve for Replacement	355	4.0	395	4.0	430	34.0	465	4.0	483	4.0	503	4.0	523	4.0
Total	825	9.3	884	9.0	939	8.7	994	8.6	1,034	8.6	1.075	8.6	1,118	8.6
Net Income	(3)	0.0	467	4.6	821	7.7	1,167	10.1	1,215	10.1	1,262	10.0	1,312	10.1

from the lease is limited while the downside risk is significant. At the same time, the hotel company is exposed to an actual cash loss with a property lease if the hotel experiences a slow occupancy build-up. The limited upside benefits afforded by total property leases have led hotel companies in recent years to avoid this structure and enter instead into either management contracts or property ownership.

Management companies eager to secure a particular location or property have offered guarantees to the ownership, effectively reducing the risk to ownership while allowing the operator to participate in the upside potential.

Exhibit 19-5 Projected Rent

Hotel *A* (normal occupancy build-up) ($000)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Rooms	$1,508	$1,809	$2,065	$2,261	$2,351	$2,446	$2,543
Food	161	181	199	214	222	231	240
Beverage	129	145	159	171	178	185	192
Other Income	92	103	112	120	124	129	134
Total Rent	$1,890	$2,238	$2,535	$2,765	$2,875	$2,991	$3,110

Hotel *B* (normal occupancy build-up) ($000)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Rooms	$1,170	$1,336	$1,475	$1,611	$1,675	$1,742	$1,812
Food	135	147	157	168	174	181	188
Beverage	108	117	125	134	139	145	151
Other Income	80	86	92	97	101	105	110
Total Rent	$1,494	$1,686	$1,849	$2,009	$2,090	$2,173	$2,260

Exhibit 19-6 Division of Hotel *A* Net Income Under Property Lease

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Net Income	$1,439	$2,475	$3,316	$3,910	$4,065	$4,230	$4,397
Plus RE Tax	349	363	378	393	409	425	442
Less Rent	1,890	2,238	2,535	2,765	2,875	2,991	3,110
Net to Tenant	($102)	$600	$1,159	$1,538	$1,599	$1,664	$1,729
Rent	1,890	2,238	2,535	2,765	2,875	2,991	3,110
Less RE Tax	349	363	378	393	409	425	442
Net to Landlord	$1,541	$1,875	$2,157	$2,372	$2,466	$2,566	$2,668

Exhibit 19-7 Division of Hotel *A* Net Income Under Management Contract ($000)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Basic Fee	$330	$385	$432	$469	$487	$507	$527
Plus Incentive Fee	235	348	440	506	527	548	570
Net to Management Company	$565	$733	$872	$975	$1,014	$1,055	$1,097
Net Income	1,439	2,475	3,316	3,910	4,065	4,230	4,397
Less Management Fee	330	385	432	469	487	507	527
Net to Owner	$1,109	$2,090	$2,884	$3,441	$3,578	$3,723	$3,870

Exhibit 19-8 Hotel *A* Under Lease vs. Management Contract

	Management Company	Property Owner
Lease	$8,188,000	$15,644,000
Management Contract	6,310,000	20,695,000

Exhibit 19-9 Division of Hotel *B* Net Income Under Property Lease ($000)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Net Income	($3)	$467	$821	$1,167	$1,215	$1,262	$1,312
Plus RE Tax	349	363	378	393	409	425	442
Less Rent	1,494	1,686	1,849	2,009	2,090	2,173	2,260
Net to Tenant	($1,148)	($856)	($650)	($449)	($466)	($486)	($506)
Rent	1,494	1,686	1,849	2,009	2,090	2,173	2,260
Less RE Tax	349	363	378	393	409	425	442
Net to Landlord	$1,145	$1,323	$1,471	$1,616	$1,681	$1,748	$1,818

Exhibit 19-10 Division of Hotel *B* Net Income Under Management Contract ($000)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Basic Fee	$266	$297	$322	$349	$363	$377	$392
Plus Incentive Fee	82	135	176	216	225	234	243
Net to Management Company	$348	$432	$498	$565	$588	$611	$635
Net Income	(3)	467	821	1,167	1,215	1,262	1,312
Less Management Fee	266	297	322	349	363	377	392
Net to Owner	($269)	$170	$499	$818	$852	$885	$920

Exhibit 19-11 Hotel *B* Under Lease vs. Management Contract

	Management Company	Property Owner
Lease	($4,562,000)	$10,803,000
Management Contract	$3,677,000	$3,875,000

¶ 19.05 TYPES OF HOTEL MANAGEMENT COMPANIES

[1] First-Tier and Second-Tier

The management companies that enter into management contracts with hotel owners are generally classified as either first-tier or second-tier. First-tier companies operate lodging facilities for third parties under management contracts and provide day-to-day operational supervision and property management as well as national or regional customer recognition through their trade names. Hilton, Hyatt, Marriott, and Sheraton are examples of first-tier management companies. Second-tier management companies also operate lodging facilities for third parties and provide day-to-day supervision and management. They do not, however, provide any customer recognition through their corporate name, but make use of franchise affiliations to generate customer identification. Examples of second-tier management companies are Interstate Hotels, American General Hospitality, Richfield Hospitality, and Hospitality Equity Investors.

[2] Pre-Opening and Technical Services

In addition to daily operations, management companies also frequently contract to provide pre-opening services and technical services. Pre-opening services are provided by the management company before the opening of a facility to the public. Typical services include a pre-opening plan and budget, personnel recruiting and training, sales and advertising, purchasing, and establishing an account system and controls. Pre-opening services may be used at both newly developed hotels and existing properties that change ownership. Fees for such services are generally separate from and in addition to those charged for management supervision.

Technical services are provided by hotel management companies during the planning, design, and construction stages of a new hotel development. These services include design and facilities planning, architectural assistance and review, interior design and lighting recommendations, and mechanical and food facilities installation. Technical services are also available for the expansion and renovation of existing properties. As is the case with pre-opening services, fees for technical services are generally separate from and in addition to fees charged for management supervision.

¶ 19.06 MANAGEMENT CONTRACTS

Management contracts have certain advantages and disadvantages to both the hotel company and property owner. In order to negotiate and structure an equitable agree-

ment, both parties should understand each other's motivations for entering into a management contract.

