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HVS GUIDE TO HOTEL MANAGEMENT CONTRACTS: THE AMERICAS

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The hotel management contract, that was introduced as a tool for asset-light growth of operating companies more than half a century ago, is today among the most popular modes of operations worldwide. So much so that it has unfastened a realm of opportunities for operators to expand at a rapid pace without being exposed to development and ownership risks, for owners to outsource the management of the hotel to the "experts" in the field while enjoying enhanced financial returns, and for stakeholders such as consultants and lawyers to develop a dedicated service line around this model.

From the first contract HVS ever negotiated on behalf of the developer to the numerous agreements that we help structure and negotiate now, this legally binding document has transformed manifold becoming more sophisticated and individualized than in the past. Particularly striking is the shift from leaning heavily in favor of the operator to the contract becoming a lot more balanced in present times. While there are several reasons for this change, among the most prominent are, firstly, the evolution of the hotel owner, who is a lot more diverse, aware, knowledgeable, and experienced in negotiating contracts with an operator and, secondly, the notable rise in the presence of consulting firms like ours that not only help make the right match by negotiating a balanced agreement, but also educate the industry of the latest trends, opportunities and options on the subject.

The *HVS Guide to Hotel Management Contracts* is one such substantive document that will help industry players to understand the key terms and provisions of contemporary management agreements. It includes exclusive HVS insights on critical contract provisions in addition to the results of an invaluable and extensive survey that truly offer a global perspective by highlighting the common as well as unique trends in the primary geographies of the world. The authors have significant hands-on experience in the hotel sector and in negotiating hotel management contracts, placing them in a relevant position to conduct, analyze and publish this comprehensive topical research. Covering ten principal areas of discussion – management contract term, territorial restrictions, operator fees, operator performance test, budgeting, owner approvals, employees, indemnification, operator investment in property and termination of the agreement – the endeavor of the authors to provide an eminent reference document is fully realized.

Finally, this guide and survey report is a product of the collaboration of many HVS regional offices showcasing the firm's unrivaled hospitality intelligence, worldwide.

Stephen Rushmore, Jr. MAI, FRICS, CRE
President and CEO
HVS

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SUMMARY

The HVS Guide to Hotel Management Contracts presents the results of an extensive review of hotel management agreements conducted across the Americas (USA, Canada and South America), Europe, the Middle East, Africa (EMEA), and the Asia Pacific (APAC) regions, in addition to offering an in-depth understanding of the key terms and clauses of such agreements.

INTRODUCTION

The financial success of any lodging facility is largely dependent on the skill and ability of its on-site management. Historically, hotel owners have either hired individual on-site managers (aka hotel managers or general managers) to operate their properties, or engaged the services of professional hotel management companies through hotel operating agreements such as property leases (see **overleaf** for more detail) 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.

Although **hiring a professional management company** to operate a hotel is largely beneficial to the property and ownership, both the owner and operator must understand the various benefits and challenges that such arrangements may pose. An understanding of these considerations would greatly assist both parties to recognize each other's motivations as well as assist in making well-informed decisions. Figure 1 compares and contrasts the advantages and disadvantages of engaging a professional hotel management company from both the owner's and the operator's standpoint.

FIGURE 1: OWNER AND OPERATOR CONSIDERATIONS | ENGAGING A HOTEL MANAGEMENT COMPANY

Advantages	Disadvantages
Owner	
Acquisition of operational expertise	Loss of operational control
Immediate name recognition	Liability of ongoing expenses
Quality management	Cost of management
Enhanced financial returns	Termination of operator is difficult
	Sale of property could be more difficult
	Operator may favor properties it owns in the same market
	High downside risk
Operator	
Inexpensive, rapid expansion	Residual benefits of ownership are eliminated
Low downside risk	Minimal input in ownership decisions
Quality control	Dependence on finances of owner
No depreciation expenses	Contract termination
	Critical mass needed to generate acceptable profits

Source: HVS Research

HVS Insight

Select disadvantages of engaging a hotel management company have been elaborated hereunder:

For the Owner: *The **sale of a hotel property** is often much more difficult if it must be sold in conjunction with an existing management contract. Hotel companies rarely purchase hotels operated by other companies; therefore, an ongoing, non-cancelable contract reduces the number of possible buyers and consequently increases the time required to find a qualified buyer.*

For the Operator: *While the actual operating expenses and home office costs associated with providing hotel management services is minimal, a **critical mass** of properties under contract is necessary to cover the cost of key operational executives, home office, and support staff while still generating acceptable profits for the operator.*

Hotel management companies are generally classified as either first-tier or second-tier. Figure 2, on the next page, highlights the pros and cons of both **types of hotel management companies** from an owner's perspective.

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 brand names. Marriott International, Hilton, Hyatt Hotels Corporation, Mandarin Oriental, Jumeirah Group, Taj Group and InterContinental Hotels Group are some 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 instead make use of franchise affiliations to generate customer identification. Some examples are Interstate Hotels and Resorts, White Lodging Services Corporation, Aimbridge Hospitality, GCH Hotel Group, Bespoke Hospitality Management Asia, PREM Group and Hersha Hotel Management.

FIGURE 2: PROS AND CONS OF DIFFERENT TYPES OF HOTEL MANAGEMENT COMPANIES FROM AN OWNER'S PERSPECTIVE

Advantages	Disadvantages
First-tier Management Companies	
Less expensive than second-tier companies and the requisite franchise affiliation	Restrictions on property size
Corporate brand identity	Restrictions on financial conditions
Efficient operations (more unified)	Restrictions on contract terms (length of the initial and renewal terms)
Convention and group sales capability	Restrictions on termination
Ease of financing (recognizable "brand name" management companies)	Less flexibility and difficulty in negotiations
Second-tier Management Companies	
Flexibility in negotiations	Financing more difficult to obtain
Individual attention	Perceived risk
	Possible high cost
	Inability to guarantee performance and make financial contributions (often)

Source: HVS Research

Furthermore, to properly evaluate hotel management companies, property owners should be familiar with the **two basic operating philosophies** found in the industry. Management companies generally either have 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.

A *centralized operating philosophy* is characterized by manuals that detail all aspects of the company's hotel management system covering every conceivable eventuality. These reference guides provide on-site management with information regarding a broad range of topics such 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. Employees at 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. On the flip side, such a philosophy can make it difficult to modify procedures to meet local conditions or customs.

On the opposite end of the spectrum is the *decentralized operating philosophy*, where on-site managers are given broad latitude in forming property-level operating systems and procedures. It must be noted that the company does provide general guidelines from its home office, but managers are allowed wide discretion regarding the way they operate their property. The primary advantage of a decentralized operating philosophy is that it encourages constant modifications and updating of methods, which can be beneficial in the hospitality industry.

HVS Insight

Total Property Leases: *Essentially, a total property lease is an agreement between a hotel company and a hotel property owner whereby the former 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 the losses when operating performance is inadequate. Because of the popularity of management contracts, hotel operating leases are less common today, except in some European countries (like Germany and the UK) and Japan, where they remain a predominant operating model. Having said that, operating leases are being reestablished in certain parts of the world with the resurgence of real estate investment trusts (REITs).

Advantages for the Owner:

- *Retain title to the property*
- *Financial risk of ownership is minimized*
- *No operational responsibilities*

Disadvantages for the Owner:

- *Operator has little incentive to maintain the property in top condition as the lease term nears its expiration date*
- *Places the owner in a passive position, with no input in operations of the hotel*
- *Financial rewards are lesser compared to an owner-operator, if the hotel is successful*
- *Leases are difficult to terminate*

Hotel management contracts came into use between 1950 and 1960 stemming from the desire of American hotel companies to expand globally, without exposing them to development and operating risks associated with owning or leasing a hotel in a foreign country. Over time, this mode of operation gained popularity worldwide, with the hotel industry in Europe, and more recently in the Middle East, Asia Pacific and Africa seeing an advent of management tie-ups.

Fundamentally, a hotel management contract is an agreement between a hotel management company and a hotel property owner whereby the former 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 on the owner, who enjoys the upside benefits of a successful property, but suffers the downside losses if the operation is not profitable.

The proper execution of a hotel management contract between the owner and the operator is a critical step in the development of a successful hotel venture. In today's highly competitive environment, operators are keen to "seal the deal" as quickly as possible, sometimes overpromising performance results. Owners, however, are now more aware and and knowledgeable, wanting to safeguard their investment by understanding the management contract terms and conditions thoroughly prior to signing.

This guide and survey report is an HVS endeavor to provide a substantial reference document that presents and distinguishes the key terms and clauses of management contracts across the following primary geographic areas – Americas (USA, Canada and South America); Europe, the Middle East, and Africa (EMEA); and the Asia Pacific (APAC). Please note that the aim is not to make hotel owners in any part of the globe feel shortchanged; instead, we urge the readers to bear in mind local factors and influences that could impact regional contract clauses, in addition to asset specific considerations that may affect owner-operator negotiations**.**

SURVEY METHODOLOGY

The following methodology has been adopted for the survey:

Data Compilation: Data collection for the survey was implemented using a combination of different ways. We looked at contracts from the HVS global database, dispatched an online self-reporting questionnaire to owners who wished to participate voluntarily, and held discussions with hotel owners as well as operators. Eventually, the global survey sample set comprised **475 management contracts representing close to 120,000 hotel rooms**. Regional breakdown is depicted in Figure 3, alongside**.**

FIGURE 3: SURVEY SAMPLE SET

Region	No. of Contracts	Rooms Represented
Americas	257	70,862
USA	150	42,754
Canada	76	22,197
South America	31	5,911
EMEA	111	27,610
Europe	73	18,945
The Middle East	24	5,755
Africa	14	2,910
APAC	107	21,454
India	64	12,132
Rest of APAC	43	9,322
Global	**475**	**119,926**

Data Analyses: Primary **independent variables** (defined as inputs or causes) that were chosen for the data analyses are *Market Positioning*, *Room Inventory* and *Age of the Contract*. For the USA and Canada sample sets, we also looked at *Type of Management*, since both first-tier and second-tier management companies are widespread in these markets. Plus, it is important to note that the survey captured information on secondary independent variables as well, which have been discussed in this report to explain results where applicable. Figure 4, overleaf, depicts all the independent variables used for data analyses.

Report Presentation: The **major terms and provisions** of hotel management contracts in the sample set were analyzed across all the primary geographic regions; these terms and provisions are recognized to be critical areas for owner-operator negotiations. In terms of presentation, the guide and survey report has four major sections as highlighted in Figure 5 on the following page, with the survey results being presented by the prinicipal areas of discussion that are listed in Figure 6.

FIGURE 4: VARIABLES USED FOR ANALYSES

Variables	Parameters
Primary Independent Variables	
Market Positioning	Budget, Mid Market, Upscale, Upper Upscale, Luxury, Extended Stay
Room Inventory	Less than 100 rooms, 100-299 rooms, 300-500 rooms, Above 500 rooms
Age of the Contract	Before Year 2005, In or After Year 2005
Type of Management (for USA and Canada Sample Sets)	Brand Managed (First-tier), Third-Party Managed (Second-tier)
Secondary Independent Variables	
Type of Management	Brand Managed (First-tier), Third-Party Managed (Second-tier)
Type of Property	New Development, Conversion/Rebranding
Year of Property Opening	Before Year 2005, In or After Year 2005
Location of the Property	By City, By Country

FIGURE 5: MAJOR REPORT SECTIONS

Section	Region and Major Contents
I	Global
	Global Sample Set Profile and Survey Results
	(Includes Definitions and Discussions)
II	Americas
	USA Sample Set Profile and Survey Results
	Canada Sample Set Profile and Survey Results
	South America Sample Set Profile and Survey Results
III	EMEA
	Europe Sample Set Profile and Survey Results
	The Middle East Sample Set Profile and Survey Results
	Africa Sample Set Profile and Survey Results
IV	APAC
	APAC Sample Set Profile and Survey Results
	(Separate Discussion on India where applicable)

FIGURE 6: PRESENTATION OF SURVEY RESULTS BY PRINCIPAL AREAS OF DISCUSSION

Principal Discussion Areas	Key Aspects
Management Contract Term	Initial Term Extensions/Renewals
Area of Protection/Territorial Restrictions	Inclusion/Exclusion of this Provision Key Considerations
Operator Fees	Initiation/Joining/Commitment Fee Technical Services Fee and Pre-Opening Fee Base Management Fee Owner's Priority Return Incentive Management Fee Other Fees/Charges/Reimbursables
Operator Performance Test	Commencement Year Test Period Type of Test Performance Thresholds Provision for Operator to Cure
Budgeting	Annual Plan Expenditure Thresholds FF&E Reserve Contribution Control of Receipt/Operating/Revenue Account
Owner Approvals	Items Subject to Owner's Approval
Employees	Employer Senior Management Hiring Process
Indemnification	By Owner By Operator
Operator Investment in Property	Key Money Deferred Fees Owner's Priority Return and Operator Profit Guarantees Operator Loans
Termination of Agreement	Standard Conditions Termination by Owner Termination by Operator

LIMITING CONDITIONS

The 475 contracts in the global sample set are not in the same format. By this we mean that some of these are complete with all supplemental agreements on Licensing and Royalty, Marketing, Chain Services and Technical/Pre-Opening Services, among others, being available, while the rest are either just the Hotel Management Agreement (HMA)/Operating Services Agreement (OSA) or the final Letter of Intent/Memorandum of Understanding/Term Sheet, which may not provide all the information sought through this survey. This limiting condition has been highlighted where applicable in this report to equip the reader with the information necessary to make a fair assessment of the data provided herein.

Secondly, a sizeable number of contracts in the sample set **(69%) were signed in or after 2005**; however, only 20% of the sample set corresponds to those signed in the last five years (2012 and onwards). While one may consider this to be a limitation, it must be borne in mind that hotel management contracts have long operating terms (averaging a little over 18 years for the global sample set), with the provisions of the majority of agreements still very much valid today. Besides, the number of hotel management contracts signed each year by management companies, particularly the branded ones, is limited. All the same, we have tried to address this limitation (if any) by speaking to HVS regional experts and hotel operators in order to better gauge the current on-the-ground scenario, and have presented our findings, as applicable, in the discussions herein.

QUALIFYING CONDITIONS

The **classification of hotels** across Budget, Mid Market, Upscale, Upper Upscale, Luxury and Extended Stay positioning is an HVS judgement bearing in mind that the product profile of hotels, even for the same brand, may vary from region to region.

Moreover, while it has been our effort to have a sample set that is uniform across the primary geographic regions, this has not been entirely possible. For instance, 81% of the EMEA contracts represent upscale/upper upscale/luxury hotels, which in the case of the Americas is 62%, and for APAC it is 65%. Therefore, **we recommend that the reader review the survey profile sections of this report carefully prior to looking at the survey results**.

It must also be noted that the survey results for **franchised properties** are indicative of the operating terms of second-tier management companies (aka third-party hotel operators) and not those of the brands.

Additionally, **the terms and definitions** provided herein are broad indications only, and any of these can vary depending on factors such as location, project profile, operator and investor type.

Data confidentiality has been strictly maintained throughout this survey, with results being presented only in aggregate; no individual contract, asset or hotel management company has been identified.

Lastly, HVS reserves the right to amend all or part of the report without prior notice. **No information contained in this report may be reproduced or distributed in any form without due acknowledgement and the prior written permission of HVS.** For avoidance of doubt, such approval is required whether or not HVS is referred to by name, and whether or not this report is combined with others.

SECTION I | GLOBAL

This section of the guide and survey report presents the global sample set profile, corresponding survey results and an explanation of the main terms and provisions of hotel management contracts.

GLOBAL SAMPLE SET PROFILE

The global sample set profile has been illustrated below by the primary independent variables – *Market Positioning*, *Room Inventory* and *Age of the Contract* – and select secondary independent variables. Clearly, the **majority** of the global sample set is represented by:

- Contracts for hotels with upscale-luxury positioning **(67%)**
- Contracts for hotels having less than 300 rooms **(71%)**, with the **average rooms per hotel being 252**
- Contracts signed in or after Year 2005 **(69%)**

Furthermore, it may be noted that there are more contracts for brand managed hotels **(74%)** than for third-party managed properties **(26%)**, in addition to a near equal representation of new hotel developments **(53%)** and conversions **(46%, 1% NA)** in the global sample set.

FIGURE 7: GLOBAL SAMPLE SET PROFILE

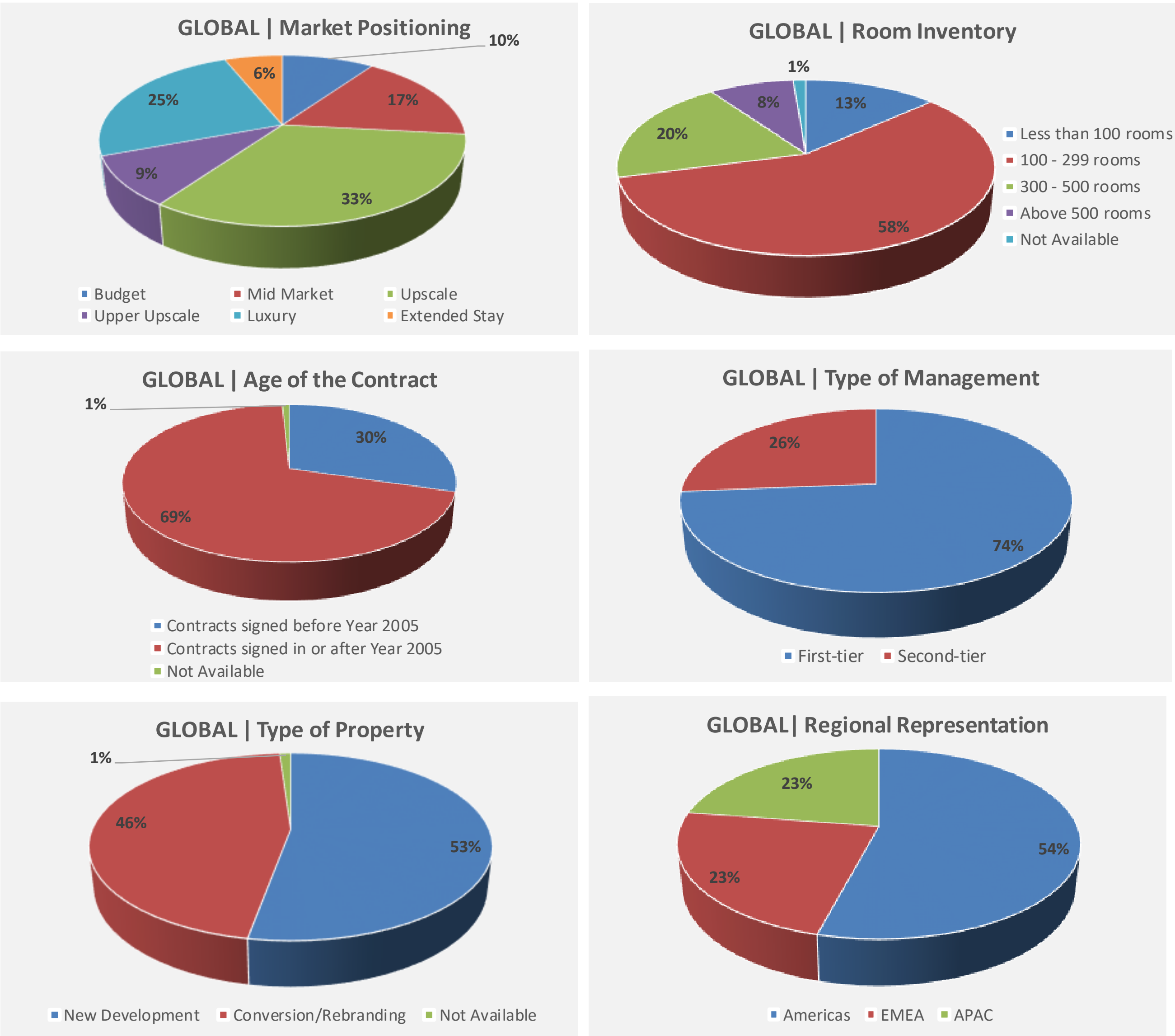


Figure 8, below, lists the 55 first-tier (branded) hotel management companies represented in the survey. Several second-tier management companies (third-party) along with a few independent hotels also feature in the sample set, but as these may be linked to only one or few assets, we have not listed them for data confidentiality reasons.

FIGURE 8: FIRST-TIER (BRANDED) HOTEL MANAGEMENT COMPANIES REPRESENTED IN THE SURVEY

Accor	Hampshire Hotels	One&Only Luxury Resorts
Ace Hotel	Hilton	Peninsula Hotels (HSH Group)
Adina Apartment Hotels (TFE Hotels)	Hyatt Hotels Corporation	Rosewood Hotels and Resorts
Aldesta Hotel Group	InterContinental Hotels Group	Rotana Hotels and Resorts
Aman Resorts	Jumeirah Group	Sarovar Hotels and Resorts
Americas Best Value Inn (Vantage)	Kempinski	Shangri-La Hotels and Resorts
Banyan Tree Hotels and Resorts	La Quinta Inn and Suites	Shaza Hotels
Best Western International	Langham Hotels and Resorts	Six Senses Hotels, Resorts and Spas
Cambridge Suites	Le Germain Hotels	Starwood Hotels and Resorts (Marriott International)
CampbellGray Hotels	Lotte Hotels and Resorts	Staybridge Suites
Carlson Rezidor	Louvre Hotels	Taj Hotels, Resorts and Palaces
Caesars Hotels and Casinos	Mandarin Oriental Hotel Group	The Fern Hotels and Resorts
Choice Hotels	Marriott International	The Leela Palaces, Hotels and Resorts
Club Méditerranée	Melià Hotels International	Trump International
Delta Hotels and Resorts (Marriott International)	Minor Hotel Group	Whitbread PLC
Dusit Hotels and Resorts	Morgan's Hotel Group	Wyndham Worldwide
Fairmont Raffles Hotels International	Mövenpick Hotels and Resorts	
Fortune Hotels	Oakwood Serviced Apartments	
Four Seasons Hotels and Resorts	Omni Hotels and Resorts	

GLOBAL SAMPLE SET SURVEY RESULTS

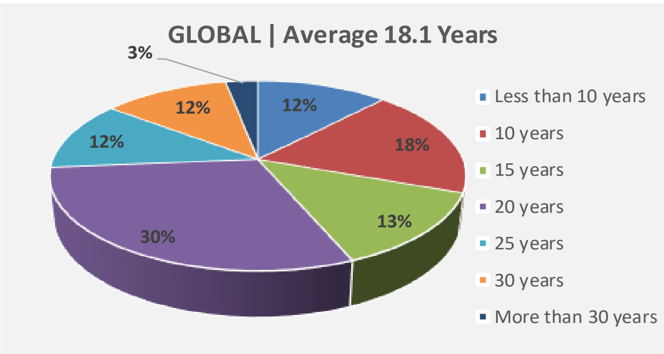
Survey results pertaining to the main terms and provisions of hotel management contracts for the global sample set have been presented below.

Management Contract Term

Management Contract Term can be defined as the length of time that the agreement is to remain in effect. Both a commencement date and a termination date are usually specified in this provision. The commencement date may be either a specific date or it may be as of a certain occurrence, such as the date the hotel officially opens for business. Whatever the certain occurrence may be, the parties to the contract must be careful to define it clearly. The contract term may consist of an initial term and one or more renewal terms that extend the total length of the agreement.

