Hotel Investment Strategies

Performance Clauses Essential In Contract

When you turn the keys of your hotel over to a management company, you expect the property will be competently operated. I define competence as the ability to maximize long-term revenues while minimizing long-term expenses. While most hotel management companies are able to operate in accordance with this definition, what do you do when your operator does not? Hopefully, you have included one or more performance clauses within the management contract, which will enable you to terminate the operator and find someone who will do a better job.

Most hotel management companies will not voluntarily include a performance clause within their "standard" contracts. This provision usually comes at the insistence of the owner and generally requires intensive negotiations to structure a workable arrangement whereby the hotel owner is protected from an incompetent operator, and the management company has a performance standard that is fair and related to events and circumstances that are controllable. Hotel management contract performance clauses typically contain four components: the criteria standard; an implementation period; ability for operator to cure; and exceptions to termination.

There are a number of criteria utilized to structure a management company's performance clause. The simplest and what seems to have become the most popular is the RevPAR (revenue per available room) standard. This clause identifies several nearby hotels comparable to the subject property. The RevPAR for this comparable set is determined periodically and compared to the RevPAR of the subject property in the form of a RevPAR yield (the RevPAR of the subject property divided by the RevPAR of the comparable set). Should this RevPAR yield fall below some stipulated level, a default occurs that could lead to a termination by the owner. The stipulated RevPAR yield used as the standard often depends on the current RevPAR of the comparable set when the contract is negotiated, but most well-run hotels should achieve a RevPAR yield of 100%.

While the RevPAR standard is simple to compute, I generally do not recommend using it because it incentivizes the operator to focus only on the revenue line and ignore the total cost of achieving a predetermined level of revenue. An unscrupulous operator could artificially inflate RevPAR by overspending in areas such as marketing, service and amenities.

A more relevant standard is to define a level of profitability (net income) that the operator must achieve not to go into default. Usually, the owner wants this standard to be an amount sufficient to cover the existing debt service plus a return on equity. Operators tend to insist on a standard that would include only expenses they have direct control over and focus on the operating profit line. In either case, a predetermined monetary amount needs to be agreed upon and stipulated in the contract. This amount may sometimes be adjusted for inflation over the term of the agreement—but usually not.

Other standards that I have seen include a defined net income percentage of total revenue. The object of this standard is to have an operator maintain a certain level of profitability irrespective of the length of the contract. This eliminates the need to adjust the previous standard for inflation. However, the operator can sometimes manipulate a defined profit percentage by, for example, decreasing the amount of food and beverage sales (this will generally increase the bottom line profit percentage).

If you want your operator to maintain a certain quality standard for the product and the service, I have seen performance clauses tied to a specified rating from a government rating department or private rating service such as Mobile or AAA.

Once the standard is agreed upon, most operators will insist on an implementation period. Usually, hotel management companies are given one to three years to achieve the specified standard after taking over the operation of the property. For a new hotel, this accounts for the normal build-up period, and for an existing hotel, it enables the operator to implement new systems and procedures. In addition, a default period of two to three years is normal so the operator would not be terminated for one poor performance year.

Some contracts, particularly those that define a level of profitability, contain provisions allowing the operator to cure the default by either giving or lending the owner sufficient funds to make up the difference between the stipulated level of net income defined in the standards and the actual level. This allows hotel management companies to avoid a default in the event they just missed meeting the standard.

While performance standards can be very specific, there should be a list of exceptions that allow an operator to perform below a standard without default in the event there are circumstances beyond the operator's control. This is what attorneys call *force majure* and includes things like floods, hurricanes, war and strikes. Performance exceptions need to be defined carefully. Usually, having the default period described above provides the operator sufficient time to recover from an unusual event and therefore reduces the need for a long list of exceptions.

There is nothing worse than being stuck with an under-performing hotel that easily could be turned around with competent management. Performance clauses should always be included in a hotel management contract. In fact, I often suggest that an owner give the operator a slightly higher fee as a trade off for allowing a more restrictive performance standard. ◆

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