[1] Advantages for Operator

[a] Inexpensive, Rapid Expansion

Because management contracts typically require very little in the way of capital outlay on the part of the operator, their use can make possible inexpensive and rapid chain expansion with a low level of investment. In fact, on occasion, in order to secure a management contract, hotel companies contribute working capital in the form of a loan or some other small good-faith investment. As mentioned previously, management companies may also extend guarantees to ownership, but are typically paid a higher incentive fee if this is the case. The management fee set by the contract is generally structured so that the basic fee, which is a guaranteed flow of income computed as a percentage of total revenue, is more than sufficient to cover the hotel company's home office overhead and operating expenses. The lead time involved with developing new hotels is eliminated for operators willing to take over existing properties. Additional supervisory staff and some home office overhead is all that is required in order to do so.

[b] Low Downside Risk

Under a typical management contract, the hotel owner is financially responsible for all working capital, operating expenses, and debt service. The management company has no financial exposure and essentially covers its operating expenses and makes a small profit from the basic management fee and makes an even larger profit from any incentive fee.

[c] Critical Mass

While the actual operating expense and home office cost of providing hotel management services is minimal, a critical mass of properties under contract is necessary in order to cover the cost of key operational executives and home office and support staff and still generate acceptable profits. First-tier management companies also usually offer a computerized reservation system, so their fixed overhead is generally greater than that of a second-tier operator. The size of the critical mass varies depending on the class and types of hotels operated, along with the nature of the services offered by the management company. The typical range of critical mass for a first-tier company is forty to fifty hotels under contract; for second-tier companies, the range is usually ten to fifteen hotels.

Luxury hotels require a greater critical mass than budget operations because home office support must be more extensive. Similarly, convention-oriented chains with extensive group marketing needs require a larger critical mass than chains catering primarily to commercial travelers.

[d] Quality Control

Management contracts allow hotel companies to maintain control of both physical and operational quality. Hotel companies, particularly the more well-known first-tier chains, are always concerned about maintaining a favorable public image. A hard-

earned reputation can be tarnished quickly if a single property suffers from physical and managerial neglect. Consequently, a management contract provides the necessary level of quality control for a hotel operator. With an unrestricted management policy and an adequately funded reserve for replacement, a management company has almost total control of the quality and image of its properties. In a franchise relationship, on the other hand, where a hotel merely carries a chain identification and there is no central managerial control, it is much more difficult to maintain a uniform level of quality. Several hotel chains, including Hyatt, Four Seasons, and Motel 6, follow a general policy of not franchising in order to have total quality and operational control over their hotels.

[e] No Depreciation Expense

Management contracts are attractive to public hotel companies because the cash flow they realize is often close to what ownership of a property would provide, yet they allow the company to avoid the depreciation expenses for which a property owner is liable. Management fees paid to hotel companies are considered ordinary income for income tax purposes, but if a hotel company owns a hotel, the income it realizes is eroded by depreciation expenses required for both the improvements and the personal property under current tax regulations.

Publicly held hotel companies find management contracts particularly rewarding because they can minimize the amount of depreciation expenses shown on their income statements, thus enhancing their price/earnings ratio and making their stock more attractive to investors.

[2] Disadvantages for Operators

[a] Residual Benefits of Ownership Eliminated

Any increase in the value of a hotel generated by the management company over the course of a management contract accrues to the benefit of the owner when the hotel is sold or refinanced.

During the early 1990s, many second-tier hotel companies provided short-term management contracts to lending institutions in order to assist with their distressed foreclosures. Many of the management companies that successfully reestablished cash flow and economic value in problem hotels were rewarded by losing their contracts when the properties were sold to new owners.

[b] Minimal Input in Ownership Decisions

Most management agreements apply minimal restrictions on the owner's ability to transfer ownership to another party. An undercapitalized owner, for example, can restrict cash needed to cover shortfalls and adversely affect the operation and quality of the property. Also, as with any relationship, a management contract requires cooperation from both parties; a difficult owner can make life miserable for a management company by imposing any number of unreasonable demands.

[c] Dependence on Finances of Owner

If the cash flow generated by a hotel operation is not sufficient to cover operating expenses and debt services, the hotel operator is totally dependent on the owner for pro-

viding necessary funds. No matter how thoroughly a management company investigates the creditworthiness of a hotel owner prior to entering into an agreement, adverse circumstances can quickly deplete anyone's financial resources. The risk to a hotel management company goes beyond the inconvenience of insufficient operating capital or a deferral of needed furniture replacement; it could ultimately result in the loss of a management contract as a result of bankruptcy or foreclosure. Beside the negative effect on a management company's income and reputation, such a cancellation (on the part of a bankruptcy court or foreclosing lender) seldom involves payment of a cancellation fee to the management company.

[d] Contract Termination

Hotel management contracts often contain cancellation provisions, typically upon a sale, that allow owners to terminate the agreement upon payment of a stipulated cancellation fee. The disruption in management deployment and public identity, however, can be damaging especially to a first-tier operator.

[3] Advantages for Owner

[a] Acquisition of Operational Expertise

Hotel management contracts provide owners with the essential operational expertise necessary for establishing and preserving the long-term profitability of their investment. At the same time, a management contract allows owners to keep such ownership benefits as cash flow, depreciation deductions, tax benefits, value enhancement, refinancing opportunities, and possession of the property after the contract expires.

[b] Immediate Name Recognition

A management contract with a first-tier management company immediately gives the owner's hotel a national or regional identification. This recognition is achievable only through a second-tier management company if coupled with a franchise affiliation.

[c] Quality Management

In recent years, hotel lenders and investors have become more knowledgeable about the industry. One aspect of this increased sophistication is the emphasis now placed on quality management as a key component of a successful hotel venture. In addition to evaluating the local market for transient accommodations, the area and neighborhood characteristics, and the actual real estate itself, hotel lenders and investors take great interest in the ability and financial track record of a proposed operator. Most lenders and investors require that an established hotel management company be put in charge of the day-to-day operations of any hotel in which they have an interest. Some even demand that a professional hotel asset manager supervise the hotel company.