Initial Term: The initial term of a management contract for a proposed hotel typically commences from the Effective Date (date of execution of the management agreement) and continues until the expiration of a specified number of years after the Opening Date. In the case of existing hotels, the initial term is generally calculated from the Effective Date until the expiration of a specified number of years. **The average length of the initial term for the global sample set is around 18 years, with nearly one-third of the contracts averaging 10 years or less.**

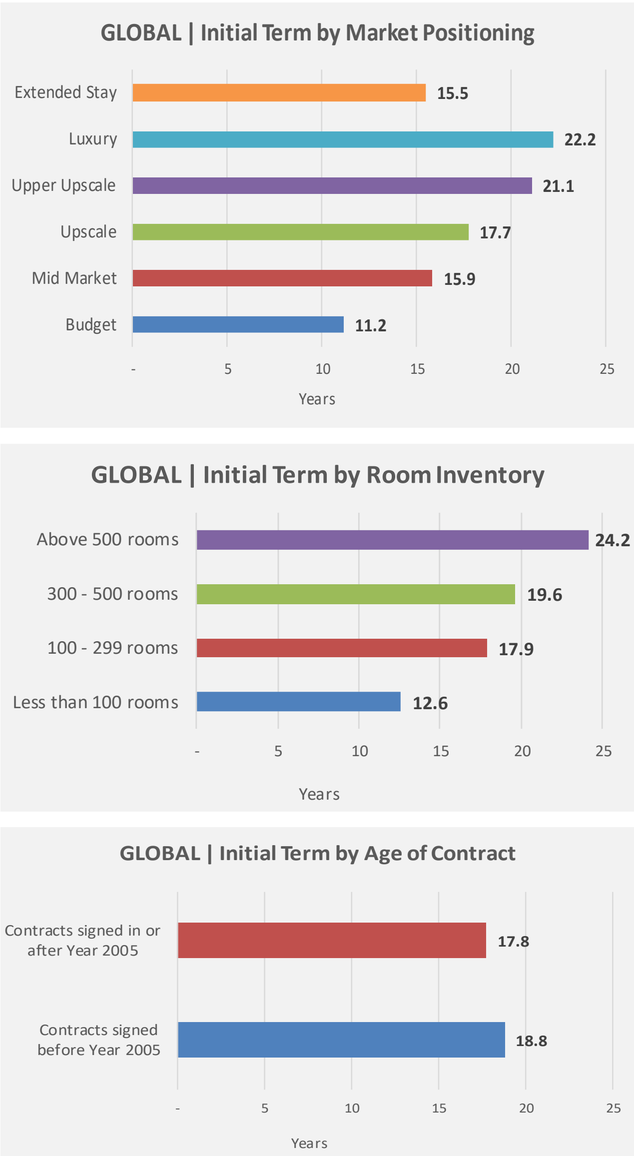
FIGURE 9: LENGTH OF THE INITIAL TERM



It is common knowledge that **operators prefer a longer contract term** with automatic renewals (or those exercisable by the operator at its option) citing the need for stability, to protect their brand image as well as to obtain the desired return on their investment. A hotel company generally incurs start-up costs when taking over new contracts; so, the company needs a term long enough to recoup the initial one-time expenses. In addition, most management fees are structured so that they reward profitable operating results, and as a consequence, it may take an operator several years to achieve the level of profitability needed to earn a reasonable amount of compensation. On the other hand, **owners prefer a shorter initial term** with multiple renewal options on mutual consent, seeking flexibility, and more importantly enhancing their ability to sell the property unencumbered by a management contract after the expiry of the initial term.

Besides which side of the table you are on, the length of the initial term is also dependent on the **region of operation, hotel's market positioning, type of management, room inventory and the year of signing the contract,** among others. For instance, operators in USA and Canada appear more comfortable with a shorter initial term than other regions. Conversely, EMEA witnesses maximum number of contracts with an initial term of 30 years or more. The regional differences have been highlighted in greater detail in the forthcoming sections of the report.

FIGURE 10: LENGTH OF THE INITIAL TERM BY MARKET POSITIONING, ROOM INVENTORY AND AGE OF THE CONTRACT



HVS Insight

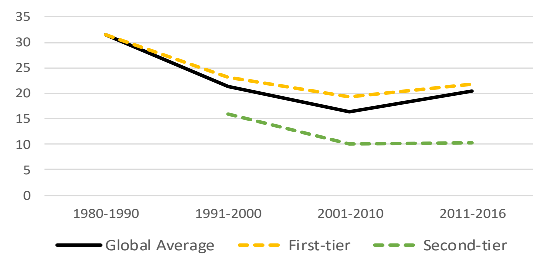
Trend in the Initial Term: *Hotel management contracts used to have a long initial term back in the 1980s averaging 30+ years, with even 50 to 60-year terms being common, especially for upper upscale and luxury assets.*

*The next two decades saw the initial term shrinking progressively as more management companies entered the marketplace, resulting in a highly competitive environment. This period also saw a proliferation of second-tier (third-party) management companies in North America, which are more flexible in negotiating a shorter initial term – a trend validated by the survey results that show contracts signed by **first-tier** hotel management companies have an average initial term of nearly **21 years**, while the initial term for **second-tier** management companies averages close to **11 years**, globally.*

More recently, in the last six years since 2011, the initial term has averaged around 20 years, globally, up from the past decade, which could be attributed to the increasing number of contracts getting inked in newer hotel markets in APAC, Africa and South America, where the brands (first-tier companies) have substantial bargaining power and can impose stricter terms on less-experienced owners.

Figure 11 highlights the overall trend based on the global sample set data.

Figure 11: Average Length of the Initial Term (Years)



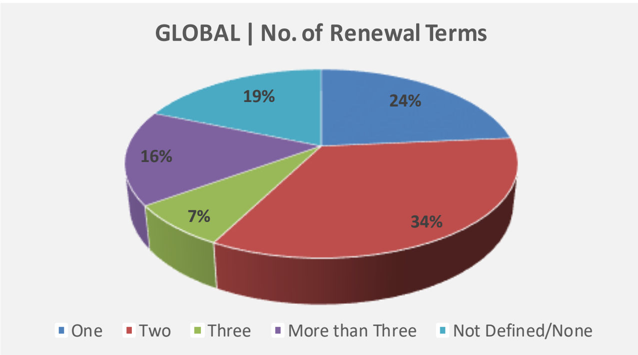
Typically, **higher the hotel market positioning, longer the initial term** – both owners and operators would prefer greater continuity and stability for properties with a higher investment such as upscale/upper upscale/luxury hotels, than for budget/mid market hotels, which are more vulnerable to market conditions. Also, as the survey reveals, **the higher the room inventory, the longer the term.** Usually, operators stand to gain from a longer term for higher number of rooms as most of their fees for support/centralized services are on a per room basis. In terms of the age of the contract, we note that increased competition owing to more number of players in hotel markets, besides the rising awareness of hotel owners, have together with other factors resulted in **recent management contracts overall having a shorter initial term than those that were signed before Year 2005.**

The average length of the initial term for **conversion/rebranded (existing) hotels** (46% of the global sample set) is found to be **17.4 years** vis-à-vis **new developments** (53% of the global sample set) that have a longer average term of **18.8 years**. This data is particularly important when one considers the survey results by region later in this report. To offer an example, USA, a matured hotel market with 69% of the sample set being represented by conversion properties, has contracts with a shorter initial term than those in the APAC region that comprises several developing/emerging hotel markets, with 80% of the regional sample set corresponding to new developments.

Extensions/Renewals: Renewal terms extend the contract for a stated period beyond the initial term, and may/may not contain the same provisions as the initial term. It is typically structured as a contract extension option that may be exercised by either the operator or the owner acting alone or in agreement.

Notably, **58%** of the contracts surveyed offer either one/two renewals, **with the overall average length of the renewed term being 7.9 years** (Figure 12)**.** For conversion assets in the global sample set, the average length of the renewed term is **7.6 years**, whereas for new hotel developments it is **8.1 years.** Figure 13, below, presents the nature of renewal options offered by the contracts in the global sample set.

FIGURE 12: RENEWAL/EXTENSION TERM(S)



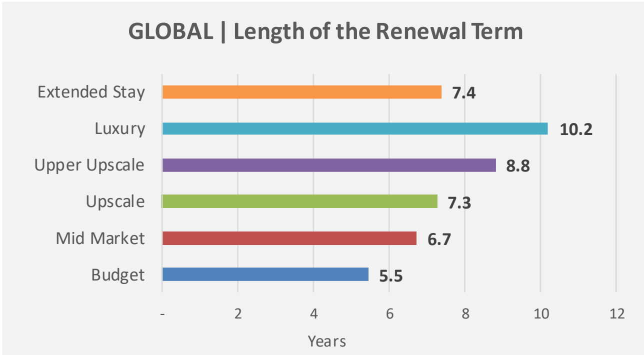
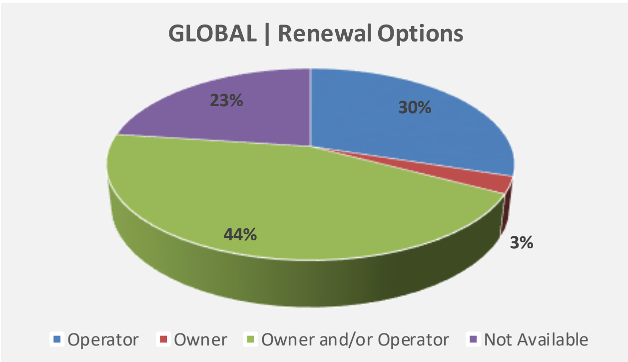


FIGURE 13: RENEWAL/EXTENSION OPTIONS



Operator
At the sole option of the operator
At the option of the operator provided a pre-defined performance standard is met
Exclusively automatic
Automatic unless operator elects not to renew
Automatic as long as the operator has a pre-defined number of rooms operational under it
Owner
At the sole option of the owner
Automatic unless owner elects not to renew
Owner and/or Operator
Upon mutual consent of the owner and operator
At the option of the owner or operator
At the option of the operator for the first one/two renewal terms, and then upon mutual consent
Automatic unless operator or owner elect not to renew

A notable trend relating to this provision across regions (but more common in North America, particularly USA), as highlighted in Figure 13, is the renewal being at the election of the operator or automatic, "but" contingent to the operator crossing a pre-defined performance hurdle. The performance hurdle may take any of the following forms:

- RevPAR of the hotel for each of the two/three most recent full fiscal years preceding the expiration of the initial term should be equal to or higher than a pre-fixed percentage of the weighted average RevPAR of the competitive set.
- Annual operating profit of the hotel for each of the two/three most recent fiscal years prior to the expiration of the initial term must be equal to or higher than a pre-defined extension threshold, which can be
    - A fixed monetary amount; or
    - A percentage of the budgeted operating profit; or
    - A percentage of the hotel's development cost (10.00%-13.00%).

All renewal options are based on a standard condition that at the time of extension, there should not be any uncured default by the operator. Furthermore, if the renewal term is automatic or at the discretion of the operator then, expectedly, the length of the management contract is considered to be a sum of the initial term and renewal term(s). Such an extension option is preferred by all operators as it allows for a higher valuation of the management company. However, with owners seeking greater flexibility, renewal of the contract upon mutual consent of both parties is on the rise, especially in South America, the Middle East, and APAC.

Area of Protection/Territorial Restrictions

Competition among different hotel chains within the same market area can adversely affect the operating results of a particular property. Competition from hotels with the same chain affiliation or management can be even more devastating in some cases. Moreover, hotels with identical names operating in the same market area and going after the same market segments can produce a competitive environment that is not only confusing to the market but counterproductive in capturing room night demand. To prevent a situation in which a hotel chain establishes too many "same/similar brand name" hotels within a market area, hotel management contracts frequently provide for area restrictions (Figure 14, overleaf, depicts the **inclusion/exclusion of this provision** in the surveyed contracts).

Area of Protection (AOP) refers to a geographical area mutually agreed upon by the owner and operator at the time of signing the management contract that restricts the operator from owning, leasing, operating, franchising or being affiliated with another property of the same/similar branding as the subject hotel for a specified period or for the entire term of the contract. This **owner-oriented provision** is particularly important in the case of first-tier management companies whose corporate name has a public identity. Second-tier (or third-party) management companies, without a recognizable brand name, have far less impact on existing hotels when they take over additional assets in the same market area. Nonetheless, the owner must work toward safeguarding himself/herself against any possible conflict of interest, and therefore must attempt to negotiate some form of area restriction irrespective of whether the contract is being signed with a first-tier/second-tier management company.

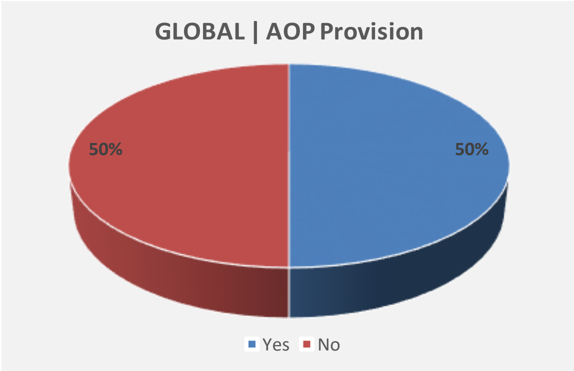
An area restriction clause must provide two important pieces of information. First, a primary market area must be defined either via radius or actual road names that outline the perimeter of the proposed area (oftentimes illustrated on a map). Second, the clause must specify the duration of the restriction – either from the effective date of the agreement or from the date of the hotel's formal opening.

Our study of the contracts in the global sample set reveals the following interesting results relating to AOP:

- It has been regularly found that **higher-positioned hotels have an AOP with a larger radius and for a longer period of time** than budget and mid-market hotels.
- Besides, the **AOP provision could depend on the amount of fees the property is forecasted to generate** for the operator – higher the fee generation potential, stronger will be bargaining power of the owner to command more favorable AOP rights.

- Operators may at times have **two/three AOPs built-in** to their contracts; the first one involving a larger radius for a shorter period of time, followed by others with a progressively shorter radius for a longer duration, which could even span the entire length of the initial term.
- Others may have a **performance criteria incorporated**, usually in the form of an **occupancy threshold** as a prerequisite before the operator is allowed to enter the market with another property. For example, a clause might give the operator permission to add another hotel any time after the existing property has achieved an occupancy level of at least 75% for two consecutive years. Whatever the occupancy level selected, it should be high enough to demonstrate that there is sufficient room night demand to support another property carrying the same trade name in the area.

FIGURE 14: AREA OF PROTECTION PROVISION



- During our research, we also gathered that some operators may use the **AOP provision as a tool to ensure that owners meet the project development milestones**, keeping it on track, by way of "burning off" the AOP due to project delays.
- Additionally, operators may also use the AOP provision as **means to limit the scope of the performance test**. Many of them routinely define the competitive set (in a RevPAR-based performance test) to include only those hotels that are situated within the "restricted area".
- Lastly, almost all contracts with an AOP provision **carry a caveat** that the restriction shall not apply to: (i) any other brand of the management company; and (ii) an acquired hotel that is part of a portfolio transaction.

Overall, we think that restrictions on a management company to own, lease, operate, or franchise other lodging facilities within a defined market area should be structured so that they protect an existing property from adverse competition but, at the same time, give the operator the opportunity to expand when demand allows.

Operator Fees

Operator fees relate to the compensation a hotel company receives for providing the various services called for in a management contract. From an owner's point of view, these represent an operating expense, something that should be controlled and minimized. However, some operator fees can be treated as an incentive and thus become an ownership tool for fostering profitable operations. One of the primary goals of hotel owners is to receive maximum net income from their hotels. The ability and efforts of the management company have a direct impact on whether the hotel is able to realize this goal.

The survey captures information on the following different kinds of operator fees.

Initiation/Joining/Commitment Fee: For 2% of the contracts in the global sample set (mostly from APAC), operators have charged an initiation/joining/commitment fee at the time of signing, which is non-refundable. **This fee was charged mainly for budget/mid market hotels, ranging between US$125-US$350/key; lumpsum amounts were observed to be between US$25,000-US$50,000.** It may be noted here that an initiation fee is more commonly charged in franchise/license arrangements than in management contracts. As charging of this fee is not widespread across the survey sample set, we have refrained from exploring it in further detail.

Technical Services Fee and Pre-Opening Fee: **Technical services** are provided by the operator during the planning, design and construction stages of a new hotel, and during the product improvement stage (expansion/renovation) of an existing hotel. These are usually considered separate and distinct from the pre-opening services because they require a specialized level of expertise. Not every hotel management company has the in-house capability and expertise to provide technical assistance; those that don't may engage third-party consultants for rendering such services. However, from our discussions with branded operators, we gather that outsourcing technical services is not often the desirable option for them, as they run the risk of losing control and brand dilution; but, given their limited footprint compared to other major hospitality players, this is a compromise some smaller companies agree to make. It should also be pointed out that operators offering such assistance are not attempting to take over the development responsibilities of creating a hotel; they are merely another consultant providing overall project review, critique, recommendations, and approval.

The hotel owner should exercise particular care when entering into a T**echnical Services Agreement** (a separate contract from the operating services agreement/hotel management agreement) with a hotel management company. The **in-house capabilities of the operator** must be carefully evaluated to be sure that the technical services will be performed by knowledgeable experts. The operator must also have a sufficient number of personnel providing these services so that critiques, recommendations, inspections, and approvals can be made on a timely basis. Some hotel companies overextend themselves in the development area, thereby causing costly delays. Additionally, owners should ask the potential operator where its technical team is based, as distant locations could mean high reimbursable out-of-pocket expenses to be usually borne by the owner. Having said that, owners should also realize that hotel management companies are primarily interested in obtaining long-term management agreements and will at times consider pre-opening and technical services a loss leader or giveaway in order to secure the contract.

Moreover, in contrast to the pre-opening services, technical services provided by the operator kick-in right from the beginning, when the operator comes on board, and could last until the opening of the hotel. An interesting observation here is that owners in Asia Pacific and Africa are seeking more initial support than those in other parts of the world. Resultantly, **"interim technical services/advisory agreements"** are on the rise, which are entered upon the signing of the memorandum of understanding (or letter of intent/term sheet), much ahead of the definitive agreements being executed. The fees payable for the interim technical services is then credited against the overall technical services fee payable once the definitive agreements are effected. Such instances are a win-win for both parties – owner gets the comfort of the operator being involved in the development of the hotel sooner, and the operator almost certainly is guaranteed of the deal coming through.

Technical Services Fee is a one-time consultation, advisory or technical assistance fee charged by the operator for design/construction review and implementation monitoring, typically payable in pre-defined tranches. In this survey, we did not have information pertaining to the technical services fee for **60%** of the contracts, which is due to the supplemental agreements not being in our possession, the fee being waived, or owing to some assets being franchised properties and us not having the corresponding franchise agreements. From our review of the remaining **40%** of the contracts, we note that this fee for **new-build assets** fluctuates considerably across operators and positioning, as highlighted in Figure 15, below. In contrast, the technical services fee for **conversion properties** is noted to be in the range of **3.00%-8.00%** of the total project costs, excluding out-of-pocket expenses.

FIGURE 15: TECHNICAL SERVICES FEE RANGE – NEW-BUILD HOTELS

Market Positioning	Technical Services Fee Range
Surveyed Contracts (includes old and new contracts)	
Budget-Mid Market	US$50,000-US$350,000
Upscale-Upper Upscale-Luxury	US$100,000-US$500,000
Discussion with Operators (current on-the-ground scenario)	
Budget-Mid Market	US$50,000-US$150,000
Upscale-Upper Upscale-Luxury	US$200,000-US$350,000

This fee is highly negotiable, with discounts being made on account of under construction assets, reputed and experienced developer/project management company, multiple assets with the same developer or as part of the same development, and/or competitive market conditions. An important trend is that most contracts now specify a duration for which the technical services will be provided at the mentioned fee – commonly 24-36 months, at times 42-48 months. Thereafter, an additional monthly fee becomes payable to the operator until the formal opening of the hotel. Some may cap the number of permitted iterations to the final design of the hotel as well, beyond which an additional fee is charged.

Travel and related reimbursements linked to the technical services rendered by the management company tend be flexible in terms of being included/excluded in the fee. Sometimes, these may be capped at 10-15 trips, past which the owner is required to reimburse the operator.

Pre-opening services typically kick-in anywhere between 6-24 months prior to the hotel opening, varying across operators and depending on the type of hotel as well as the need for pre-opening sales activity. They mostly commence with the appointment of the General Manager of the property, and are normally handled by the unit's operations team that is distinct from the operator's design and technical services team, with separate reporting structures. However, both the pre-opening and technical services are often clubbed under a singular agreement to be signed between the owner and the operator.

Pre-Opening Fee is charged by "some" operators for providing hotel pre-opening support such as purchasing, recruitment, training, installation, financial systems and controls, marketing, budgeting etcetera. However, more often that not, this fee is waived or not charged at all as a standard practice. Irrespective of the above, all direct costs associated with rendering such services are charged to the owner, i.e. the operator may assist the owner in procuring the necessary licenses/permits for the hotel, but the actual costs associated with obtaining these and the out-of-pocket expenses incurred while providing the service, such as payroll of the personnel involved and travel, is borne by the owner. Similarly, centralized services rendered during the pre-opening period, especially those related to marketing and purchasing, are charged for by the operator as a pre-opening expense.

Pre-Opening Budget (to be allocated by the owner) could be on a per key basis, a flat amount, or be dependent on the hotel's revenue generation potential. This budget commonly entails expenses related to recruitment, training, payroll, marketing and promotion, communication, centralized services, utilities, opening gala, operator out-of-pocket expenses, and those linked to the organization of the hotel's operations during the pre-opening period. Once a budget is established, the operator usually cannot incur expenses whose aggregate exceeds the budgeted amount without the prior approval of the owner. It is important to mention here that the pre-opening budget described above does not include working capital, which is the amount of liquid funds needed for the daily operations of the hotel to meet its obligations on a current basis. If there are any material delays in the opening date, change in the scope, size or design of the hotel, change in the market price of goods and/or services, change in the brand standards or relevant laws, then the pre-opening budget is increased to cover the corresponding cost overruns.

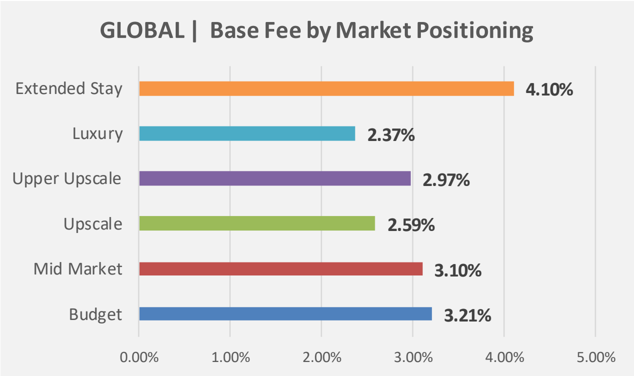
Management Fees: **Base Fee** and **Incentive Fee** together make up the Management Fees charged by the operator in exchange for performing the duties specified in the contract. For first-tier/branded hotel companies, the management fee covers both their management services and the value of their chain identity; second-tier/third-party operators are compensated for their management services alone. The calculation of the management fee is usually tied to one or more financial indicators, such as revenue or profit.

