How to Protect Yourself From an Incompetent Hotel Management Company

As more and more hotels head toward foreclosure and bankruptcy, hotel owners and lenders are looking to remove incompetent operators in order to improve their property's financial operating results. Hotels are complicated businesses requiring highly skilled management necessary to generate profitable operating results. Selecting a replacement hotel management company is a two step process:

First: Identify several management companies which have the specific competencies to operate your hotel in a profitable manner. The best operators have experience managing properties similar to yours in areas such as size, location, types of facilities, brand affiliation and markets. Look for several operators possessing the necessary qualifications so you can start the negotiations with two or three- competition generally produces a more favorable agreement for the owner.

Second: Negotiate a performance based management agreement that provides incentive for the operator to maximize long-term revenues while minimizing long-term expenses. In addition, the contract needs provisions that allow the owner to quickly remove an incompetent operator.

The key component of the Step #1 due diligence process is to verify the operator's competency by reviewing their actual financial performance managing properties similar to yours. Simply, the contemplated operator needs to allow you or your consultant to review the financial statements of the hotels they manage that are similar to yours. If they balk at this request by citing confidentiality or some other excuse- you can assume they are not proud of their financial results which suggests you should move on to another operator. I have reviewed unidentified operating statements that contain only the operating ratios which maintain confidentiality but allows the evaluation of operator's competency. Focus on the key operating ratios such as Rooms and Food and Beverage Expenses which need to be on the low side of national averages. Look to see how the property's occupancy and average rate compares to its competitive set. Lastly, ask the management company for references, particularly those owners that terminated the company before the end of contractual term. While there may be many legitimate reasons to cancel a hotel operator- you need to determine whether competency was ever the issue.

Once you select several hotel management companies that demonstrate they have the ability to operate your property profitability you can commence the negotiation process. While hotel management agreements have a number of important provisions that need to be addressed there are four which are critical to protect the owner from an incompetent operator. Simply, a hotel management agreement must have provisions that will allow the owner to either have control over the operations of the property or to terminate the agreement quickly in the event the hotel fails to achieve an adequate level of profitability. This type of financial safety can be achieved through the use of the following provisions-

Management Fee Based on Performance- The operator should not make a profit when you are suffering a loss. Structure the management fees in a manner where the operator is able to cover its costs in the base fee (which is generally a percentage of total revenue), but only achieves a profit when the owner gets a sufficient cash flow to cover debt service. Typically, a hotel management company will be able to cover all of its costs with a base fee of 1% to 2.5% of total revenue. The incentive fee should not kick in until there is a sufficient bottom line to pay the mortgage.

Budget Control- If the management company fails to produce adequate profit to pay the mortgage- the owner should have absolute approval rights over the operating budget. Too many hotel companies are more concerned about maintaining "brand standards" than cutting back on expenses during a down market. If the operator is not willing to make the necessary cuts to eliminate or reduce financial losses- the owner (or its asset manager) needs to get involved in making the budgetary decisions.

Exclusive Areas- Non-Compete- There is nothing worse than to have your management company take over a property that competes directly with yours. This not only dilutes the value of your property but reduces the attention your hotel will receive from the operator. Your management agreement must allow you to terminate the operator if you determine one of their properties's compete directly with yours.

Termination for Incompetency- All hotel management contracts should allow the owner to terminate the operator for poor performance. There are a number of performance provisions such as the REVPAR test which are totally useless. The only one that is fair to the owner is a provision that allows for termination in the event the operator fails to produce an adequate profit to cover debt service.

Ability to Quickly Terminate- I call this the "if all else fails" provision. In my opinion, the most important provision that the hotel owner should insist on having is the Buy-Out clause. This provision allows the owner to terminate the contract at any time upon payment of a termination fee. This clause not only enables the owner to quickly get rid of an incompetent operator before much financial damage occurs but also allows the owner to sell the property without the encumbrance of the existing management company.

The preceding hotel management contract provisions are the ones an owner should make sure are structured in a manner that provides the most protection for the owner from an incompetent management company. While other contract terms are important- I find that incompetency is the greatest risk an owner faces when their property is handed over to a management company.

If you would like to read further about hotel management contracts- drop me an e-mail and I will send you several articles on this subject- srushmore@hvs.com