If the operator is a second-tier company, it generally must have a franchise affiliation in order to attract the necessary financing. While including a nationally known hotel company as part of the project team does not guarantee financing, it does show positive interest on the part of the operator that can favorably influence the investment decisions of the lender.

[4] Disadvantages for Owner

[a] Loss of Operational Control

A management contract gives the operator total operational control of the property. If the management company operates the hotel in a competent manner, this loss of control is not a problem. However, if the property is mismanaged, the owner may find it very difficult to remove the incompetent operator. As a result, a greater number of management agreements have included specific standards that allow owners to terminate operators who do not achieve certain levels of performance. However, even with stringent performance criteria, the process of removing a poor management company must be timely; the reputation of the hotel can be badly damaged if new management is not quickly in place.

[b] Liability for All Ongoing Expenses

The owner of a hotel under a management contract is financially liable for all costs and expenses, including fixed charges and debt service. This means that even though the manager's neglect or incompetence may actually cause the financial loss, the owner is still ultimately responsible for funding the negative cash flow. For this reason, a well-structured management contract should contain incentives for the operator to maximize revenues and minimize expenses. Deferring a portion of the management fee to be paid as a percentage of a defined level of profit creates a financial incentive for an operator to manage efficiently. Essentially, through an incentive management fee, the management company's earnings become directly tied to the profits of the hotel. The actual contractual structure of the operator's incentive fee can often create greater or less incentive. For example, if an incentive fee is based on 10 percent of income before fixed charges and paid only if sufficient income remains after debt service, the operator would have a greater incentive to maximize revenue and minimize expenses than if the incentive fee was payable whether or not a positive cash flow was generated. This formula can be further modified to produce even greater operator incentive by requiring the management company to forever forfeit the incentive fee if the income after debt service is insufficient, rather than merely deferring and accumulating the fee until repayment can be made from future cash flows.

[c] Termination of Operator

Most management agreements are difficult for owners to terminate prematurely or without a sale. First-tier management companies, concerned about adverse publicity from losing their identification within a particular market generally require a noncancellable contract that exceeds ten years in length, in addition to one or more extension clauses. Second-tier operators usually accept a shorter relationship, but often insist on provisions limiting the owner's ability to terminate at an earlier date. The inability of an owner to unilaterally terminate a hotel management contract for poor performance can significantly increase its exposure to financial loss. To reduce these risks, management contracts should be written with specific performance standards tied to cancellation provisions. In addition, owners often negotiate an all-purpose contract buy-out clause that allows for the removal of the management company at any time upon payment of a stipulated amount.

[d] Sale of Property

The sale of a hotel property is often much more difficult if it must be sold subject to an existing management contract. Hotel companies rarely purchase hotels operated by other companies; therefore, an ongoing noncancellable contract reduces the number of possible buyers and consequently increases the time required to find a qualified buyer. For this reason, the sale of a hotel with management in place often brings a lower price than if the property were sold without management. A buy-out provision gives an owner the option of selling the hotel subject to the existing agreement or purchasing the contract and selling the hotel unencumbered by management. (See Chapter 20 for a discussion of such provisions.)

[e] Cost of Management

The cost of management can absorb a substantial portion of the cash generated by a hotel. Simply put, quality hotel management is expensive. Depending on the operator and the terms of the management contract, the total management fee, expressed as a percentage of the cash flow after debt service, can be as much as 70 to 85 percent. If the occupancy level is low, as in the case of a newly opened hotel, the total management fee could exceed the cash flow after debt service, meaning the owner would have to contribute additional capital to the venture. To assist owners during start-up periods and provide lenders with an additional debt service cushion, most hotel management companies will subordinate their incentive fee to debt service. This means that if the income before debt service is insufficient to cover the mortgage payment, the management company would either forgo or defer their incentive management fee.

[f] High Downside Risks

Owners of lodging facilities face downside risks that are due to the high amount of fixed costs associated with the operation of a hotel or motel. As occupancies drop, losses escalate rapidly because many of the fixed hotel expenses cannot be cut back. The use of property leases shifts this downside risk from the owner to the operator, but under a management contract, any negative cash flow is the responsibility of the owner.

[g] Operator May Favor Own Property

A conflict of interest always exists when a hotel company both owns and operates properties for its own account and operates hotels for nonrelated third parties. Because a hotel company generally receives a greater economic benefit from sending guests to its owned hotels rather than to properties it manages, the possibility for unfair practices is always present. Owners should be aware of this basic conflict and be sure that management agreements include provisions restricting possible abuse.

¶ 19.07 MANAGEMENT COMPANIES

Once an owner has decided to use the services of a hotel management company, a decision must be made as to whether a first- or second-tier operator should be selected. A first-tier hotel management company provides the owner with a publicly identifi-

able name (e.g., Hilton, Sheraton, or Marriott) and management expertise. A second-tier management company has no "brand-name" image and therefore can offer only management expertise.

[1] Advantages of First-Tier Companies

[a] Cost

The cost of a first-tier management company is often less than that of a second-tier operator and the requisite franchise affiliation. Second-tier management companies provide no national identification, so the cost of a franchise affiliation must be added to the second-tier management fee in order to reflect the same benefits of a first-tier company.

[b] Corporate Identity

First-tier companies have a strong interest in running successful operations. Consequently, some chain affiliations, as previously noted, are available only by management contract. The primary reason these companies have for not franchising is the desire to maintain total control over the operational and physical quality of the property.

[c] More Efficient Operations

First-tier companies, perhaps because they are complete operating entities, tend to be more unified and seem to have a better ability to implement company managerial and operational philosophies than do second-tier companies operating under a franchise affiliation. For example, on-site first-tier management personnel are often more familiar with the chain's home office systems, procedures, and personnel and can take greater advantage of the various services offered than can second-tier personnel in a similar situation. A franchise affiliation tends to be more detached and the productive interaction between the property and home office is frequently reduced.

[d] Convention and Group Sales Capability

Convention and group sales require a very specialized form of marketing that necessitates a massive capital investment in order to gather information detailing the specific meeting requirements of associations, organizations, corporations, and groups. It takes years of effort to assemble this information into a usable format. Since the data is so specialized, only a few hotel chains (e.g., Marriott, Sheraton, Hilton, and Hyatt) have made this infrastructure investment and effectively use it for group sales. Most franchise organizations and second-tier hotel operators do not accumulate the information that would enable them to compete in the convention and group sales markets with first-tier companies.