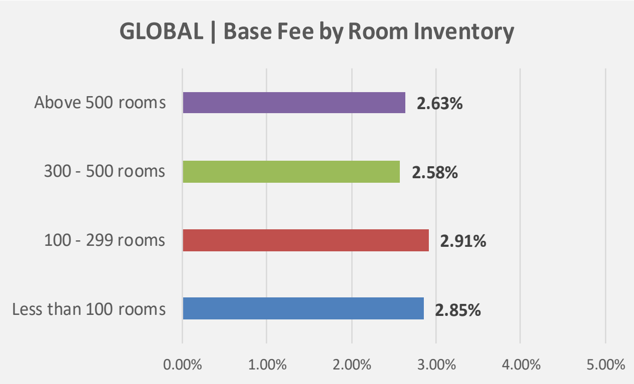
Base Management Fee (aka Basic Fee): The base management fee is usually calculated as a percentage of the **hotel's Gross Operating Revenue**, creating an incentive for the operator to increase marketing efforts and other activities that increase sales volume. The drawback to this arrangement is that the basic fee provides no incentive to minimize operating expenses. If the entire management fee is in the form of a basic fee, the operator can theoretically increase marketing and sales efforts to the point at which the highest possible revenues are reached, but any margin of profit is eliminated.

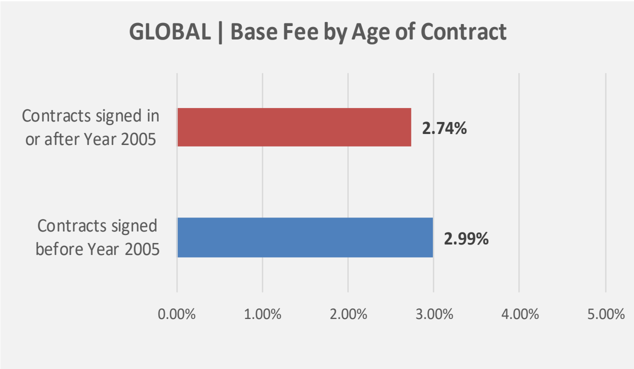
Base management fee could either be a single fee, or a sum of advisory/operating/management fee and licensing/royalty fee. Moreover, it is generally chargeable throughout the life of the contract; however, it could be either computed as a "constant" percentage across all years, or it could ramp-up in the initial years, gradually stabilizing for the remainder term of the contract. **The stabilized average base fee for the global sample set is 2.81%.**

Figure 16, on the following page, discusses the survey results pertaining to this fee by market positioning, room inventory and age of the contract. The following information must be borne in mind while reviewing the results – **(i) 17% of the EMEA contracts** do not provide complete details on the base management fee, lowering the average, as we do not have the licensing/royalty agreements for these; **(ii) 7% of the APAC contracts** do not charge base fee separately; they instead charge a higher incentive management fee, which is inclusive of the base fee, and for another **6%** of the contracts from this region, we do not have the licensing/royalty fee component; **(iii)** overall, the stabilized base fee for conversion properties **(2.98%)** is found to be higher than that for new-build hotels **(2.66%).**

FIGURE 16: STABILIZED BASE FEE BY MARKET POSITIONING, ROOM INVENTORY AND AGE OF CONTRACT







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Base Fee by Market Positioning: *Base fee is mostly seen falling with an increase in the market positioning. Although 3.21% base fee for budget hotels (limited-service) appears high, it is important to note that unlike luxury and full-service hotels, budget/limited-service properties tend to generate relatively lower overall revenues due to a minimal food and beverage component and lower average room rates. As such, these properties charge a comparatively higher base management fee to yield a dollar amount that is adequate to make the operation of the hotel feasible for the management company.*

Base Fee by Room Inventory: *It is necessary to correlate the data for this chart with that illustrated for market positioning. Close to 50% of the contracts for hotels with less than 100 rooms correspond to budget-mid market positioning, and 98% of the contracts for hotels with over 500 rooms relate to upscale-luxury positioning.*

Base Fee by Age of Contract: *Base fee over the years has generally decreased. In our experience of negotiating hotel management agreements, we have come across base fee to be as low as 1.50%-1.75% for strategic projects in recent times, with some operators even agreeing to a ramp-down – higher fee in the initial years and a relatively lower fee on a stabilized basis.*

In addition:

- *Base fee tends to have a negative correlation with the initial term, i.e. shorter the initial term, higher is the base fee and vice versa.*
- *Moreover, if any form of financial commitment is offered by the brand such as key money, operator minimum performance guarantee, or an owner's priority return, then a higher base fee is usually applicable.*
- *Lastly, we gather that for large format hotels (400/500 keys and above) that have a high revenue generation potential driven by the average rate, brands can agree to a lower base fee than is commonly acceptable.*

Owner's Priority Return: Before we progress to discussing incentive management fee, it is important to understand the concept of **owner's priority return**. Invariably, incentive management fee is payable to the operator only subsequent to the satisfaction of certain performance thresholds. These thresholds could be in the form of operating profit margins, or include a return on investment to the owner, referred to as the owner's priority return. Although there are several ways to structure an owner's priority return, it is usually **a percentage return on the capital invested in the development of the hotel by the owner**; i.e. the development costs associated with the hotel (including acquisition price) and any subsequent capital investments in property renovations outside the stipulated reserve for replacement. A logical way of setting a parameter to establish an owner's priority return would be to assess the typical returns that the owner may be able to secure by investing the same amount of capital in alternative investments over a long term. Owner's priority return may be valid **throughout the term of the contract or for a specified number of operating years**.

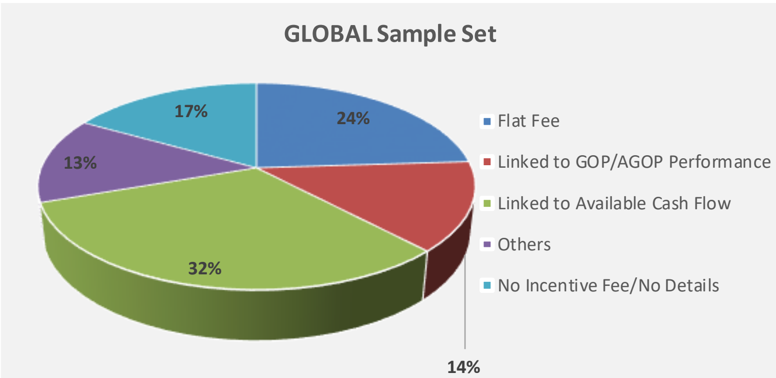
Totally, 188 contracts (40% of the global sample set) in this survey offer an owner's priority return. Some of these define it as an absolute monetary amount (also referred to as a Hurdle Amount adjusted to inflation), while others express it as a percentage of the owner's investment in the hotel development. For instance, owner's priority return in the **USA sample set** has been provided as a percentage of the owner's initial investment in the majority of contracts – observed to be in the range of **7.25% to 15.00%.** On the other hand, most European, South American and APAC contracts have defined it as an **absolute monetary amount** varying by asset class and positioning. In a large number of cases, across regions, **the Incentive Management Fee** (discussed in greater detail below) **is subordinated to the owner's priority return where applicable:** this means that the operator will not receive its incentive fee until the owner's priority return has been fully paid to the owner. However, many contracts allow for unpaid incentive fees (deferred/stand-aside amounts) to be clawed back once future profits are earned to cover the shortfall.

Additionally, it is important to understand the **difference between owner's priority return and operator minimum performance guarantee**. Simply put, owner's priority return is a pre-defined annual return or profit that supersedes the payment of operator's incentive fees. An operator minimum performance guarantee, on the other hand, is a commitment made by the operator ensuring that the owner receives a certain level of profit. In case of a failure, the operator guarantees to make up the shortfall to the owner via extending its own funds – either in cash or by way of forgoing certain fees due to it. Nonetheless, similar to owner's priority return, such a guarantee is often accompanied with a claw back provision, that allows the operator to retrieve any payments made out of future surplus profits.

Incentive Management Fee: As mentioned previously, management fees are typically a combination of a base fee calculated as a percentage of total revenue, and an incentive fee calculated as a percentage of either gross or net operating income. The purpose of the incentive fee is to reward the operator for efficient, profitable management of the hotel. Ideally, hotel owners prefer to have most of the management fee calculated as an incentive fee. In addition, owners want this compensation based on a defined net income that appears as low in the hotel's income statement as possible. This is why it is regularly referred to as a "low-level line item".

In this survey, contracts are seen having different incentive management fee structures. Broadly, these can be identified as under:

FIGURE 17: TYPES OF INCENTIVE MANAGEMENT FEE STRUCTURE

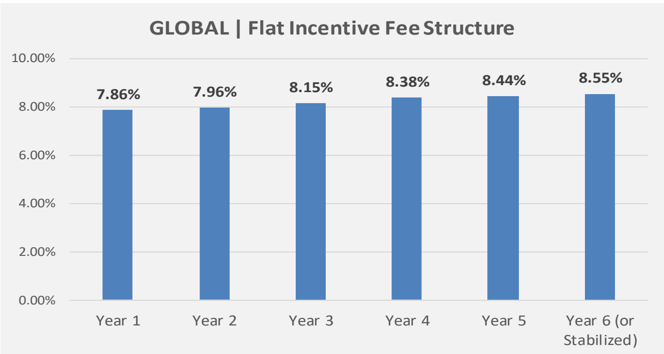


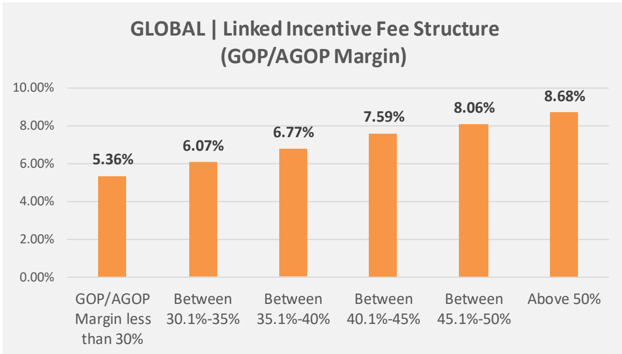
- **Flat Fee Structure:** Incentive fee is expressed as a percentage of the annual operating profit (defined differently across contracts, although commonly it is the Gross Operating Profit – GOP, or the Adjusted Gross Operating Profit – AGOP, per the Uniform System of Accounts for the Lodging Industry). This percentage could either remain constant or could scale upward through the term of the contract – i.e. lower in the initial years and peaking from Year 5 or 6 onwards. For example, Operating Years 1-4 could have an incentive fee of 6.00% of GOP, and for the remainder of the term it could equal 8.00% of GOP.
- **Linked to the GOP/AGOP Performance of the Hotel:** Incentive management fee is defined as a percentage of the annual operating profit, with it being dependent on the pre-defined ranges of GOP/AGOP Margin performance. For example, incentive management fee could equal 7.00% of GOP/AGOP, if the hotel achieves a GOP/AGOP Margin between 35.00%-40.00%; and it could equal 9.00% of GOP/AGOP for a Margin >40.00%.
- **Linked to the Available Cash Flow of the Hotel:** Where applicable, incentive management fee is typically subordinated to the owner's priority return (most contracts in this survey offering this type of incentive fee structure also provide for an owner's priority), with "Available Cash Flow" being defined differently in each contract, but commonly meaning "residual cash flow" after the payment of owner's priority return and sometimes the debt service.
- **Others:** This type is represented by contracts that either have a combination of Flat and Linked Fee structures or present a very customized calculation of the incentive management fee. For example, the fee could equal 10.00% of the actual net operating income less the budgeted net operating income.

The effective negotiation of the incentive management fee is one of the most critical aspects of negotiating a hotel management agreement, since the payment of such fee directly influences the net return an owner will receive on the investment. As presented previously, there are several variations of the formulae utilized in the structuring of an incentive management fee, and hence, special care should be taken while negotiating incentive management fee clauses. To illustrate, the subordination of the incentive management fee to debt service has a substantial impact on the remaining cash flow that accrues to the owner. A structure where incentive management fee is payable prior to the payment of debt service can result in a drastic lowering of the net cash flow to the owner after all payments are made.

Figure 18, below, presents the incentive management fee ranges of the surveyed contracts across two different types of structure. Where the incentive management fee is **linked to the available cash flow**, it is found to be mostly ranging between **10.00%-20.00%** of the same, with some charging as high as 30.00%-35.00% as well.

FIGURE 18: INCENTIVE MANAGEMENT FEE RANGES | FLAT AND LINKED FEE STRUCTURES





Other Fees/Charges/Reimbursables: Centralized services, also known as **system services/group services/shared services/chain services**, typically include system-wide advertising, national and regional sales offices, reservation and distribution, accounting/finance support, management information and purchasing systems, as well as education/training programs. These are **group-wide services, which are distinct from the property-specific** activities conducted with regard to sales, marketing, finance, HR and training, among others.

Operators by and large charge additional fees for rendering such services **(commonly 4.00%-6.00% of Gross Operating Revenue, cumulatively)**, which are purportedly a non-discriminatory allocation of system costs and expenses among all participating hotels in a brand's system. Some operators list these fees in detail and go on to provide the cumulative percentage off the top-line upon owner's request, whilst others are not as transparent – hence, these are often referred to as potential **"hidden costs"** of a management contract. The fees for centralized services are usually treated as an operating expense in the hotel's P&L.

The **charging mechanism** for centralized services or system reimbursables frequently takes any of the following forms:

- **Percentage of Revenue:** Cost of some centralized services such as the reservation system, and occasionally the marketing support, is generally allocated on the basis of a percentage of revenue—usually rooms revenue—which reflects three important operational variables: the property's room count, occupancy, and average room rate. This method can be somewhat unfair to hotels that do not receive an adequate share of reservations from the centralized system but nevertheless must pay the formulated portion of this expense.
- **Per Available Room:** Allocating centralized services on the basis of the room count in the subject property divided by the total room count in the chain is a common procedure that is simple to administrate and does not involve communicating confidential information such as occupancies and average room rates. It can, however, produce an allocation that is more unfair than the percentage of revenue method because it does not account for the actual operating performance of a property. For example, using the per-available-room basis of allocating centralized advertising, a 300-room hotel operating at 75% occupancy with a US$100 average rate would pay the same amount as a 300-room hotel with a 60% occupancy and an US$85 average

rate. Furthermore, this method also does not take into account the actual usage and benefit an individual hotel might or might not receive from the centralized advertising program.

- **Per Service Received:** This method of allocation tends to produce the fairest results because it divides the centralized costs based on actual usage and benefit derived. For example, the cost of centralized reservations may be allocated on the basis of US$7.00 per guaranteed reservation. Properties that obtain a greater number of reservations from the system pay a larger share of the centralized costs. Similarly, cost of centralized recruitment services may be on a per hire basis.
- **Flat Fee:** System charges for centralized financial and IT-related services often take the form of a flat absolute monetary amount, payable one-time or periodically, depending on the nature of service rendered. For instance, occasional services such as the installation of integrated property system or licensing software could attract a one-time fee, with minor charges for re-installation. In contrast, recurring ongoing services such as those related to communications, connectivity, plus maintenance or hardware and software could cost a monthly fee.
- **Per Diem:** Auditing services (like internal audits, quality control audits, security audits, environmental sustainability audits), and sometimes training services provided by the management company usually attract a per diem charge plus cost of travel and expenses.

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Hidden Costs of a Management Contract: *The property owner should request documentation as to the management company's historical allocation procedures and costs for centralized system charges and reimbursables during negotiations so that projections can be made for the subject property.*

It may be noted that many brands don't specify the exact fee/charge for several of their centralized services in their contracts; instead, they share a "charging or cost allocation methodology" with the owner that typically includes the list of services and any one of the following against each:

- *Variable charges based on services provided.*
- *Charge made on an actual usage basis per hotel.*
- *Charge made on a reimbursable basis per hotel.*
- *Costs allocated equitably between hotels.*
- *Charge made on a per hire, per participant basis (mostly for HR-related services).*

In several of the **surveyed contracts (35% of the global sample set)**, details are missing pertaining to this set of fees/charges/reimbursables, as the documents are either just the management agreement/operating services agreement, or term sheet/memorandum of understanding/letter of intent. Perhaps these fees have been detailed in supplemental agreements, which are not in our possession. Nonetheless, based on the information available in the sample set supplemented with data gathered during our discussions with various operators, we have presented our findings related to fees/charges for major centralized services in Figure 19, below. Notably, there are numerous other mandatory and optional centralized services offered by management companies under the heads of Human Resources, Information Technology, Accounting and Purchasing, among others. However, since the charging mechanisms for these vary greatly between operators, we have not discussed them in any further detail herein.

FIGURE 19: FEES/CHARGES FOR MAJOR CENTRALIZED SERVICES

Marketing
Gross Operating Revenue: 1.00%-5.00%
Gross Rooms Revenue: 1.00%-4.50%
Note: In some cases, the marketing fee (especially the higher end of the ranges) includes fee toward other group services like reservations, revenue management, training etc.
Loyalty Program
Member's Full Folio: 2.50%-6.00%
Gross Operating Revenue: 1.00%-1.50%
Note: Nearly all branded operators waive this charge on the first stay when the guest is enrolled by the participating hotel.
Reservations
Gross Rooms Revenues: 0.60%-1.00%
Per Reservation: US$5.00-US$15.00
Per Room: US$8.00-US$13.00/month
Note: Most management companies use a combination of charging mechanisms for reservation services. The fee per reservation varies depending on the source of reservation like brand's website, GDS, third-party websites etc. Also, the most commonly found charges have been represented via the above ranges; outliers have not been included.

To end, it is important to **carefully consider the "optional" centralized services** offered by operators prior to enrolling the property for the same. A case in point is the purchasing-related services extended by management companies. At their discretion, operators may elect to procure items using negotiated vendor contracts available to them under any volume purchasing contract, while giving due consideration to competitive standards and practices of potential suppliers. The service is intended to be at no profit or loss to the operator. In developing markets, however, we have found centralized purchasing systems to be an area of conflict between owners and operators – owners believe that they are able to procure better independently, particularly if the procurement contracts are global in nature and when the local prices are sometimes not appropriately verified.

Operator Performance Test

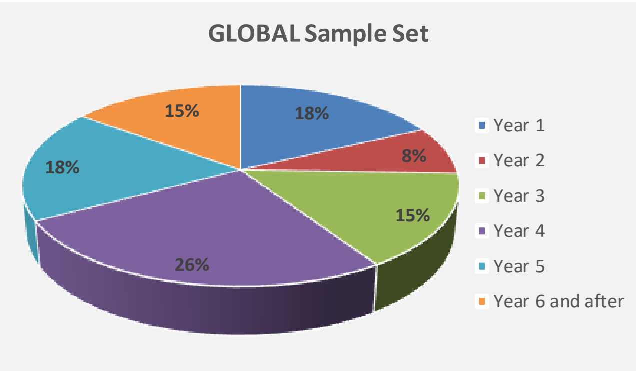
One of the most important provisions of a management contract from an owner's point of view is a performance clause that sets specific operating standards that the management company must meet in order to remain as the operator of the property. Stipulation of an operator performance test in management contracts – which if failed and left uncured can give rise to an owner's right to terminate the agreement(s) – **is gaining ground worldwide** with the test parameters becoming increasingly stringent. Owners have begun to realize that this clause is perhaps the only way they can exercise termination rights without having to pay any liquidated damages or a termination fee to the operator.

Generally, the best measure of operating performance is profitability. Owners invest in hotels to realize profits, and the ultimate test of the management company is whether profits are actually made. A well-written performance clause protects the hotel owner from an incompetent operator, while at the same time assuring the management company that it will not be terminated for circumstances beyond its control. Hence, the **right of termination of the owner is generally not exercisable** should the performance test failure occur as a result of a force majeure/extraordinary event; renovation of the subject hotel; material default by owner impacting the operator's ability to perform; closure of a hotel in the competitive set; or any other reason that may have been defined in the contract.

Notably, **65% of the global sample set provides for an operator performance test.** Furthermore, almost half of this carve corresponds to existing hotels, 70% is represented by properties with an upscale-luxury positioning, and 72% of all such contracts have been signed in or after Year 2005. Hereunder, we have elaborated on the survey results pertaining to the following aspects of operator performance tests:

Commencement Year: This refers to the operating year from when the performance test is set in motion. Typically, the commencement year reflects the year by which the hotel is anticipated to attain stabilized levels of performance in terms of market penetration. A sizeable number of contracts in the global sample set have highlighted a preference for **Year 4** as the commencement year (Figure 20, alongside).

FIGURE 20: PERFORMANCE TEST COMMENCEMENT YEAR



Interestingly, **80%** of the contracts that have the performance test beginning in Year 1 are **for conversion or rebranded properties**, whereas those that have the test becoming effective from Year 6 onwards correspond mainly to **new hotels (80%)**.

Test Period: All contracts offering this provision define a test period, during which the performance test is applicable. The operator needs to fail the test in the "full" applicable test period for the owner's performance test failure "notice" (served to the operator) to hold merit. For instance, in case of a test period of two consecutive years, the operator must fail the test in both years. Per the surveyed contracts, commonly agreed upon test periods are: two consecutive operating years **(73%);** three consecutive operating years **(8%);** every single operating year **(10%);** others – such as two of every three, or three out of every five consecutive years **(9%)**.

Almost two-thirds of the management contracts in the global sample set having the test period as every single operating year relate to conversion properties, indicating that the bargaining position of the owner is often stronger when a running, cash flow-generating property is available for rebranding.

Type of Test: Type of operator performance test can vary significantly across contracts, though they can broadly be categorized under **Budget Test** or **RevPAR Test**.

- **Budget Test:** This type of performance test requires the operator to achieve a hotel GOP, AGOP or Net Operating Income (NOI) that is equal to or more than a pre-defined threshold percentage of the budgeted GOP/AGOP/NOI set forth in the annual operating plan for the test period. The budget test largely assesses internal efficiency focusing on the bottom-line.

- **RevPAR Test:** This sort of test calls for the operator to achieve a hotel RevPAR (revenue per available room) that is equal to or more than a pre-defined threshold percentage of the weighted average RevPAR of the subject hotel's competitive set (mutually agreed upon by the owner and the operator) for the test period. The RevPAR test largely measures external effectiveness and focuses only on the top-line.

Some management contracts are seen having other types of profit-oriented test, which may evaluate the performance of the hotel's GOP/AGOP/NOI vis-à-vis the owner's priority return (seen mostly in North America and Europe), against a pre-determined monetary threshold amount, or any other benchmark as defined in the contract. The RevPAR test may also assume a different form like requiring the hotel to feature among the top three or four comparable hotels in the defined market area in terms of RevPAR performance.

Management contracts may feature the Budget/Other Profit-oriented test and RevPAR test **(i)** collectively; **(ii)** separately; or **(iii)** independently (Figure 21).

- **Collective Test:** The operator needs to fail "both" the Budget/Profit-oriented "and" RevPAR tests in order to give rise to the owner's right to terminate. Operators usually prefer this structure as it is highly unlikely that they will fail on both performance parameters simultaneously during the full test period.

- **Separate Test:** The operator needs to fail "either" the Budget/Profit-oriented test "or" the RevPAR test (both being listed in the contract) in order to give rise to the owner's right to terminate. Naturally, owners tend to push for this kind of a structure, as it requires the operator to perform well both on internal (budget/GOP/AGOP/NOI) and external parameters (competition).

