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PRICING A MANAGEMENT CONTRACT

Lodging appraisals demand some unique approaches. How, for instance, can you determine the value of a hotel management contract?

A management contract is an agreement made with the owner in which a management company takes over the day-to-day responsibility of operating the hotel and the owner defers on many management decisions. The hotel management company receives a fee for providing these services and generally makes no assurances regarding the financial success of the property.

A hotel management contract is not a lease, nor does it convey any type of interest in the property. Some courts have ruled that a hotel management contract is an agency agreement that the owner can cancel at will. As such, the value of the management fee income to the hotel management company is typically worth less on a dollar-for-dollar basis than the income derived by a hotel owner.

When valuing any type of business, one has to consider the associated risks and benefits. Among the factors influencing the value of a lodging management contract:

- Amount of management fees. Management contracts involving national chains typically have more value than those involving independent management companies.
- Term. The longer the remaining term, the more the contract's likely worth.
- Cancellation provisions. A contract that allows the hotel owner to terminate for performance or other causes will sometimes diminish its value to a management company.

A contract provision known as an "operator's buyout provision" indicates how hotel management companies actually value their management agreements. When inserted in a hotel management contract, this clause permits the hotel owner to terminate the contract by paying the operator a lump sum fee.

Since the owner and operator normally negotiate a buyout provision prior to entering into the actual agreement, we normally assume that the amount of the buyout fee represents the value of this contract to the hotel company. Essentially, the owner is buying the management contract from the operator for a value determined by the buyout provision.

Over the years, I have reviewed hundreds of hotel management contracts, many of which have operator buyout provisions. Based on this research, an industry standard for an operator buyout would be approximately two to three times the previous year's management fees paid to the management company. This amount might be adjusted slightly upward or downward depending on the other contract factors previously described, but this range is generally appropriate.

As an illustration, assume that the management fee income to a hotel operating company was $200,000 last year. A buyout provision of two times would create a value of $400,000 and a buyout of three times, $600,000. From an appraisal point of view, the capitalization rate indicated by a multiplier of two or three would be 50 and 33 percent, respectively.

In addition to this multiplier method, which seems to produce highly accurate results, we sometimes value the net income to the management company after payment of operating expenses. This approach utilizes a somewhat lower capitalization and discount rate.

As hotel management contracts become more prevalent in the lodging industry, there will undoubtedly be many transfers of these agreements requiring an estimate of value. Utilizing an owner's buyout clause is currently the most effective way to value hotel management contracts. **LH**

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