[e] Ease of Financing

First-tier hotel management companies tend to be more ""financible"; that is, lenders in the hotel field, as well as equity investors, are often more comfortable lending money to projects operated by recognizable, "brand-name" management companies. Whether the perception that a name operator reduces risk is correct or not, first-tier

hotel management companies usually find it easier to acquire financing than do most second-tier operators.

[2] Disadvantages of First-Tier Companies

[a] Restrictions on Property Size

First-tier hotel management companies do not often manage smaller properties; most first-tier companies have size requirements for the hotels they will operate under a management contract. Generally, hotels of fewer than 200 units are considered too small by these operators. First-tier companies believe that their organizational structure and overhead cannot be sustained by such smaller properties. Exceptions are made, however, for factors such as desirable locations or unique property characteristics that would make a particular contract attractive to a management company.

[b] Restrictions on Financial Condition

First-tier hotel management companies are concerned about their image and the negative effect that adverse publicity might have on their name and reputation. For this reason, first-tier companies generally avoid involvement with financially distressed hotels because of the increased likelihood that their name might be associated with a bankruptcy or foreclosure.

[c] Restrictions on Contract Terms

The term of contract for a first-tier management company is typically longer than that for a company in the second tier. Most first-tier companies require contract terms of at least ten years. Because a first-tier operator is actually granting a license for the use of its name, management contracts with first-tier operators incorporate many of the same provisions as a franchise agreement. First-tier lodging chains operating under a nationally recognizable trade name generally want to maintain a presence at a particular location for an extended period of time. A short-term contract, which would allow the removal of the trade name of the first-tier company from the property after a relatively short amount of time, might result in an appearance of instability and thus undermine the traveling public's image of the company.

[d] Restrictions on Terminations

Termination provisions are often more difficult to obtain from a first-tier hotel management company because it has its name, and therefore its reputation, prominently displayed on the hotels it manages. Given this stake, first-tier companies must be careful to present to their customers the appearance of long-term stability. Because early contract termination generates adverse publicity for the operator, management companies are reluctant to provide the property owner with any form of termination provision that might end a contract early. During the past several years, the use of performance termination standards has become more common by both first- and second-tier companies. Generally tied to some specified level of profits, these performance criteria allow owners to terminate operators who fail to achieve satisfactory results.

[e] Less Flexibility in Negotiations

First-tier hotel companies typically have more rigid requirements than do second-tier companies when it comes to the specific terms of a management contract. Provisions such as a reduced length of term, performance cancellations, contract buy-out, and exclusive operating territories are more difficult to obtain. This inflexibility might be attributable to the general sense that first-tier hotel companies have a stronger bargaining position and can impose stricter terms on less experienced owners.

[f] Difficulty of Negotiations

The actual negotiating process between a first-tier hotel company and a property owner can be longer and more difficult than that involving most second-tier operators. Large hotel companies usually use experienced mid- to upper-level executives to perform the actual negotiating, and while these employees have the authority to develop the specific terms of an agreement, the final structure is generally subject to the approval of a higher-level executive committee. Often this committee will want to make changes to the agreement, and the negotiating process must then be resumed. Second-tier hotel companies are generally smaller and usually less formal in their negotiating procedures, so property owners can often deal directly with the company's decision maker, facilitating the approval process considerably.

[g] Operating Information Difficult to Obtain

Some of the most critical information needed to fully evaluate the ability of a hotel management company is actual operating data (specifically, profit and loss statements) from properties similar to the hotel under consideration. Without these statements, a property owner cannot verify that the management company is capable of running an efficient operation. Most hotel companies that have proven track records find little difficulty in allowing owners to confidentially review their financial statements.

First-tier management companies tend to be more restrictive than second-tier companies in releasing operating information and other data pertaining to their management ability. Again, this seeming lack of cooperation may be attributable to a sense of superior bargaining power, but it should not be permitted to lead to refusal of an owner's legitimate request for necessary information.

[3] Advantages of Second-Tier Companies

[a] Flexibility in Negotiations

Second-tier management companies are basically less strict in their overall requirements than first-tier companies. In particular, they are more likely to accept shorter contract terms, agree to more demanding performance criteria, and allow more reasonable buy-out provisions. This flexibility, in addition to a general willingness to quickly structure management contracts and take over a wide variety of operations, causes them to be preferred by lenders looking for interim hotel management after a foreclosure.

[b] Individual Attention

Smaller management companies are likely to give properties more individual attention. Most second-tier hotel management companies are smaller than first-tier opera-

tors, so they often can provide a hotel with more individual high-level management attention. This ability is important for distressed hotels that require specialized work-out experience (i.e., experience with improving poor operating performance) not typically available from most property-level general managers. Unique properties facing unusual markets and/or competition can also benefit from smaller management companies that are capable of providing intensive expertise.

Second-tier hotel management companies are thus more likely to manage the more unique hotels: those that are, for example, small, distressed, in specialized markets, or in secondary locations. First-tier hotel companies do not generally become involved with such properties, because they do not fit their quality level or style of operation. As a result, they generally pass up opportunities involving distressed hotels or those properties for which the chance for success is either limited or in doubt. One change that has taken place recently with larger chains is that their minimum size requirements have begun to shrink as increased competition forces them to downscale their products and consider penetrating the secondary and tertiary lodging markets.

[4] Disadvantages of Second-Tier Companies

[a] Financing More Difficult to Obtain

Most second-tier management companies are not as attractive to lenders as first-tier operators. Lenders and institutional investors usually try to minimize their exposure to risk by always using the services of a "name brand." They believe that if a known hotel company is operating their property, they cannot be blamed for selecting an incompetent operator should the project encounter financial difficulties.

[b] Perceived Risk

The perceived risk of using a second-tier management company is higher for much the same reason as the lack of available financing. First-tier hotel companies have a name recognition benefit that gives them a low-risk image. Whether or not this is justified, it does create the perception that second-tier operators will make a project more risky. Higher perceived risks are more difficult to finance and generally increase the cost and decrease the availability of both debt and equity capital.