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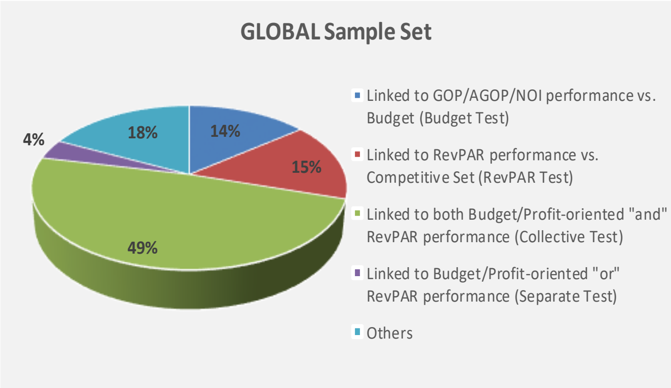
RevPAR Test: *Operators lay a lot of importance on determining the subject hotel's competitive set for a RevPAR test, even relying on third-party experts, should the brand and the owner reach a deadlock in negotiations over this. Some considerations are:*

- *Group of at least four or five hotels (including the subject hotel).*
- *Competitive hotels must have agreed to report their RevPAR data to a RevPAR source such as STR (this is gaining ground outside USA).*
- *Competitive hotels must be comparable to the subject hotel in terms of overall quality; the number, size, quality and mix of guestrooms; and quality and size of meeting/conference space.*
- *Competitive hotels should be in the restricted area (as defined in the contract) or subject hotel's immediate market area.*
- *No single hotel in the competitive set may account for more than 30% of the total rooms of all hotels in the competitive set; OR competitive hotels must have at least the same number of guestrooms as the subject hotel; OR each competitive hotel should at least have a room inventory that is neither higher nor lower by more than 25% of the room inventory of the subject hotel.*
- *Each hotel in the competitive set must have been in operation for at least three years, and during every month in each test period.*
- *No competitive hotel should include a residential component in the calculation of the RevPAR.*
- *When the competitive set is established or changed, the subject hotel's RevPAR must be equal to or higher than the competitive set.*

Note: *Some operators may use many or even all the above criteria in defining the competitive set in their contracts, while others may use just few of these.*

FIGURE 21: TYPE OF PERFORMANCE TEST



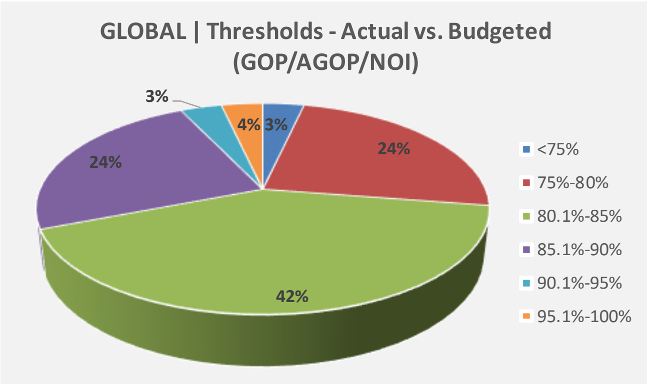
- **Independent Test:** The operator needs to fail the mentioned test (with only **one type of test** featuring in the contract) in order to give rise to the owner's right to terminate.

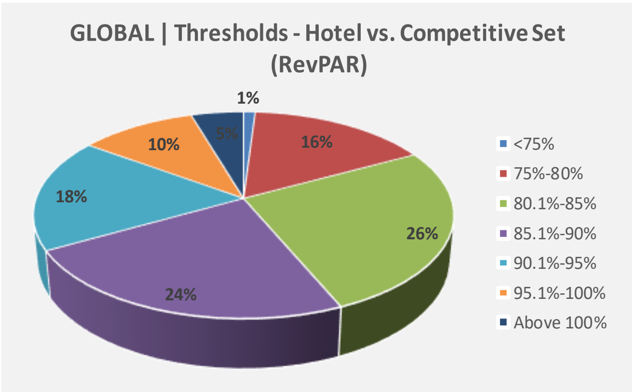
In some circumstances, **having just one type of test could be justifiable.** For instance, in a nascent hotel market, where an operator has a first-mover advantage, it will be nearly impossible to employ a RevPAR test owing to limited or no competition. In such conditions, including a budget/profit-oriented test alone in the management contract may be more prudent, allowing for a RevPAR test to be incorporated in the future once the market matures. Furthermore, **our discussions with operators reveal that many of them now avoid including a specific type of performance test in new markets**, and when owners insist, they instead make a provision in contracts stating that the nature of the performance test will be mutually decided upon by the owner and the operator one year prior to the hotel's anticipated stabilization.

Performance Test Thresholds: Interestingly, just **31%** of the contracts having a budget test require the operator to achieve a hotel GOP/AGOP/NOI that is **>85% of the Budgeted GOP/AGOP/NOI** set forth in the Annual Operating Plan. On the other hand, **57%** of the contracts having a RevPAR test require the operator to achieve a hotel RevPAR that is **>85% of the weighted average RevPAR of the competitive set**.

On the whole, of the key geographic regions surveyed by HVS, contracts signed in North America have the highest performance thresholds for both the Budget and RevPAR tests (mostly upward of 85%, including 100% and 105%), followed by those signed in EMEA, South America and then, APAC.

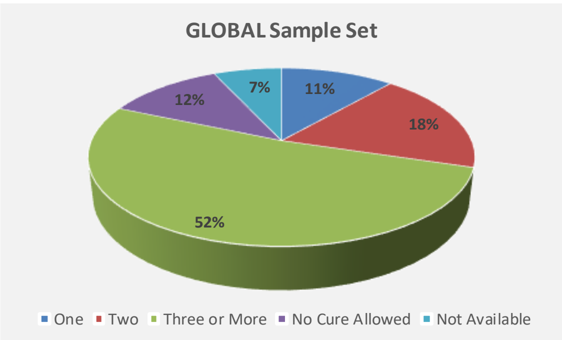
FIGURE 22: PERFORMANCE TEST THRESHOLDS





Provision for Operator to Cure: If an operator agrees to a performance termination clause, it usually insists on receiving the right to cure. A right-to-cure clause allows the management company to provide the capital necessary to make up any difference between the hotel's actual level of performance and the performance level set forth in the management contract. For example, the **cure amount** in the case of a budget test is generally the difference between **(i)** the GOP/AGOP/NOI the hotel would have achieved had the performance threshold been met and **(ii)** the actual GOP/AGOP/NOI attained; or, in case of a RevPAR test **(i)** the Rooms Revenue the hotel would have achieved had the RevPAR threshold been met and **(ii)** the actual Rooms Revenue attained. At times, the cure amount calculation can be a specific formula either customary to the operator or tailor-made for the contract, though the general essence of making up for the shortfall amount the owner would have been entitled to receive had the test been passed, is the same across all.

FIGURE 23: PROVISION FOR OPERATOR TO CURE



The **deficiency/cure amount could be payable to the owner either in cash or by setting it off against the next payment of management fees** (base and incentive, or just the incentive fee) due to the operator, or in any other form defined in the contract. However, the operator may be allowed recover the cure payment as a pre-condition to early termination arising from a default by the owner, or once future profits are earned to cover the shortfall.

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Testing the Operator's Performance: *It is worth considering that in recent times the operator's ability to perform under a management contract is being tested across many areas – it is no longer limited to just the performance test. The following clauses/provisions (not exhaustive) in a contract "also" require an operator to demonstrate the ability to meet or cross mutually agreed upon performance thresholds:*

- *Renewal of a contract being subject to the operator meeting or crossing a pre-defined extension threshold or performance hurdle.*
- *Territorial restriction/AOP remaining in effect unless a performance hurdle is crossed/met (typically occupancy driven).*
- *Provision for an owner's priority return or minimum performance guarantee.*
- *Subordination of the incentive fee.*

Non-financial performance tests based on TripAdvisor ratings, or on the number of materialized reservations generated through the operator's distribution systems versus those that are generated by online travel agencies (OTA) or third parties are also on the rise, especially in Europe.

Remarkably, **the cure amount in some contracts in the global sample set corresponds to only the last year of the test period.** For example, if the test period is for two consecutive years, the cure amount is frequently calculated in respect of the shortfall in the second year and not both years. On the other hand, some operators have considered the test period in entirety, even as a few others have looked at an average of the shortfall amount across all years of the test period. **Once the operator has cured the failure**, owner's termination notice is deemed withdrawn, the contract remains in effect, and the owner does not have the right to serve another notice to the operator with respect to the same test period in question. Nonetheless, the owner can serve another termination notice should the operator fail to meet the performance obligations during a separate test period thereafter.

Moreover, to protect the operator from external circumstances that could adversely affect a hotel's operating performance and thereby subject the management company to termination, some contracts contain an **arbitration provision** that allows the operator to prove that the failure to meet the performance standard was due to causes or conditions beyond the operator's control. On the whole, the performance test clause has a tendency to incline towards favoring the operator, and the termination of the contract under this provision continues to remain uncommon.

While the above-mentioned test formats are based on what is present in the surveyed contracts, we are of the strong opinion that the only real test of an operator's ability, or lack thereof, is a net income test, which is based on the operator achieving a specific level of net income pre-determined by both parties to the contract. A budget test can be manipulated by the operator, while the RevPAR test does not test expense control; in contrast, a net income test checks the operator's ability to enhance the hotel's revenues as well as conduct efficient operations.

Budgeting

All well-run businesses prepare budgets, plans for future operations, and evaluations of past performance to facilitate financial planning and control costs. Such planning and analysis are especially important for lodging facilities operated by hotel management companies.

Annual Plan: Given the terms of the management contract, the owner either has minimal input in the budgeting process or, at the other extreme, has the opportunity to exert a great deal of control over the operation through a strict review. **Either way, the owner has some power to approve or consult on the budget**. Hence, this process is one of the most **collaborative activities** between an owner and an operator in the life of a management contract. This exercise is by and large conducted a little before the beginning of the following year (calendar or fiscal, as defined in the contract) with the operator submitting a **draft annual plan** to the owner detailing the expectations of the management company for the subject property over the following 12 months. Annual plans normally include a forecast of income and expenses, a capital expenditure budget, a repair and maintenance budget, a marketing plan, and reports on engineering systems, leasing plans for commercial space, staffing, and salaries, among other miscellaneous items based on the operating procedure adopted by the management company. Subsequently, there can be a lot of back-and-forth, before a final consensus is reached.

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Annual Plan Approval: *Not all operators agree to providing the owner with approval rights for the annual plan. Many simply offer consultation rights, or approval rights with a caveat listing the items that are not subject to owner's approval. Commonly, these items include:*

- *Projected costs relating to centralized services, or system charges*
- *Fees, royalties and costs payable to the operator*
- *Costs beyond the control of the operator such as insurance, and sometime utility costs*
- *Payroll expenses*
- *Increases in the hotel's projected operating costs caused by increases in revenues*
- *FF&E reserve contribution*

Some operators even go as far as to add revenue projections to the above list, highly limiting the owner's approval rights. Hence, it is critical that this section be reviewed thoroughly during negotiations – the owner must understand what is being agreed upon.

The manner in which **budgetary disagreements** are resolved ultimately determines the degree of influence that the property owner can wield. In most management contracts that provide for owner approval of the annual plan, if the owner and operator cannot agree on one or more specific terms, the terms that both parties do agree on go into effect on the date required to implement the new plan. In lieu of the provisions that cannot be agreed upon, the terms from the preceding annual plan are used after they are adjusted by a factor such as the Consumer Price Index (CPI), or national inflation. This procedure allows for the continued operation of the property under some form of budget while providing additional time for the parties to resolve their differences. If, after a stated period of time, the parties still cannot agree on the annual plan, then arbitration procedures may come into play.

For both parties, **the budgeting activity is important, as it helps indicate** the amount the operator could receive as fees, the owner's share of profit, threshold amounts linked with operator performance tests, and extent of capital expenditure to be incurred for the coming year. More specifically, the key reporting requirements typically sought by the owner from the operator (within an annual plan) have been discussed briefly, below:

- **Forecast of Income and Expense:** Perhaps the most important element of an annual plan is a month-by-month forecast of income and expense, as such a forecast tangibly summarizes the operator's expectations. This forecast should include full supporting schedules of each revenue and expense category.
- **Budgets for Capital Expenditure and Repair and Maintenance:** The capital expenditure budget should contain a detailed listing of all necessary expenditures. Each entry in the listing should provide a full description of the expenditure, a concise explanation of why it is necessary, and an identification of the aspect of the property it will improve. In addition, the listing should include the manner in which the cost will be funded and a time frame for its occurrence. The repair and maintenance budget should contain the same type of information as the capital expenditure budget, except that the items listed in it will relate to expenses contained in the repair and maintenance category of the income and expense statement.
- **Marketing Plan:** The marketing plan should be a comprehensive description of the operating company's marketing efforts on behalf of the subject property. It should contain the following:
    - An analysis of the current market position of the hotel, including competition mapping and market area analysis.
    - An analysis of the current status of any marketing efforts in-progress including all marketing programs underway and an evaluation of their effectiveness, market segmentation and demand analysis, and an analysis food and beverage marketing efforts.
    - An overview of the long-term marketing strategy for the next three to five years.
    - A description of the marketing program for the next 12 months detailing monthly marketing efforts, budget requirements organized to show the manner in which funds will be spent, projections of room nights captured along with the expected average rate, and projections of food and beverage revenue by outlet on a monthly basis.

Expenditure Thresholds: Usually, the operator has greater control over the bank accounts of the hotel (discussed later) in comparison to the owner; therefore, it becomes imperative from the latter's point of view for expenditure thresholds to be defined in the contract. The annual budgeting exercise is a critical step in that direction; although, the fact that the approval of the owner may be necessary for implementing the annual plan does not by itself result in ownership control. To accomplish this, specific restrictions that prevent the management company from operating at variance with the budget must be established.

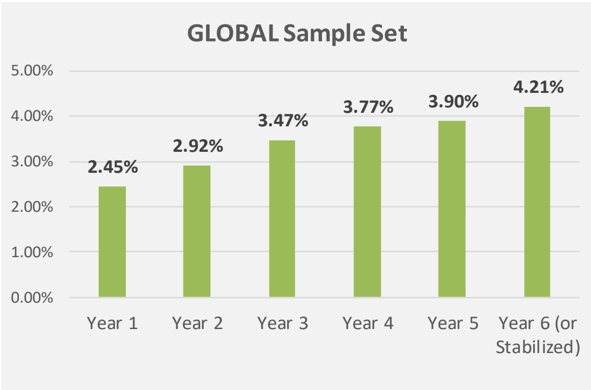
Nearly **all contracts that have been surveyed provide details pertaining to an expenditure threshold**, beyond which the owner's prior consent is required. Although the threshold definition is found varying across the contracts, common features identified are:

- **Deviation from the Annual Plan:** Owner's approval is required prior to the operator incurring costs that can result in the total expenditure/single line-item expenditure to exceed the agreed upon amounts provided in the annual plan **by more than 0%-10%.** A specific dollar amount (e.g. US$20,000) may also be used in place of a percentage, but such an amount is regularly revised to account for inflation.

- **Restrictions on Entering into a Contract**: Owner's approval is required prior to the operator entering into any service contract that has a term in excess of a specified number of years or entails an expenditure over and above a pre-defined monetary amount.
- **Restrictions on Entering into a Lease:** Owner's approval is required prior to the operator entering into any equipment/hotel real estate lease, sub-lease or concession if the total term exceeds a specified number of years or the payment required to be made by the lessee/sub-lessee exceeds a pre-defined monetary amount. In case of a hotel real estate lease/sub-lease (eg. Shop), there could be a restriction on the square footage as well.
- **Emergency Expenditures and Those Not Covered in the Annual Plan:** Owner's approval is required prior to the operator making emergency expenditures in excess of a pre-defined monetary amount as well as for those not covered in the annual plan.

FF&E Reserve Contribution: FF&E refers to Furniture, Fixtures and Equipment that can be removed from a property and are not part of the building structure. **FF&E reserve** is an annual/periodic monetary allocation/contribution to fund future expenditures related to the replacement of FF&E.

FIGURE 24: FF&E RESERVE CONTRIBUTION



Generally, the FF&E reserve allocation is expressed as a percentage of the hotel's Gross Operating Revenue, **ranging from 2.00%-5.00% on a stabilized basis.** The allocation is determined at the time of signing the management contract, and is then supplied by the funds available from the hotel's operations, with any shortfalls being made up by the owner. Moreover, the extent of withdrawals from this reserve is mostly planned during the annual budgeting exercise. Although this is not a payment to be made to the operator, owners are usually hesitant regarding a higher FF&E reserve contribution as it has a direct bearing on their share of profits. On the other hand, operators are insistent that adequate reserves (if not more) be maintained in order to ensure the property's upkeep, which affects its income generating potential and compliance with brand standards. Figure 24, alongside, exhibits the FF&E reserve contribution sought by the management contracts surveyed.

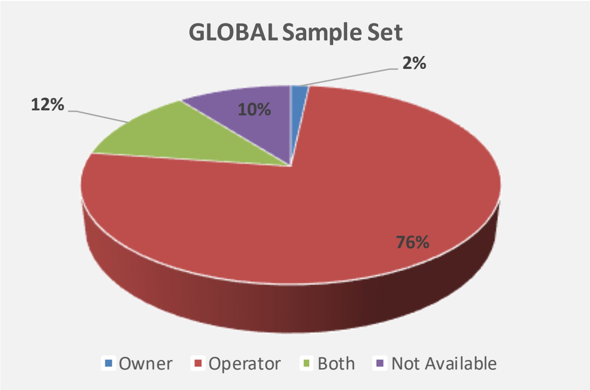
It is important to highlight here that expenditures made using this fund typically provide for "routine" capital improvements and are distinct from major capital expenditures (investment capital) undertaken in order to generate "higher" revenue and profits during the life of a hotel.

The FF&E reserve is normally maintained in a separate bank account with the operator entitled to expend any amounts in accordance with the agreed annual operating plan. Having said that, based on our discussions with hotel operators, we gather that some management companies are comfortable with the FF&E reserve being a **notional allocation** each accounting period. In this case, although no actual cash is deposited into a bank account periodically, the owner is expected to provide the real sum corresponding to the notional amount as and when demanded by the operator for expenses toward routine capital improvements.

Furthermore, **allocation toward this reserve is seen ramping up** from Year 1 of operations to Year 5 or 6, stabilizing thereafter, accounting for the newness of the property in the initial years. While this is particularly true for new hotels, in the case of existing/conversion properties, the allocation toward this reserve could be a higher percentage right from the first year of operations depending on the age and condition of the hotel at the time of signing the management contract. In fact, most operators demand capital improvements be made at the property prior to re-branding and/or the new management assuming its role. Resultantly, the average FF&E Reserve contribution for Years 1 and 2 of operations for **new hotels** represented in the survey **is 1.71% and 2.42%, respectively,** while for **existing/conversion hotels it is 3.28% and 3.47%.**

Control of Receipt/Operating/Revenue Account: Receipt/Operating/Revenue account refers to the bank account in which all monies/funds derived from the operation of the hotel (which may or may not include working capital) is deposited and payments toward operating expenses of the hotel are made. This account, usually bearing the hotel/owner's name, can be opened in a bank either designated by the operator subject to owner's approval, or vice-versa.

FIGURE 25: CONTROL OF OPERATING ACCOUNT



The **assignment of rights** to control or administer this account on a day-to-day basis can vary across management contracts, even as most of these allow the owner to review bank reconciliations at any point in time. Figure 25 illustrates the control exercisable by the owner and operator toward the operating account of hotels covered in this survey. Moreover, unless agreed upon otherwise by the parties, at the end of each accounting period, the operator is required to disburse to the owner any funds remaining in the operating account after the payment of all operating expenses and any other amounts stipulated in the management contract.

Owner Approvals

Some hotel management contracts require virtually no approvals from hotel ownership; others contain numerous opportunities for owners to provide input into the decisions involved with managing a lodging facility. As with budgets, many operators prefer to restrict any provisions requiring any form of approval, and owners generally attempt to exert as much control over management in the form of approvals as possible. The following list sets forth some of the elements of a hotel operation that "may" be subject to approval by the owner, beyond the annual plan:

- Expenditures for non-capital expenses (generally, those exceeding a specified level)
- Expenditures for capital items (generally, those exceeding a specified level)
- Plans to renovate the facility
- Expenditures not covered in the annual plan, leases and concessions (exceeding certain limits)
- Use of the operator's optional centralized services, the cost of which is not included in the normal management fee
- Use of outside consultants
- Changes in room rates and food and beverage pricing
- Initial salaries, raises, benefits, and labor negotiations
- Changes in key operating personnel
- All initial operating policies and subsequent changes
- Selection of a depository bank
- Size of the working capital account
- Withdrawal of funds from operating accounts
- Credit policies
- Insurance coverage
- Use of insurance or condemnation proceeds
- Legal proceedings
- Assignment of the management contract by the operator

In most instances, the approval process is one-sided – that is, the owner is required to approve a request from the operator rather than the operator approving a request from the owner. **As a result, any approvals contained in a management contract usually create an advantage for the owner.** Most first-tier/branded hotel companies provide the owner with very few opportunities to review and approve their actions. Second-tier/third-party operators are generally more accommodating in allowing for owner approval of some of the operational elements previously outlined. As with the budget approval process, the more control ownership can exert over a management company, the greater say it has in the hotel's overall operation.

Employees

In this sub-section, we have discussed two key aspects relating to hotel employees that are deliberated on during negotiations of a management contract between the owner and the operator: (i) **Employer** and (ii) **Senior Management Hiring Process.**

Employer: One of the major issues in management contract negotiations relates to whether the personnel employed in the hotel are to be employees of the owner or of the management company. **Owners generally want the personnel to be employees of the operator, while operators want the owner to be the employer.** The basis of this issue is primarily **liability**; the employer is generally directly responsible for witholding taxes, other applicable deductions and timely payments to concerned authorities. If these obligations are not fulfilled, the employer becomes subject to penalties, interest, and at times even criminal prosecution. In addition to the employee tax liability, an employer faces various types of personnel liability, such as employee theft, assault, discrimination, and negligence.

Under most hotel management contracts, the hotel owner is usually responsible for providing any funds needed to cover cash flow shortfalls, so most operators contend that they should not be the employer when they do not have total control over the availability of capital. On the other hand, because the operator usually has direct responsibility over employee hiring practices and should be in a position to monitor the quality and integrity of the personnel, many owners feel that the operator should be the employer. **Occasionally, the management company will request that top-level personnel be employed by the operator (with the operator being reimbursed for the full employment cost of such personnel during each accounting period) while all others work for the owner.** This agreement allows top management to participate in the chain's benefit programs while restricting the inclusion of all other employees. It also provides the operator additional control over the key executives. Furthermore, we gather from our discussions with operators that the **General Manager of the hotel can be on a dual appointment** with both the management company and the owner, although employment-related costs are borne by the owner (from hotel's cash flow). Here, the General Manager is **seconded** by the operator to the owner.

Interestingly, we find that in **USA**, more often than not, all hotel personnel are employees of the operator (with payroll and related costs being an operating expense of the hotel). On the other hand, in **APAC**, **South America, the Middle East and Africa,** nearly all contracts define the employment relationship as the hotel personnel being employees of owner at all times with the exception of select senior personnel. In **Europe**, we have come across both.

Senior Management Hiring Process: In our experience of negotiating management contracts, we have seen some owners being very particular about having the rights to interview and approve the appointment of the **General Manager and/or other members of the Executive Management team**, while the rest don't seem to care for this clause too much. The essence of this clause revolves around who has higher control over the management of the hotel – the owner or the operator. Naturally, neither side wants to lose control. Here, in this survey, we have looked at owner's approval rights for the following senior-level positions:

- General Manager
- Financial Controller
- Director/Head of Sales and Marketing
- Director/Head of F&B

- Executive Chef
- Head of Purchase
- Head of Human Resources
- Expatriates
- Others (Resident Manager, Deputy General Manager, Director of Revenue, Chief Engineer, Rooms Division Manager, Operations Manager, Director of Public Relations, Security Manager and Health Club Manager – per the survey results)

Where such approval rights are granted to the owner, the operator offers the opportunity to **participate in the hiring process** in the following manner:

- Operator submits a candidate for owner's approval. Owner typically has a few days (specified explicitly in the contract) to interview and evaluate the candidate.
- Owner is deemed to have approved the candidate unless owner notifies the operator of its disapproval within a mentioned timeframe. If the owner disapproves the first candidate, operator is required to submit a second candidate using the same process outlined above.
- By and large, all contracts that require the owner's prior consent for the appointment of senior personnel, **restrict the number of rejections by the owner to usually two or three candidates** presented by the operator each time such a position is to be filled. Thereafter, the candidate chosen by the operator becomes the General Manager/Other as the case may be.