[c] Possible High Cost

As previously mentioned, the services of a second-tier hotel management company, combined with a national franchise, can sometimes cost more than a first-tier operator that provides both operational expertise and name recognition in one package. In addition, some second-tier management companies believe that they can structure a management fee formula on the same basis as a first-tier operator. Consequently, the resulting compensation is often not commensurate with the benefits provided.

[d] Lack of Financial Strength

Second-tier hotel companies do not always have the necessary financial strength to make meaningful investments in a property or to guarantee operating results. The current investment climate, in which tax benefits have been greatly reduced, has caused many property owners to require that hotel management companies make some form

of capital contribution in order to obtain a management contract. This investment can take many forms, including pre-opening services; initial inventories and operating supplies; working capital; furniture; fixtures; and equipment; operating losses during start-up; and debt service guarantees. The net worth of the smaller second-tier hotel companies often does not allow this type of investment and therefore they have a difficult time obtaining a financial interest in property. In addition, many owners believe that an operating company should have a monetary commitment in the property in order to have a sufficient incentive to do well.

¶ 19.08 MANAGEMENT COMPANY OPERATING PHILOSOPHIES

In order to properly evaluate hotel management companies, property owners should be familiar with the two basic operating philosophies found in the industry. Management companies generally have either a highly centralized management structure or use a decentralized organizational approach. Both philosophies can produce desirable results, but the manner in which the results are achieved will be markedly different. For this reason, property owners should select the type of company whose methods most easily lend themselves to the characteristics of their individual properties.

[1] Centralized Management

An example of a highly centralized hotel management company is the Marriott Corporation. Marriott employs thousands of people to supervise the management of its hotels and restaurants. All aspects of Marriott's hotel management system are contained in manuals that cover every conceivable eventuality. These reference guides provide on-site management with information regarding such topics as how to prepare a prime-rib dinner from a standardized recipe, what to do in the event of a bomb scare, where to purchase operating supplies, and how to update a marketing plan for the next accounting period. This sort of centralized operating philosophy leaves little to chance or human error, because virtually everything involving the operation of a hotel has already been thought through and the proper solution set forth in clear language. Employees on the property level, particularly those with minimum skills or experience, are given very little latitude in the interpretation of the policies set forth in the procedure manuals. The end result is a highly structured and standardized hotel operation in which individual creativity is minimized. This type of philosophy promotes tight operating controls, because anything outside of the norm, such as high food or labor costs, is readily apparent from financial statements or other control systems. The most significant drawback to a highly centralized hotel management philosophy is that it can be difficult to modify procedures in order to meet local conditions or customs.

Marriott Corporation has one of the most centralized hotel operating systems in the industry. The massive layer of operational control, which has been developed over the past thirty years, has enabled Marriott to expand rapidly while maintaining a consistent product and an extremely profitable company.

[2] Decentralized Management

On the opposite end of the spectrum is another respected, highly successful hotel management company, the Hyatt Corporation, which runs its hotels in a very decen-

tralized manner. In the Hyatt system, on-site managers are given a broad latitude in forming property-level operating systems and procedures. Hyatt does provide general guidelines from its home office, but managers are allowed wide discretion regarding the manner in which they operate their property. The primary advantage of a decentralized operating philosophy is that it encourages individual creativity, which can be beneficial in the hospitality industry. Hyatt employees are encouraged to constantly modify and update their methods in order to meet the changing needs and expectations of the market.

Most hotel management companies tend toward decentralized management. Hotel owners should be aware, however, that some operators employ this type of structure out of necessity, if they do not have the personnel and resources to develop and implement even a partially centralized format. These companies often operate without any set system, even on the property level, so general managers must establish and implement all operating policies. Hotel companies that fall into this category cannot provide the services normally expected from a professional hotel management company and should be compensated accordingly.

¶ 19.09 SERVICES PROVIDED BY MANAGEMENT COMPANIES

When selecting a management company and negotiating the management fee to be paid to it, the owner should be aware of the services that are normally provided by most hotel companies and should be able to tell when the services that a particular company offers are unique. The following list contains the various services that are usually offered by most companies.

- Management supervision
- Implementation and maintenance of systems, procedures, and controls for:
  - —Accounting and bookkeeping
  - —Audit and control procedures
  - —Budgeting
  - —Marketing
  - —Purchasing
  - —Advertising and promotion
  - —Maintenance
  - —Personnel
- Selection, training, and supervision of all employees
- Establishment of all prices and charges
- Preparation of monthly and annual financial statements
- Applications for and maintenance of all licenses and permits
- Negotiation for and granting of all concessions and leases
- Negotiation of service contracts
- Purchase of inventories, supplies, and equipment
- Establishment of bank accounts
- Maintenance of insurance policies
- Institution of any necessary legal action

- Supervision of building repair and maintenance and replacement of furniture, fixtures, and equipment
- Preparation of budgets and operating plans
- Planning and implementation of advertising, promotion, and marketing

First-tier hotel management companies generally provide significant additional services that generally include:

- Regional or national trade names and identification
- Trademarks, logos, trade phrases, and service marks
- Centralized reservation systems
- Chain and group advertising programs
- Frequent guest programs

There are a number of unique services that are offered by some management companies—for example:

- Centralized purchasing with group discounts
- Centralized personnel and recruiting
- Centralized reservations
- Centralized marketing and promotion
- Property tax representation
- Insurance assistance and package rates
- Energy management systems
- Preventive maintenance systems
- Centralized accounting
- Centralized employee education and training
- Labor relations assistance
- Site and building engineering assistance
- Architectural design
- Interior design
- Convention and group sales
- Frequent guest programs
- National and regional sales offices
- Pre-opening services
- Technical services
- Auditing
- Market demand studies

¶ 19.10 MANAGEMENT COMPANY SELECTION PROCESS

Selecting a hotel management company with the specific capabilities necessary for running a particular property is one of the key steps in a hotel investment. While

location, product, and image of the facility are important ingredients, the ability of the on-site and supervisory management is what holds the operation together and makes it work. The following section describes the selection process for finding, negotiating, and retaining the hotel management company best suited for a particular project.