Moreover, some management companies allow only **consultation rights** to the owner, with the operator not obligated to comply with the owner's recommendations. In either circumstance, it is the operator who shall ultimately supervise the hotel's team. Figure 26 presents the nature of owner's rights toward the appointment of senior hires across the contracts surveyed globally. Evidently, approval rights are sought and offered mostly for the positions of General Manager and Financial Controller.

FIGURE 26: SENIOR HIRE | OWNER'S RIGHTS

Employee	Approval	Consultation	No Rights	NA
General Manager	64%	5%	26%	4%
Financial Controller	38%	5%	52%	4%
Head of Sales and Marketing	17%	5%	73%	4%
Head of F&B	3%	2%	91%	4%
Executive Chef	2%	1%	93%	4%
Head of Purchase	2%	1%	93%	4%
Head of Human Resources	2%	1%	92%	4%
Expatriates	2%	1%	92%	4%
Others	8%	1%	88%	4%

Indemnification

Indemnification provisions in hotel management agreements identify **when either party will be responsible for, and protect from, a claim against the other.** It is a way of allocating risk between the owner and the operator, and is commonly used to deal with third-party claims such as those from vendors, guests and government, among others. **Most often than not, it is the owner that indemnifies the operator** against all damages, loss and/or expenses arising from any and all claims against the operator except for those that are caused by the **operator's willful misconduct or gross negligence**. It must be noted here that the indemnification provision not only applies to the owner and the operator, but also extends to the affiliates and respective agents, principals, shareholders and employees of both parties.

The major types of indemnification clause in a hotel management agreement are as follows:

By Owner: Generally, the operator wants indemnity from all liability, loss, damage, cost, or expense relating to or arising from the operation of the hotel. It typically requires the owner to assume the cost and expense of the defense of any legal proceeding arising out of the allegation of any such act or omission. In most instances, the indemnification provisions protecting the operator are not totally absolute; they usually contain exceptions for circumstances such as willful operator misconduct, gross negligence, fraud, theft, malicious conduct, and breach of trust. During the negotiation process, hotel operators try to limit these exceptions by using modifying terms such as "gross" negligence, while owners try to broaden the exceptions so that no indemnification would be required if the operator was merely negligent. In addition, some operators seek indemnification from damages, loss or demands arising out of any offering document that is intended to interest potential investors in any debt/equity financing related to the hotel (prospectus), plus for those arising from presence of hazardous materials at the site or in the hotel.

By Operator: Most management contracts contain provisions that require the operator to indemnify the owner from liability, loss, damage, cost, or expense caused by the operator's breach of the management agreement. In addition, the hotel company is sometimes required to also indemnify actions outside the scope of the agreement, including gross negligence, willful misconduct, fraud, or breach of trust. Operators attempt to lessen the impact of these clauses by adding modifying terms, such as "material" breach of the management contract and "willful" misconduct.

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Indemnification Provisions: *The use of indemnification provisions in hotel management contracts requires extensive local legal knowledge. The parties to the agreement should consult with their attorneys before approving any indemnification clause.*

Moreover, for dealing with such kind of potential exposure to liability, purchasing the applicable insurance policy is imperative. In fact, most contracts specify that with respect to any liability of either party, the other party shall not seek indemnification to the extent that there are available insurance proceeds under the insurance policies maintained under the agreement.

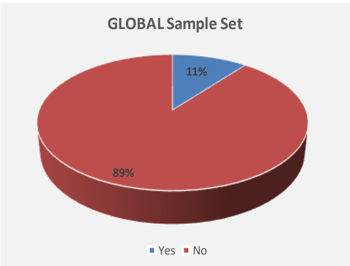
Lastly, our research shows that over time, brands have increasingly tried to reduce their liability and obligations relating to hotel management agreements to increase the value of their contracts. In stray cases, some brands even limit the owner's right to damages on occasions of proven willful misconduct or gross negligence of the operator, to a fixed amount that is usually linked to the management fees earned by the operator in the past fiscal(s).

Operator Investment in Property

Many hotel owners attempt to negotiate some form of financial commitment to the property on the part of the management company in the **belief that having the operator financially tied to the success of the project will create additional incentive to manage in a profitable manner**. This practice is more common with first-tier/branded hotel operators than with second-tier/third-party operators. Hotel management companies generally pursue one of the following options if an investment in the property is required:

Key Money: In some highly desirable hotel markets, hotel management companies sometimes pay what is known as key money to obtain the right to put their name on and manage a hotel. Based on our review of the global sample set in addition to our discussions with brand representatives, we find that **key money is the most widespread incentive (relative to equity contribution and loan guarantees)** offered by hotel companies to owners in order to get them to use one of their brands. Often regarded as an evidence of the operator's genuine interest in the engagement, key money can be a trump card played by the operator to seal the deal for marquee assets. Nonetheless, in most cases this amount is provided as the **last funding available to the owner** after the operator is convinced that the project will see the light of day. Under such an arrangement, if the hotel performs well, the operator directly realizes a return for the investment. Needless to say, the operator needs to be convinced that the hotel's income generating potential will likely match its expectations.

FIGURE 27: KEY MONEY INCENTIVE



Going by the fact that **31% of the surveyed contracts offering key money were signed before Year 2005,** this concept is not entirely new to the hospitality industry. Regionally speaking, offering key money is more customary in the Americas, followed by Europe. In APAC, the trend is picking up, albeit gradually, with international brands getting more comfortable with contributing key money for strategic assets and to owners, who have a proven track record of delivering on their promises. On the other hand, this investment option remains uncommon in the Middle East and Africa.

Figure 27 shows the percentage of contracts in the global sample set that feature a key money incentive.

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Owner Considerations Relating to Key Money: *An owner should be careful while negotiating key money, as such receipts may at times tend to compromise the owner's bargaining power.*

Furthermore, it is useful to know that the key money amount never exceeds the total amount of fees the operator is expected to earn from a hotel during the contract term.

Key money can be offered in a variety of formats, including:

- *An **absolute monetary amount** estimated as a percentage of the Net Present Value (NPV) of the operator's fees that it expects to earn over the life of the contract, or not exceeding two to three times the stabilized year's management fees anticipated to be earned by the operator.*
- *A waiver of the **technical services fee** or making it reimbursable after the hotel opens in the form of key money.*
- ***Forgoing base and/or incentive fee** for a specified number of years with/without a claw back provision as a key money incentive.*

To end, common industry knowledge indicates that the amortized key money is often claimed back by the operator if the management contract is terminated prematurely.

Deferred Fees: The deferral of all or a portion of the management fee **(usually, incentive management fee)** is actually a form of capital investment on the part of the operator. Most management companies in North America are willing to accrue the incentive portion of the fee in instances in which cash flow is insufficient to cover debt service. If this portion **accrues at interest** and is ultimately repaid sometime in the future, the actual cost to the operator is minimal. If the deferred incentive fee **accrues without interest (more common of the two)**, the operator loses the time value of money but generally receives full payment at some point in the future. Occasionally, fee structures are negotiated that stipulate that any unpaid incentive fee will not accrue and that the operator forfeits all monies owed. This structure is the most likely one to induce a meaningful investment from the operator.

Owner's Priority Return and Operator Profit Guarantees: Both **owner's priority return** (that supersedes the incentive management fee payment to the operator) and **operator profit guarantees** (where operator guarantees to make up the shortfall to the owner via extending its own funds if certain pre-defined levels of profits are not attained) are other forms of investment by the management company. However, these are normally accompanied with a claw back provision that allows the operator to retrieve any fees forgone or payments made to the owner out of future surplus profits.

Operator Loans: In this type of investment, operator contributes capital in the form of a loan that is repaid over time with interest. **The loan is usually unsecured and maybe subordinated to the primary debt service.** However, operator loans do not expose the operator to any significant monetary loss. This may also be the case even if the loan does not accrue interest, in that the operator has lost nothing other than the time value of money. Only when the operator actually contributes capital (in the form of key money or deferred fees), can the investment be considered meaningful.

Others: The operator and owner may enter into a joint venture partnership (outright equity contribution) and split all cash flow after debt service in accordance with an agreed-upon percentage. Alternately, numerous other forms of capital investment by the operator may take place that is customized for each deal.

Even so, **while a capital contribution on the part of the operator may sound appealing to an owner, it can represent very expensive money.** From the owner's standpoint, if capital is "urgently" required for the operation of a property, the most reasonable form of capital contribution by a management company is first, the subordination of management fees and second, the loan of capital. The primary advantage for an owner in obtaining funds from the operator in the form of a loan is that the overall cost is relatively low. Interest on the funds loaned is usually tied to the prime rate or a specified percentage in excess of that rate, but amortization based on cash flow can be very rapid.

Termination of Agreement

When two parties enter into an agreement such as a hotel management contract, the implicit belief is that the relationship will continue for the full term. Often it does, but occasionally one of the participants either fails to meet its contractual obligations or the general expectations of the other party in terms of performance or compatibility, and the agreement must be terminated. To protect both parties from such situations, **hotel management contracts often incorporate specific provisions that allow one or both of the parties to terminate the agreement**. The key to any termination clause is that it should be rapid and conclusive. A drawn-out termination by either the owner or the operator is to be avoided, because it can have a devastating effect on the current and future operating results of the property, even as it may harm the reputation of either party.

Standard Conditions: Each management contract lists certain standard conditions or events that could give rise to the non-defaulting party's right to terminate. These are:

Bankruptcy/Insolvency: Most management contracts permit either party to terminate the agreement in the event the other enters/is judged to enter into bankruptcy. If it is the owner who becomes insolvent, the operator typically requires that the person/entity to whom the title or possession of the hotel being transferred to by judicial or administrative process, meet the requirements of a qualified owner. Any time a hotel is involved in a bankruptcy, its reputation suffers, and the long-term negative effect can often be difficult to overcome.

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Owner Considerations Prior to Terminating a Contract: *Fully aware of the fact that terminating a management contract could be expensive, lengthy and complicated, owners are becoming more vigilant toward the conditions for termination and the consequent payments to be made to the operator.*

*Regardless, it is important for owners to understand that **terminating a contract alone is not often the best solution to mitigate underperformance**. Apart from the additional costs associated with the termination and its adverse impact on the morale of the teams on both sides, there is also a loss of goodwill and image in the market. Besides, there could be genuine reasons behind the operator's inability to perform, which could be beyond its control and may not be solved by way of simply replacing the current management with a new one. Thereby, all factors need to be examined thoroughly prior to taking this consequential step.*

Material Breach of Contract: The material breach of one or more contract provisions (like failure to make payments or meet construction milestones) by one party usually allows the other party to terminate the agreement. In most instances, notification of the breach must be sent to the party within 10-20 days of the breach; the party then has 30-45 days to cure the breach. If the breach is not cured, the other party may then terminate the contract immediately, or in some cases must again notify the party at fault that the termination is effective. This extensive notification procedure is necessary to protect the rights of the party at fault, but it does draw out the process, which can negatively affect the hotel's operation.

Condemnation or Casualty (Damage): A permanent taking of a hotel or a substantial portion of a hotel through eminent domain or by some form of destructive casualty generally permits either the owner or the operator to terminate the agreement. Some contracts allow either the owner or the operator to determine whether the hotel has been made unusable, while others set forth certain criteria for reaching this conclusion. For example, some contracts may cite circumstances – *such as the cost of repairing and replacing the hotel to the same condition as existed before the casualty exceeds a certain pre-determined amount or is 60%-85% or more of the hotel's replacement cost at the time of the casualty* – that would render a hotel inoperative and thereby allow either the owner or the operator to terminate the agreement. In most instances, operators will attempt to reopen a lodging facility that has been partially condemned or destroyed by a casualty. However, owners must keep in mind that rebuilding a hotel may not always represent the best use of the condemnation or insurance proceeds, and thus contracts must be worded in a manner that allows owners to protect their interests.

Cross-Termination: The termination (not expiry) of any of the other definitive agreements signed between the parties oftentimes results in the termination of the operating services agreement/hotel management contract and vice-versa.

Termination by Owner: In addition to the above-mentioned standard conditions, circumstances that can trigger termination by the owner (subject to being accepted by the operator) include, but are not limited to:

- Operator Non-Performance (i.e. failing the performance test) Without Cure
- Upon Hotel Sale
- Without Cause/At Will
- Operator Revocation of License (contracts with second-tier/third-party management companies contain provisions holding either party to be in default for causing a license or franchise to be revoked)
- Operator's Misconduct, Negligence or Fraud
- Cessation of Operator Activity in the Hotel Business

In this survey, we have focused on the following specific conditions for termination of the contract by the owner:

Operator Non-Performance: As mentioned earlier in this report, failure of the operator to meet the performance test thresholds set forth in the contract is perhaps the only instance wherein the owner can terminate the agreement without having to pay any liquidated damages or a termination fee to the operator (as most of the other defaults listed previously rarely occur on account of the operator).

All surveyed contracts that have the provision for an operator performance test (65% of the global sample set) **allow the owner to terminate the contract should the operator fail the test parameters and leave it uncured.** Moreover, all of these, with the exception of a few scattering contracts, do not require the owner to pay a termination fee upon the occurrence of such an event.

Upon Hotel Sale: Some contracts allow the owner to terminate the agreement with/without the payment of a termination fee to the operator upon the sale of the hotel to a third party. This could be beneficial for the deal, as the new owner does not have the obligation to assume the responsibilities of the management contract once the hotel has been purchased. Among the contracts surveyed, **32% allow the owner to terminate the agreement upon hotel sale, with 78% of these seeking a severance payment.**

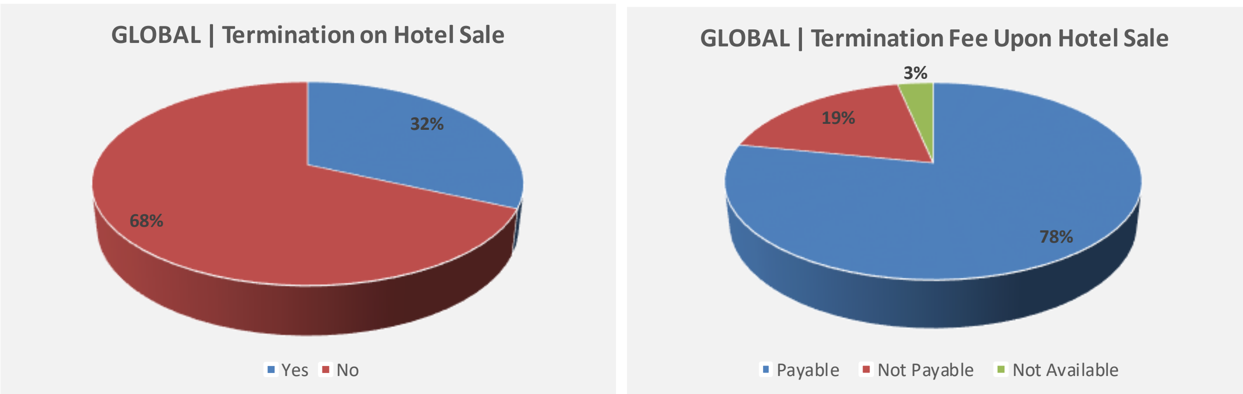
The remaining 68% of the contracts survive the sale of the hotel, requiring the purchaser to be bound by all terms and conditions of the management contract, and to assume and perform all of the owner's obligations under it. Moreover, such contracts need the owner to furnish the operator with all relevant details regarding the purchaser with the underlying condition that the sale shall not be concluded without the prior consent of the operator. Few of these also allow a right of first refusal/right of first negotiation/first right of purchase to the operator. Under this provision, the owner is required to initially negotiate in good faith the sale of the hotel with the operator prior to reaching out to a third-party (only if a consensus cannot be arrived at). Besides, some of these mention a threshold price, under which the owner cannot sell the hotel to a third-party **– typically 90-95% of the sale price being negotiated between the owner and the operator** – or put in a caveat stating that **the economic terms of the transfer are no more favorable to the third-party than the terms owner last offered the operator**.

Additionally, **agreements that do not permit termination upon sale require the purchaser of the hotel to meet certain criteria** put forth by the operator in order to qualify as the new owner, such as:

- The person(s) should have financial resources to meet the owner's obligations under the contract.
- The person(s) should not be a competitor to the operator or have ownership interests in or the power to direct the management and policies of a competing hotel company.
- The person(s) should not be regarded in public as disreputable, being of a bad moral character, or a "prohibited"/"restricted" individual.

Figure 28 illustrates the global statistics relating to contracts permitting termination under this condition.

FIGURE 28: TERMINATION UPON HOTEL SALE



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Termination Fee/Severance Payment: *The termination fee payable by the owner to the operator in the event of a hotel sale or upon termination without cause (in agreements that offer this provision) is usually an amount equal to the average monthly/annual fees earned by the operator in the preceding two-three years (24-36 months) or until the notice of termination "multiplied by" either: (i) the remainder of the term (months/years) which can include extensions; or (ii) an absolute number such as 2, 3, 5, 10 or any other as agreed upon. Few operators mention an absolute amount as a lump sum payment varying by the year in which the termination occurs. Others express it as the present value of the operator's net income that would have been earned had the contract lasted full term.*

Sometimes, the termination fee payable upon ***hotel sale*** *may take the form of a percentage of the gross sale price or a percentage of the portion of sale price over and above a certain threshold.*

At times, contracts offering termination upon hotel sale may permit such occurrence only after a specified number of years like after Year 5, 10, 15 or any other as negotiated between the owner and the operator. A sale or transfer of ownership to a third party prior to this period could result in an event of default on part of the owner, allowing the operator a recourse to damages.

While the transfer of ownership/hotel sale is generally not an immediate concern when a hotel management agreement is drafted, the structure of this provision can have a significant impact on both the residual value of the property and the ongoing relationship of the parties to the agreement. Care must be taken to view a hotel sale from the standpoint of all parties involved in order to achieve an equitable contractual structure.

Without Cause: Rarest of all termination conditions, the "without cause" or "at will" provision is offered by very few management contracts, with the operators understandably hesitant to agree to such a term. As the title suggests, the owner can terminate the contract at will, without justifying the same under this provision by merely paying a specified amount (also at times referred to as "operator buy-out"). This provision is **important to owners for several reasons**:

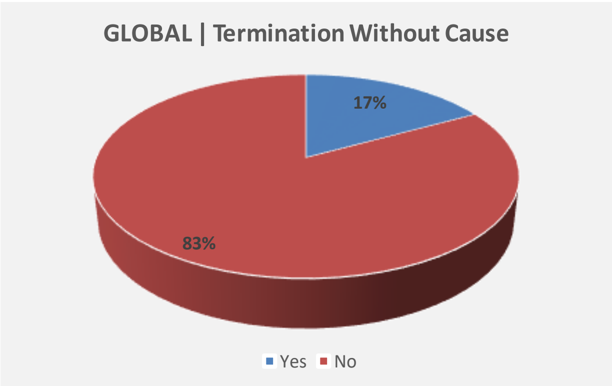
- It allows the hotel to be sold unencumbered by a management contract, generally permitting a quicker sale and usually producing a higher selling price.
- An incompetent operator can be removed in less time than that usually provided for in performance termination clauses.
- Occasionally, an owner may find it advantageous to buy out the operator and manage the property independently, thereby saving the management fee.

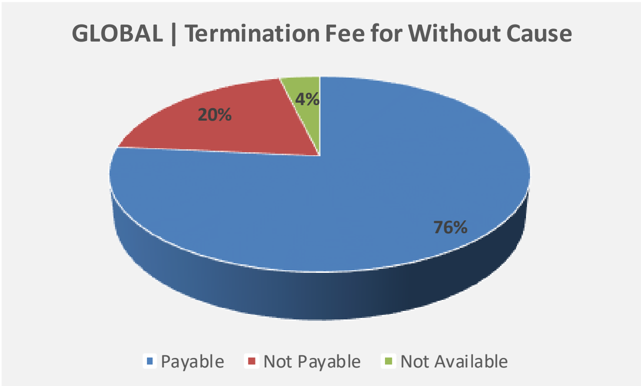
In this survey, **only 17% of all contracts allow the owner to terminate the agreement without cause, of which 76% demand a severance payment.** Interestingly, 78% of these have been signed in or after Year 2005, and two-thirds of such contracts are for conversion properties; there is a near equal representation of agreements with this provision across all market positioning in the global sample set.

Finally, select contracts offering this condition entail a compensation to the operator **only if** the termination occurs in the first 5-10 years of the initial term. On the contrary, a few others allow the owner to exercise his/her right to terminate under this provision only **after** the first 5-10 operating years.

Figure 29 presents the global sample set results relating to contracts permitting termination without cause.

FIGURE 29: TERMINATION WITHOUT CAUSE





Termination by Operator: In addition to the standard conditions discussed earlier in this section, events that can bring about termination proceedings by the operator may include:

Owner Revocation of License: In order to protect licenses and franchise documents, management contracts contain provisions to hold either party in default for causing a license/franchise to be revoked – mostly applicable in situations where a second-tier/third-party management company is engaged.

Owner's Failure to Provide Adequate Funds (or Nonpayment of the Operator): Under a management agreement, the operator generally has no responsibility to provide operating capital for the hotel. All funds either come from the property's cash flow or are contributed to the operation by the owner. To provide adequate management services, the hotel company must have access to sufficient financial resources to pay bills and other liabilities. Lack of necessary funds puts undue pressure on the operator, making it difficult to manage effectively. In addition to their concerns regarding access to sufficient capital to operate the property, management companies obviously want assurance that owners have the resources necessary to pay their management fees.

Adequate funds are typically defined in the management contract as a specific dollar balance/any other that is to be maintained in the property's operating bank account. When cash drops below this pre-established level, the owner must deposit more funds or the agreement goes into default.

Mortgage or Lease Default Including Foreclosure: Provision for termination because of a mortgage or lease default is often tied in with the operator's right of termination in case of the owner's failure to provide adequate funds. Operating under the threat of either a lender foreclosure or a landlord eviction is difficult for a hotel management company. Such situations not only result in adverse publicity, they also have a damaging effect on the employees, suppliers, and customers. As with a bankruptcy, the reputation of the management company, particularly first-tier chains, can be quickly tarnished, affecting the image of the entire company.

Most operators want the option to remove themselves from such circumstances. At the same time, lenders also want the option to either remove the operator or continue under the same management in the event of foreclosure on the owner's mortgage. Depending on the negotiating power of the respective parties, the clause providing for termination because of a mortgage default can be written to favor either the hotel operator or the lender.

In conclusion, once the owner and the operator have decided to terminate the management contract, the **execution** of the termination requires certain actions such as:

- Owner shall repay all outstanding amounts the operator is owed or has funded.
- Operator shall release and transfer to owner any funds which are held or controlled by the operator with respect to the hotel.
- Operator shall prepare a final accounting statement for the fiscal year in which the termination occurs and submit to the owner within a specified number of days after termination.
- All books and records for the hotel maintained by the operator shall be turned over to the owner; however operator may have the right to retain a copy of the guest data.
- Operator shall provide to owner all information in operator's control necessary for owner to process existing reservations and all contracts made in connection with hotel convention, banquet or group services for the time after termination.
- Operator shall assign to owner/successor operator all operating licenses and permits for the hotel issued in operator's name, to the extent permissible by the governing laws.
- Operator shall peacefully vacate the hotel premises.
- Owner shall make arrangements to remove any brand trademarks and similar identification from the hotel.
- All software used at the hotel that is owned by the operator shall remain the exclusive property of the operator, and these might be removed with/without any compensation to the owner.