[1] Analysis of Market Study

The first step in selecting a hotel management company is to analyze the findings of the market study for the project in order to determine the type, class, and market position of the subject property. The findings of the market study that bear most closely on the selection of a management company are the following:

- Current and future demand for transient accommodations, including probable demand growth rates
- Characteristics of demand, including market segmentation, rate categories, average length of stay, seasonality, special requirements, and facility needs
- Current and future supply of transient accommodations (competition)
- Characteristics of supply, including market segments, rate categories, facilities, location, image, and reputation

Several basic characteristics of the subject property can be determined from these areas of the market study. In turn, these characteristics are used to determine the sort of management company best suited to the property. The following characteristics are analyzed in this regard.

Market segment. The primary and secondary market segments (i.e., commercial, meeting and convention, and leisure) that are expected to be captured by the facility must be identified, with an estimate as to what percentage each segment will represent as part of the whole. Information pertaining to the potential future growth of each segment and the expected competition is also useful. The data serves as a basis for determining the facilities and amenities needed to attract the intended market segment.

Class of facilities and level of service. Competitive lodging facilities operating within the market should be investigated to determine the level of services offered (i.e., economy, standard, first class, luxury). The market position best suited for the subject property's particular location and the correct class for the subject property can be established on the basis of this information. In addition, the level of services and types of amenities must also be defined in order to create a complete and competitive project.

Extent of facilities. The facilities (e.g., food, beverage, meeting and banquet, recreational, amenities, and shops) within a hotel project must be as carefully evaluated as the number of guest rooms. Building more facilities than are actually needed will reduce profit potential. Too few facilities will not satisfy the market and could reduce the competitive standing of the property.

Room count or size of hotel. Many factors go into establishing optimum size. For example, site and zoning restrictions can place limits on the permitted number of buildable units. Market-related supply and demand considerations will also either push the size upward or will hold it down depending on future expectations. Finally, economic influences such as land values, construction costs, a property's critical mass, and economies of scale will affect the final room count.

The purpose of this stage of analysis is to define broad project parameters, rather than specific guidelines. The actual layout and design of the subject property should be done in conjunction with the hotel management company ultimately retained to manage the project. The management company will be responsible for generating profits, so the hotel should be specifically planned to fit its mode and style of operation.

[2] Selection of First- or Second-Tier Company

To narrow the search for a management company, the owner should decide as early in the selection process as possible whether a first-tier or second-tier operator would be the most appropriate choice to manage the subject property. In some instances, the owner may choose a first-tier company, but find that a suitable candidate is not available. If this happens, the owner must be prepared to quickly turn to a review of possible second-tier operators.

[3] When a First-Tier Company is Chosen

If the owner decides to use a first-tier management company or franchise affiliation, the first step that should be taken in order to choose a particular operator or franchise is to determine what operators and franchises are already in the market. Generally, companies not currently represented are the most likely candidates, but a particular company should not be ruled out if it is active in the market; occasionally, a company will make a move in favor of a better project.

The owner should look for operators or franchises that have a high level of recognition and market identification in the segments and class determined to be best suited for the subject property by the market study. A commercially oriented chain, for example, would not be likely to have the marketing infrastructure to succeed with a convention hotel. Owners should look for operators and franchisors with similar properties situated in feeder cities that have established reputations and identifications to the local residents who are likely to travel to the area of the subject property.

[4] When a Second-Tier Company is Chosen

If a second-tier company is the best choice to manage a property, the owner should look for an operator with a proven ability to manage hotels with a market orientation and class similar to the subject property. Another feature that is desirable for a second-tier company (though not as important as it is for first-tier companies) is representation in feeder cities.

Owners should bear in mind that some franchises are available only to certain operators. Marriott, for example, will grant franchises only to a select group of approved operators. In any event, owners should give preference to second-tier operators that have actual experience operating under the specific franchise selected for the property. An operator who is familiar to the franchisor can sometimes expedite the franchise application process.

The key to the entire selection process is to match the various proposed elements of the subject property (i.e., size, class, image, location, market segments served and facilities offered) with the operator that has the most experience and best track record in handling these elements in a profitable manner.

[5] Consultation With Project Team

Before narrowing down the field of candidates, the owner should consult with members of the subject property project team and ask for their suggestions. This step is particularly important if the project investors can be identified at this stage. Experienced hotel investors can have definite opinions as to which operator would be best suited for a project, and as a result, considerable time can be saved if their input is solicited early in the selection process. However, owners should not select a hotel operator purely on an investor's recommendation and without performing the necessary review and due diligence process.

[6] Issues During Management Company Selection

[a] Company Profile

The profile should contain a description of the present status of the company and its management's plans for the future. The profile should also contain information regarding the number of properties currently under contract, their locations, chain affiliations, facilities, amenities, ages, market orientations, number of years under contract, the identities of the owners, and, finally, whether the operator has an equity interest. The same information should be given for properties not currently under contract that the hotel company has managed over the past five years. The operator should describe the circumstances of the management agreement terminations.

[b] Operating Performance

One of the most important issues in the hotel management company selection process is whether a particular management company can make money for the owner. The most efficient method of evaluating the operational expertise of a hotel management company is to examine the actual financial performance of properties they operate.

[c] Qualifications of Key Personnel

A hotel management company is, of course, no better than the actual staff that provides management services. Problems such as high turnover and difficulty in recruiting qualified individuals are cause for concern. Any individuals whose employment is critical to the continued success of the management company should be identified.

[d] Central Services

The various off-property services provided by the hotel management company are called central services. These include accounting, reservations, engineering, architectural design, labor relations, insurance, purchasing, and the like. The owner should identify and compare the services offered by each operator and determine whether they are included in the management fee or are charged back separately to the property. The costs of some central services, such as reservation systems, are charged back to the individual properties within the chain on a pro-rata formula basis.

[e] Reimbursable Expenses

Reimbursable operator expenses are the various expenses that are incurred in the operation of the property but are not included in the management fee and that are therefore reimbursable to the management company. For example, the travel expense incurred by the management company's home office personnel when visiting a property is often a reimbursable expense chargeable to that property. This data is necessary in order to accurately compare the relative costs of the management companies under consideration.