SECTION II | AMERICAS

This section of the guide and survey report presents the sample set profile for the Americas and corresponding survey results in the following manner: (i) **USA** Sample Set Profile and Survey Results; (ii) **Canada** Sample Set Profile and Survey Results; and (iii) **South America** Sample Set Profile and Survey Results. The disparate nature of these sub-regions requires the survey results to be presented in a sorted manner as against discussing Americas as a whole.

SECTION II-A | USA

Observations

Hotel management agreements continue to be a critical part of the development and asset management process in USA. The length of the current cycle in the country (it is now the longest hotel cycle in recent memory) and the sense that the industry is near peak levels, has given way to greater scrutiny of performance projections. As a result, the negotiation of areas of protection, performance thresholds, cures, robust reporting beyond the P&L, and the like have become as important as the setting of base and incentive management fees. Owners and operators now need to be more informed than ever about fine details that can hamstring either party or promote a flourishing relationship for the duration of the management term.

With the number of upper upscale and luxury properties under development growing as the cycle matures, and the performance of those segments strengthening, brand management is an increasing consideration for owners. Competition among brand operators for strong projects has resulted in a greater availability of key money. This key money can form a meaningful portion of the capital stack, and the negotiation of it extends into areas beyond the total amount, such as forgiveness, amortization, transferability upon sale, etc.

Hence, now more than ever, the fine print of hotel management agreements is critical to long-term operational success in USA.

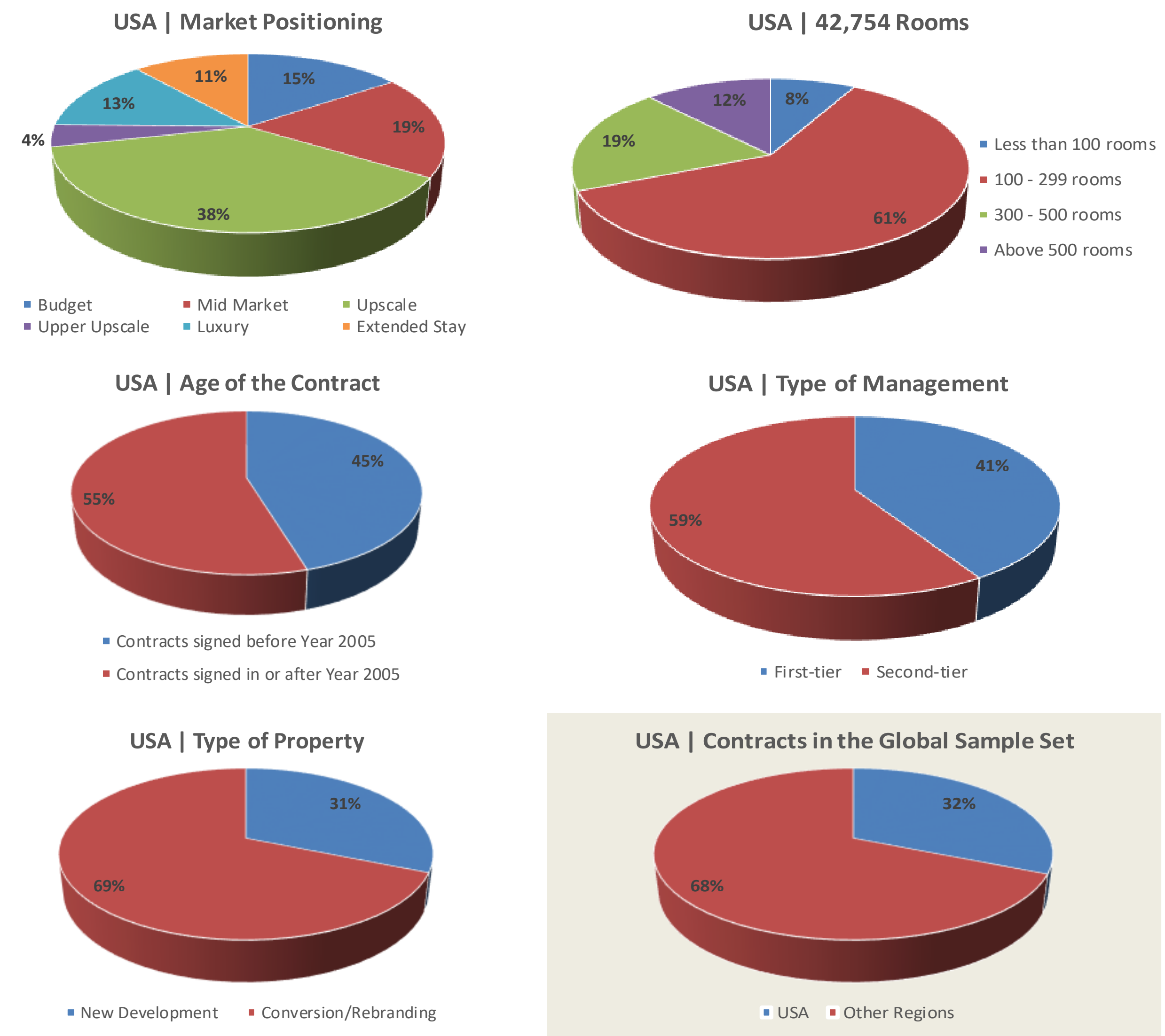
USA SAMPLE SET PROFILE

The USA sample set has a greater representation from:

- Contracts for hotels with an upscale-luxury positioning **(55%)**
- Contracts for hotels having less than 300 rooms **(69%)**, with the **average rooms per hotel being 285**
- Hotels that underwent a rebranding/conversion **(69%)**
- Properties managed by second-tier/third-party operators **(59%)**

Additionally, contracts that were signed before Year 2005 **(45%)**, and in or after **(55%)**, have an almost equal representation in the USA sample set.

FIGURE 30: USA SAMPLE SET PROFILE



USA SAMPLE SET SURVEY RESULTS

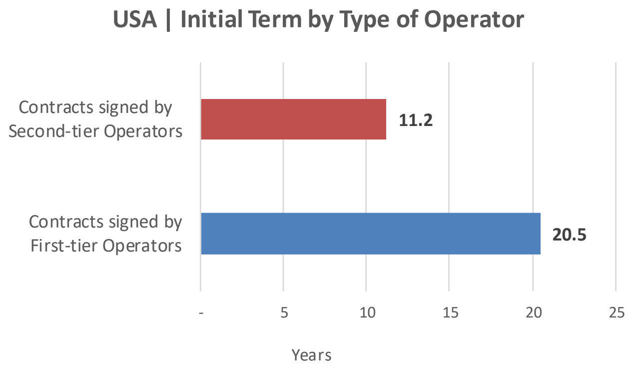
Survey results pertaining to the main terms and provisions of hotel management contracts for the USA sample set have been presented in this sub-section.

For **definitions and a deeper explanation of the terms and clauses** discussed herein, we urge readers to refer to **Section I** of this report that presents the global sample set results.

Management Contract Term

Close to half of the contracts in the USA sample set have an initial term of 10 years or lower; understandably, of all the regions surveyed in this edition, USA represents the shortest initial term, averaging **15 years**. A key reason behind the short contract term is the strong presence of second-tier operators in this market, who tend to be more flexible in negotiating relatively favorable commercial terms for the owner than the first-tier/branded hotel operators. Validating this is Figure 31, below, that illustrates the length of the initial term of a management contract by the type of operator for this region.

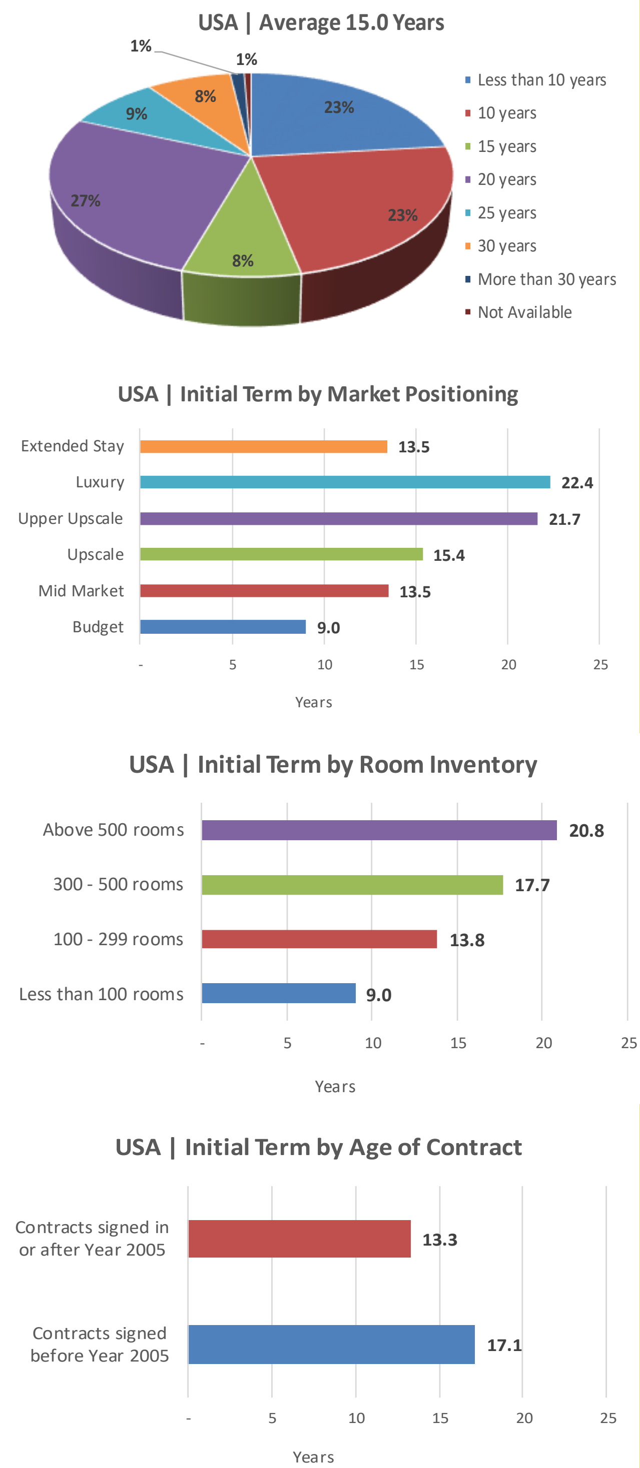
FIGURE 31: LENGTH OF THE INITIAL TERM BY TYPE OF OPERATOR



For **first-tier hotel management companies**, the length of the contract term has additional importance because of their name recognition and high start-up costs. Such companies are interested in demonstrating a stable, long-term commitment to a market area in general and a property in particular, so they will usually negotiate for the longest initial term possible. On the other hand, **second-tier operators** are typically more willing to accept shorter agreements. However, it should be noted that second-tier operators encompass a broad variety of management companies, ranging from small firms with several executive employees to large, highly structured organizations similar to many first-tier chains. The length of term that these operators agree to often varies considerably from one contract to another. When economic downturns occur in this market and there is an increase in lender workouts handled by second-tier management companies, it is not unusual to see, on average, six-month to two-year contract terms, which enable the lender-owner to quickly sell the property, unencumbered by a management contract, in the event a buyer is found.

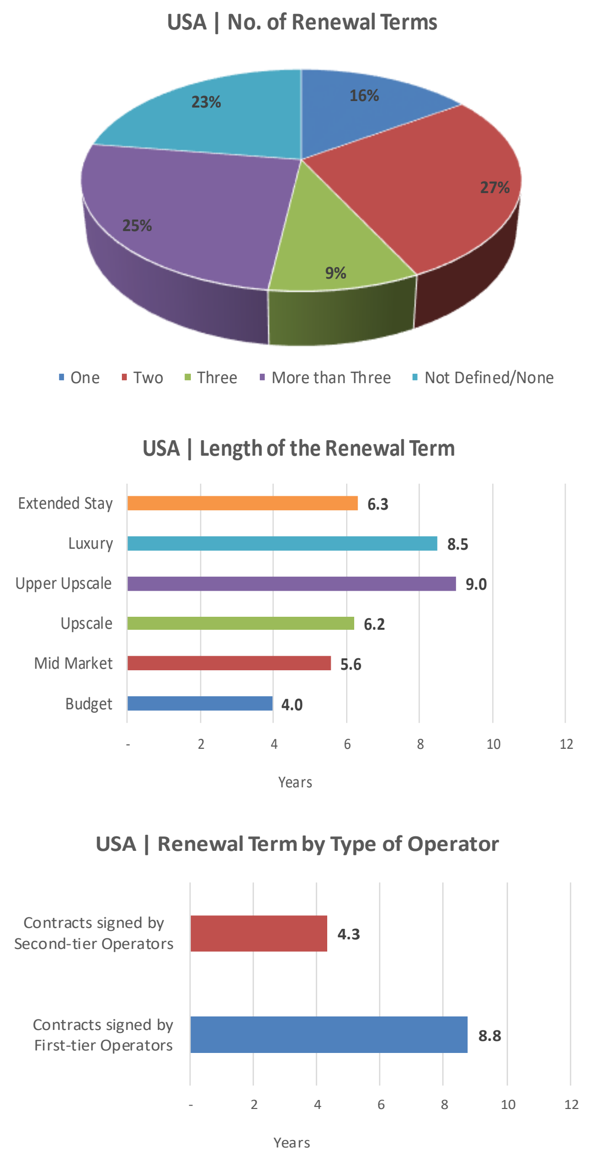
The **renewal term** too is the shortest in USA of all the regions surveyed, averaging **6.2 years** (Figure 33).

FIGURE 32: LENGTH OF THE INITIAL TERM



Note: *In line with the global sample set results, the length of the initial term in USA contracts can be seen increasing with a rise in the market positioning as well as room inventory. Furthermore, contracts that were signed before Year 2005 are for a noticeably longer duration than those that were signed in or after Year 2005 in USA. While this has been a general trend globally, it may also have to do with the fact that 72% of the newer contracts in the region's sample set were signed by second-tier operators.*

FIGURE 33: RENEWAL TERM



Note: *As can be seen, 43% of all USA contracts can be extended once or twice. More than three renewals are mostly offered by second-tier/third-party operators – where the extension may be automatic, upon the mutual consent of the owner and the operator, or at the option of the owner – on a frequent basis that could be every month, every quarter, or every year.*

First-tier companies are generally less likely to offer such provisions, and if they do, they run for longer periods of time in terms of the individual renewals as well as the total of all renewals. Moreover, first-tier operators are more likely to control the option to renew.

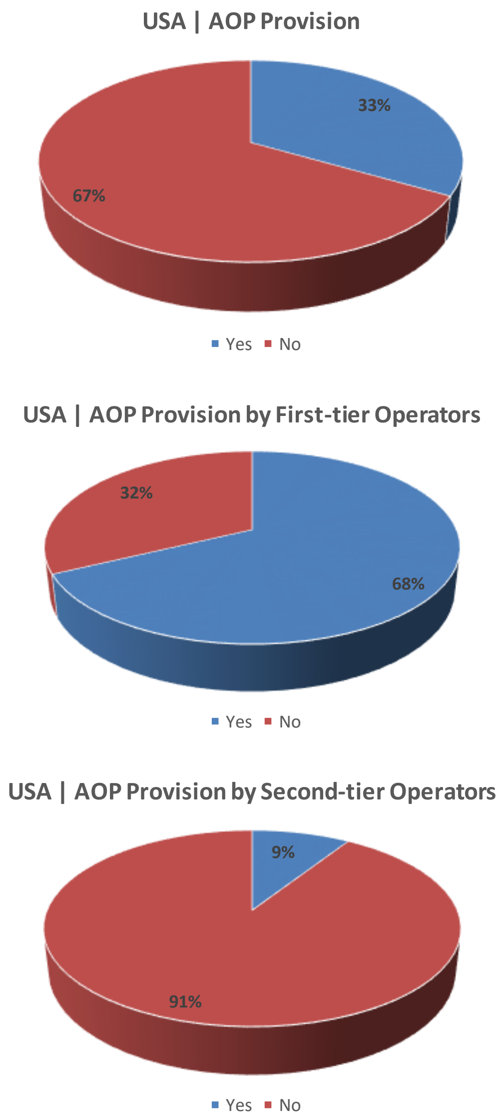
Correspondingly, the average length of the renewal term of contracts signed by second-tier operators in USA is just 4.3 years, which is about half that of the contracts signed by first-tier/branded hotel operators.

Area of Protection

The majority of USA contracts do not offer any territorial restriction or an area of protection (AOP) as has been highlighted in Figure 34, below. This could be attributed to **80% of the contracts that do not offer this provision having been signed by second-tier operators**, who without a recognizable brand name identity, have much less of an effect on their existing properties when they take over additional hotels in the same market area. Secondly, USA is a relatively matured and dense hotel market than other parts of the world, contributing to the resistance that may be put up by operators in providing an AOP in their contracts.

Moreover, **USA contracts that offer an AOP are mostly for upscale-luxury hotels**, with an average room count of 407 keys.

FIGURE 34: AREA OF PROTECTION PROVISION



Operator Fees

*Among the various operator fees applicable, only the **base and incentive management fees have been discussed in this sub-section**, as the others such as those for technical services and centralized services generally have a standard charging mechanism in place worldwide (see **Section I**), with regional variations (if at all) being driven by the number of hotels existing and/or in the pipeline of the management company.*

The **average base management fee** charged by the contracts surveyed in USA is **3.48%**, which is higher than all other regions covered herein. This is owing to **25% of the contracts in this sub-set charging a base management fee of 4.00% or higher**. In most of these cases there is a bundling of the base management fee with other fees and charges; i.e. a large number of such contracts have fees for centralized/chain services included in the base management fee, while some others do not charge an incentive fee and instead seek an asset management fee that is combined with the base management fee. Also, interestingly, inverse to the global trend, **second-tier operators have charged a lower base management fee than first-tier operators** in the country (Figure 35, alongside).

In terms of operators offering an **owner's priority** return, remarkably, **61%** of the surveyed USA contracts have this provision. Consequently, the **incentive management fee** structure here is distinct from other regions (except Canada) in that more than half of the surveyed contracts link it to the available cash flow of the hotel, subordinated to the owner's priority return (Figure 36). In this kind of a structure, the incentive management fee is seen ranging between **10%-35% of the available cash flow**, with the majority charging **20%-25%.** Notably, the first-tier operators are found representing the higher end of this fee range whereas the second-tier operators can be seen charging 10%-15% of the available cash flow of the hotel.

FIGURE 36: TYPES OF INCENTIVE MANAGEMENT FEE STRUCTURE

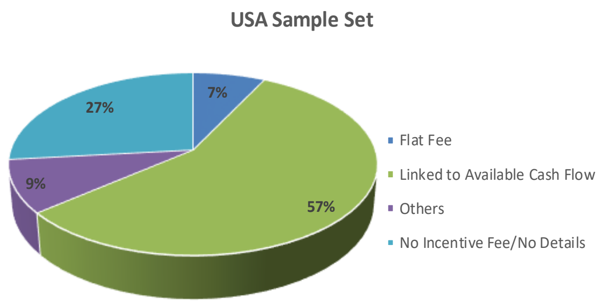
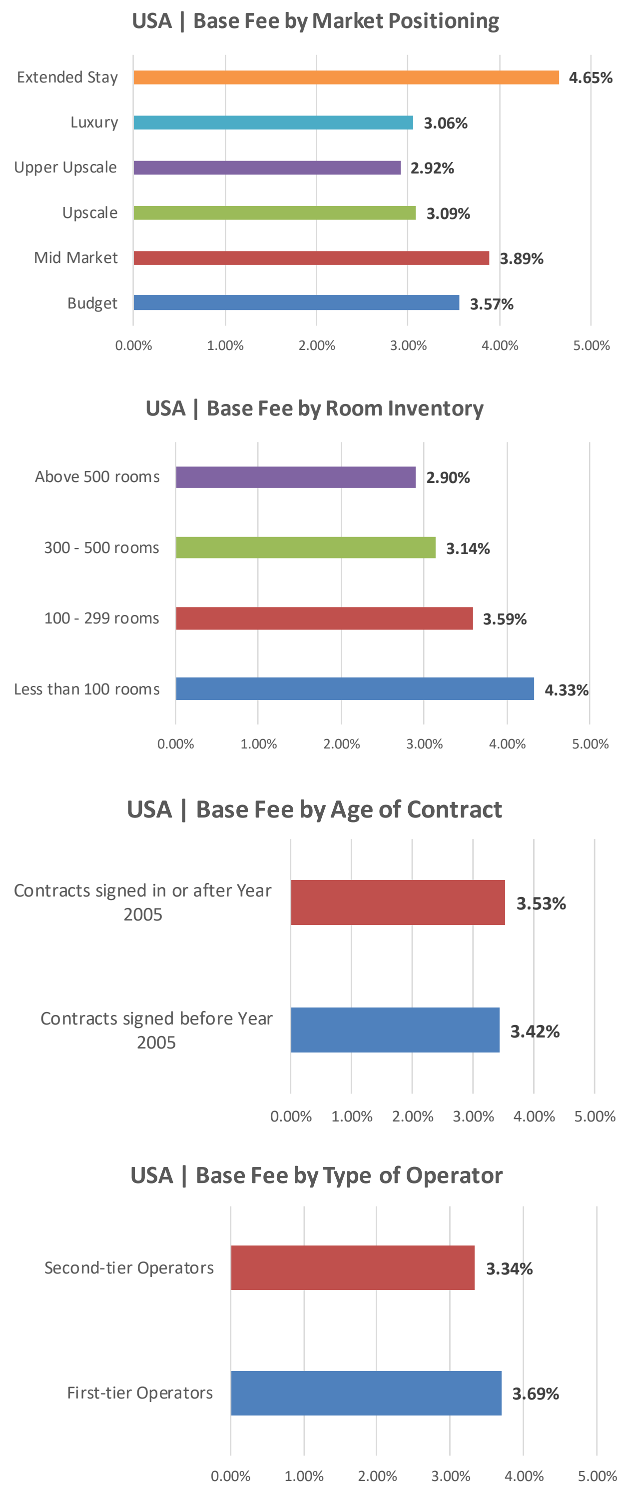
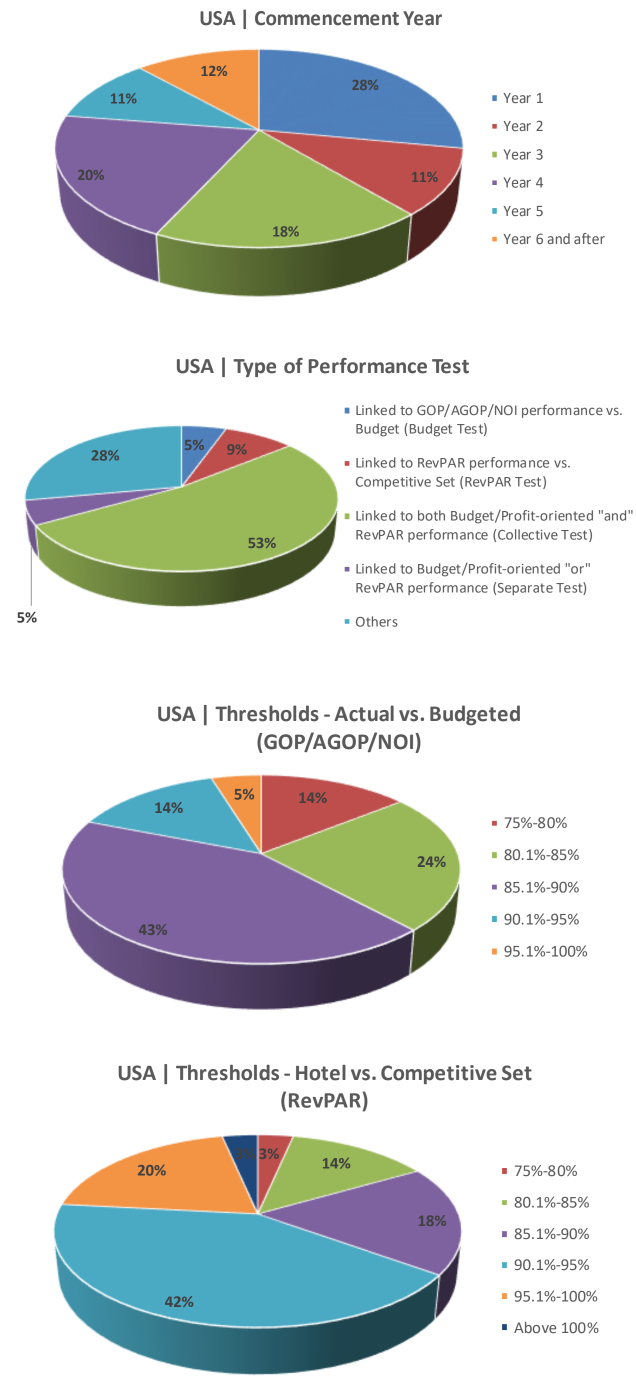


FIGURE 35: BASE MANAGEMENT FEE



***Note:** Matching the global trend, the base management fee for an upscale-luxury hotel is lower than that for a budget-mid market hotel in USA. Similarly, the fee can be seen falling with an increase in the room inventory. Now, although the base fee has generally decreased over the years, it is not apparent here as 74% of all USA contracts signed in or after Year 2005 are for conversion properties that tend to have a higher base fee than new developments, globally.*

FIGURE 37: OPERATOR PERFORMANCE TEST



Note: *We observe that 77% of USA contracts with a performance test have the commencement year in or before the fourth year of operations of the hotel. In fact, a substantial number of these have the performance test beginning in the first year itself, which can be due to 85% of such contracts corresponding to conversion properties.*

In terms of the type of performance test, "others" comprises customized structures like hotel's operating profit being linked to owner's priority return or pre-defined monetary thresholds and NOI being linked to the base year performance/ debt service, among others.

Operator Performance Test

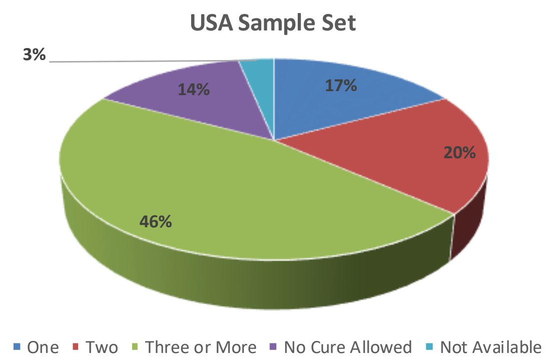
Nearly two-thirds **(62%)** of the USA sample set permit a performance-based termination of the hotel management contract by the owner. It is worthwhile to mention here that the inclusion of an operator performance test is almost equally found in contracts signed by both **first-tier and second-tier operators**.

Furthermore, a **collective test** requiring the operator to fail both the budget/profit-oriented test "and" the RevPAR test appears to be the most common structure in this part of the world. High performance thresholds are also frequent here, with 62% of the applicable surveyed contracts requiring the operator to achieve greater than **85% of the budgeted GOP/AGOP/NOI**, and 83% requiring the operator to record a hotel RevPAR **that exceeds 85% of the weighted average RevPAR** of the defined competitive set during the test period. Remarkably, about 20% of such contracts have a performance threshold of over 90% for the budget/profit-oriented test, and 23% have thresholds upward of 95% for the RevPAR test – latter being the second highest ratio among all the regions surveyed in this edition after Canada.

The test period is generally **two consecutive years**, although a sizeable number of contracts, especially for conversion properties, have it as every single year from the commencement year.

Moreover, a large number of USA contracts **(83%)** having a performance test allow the operator to cure the failure upon receipt of the termination notice from the owner. Figure 38 shows the **number of cures** permitted by them, and clearly, most operators have expansive cure rights with **three or more number of cures** being allowed during the initial term of the contract.

FIGURE 38: PROVISION FOR OPERATOR TO CURE

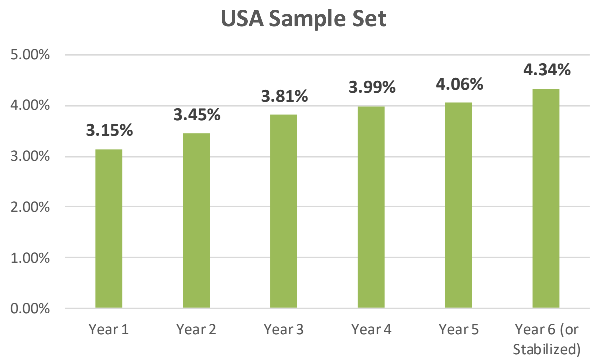


We have not delved into the ***annual plan*** *approval process and the nature of* ***expenditure thresholds*** *specified in contracts on a regional basis. We urge the reader to refer to* ***Section I*** *of this report that discusses the global sample set results for an overview of these provisions of a management contract.*

FF&E Reserve Contribution

The **FF&E reserve contribution** sought by operators in USA is higher than the global average, both in the initial years as well as on a stabilized basis (Figure 39, below). This is likely due to 69% of the regional sample set comprising conversion or rebranded properties that are older than new developments. The first and second year contributions for conversion properties here are **3.67%** and **3.81%**, respectively, in contrast to **2.01%** and **2.67%** for new hotels.

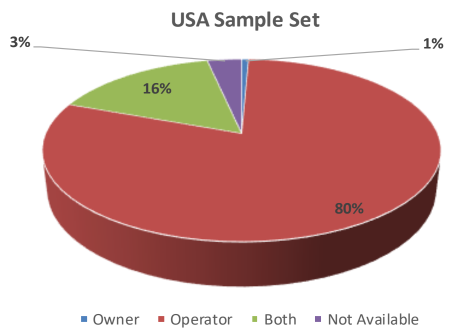
FIGURE 39: FF&E RESERVE CONTRIBUTION



Control of Operating Account

Operators in USA prefer to have complete control of the hotel's **receipt/operating/revenue account** with its designees being the only persons authorized to make withdrawals (Figure 40). While this is in line with the global trend, all of them put forth certain expenditure thresholds beyond which the operator is required to obtain the owner's prior consent.

FIGURE 40: CONTROL OF OPERATING ACCOUNT



Moreover, it is interesting that contracts that do allow the **owner to exclusively control** the operating account, or offer both the owner and the operator **the authority** to withdraw funds, are all but one signed by **second-tier operators**.

Senior Hire Approval

Operators in USA are most agreeable to the owner having approval rights for the appointment of the **General Manager** of the hotel, followed by the **Head of Sales and Marketing**. This deviates from the global trend where approval rights for the hiring of the **Financial Controller** are second-most common.

FIGURE 41: SENIOR HIRE | OWNER'S RIGHTS

Employee	Approval	Consultation	No Rights	NA
General Manager	56%	11%	32%	1%
Financial Controller	17%	5%	77%	1%
Head of Sales and Marketing	25%	6%	68%	1%
F&B Manager	5%	2%	92%	1%
Executive Chef	3%	-	97%	1%
Purchase Manager	2%	-	97%	1%
Human Resource Manager	3%	1%	96%	1%
Expatriates	1%	-	98%	1%
Others	6%	2%	91%	1%

Key Money

Types of operator investment in property *have been elaborated under* ***Section I*** *of this report. At a regional level, we have shared the survey results pertaining to the key money incentive and operator loans.*

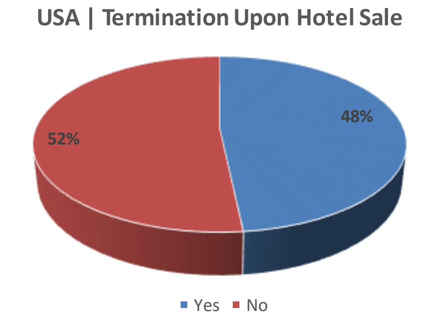
Key money incentive has been offered in just 7% of USA contracts that have been surveyed, ranging between US$0.50 million-US$3.00 million. Another **5% of the contracts offer an operator loan** that is to be repaid over time with interest.

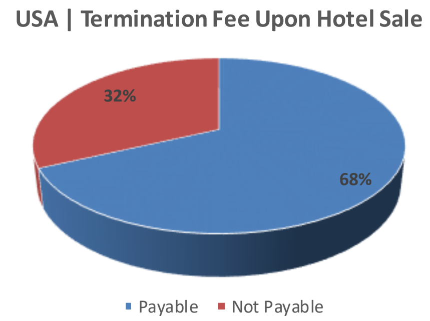
Expectedly, contracts offering key money or operator loans have been signed by **first-tier** hotel operators (branded hotel management companies) for higher-positioned hotels (upscale-luxury), mostly before Year 2005.

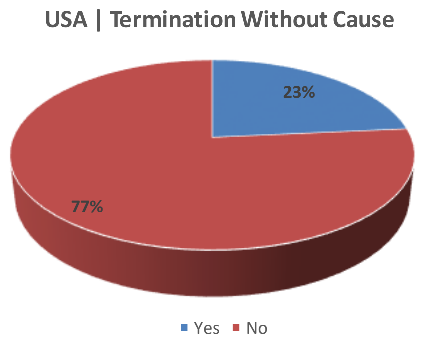
Termination of Agreement

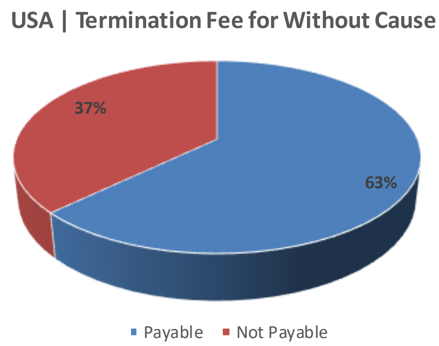
Standard conditions for termination of the hotel management agreement *have been detailed under* ***Section I*** *of this report. Hereunder, we have highlighted the survey results relating to the termination of the management contract upon hotel sale and at will/without cause based on the USA sample set.*

FIGURE 42: TERMINATION OF AGREEMENT









Note: *Remarkably, nearly all USA contracts that permit termination upon hotel sale but do not seek a severance payment are those of second-tier operators. Similar is the case with contracts allowing termination at will of the owner (without cause) – all but one such contract have been signed by second-tier operators.*

This indicates that second-tier operators tend to be more flexible during contract negotiations than first-tier operators.

A higher percentage of contracts in the USA sample set **(48%)** sanction **termination upon sale** of the hotel than the global ratio **(32%).** Conversely, a lower fraction of USA contracts seek a termination fee **(68%)** than the global percentage **(78%).** What's more, **71%** of the contracts having this provision have been signed by **second-tier operators**, and **58%** of such contracts were inked in or after Year 2005.

Rarest of all termination conditions, **at will/without cause** termination of the agreement by the owner, is infrequent in USA, with just **23%** of the surveyed contracts permitting it; however, this is still higher than the global sample set ratio **(17%).** Close to two-thirds of these contracts require the owner to make a severance payment. Furthermore, it is not surprising that **80%** of the contracts with this provision have been signed by **second-tier operators**, and about **70%** became effective in or after Year 2005.

The **termination fee** applicable for the events mentioned above is mostly seen to be a multiple of the average management fees earned by the operator during the preceding 1-3 years of the date of termination. In some cases it has been computed as the net present value of the future management fees payable to the operator from the termination date through a pre-defined anniversary of the effective date. Still others seek absolute monetary amounts as set forth in the contract. The rest have customized calculations of the termination fee.

Importantly, **60%** of the contracts allowing the owner to terminate the agreement upon hotel sale and **77%** of the contracts letting a without cause termination correspond to **conversion/rebranded properties**. This points to the fact that hotel owners generally have a higher bargaining power when negotiating a contract for operating hotels vis-à-vis new developments.

To end, all contracts that have a **performance-based termination provision** in the USA sample set do not seek a termination fee from the owner should a test failure occur and be left uncured.

SECTION II-B | CANADA

Note from Monique Rosszell

In Canada, roughly half of the hotel inventory is currently independent, but most of the new hotels being developed are associated with a brand, so the percentage of the total supply that is branded is growing. Hence, there is a greater need for management contracts. The new option of a soft brand for both established independent hotels and new developments is contributing significantly to the growth in branded supply. A soft brand, which is a kind of hybrid between an independent hotel and a branded hotel, offers the owner greater autonomy and lower franchise fees than the traditional brands, with similar access to an international reservation system.

Hotel management contracts in Canada arise out of two distinct circumstances. For full-service and luxury properties, international brands provide management services and forgo the royalty portion of their franchise fees in favor of a base management fee and incentive management fee. Recently, brands have also begun offering management services in the select-service and mid scale hotel tier because there is a dearth of third-party hotel management companies in Canada. The second situation is third-party management companies that offer their services for a pre-determined time period (some even month-to-month) in exchange for a base management fee and incentive fees. Currently, there are only a handful of third-party management companies in Canada, many with their roots in the United States. Given the rise in new select-service hotel development that is taking place, often involving first time developers, successful hotel owners in Canada are offering their local expertise and management services to third-party owners in an effort to fill this void.

Owners are becoming better educated and are hiring hotel consultants such as HVS as a way to gain greater power in the management contract negotiation process and to ensure that they are receiving customized, fair, and equitable hotel management terms based on the merits of the specific development. Many new developers of select-service hotels are demanding a management contract with a shorter term and an integrated management training component so that they may eventually take over the reins themselves.

Given that the greatest growth in hotel development in Canada is in the select-service tier without involving the complexity of full-service assets, it has enabled more and more inexperienced and first-time developers to enter the industry. For this reason, the need for education on the highly complex terms of management contracts and assistance in the negotiation process is greater than ever.

Monique Rosszell**, AACI, MRICS, ISHC, **Managing Director, HVS Toronto
mrosszell@hvs.com

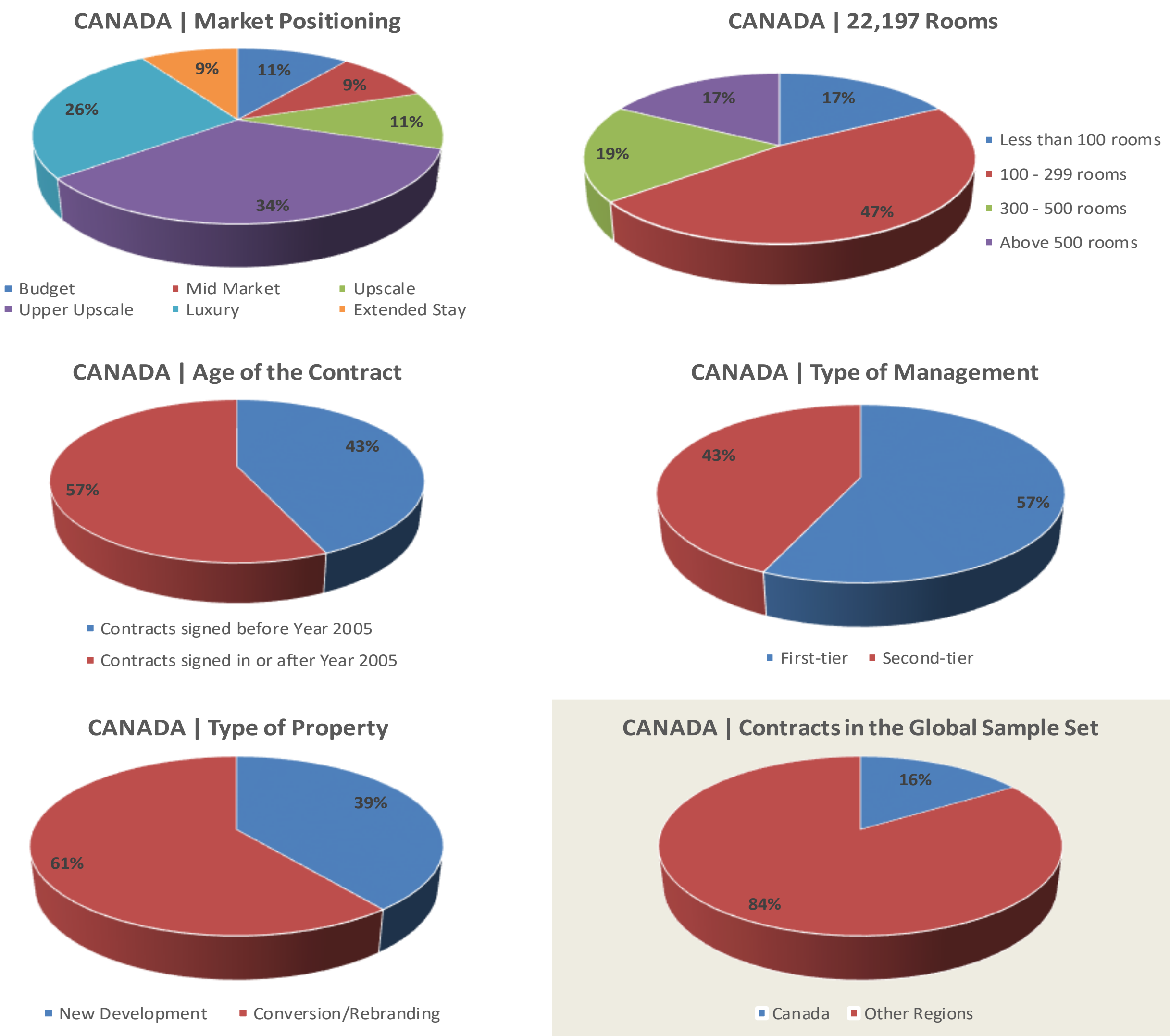
CANADA SAMPLE SET PROFILE

The Canada sample set has a greater representation from:

- Contracts for hotels with an upscale-luxury positioning **(71%)**
- Contracts for hotels having less than 300 rooms **(64%)**, with the **average rooms per hotel being 292**
- Hotels that underwent a rebranding/conversion **(61%)**
- Properties managed by first-tier/branded operators **(57%)**
- Contracts that were signed in or after Year 2005 **(57%)**

Figure 43 presents the Canada sample set profile by the major independent variables considered in this survey.

FIGURE 43: CANADA SAMPLE SET PROFILE



CANADA SAMPLE SET SURVEY RESULTS

Survey results pertaining to the main terms and provisions of hotel management contracts for the Canada sample set have been presented in this sub-section.

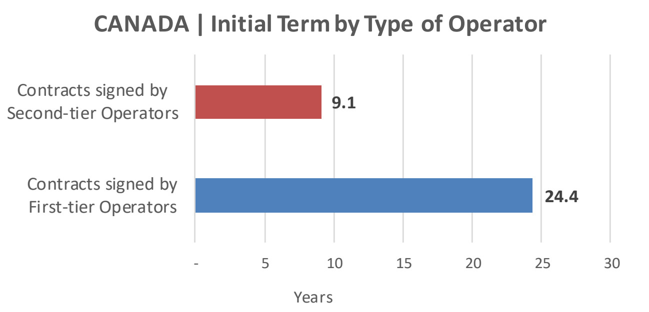
For **definitions and a deeper explanation of the terms and clauses** discussed herein, we urge readers to refer to **Section I** of this report that presents the global sample set results.

Management Contract Term

Like USA, the Canadian sample set is represented by a sizeable number of contracts having an initial term of 10 years or less. However, the average length of the initial term for this region is **17.8 years**, notably higher than USA's 15 years; this is because **32%** of the surveyed contracts from Canada have an initial term of **25 years or more that are all signed by first-tier/branded hotel operators** primarily for upscale-luxury hotels.

Second-tier operators are common in Canada, with **43%** of the regional sample set being represented by them. As pointed out earlier, such operators are more flexible when negotiating the commercial terms of a management contract, resulting in the length of the initial term being significantly shorter than that negotiated by first-tier operators. Figure 44 presents the results for Canada, highlighting this tendency.

FIGURE 44: LENGTH OF THE INITIAL TERM BY TYPE OF OPERATOR

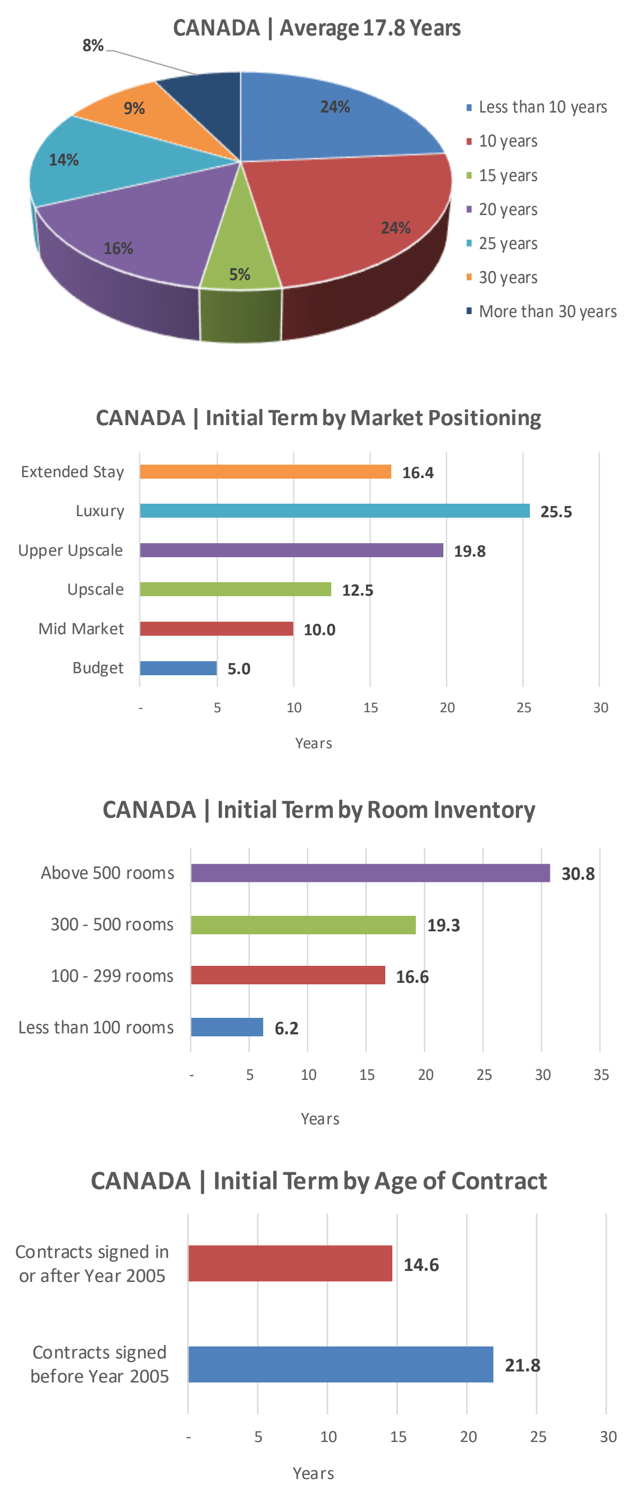


The average length of the **renewal term** for the surveyed Canadian contracts is **8.1 years**. Figure 46, overleaf, depicts the regional sample set trends pertaining to the renewal term.