[f] Sales and Marketing

One of the most important considerations in the selection of a hotel management company is the ability of a company to generate business through various sales and marketing programs. Some of the components of a sales and marketing structure include central and regional sales offices, a reservation system, frequent guest programs, a convention and group sales data base, marketing organization, and various public relations and publicity functions.

[g] Operating Projections

The preparation of a ten-year projection of income and expense (including management fee) for the subject property should be considered. The purpose of this is twofold. First, the projection establishes a basis for judging the hotel company's future management performance. A performance standard can be established from these projections and incorporated into the management contract, with termination provisions keyed directly to projected operating levels. Second, it pinpoints the operator's anticipated earnings from the management contract. This information is useful when negotiating the fee structure portions of the agreement.

Most operators faced with a request for a ten-year projection of income and expense will probably comply reluctantly. It is important for the hotel owner that a hotel management company commit to a set of operating projections; consequently, a refusal to agree to this request should be considered a "deal breaker." For the operator, the projections clearly have a catch-22 quality. If the operator is optimistic in projecting profit, that operator might appear to be a favorable choice compared with other management companies. If the owner ties the performance cancellation clause to this set of optimistic projections, however, the operator could quickly lose the contract. On the other hand, if the operator is overly conservative in the projection of income and expense, the owner could use the dollar amount of the projected management fee (which would probably be low) as the basis for estimating what the hotel company would be looking for as overall compensation. The projection of income and expense prepared by the management company should be checked against the actual operating performance shown in the financial statements of the comparable hotels to verify that the results are achievable. The quality of these projections is often a good indication of the skills and expertise of the management company.

[h] Miscellaneous Information

The following miscellaneous information should be considered:

- List of references from the management company
- Audited financial statements and projected budgets

- Description of any existing or pending litigation against the management company
- Description of the company's operating manuals
- Outline of the company's supervisory infrastructure
- Description of the company's personnel, training, and recruiting practices
- The availability of group or blanket insurance through the company

[7] Selection Rating System

Exhibit 19-12 contains a system made up of a series of questions whose answers consist of responses supplemented by some investigation into the background, structure, and integrity of the management company. Each question has several possible responses, which are assigned a value that ranges from -4 to +4. The total of all of the values for the responses chosen represents the overall rating of the management company.

Exhibit 19-12 Hotel Management Company Initial Selection Rating System

Characteristic	Score
Comparing the size of the hotels managed by the operator to the subject, most are:	
Larger	−1
The same size	0
Smaller	−1
Comparing the chain affiliations of the hotels managed by the operator, most are:	
Same affiliation	1
Similar affiliation	0
Dissimilar or no affiliation	−1
If the operator manages other hotels in the same market area, are these considered to be:	
Directly competitive	−4
Somewhat competitive	−2
Non-competitive	−1
Experience of the management company:	
New company—limited experience	−1
Moderate experience	0
Established—extensive experience	2
Management company's financial resources (ability to invest funds in the property):	
Limited—no investment potential	−1
Moderate—token investments	0
Strong—meaningful investments	2

Exhibit 19-12 (cont.)

Characteristic	Score
Operator shows willingness to invest funds in the property as a loan (double amounts if funds are contributed as equity):	
Initial inventories	1
Working capital	1
Pre-opening expenses	2
FF&E	3
Debt service guarantees	3
Management company has extensive experience in one of the following specialized areas that would directly benefit the operation of the subject property:	
Destination resort operation	2
Major convention operation	2
Unique market	1
Major food and/or beverage operation	2
Development assistance	2
Opening new hotel	2
Distressed property (turnaround)	2
Bankruptcy	2
Unions	1
Operating in secondary cities	1
Property ownership	2
Management company appears to be flexible in accommodating the following specialized needs of the owner:	
Short-term contract	2
Termination buy-out provision	2
Management company's ability to generate profits (based on actual performance):	
Normal—competent management	0
Better than average	5
Exceptional operating ability	10
Management company offers:	
Ability to obtain specialized identification	2
Ability to obtain financing	4
Feeder city representation	2
Track record of success	2
Management company has exceptional expertise or offers specialized services in the following areas:	
Centralized reservation system	2
Centralized sales and marketing	1
Regional sales offices	1
Convention and group sales	1

Exhibit 19-12 (cont.)

Characteristic	Score
Frequent traveler program	1
National advertising program	1
Top-level personnel	1
Financial systems and controls	1
Other specialized services	1
Personnel relations	1
Development capability	1
If management company is a first-tier operator, its identity is:	
Wide-spread	2
Positive	1
Management company has the following deficiencies:	
Poor references	−3
Lost contracts (deduct for each loss)	−1
Limited home office structure	−1
High management turnover	−2
No growth plans	−1
Excessive growth plans	−1
Will not subordinate incentive fee	−3
Unwilling to provide restrictive covenant	−3
Fee based entirely on percentage of total revenue	−3
Showed professional effort in:	
Preparing operating budget	1
Preparing sample marketing plan	1
Gut feeling:	
You can get along with this company	3

[8] Bargaining Positions

Once the number of management companies has been reduced to a manageable two or three, the bargaining positions of each party should be assessed in order to determine their basic negotiation strategies. The key to this exercise is to determine which party has the strongest position. Generally, the party with the strongest position will be able to negotiate an agreement that is favorable to itself. If the relative bargaining positions are understood, however, the final outcome can sometimes be altered in favor of the weaker position. The following sections outline the various elements that can produce a strong operator bargaining position or a strong owner bargaining position. (The listing of bargaining power factors is based on material presented in *The Negotiation and Administration of Hotel and Restaurant Management Contracts,* by James J. Eyster (School of Hotel Administration, Cornell University, 1988), p. 21,730.)

Strong Operator Position:

1. The property serves a specialized market that requires unique expertise possessed by operator.
2. The market is served by few national names not already in use. Many market areas have representation from most of the major hotel chains. Those operators offering an identification not already in use have a competitive advantage.
3. The operator is willing to take over distressed properties (e.g., those involved in bankruptcies, foreclosures, union problems, or that have poor reputations).
4. The operator is willing to accept contracts containing special requirements—for example, short operating terms or unique franchise and lender requirements (subordination, special approvals, and notices), cancellation or buy-out provisions.
5. Few other operators are interested in the hotel.
6. A limited opportunity exists for the operator to obtain additional management contracts from the owner.
7. The operator has other hotels in feeder cities.
8. The operator has a strong track record of success.
9. The operator is willing to engage in a joint venture, invest capital, or make performance guarantees.
10. The operator is able to secure financing for owner.
11. The operator has specialized expertise or services—for example, centralized reservations, national and regional sales offices, successful frequent traveler programs, national advertising, strong home office support staff with complete management supervision system in place, ability to provide a wide range of in-house support services (e.g., property tax consulting, interior design, engineering, and development counseling).

Strong Owner Position:

1. The hotel has a highly visible location that would provide the operator with extensive local exposure. This is a form of free advertising and promotion for the management company, particularly if it is a first-tier operation.
2. The subject market has strong barriers to entry against new development. Therefore, the operator may not have another opportunity to enter the market. New York City is currently an example of a very strong hotel market in which it is difficult to develop new lodging facilities because of high construction costs. Almost every national or international hotel chain would like to have representation in New York City, but few are able to enter this market.
3. The property is a famous existing hotel. Some hotels are landmarks to the traveling public. Properties such as the Ritz-Carlton in Boston; the Plaza in New York City; the Madison in Washington, DC; the Drake in Chicago; the Royale Orleans in New Orleans; the Arizona Biltmore in Phoenix; the Bel Air in Los Angeles; and the Stanford Court in San Francisco are examples of hotels that would be most attractive to any hotel management company.
4. The owner has a strong track record of other successful hotels. Hotel management companies like to team up with owners and developers that are

likely to create many hotel projects. If the operator can anticipate the possibility of obtaining several contracts from the same owner over a period of time, a favorable package deal can often be negotiated.

5. The owner has a strong financial statement. The owner's ability to finance new projects as well as maintain existing properties is important to hotel management companies.
6. The owner does not require capital from the management company. If the owner has a strong financial position and does not require capital from the management company, the pool of potential operators is greatly enlarged. Many excellent hotel chains are either unable or unwilling to make capital investments in projects they manage for third parties, so an owner's need for capital would eliminate these operators from consideration.
7. Many other management companies are interested in the subject property. Some highly desirable hotels are often sought after by several hotel chains.
8. Opportunity exists to obtain other management contracts. One management contract often leads to others. If the operator can see the potential for more business, the owner often picks up some bargaining power.
9. The management company is new and has limited experience and resources. Any time an operator has less to offer than competing hotel companies, the owner gains leverage in contract negotiations. New hotel companies or those with limited resources or home office infrastructure are more likely to offer an owner a more favorable contract.

[9] Issues During Negotiation

Prior to actually presenting an opening offer, both the owner and the operator should determine their basic negotiation strategy for the major terms of the contract. Although hotel management contracts contain numerous clauses and provisions, there are usually fourteen major terms that form the basis of the agreement and are primary issues in the negotiations. The following list describes these fourteen major terms and the basic objective of the owner and operator in negotiations concerning them. These management contract provisions were identified in James Eyster's *Negotiation and Administration of Hotel and Restaurant Management Contracts* (p. 35,736) as the provisions most likely to generate concerns for owners and operators and to be the focus of contract negotiations.

1. Contract term:
   - Owner—Obtain a contract term for as short a period as possible with renewals at the option of the owner.
   - Operator—Obtain a contract term for as long a period as possible with renewals at the option of the operator.
2. Management fee:
   - Owner—Base the fee solely on a percentage of net income after debt service and a minimum return on equity. Attempt to minimize the amount of this percentage.
   - Operator—Base the fee solely on a percentage of total revenue. Attempt to maximize the amount of this percentage.

3. Reporting requirements:
   - Owner—Require extensive written financial reporting and frequent budget updates and meetings with owner.
   - Operator—Minimize as much as possible the reporting of operating results and budgets to owner.
4. Approvals:
   - Owner—Structure contract so owner has the right to approve all aspects of hotel operation.
   - Operator—Structure contract so operator has total discretion with no approvals of any sort required from owner.
5. Termination:
   - Owner—Ensure owner's right to terminate management contract immediately upon written notice.
   - Operator—Under no circumstances allow the operator to be terminated before the expiration of the contract.
6. Operator's investment in the property:
   - Owner—Stipulate that operator buy right to manage hotel (i.e., invests capital or services) or make performance guarantees to obtain the management contract.
   - Operator—Stipulate that operator have no investment in the property.
7. Operator's home office expenses:
   - Owner—Make all home office expenses of operator reimbursable from management fee, with no expenses to be charged to property.
   - Operator—Stipulate that the pro rata share of all of operator's home office expenses plus all direct expenses be chargeable to the property.
8. Transfer of ownership:
   - Owner—Ensure that owner may transfer ownership of hotel to anyone at any time.
   - Operator—Ensure that owner cannot transfer ownership of property without operator's approval and that operator is allowed right of first refusal.
9. Exclusivity:
   - Owner—Establish owner's right to develop or own any hotel managed by operator.
   - Operator—Establish operator's right to manage any hotels developed or owned by owner.
10. Insurance and condemnation proceeds:
    - Owner—Exclude operator from participation in any insurance or condemnation proceeds.
    - Operator—Stipulate that operator be entitled to a pro rata share of all insurance and condemnation proceeds.
11. Hotel personnel:
    - Owner—Ensure that all hotel personnel will be employees of operator.
    - Operator—Ensure that all hotel personnel will be employees of owner.

12. Reserve for replacement:
    - Owner—Agree to fund capital replacements (furniture, fixtures, and equipment) on an as-needed basis.
    - Operator—Establish the right to establish a reserve for replacement funded by the owner that is as large as possible.
13. Restrictions:
    - Owner—Stipulate that operator cannot own, manage, or franchise another hotel within the same market as the subject.
    - Operator—Refuse restrictions on ownership, management, or franchising by the operator in the same market as the subject.
14. Indemnity:
    - Owner—Ensure that operator will indemnify owner for all actions against operator.
    - Operator—Ensure that owner will indemnify operator for all actions against operator.