Area of Protection

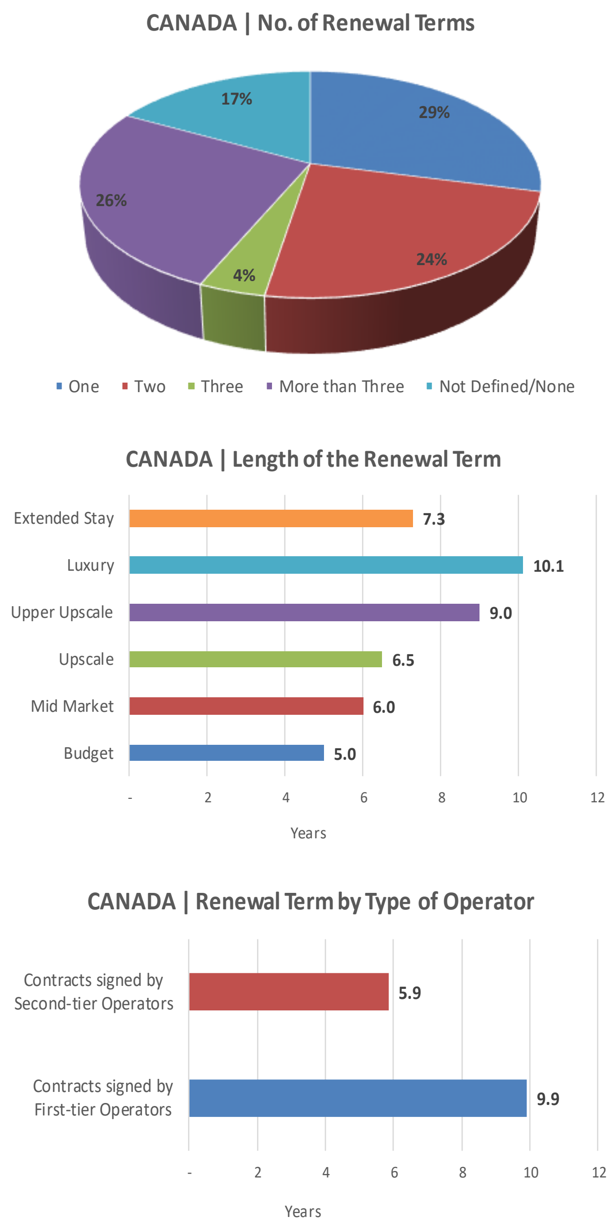
A little over half of the Canadian contracts do not offer territorial restrictions or an area of protection (AOP) as has been highlighted in Figure 47, on the next page. Almost **70% of the contracts that do not offer this provision have been signed by second-tier operators**, who without a recognizable brand name identity, have much less of an effect on their existing properties when they take over additional hotels in the same market area. In contrast, **91% of the contracts that offer an AOP have been signed by first-tier operators** whose corporate name has a public identity, and placing too many hotels with the same branding in the market area can dilute potential room night demand for existing properties.

FIGURE 45: LENGTH OF THE INITIAL TERM



Note: *The length of the initial term in Canadian contracts can be seen increasing with a rise in the market positioning as well as room inventory. Furthermore, contracts that were signed before Year 2005 are for an especially longer duration than those that were signed in or after Year 2005 in the country. Perhaps, the fact that close to half of the more recent contracts have been signed by second-tier operators, with an average length of the initial term being 8.4 years, has contributed to this result.*

FIGURE 46: RENEWAL TERM

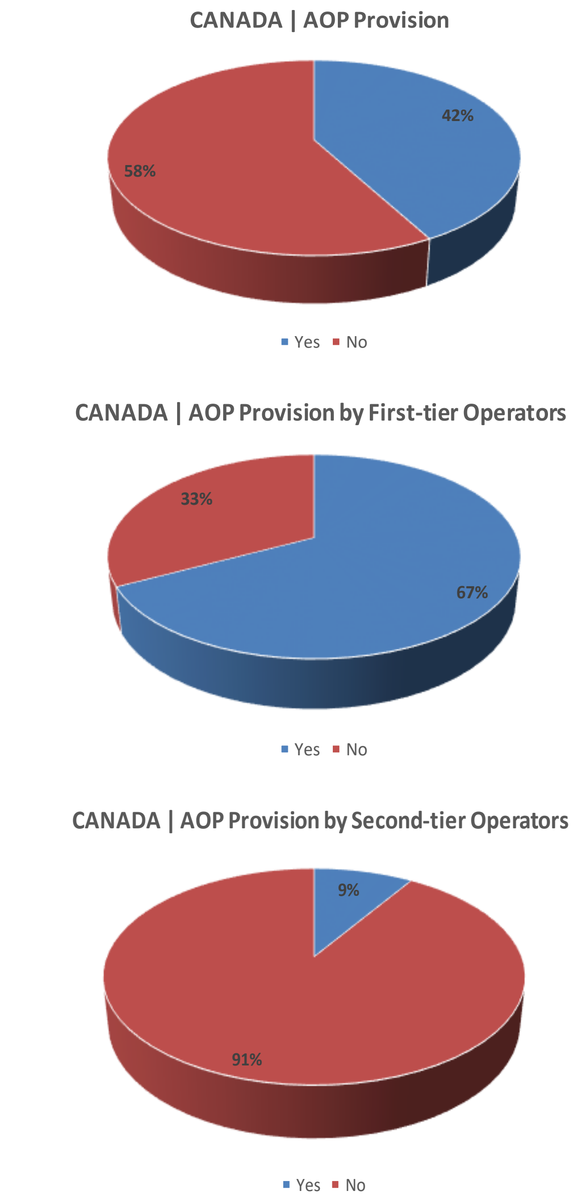


Note: *As can be seen, 53% of all Canadian contracts can be extended once or twice. More than three renewals have been offered largely for upscale-luxury hotels, with the average length of the renewal term for such contracts being around 11 years.*

Furthermore, the average duration of the renewal term of contracts for conversion/rebranded properties is 8.7 years, whereas that for new developments is 7.4 years. Also, surveyed contracts that were signed prior to Year 2005 in Canada have a renewal term averaging 9.6 years vis-à-vis newer contracts that average 7.1 years.

Evidently, like the initial term, the renewal term too is much shorter for contracts signed by second-tier operators in Canada in comparison to first-tier operators whose contracts have an average renewal term of nearly 10 years.

FIGURE 47: AREA OF PROTECTION PROVISION



Operator Fees

Among the various operator fees applicable, only the ***base and incentive management fees have been discussed in this sub-section****, as the others such as those for technical services and centralized services generally have a standard charging mechanism in place worldwide (see* ***Section I****), with regional variations (if at all) being driven by the number of hotels existing and/or in the pipeline of the management company.*

The **average base management fee** charged by the contracts surveyed in Canada is **3.35%** – nearly as high as USA. This may be due to **18% of the contracts charging a base management fee of 4.00% or higher**; in most of these cases, there is no incentive management fee that is charged separately.

Moreover, **second-tier operators in the Canadian sample set can be seen charging a base management fee that is slightly higher than that charged by first-tier operators.** In fact, the global trend is similar, with the franchised assets operated by second-tier management companies being charged **3.33%** of the hotel's Gross Operating Revenue on an average, while those managed by branded operators being charged **2.63%** on an average. This phenomenon can be attributed to the base management fee being inclusive of the charges for certain centralized services in many of the contracts signed by second-tier operators. Figure 48, alongside, illustrates the base management fee charged by operators in the Canada sample set.

In terms of operators offering an **owner's priority** return, a little over half **(54%)** of the surveyed Canadian contracts have this provision. As a result, the **incentive management fee** structure is dominated by the fee being linked to the available cash flow of the hotel, subordinated to the owner's priority return (Figure 49, below). Here, it is important to note that not "all" contracts with this type of incentive fee structure necessarily have an owner's priority provision and vice-versa; about **22%** of the contracts that have the incentive fee linked to the available cash flow of the hotel do not offer an owner's priority return in Canada.

In addition, the incentive fee is seen ranging between **7.5%-30% of the available cash flow** of the hotel in the relevant contracts, with the majority charging between **10%-20%.** Like in USA, the lower end of the range is represented by contracts signed by second-tier operators, while the higher end corresponds to those signed by first-tier operators.

"Others" in Figure 49, below, relates to customized incentive fee structures that are uncommon such as 20% of the Actual Net Operating Income (NOI) less the Budgeted NOI.

FIGURE 49: TYPES OF INCENTIVE MANAGEMENT FEE STRUCTURE

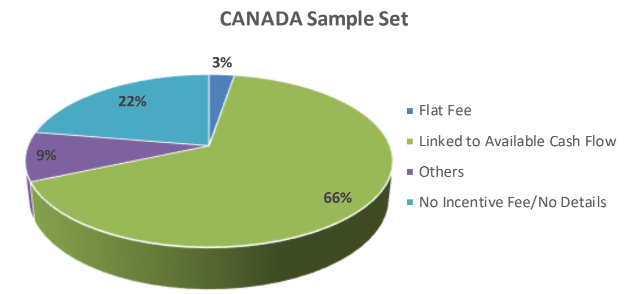
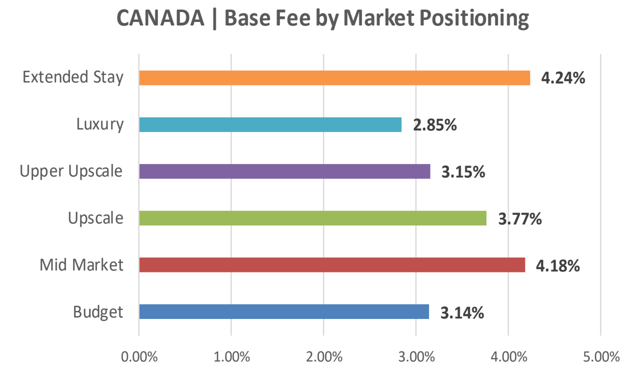
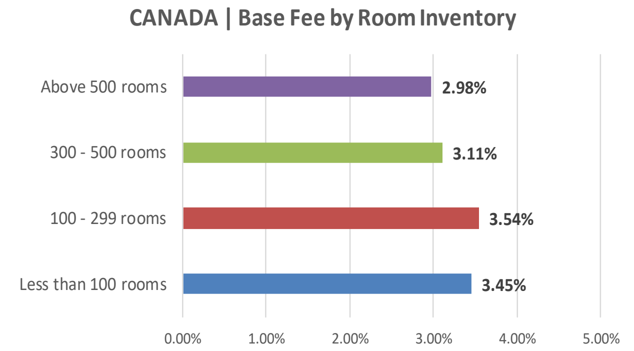
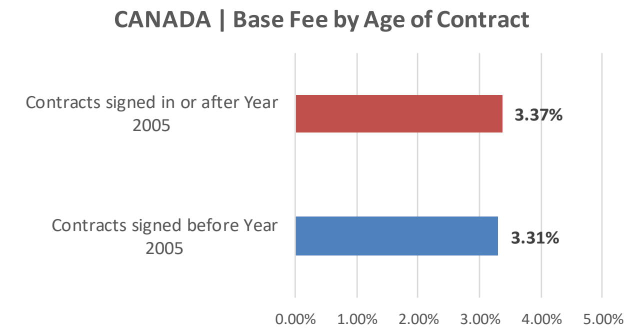
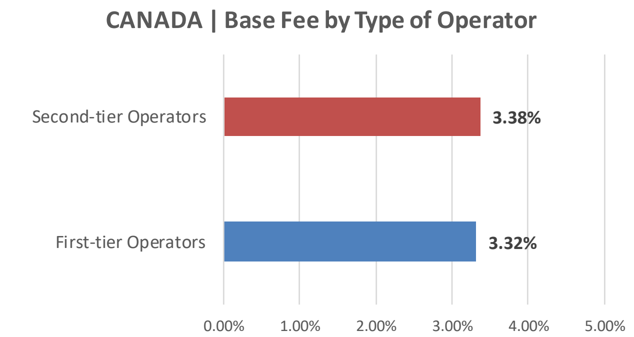


FIGURE 48: BASE MANAGEMENT FEE









Note: *While the base fee can be seen mostly decreasing with an increase in the market positioning and the number of rooms, exceptions in the case of upscale and mid market hotels in the sample set can be linked to a large number of the corresponding contracts being signed by second-tier operators. Furthermore, 67% of the contracts signed in or after Year 2005 relate to upscale-luxury hotels, resulting in a higher base fee average than for contracts signed before Year 2005.*

Operator Performance Test

Close to **60% of the Canada sample set** permits a performance-based termination of the hotel management contract by the owner. A large number of these have been signed by branded/first-tier operators for upscale-luxury positioned hotel assets.

Moreover, as can be seen in Figure 50, alongside, a **collective test** requiring the operator to fail both the budget/profit-oriented test "and" the RevPAR test appears to be the most common structure in Canada. The **separate test** structure is highly unusual with just **2%** of the sample set offering it. Also, close to half of the surveyed contracts with a budget test (48%) require the operator to attain a hotel GOP/AGOP/NOI higher than **85% of the budgeted GOP/AGOP/NOI**, and 89% that have a RevPAR test require the operator to record a hotel RevPAR **that exceeds 85% of the weighted average RevPAR** of the defined competitive set during the test period. Interestingly, 25% of the contracts have a performance threshold upward of 95% for the RevPAR test – the highest ratio among all the regions surveyed in this edition.

The test period is generally **two consecutive years**, although a sizeable number of contracts, especially for conversion properties, have it as every single year from the commencement year. Some also have it as two out of every three consecutive years, or even four out of every six consecutive years – making it a little more robust and in favor of the owner.

In addition, the majority of Canadian contracts **(66%)** having a performance test allow the operator to cure the failure upon receipt of the termination notice from the owner. Figure 51 shows the **number of cures** permitted by them, and notably **55%** of these allow the operator the option to cure the failure **twice or more** during the initial term of the contract. To be impartial, a lot of these contracts have high performance thresholds, mostly higher than 90%.

FIGURE 51: PROVISION FOR OPERATOR TO CURE

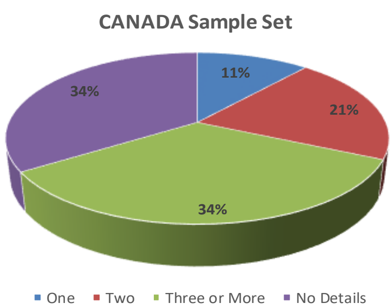
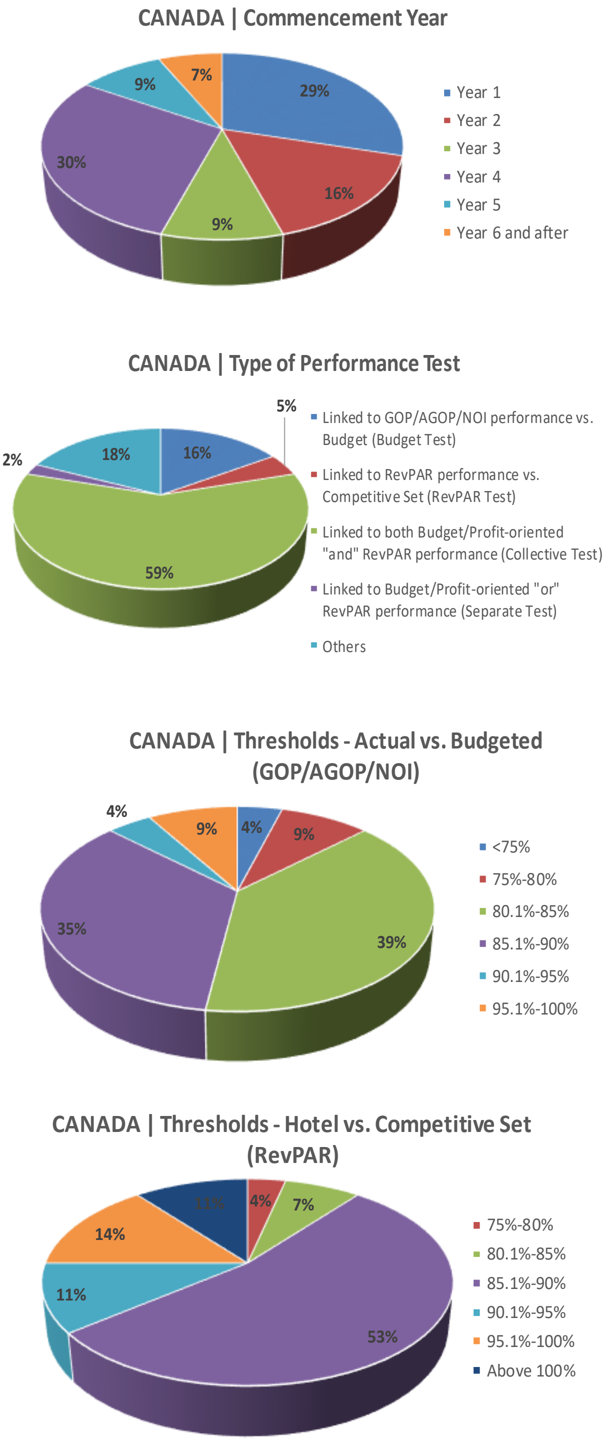


FIGURE 50: OPERATOR PERFORMANCE TEST



Note: *Evidently, 84% of the Canadian contracts with a performance test have the commencement year in or before the fourth year of operations of the hotel. Among these, about 30% have it as Year 1 of operations, which is understandable considering 77% of such contracts are for conversion/rebranded properties.*

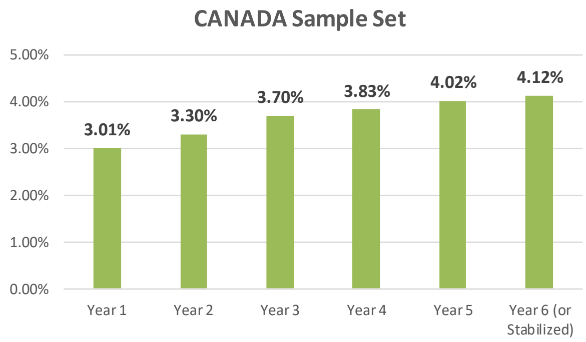
"Others" under the type of performance test refers to customized structures such as linking the NOI performance to a historical benchmark or linking the GOP to a fixed monetary amount, among others.

*We have not delved into the **annual plan** approval process and the nature of **expenditure thresholds** specified in contracts on a regional basis. We urge the reader to refer to Section I of this report that discusses the global sample set results for an overview of these provisions of a management contract.*

FF&E Reserve Contribution

The **FF&E reserve contribution** sought by operators in Canada averages at 4.12% of Gross Operating Revenue of the hotel on a stabilized basis (Figure 52). It may be noted that 61% of the regional sample set comprises contracts for hotels that have undergone rebranding/conversion. The first and second year average contributions for conversion properties here is **3.08%** and **3.34%**, respectively, in contrast to **2.88%** and **3.24%** for new hotels.

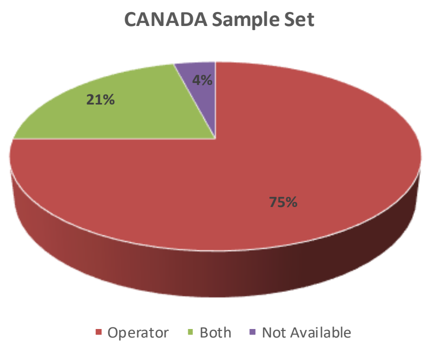
FIGURE 52: FF&E RESERVE CONTRIBUTION



Control of Operating Account

Most operators in the Canada have complete control of the hotel's **receipt/operating/revenue account**, with its designees being the only persons authorized to make withdrawals (Figure 53). While this is in line with the global trend, all of them mention certain expenditure thresholds beyond which the operator is required to obtain the owner's prior consent.

FIGURE 53: CONTROL OF OPERATING ACCOUNT



Senior Hire Approval

Operators in Canada are most agreeable to the owner having approval rights for the appointment of the **General Manager** of the hotel, followed by the **Head of Sales and Marketing** and then, the **Financial Controller**. Interestingly, several Canadian contracts, mainly for budget hotels, specify that hiring any employee for an annual basic salary in the excess of a pre-defined amount (C$60,000-C$75,000) will need the owner's prior consent.

FIGURE 54: SENIOR HIRE | OWNER'S RIGHTS

Employee	Approval	Consultation	No Rights	NA
General Manager	58%	-	42%	-
Financial Controller	28%	-	72%	-
Head of Sales and Marketing	32%	-	68%	-
Head of F&B	5%	-	95%	-
Executive Chef	1%	-	99%	-
Head of Purchase	1%	-	99%	-
Head of Human Resources	1%	-	99%	-
Expatriates	-	-	100%	-
Others	20%	-	-	80%

Key Money

__Types of operator investment in property__ have been elaborated under Section I of this report. At a regional level, we have shared the survey results pertaining to the key money incentive and operator loans.

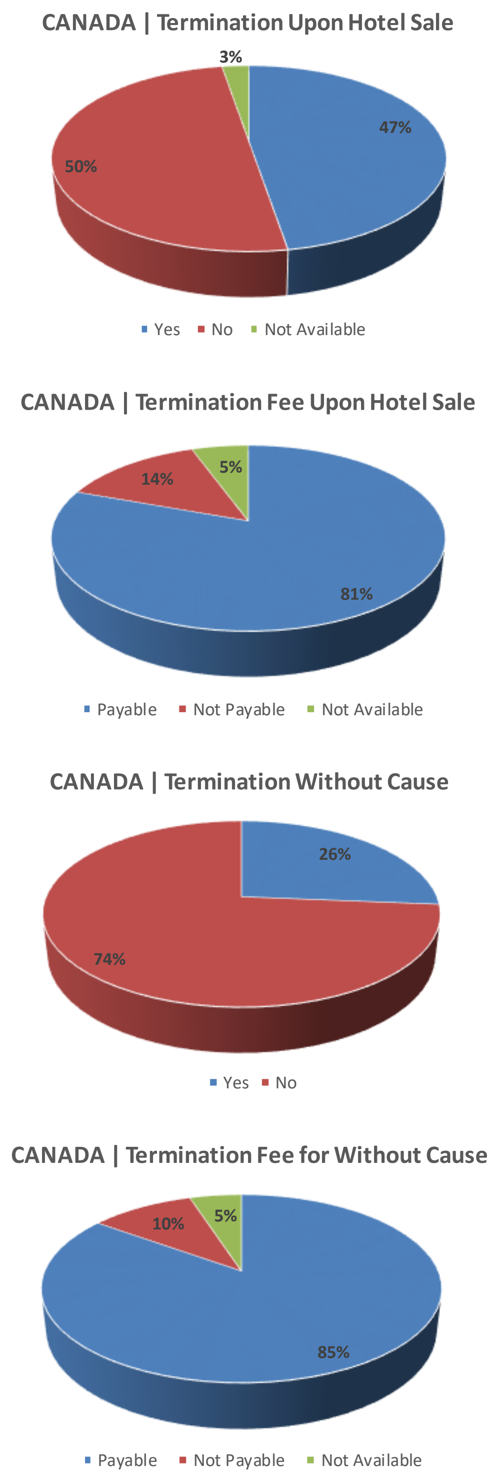
Key money incentive has been offered in just 12% of the Canadian contracts that have been surveyed, ranging between C$0.25 million-C$3.25 million. We did not find any contracts in the regional sample set offering an operator loan.

Not surprisingly, contracts offering key money have been mostly signed by **first-tier** hotel operators (branded hotel management companies) for higher-positioned hotels (upscale-luxury). Nonetheless, it may be noted that the majority of these contracts are for conversion/rebranded assets, and signed equally before and in/after Year 2005.

Termination of Agreement

__Standard conditions for termination of the hotel management agreement__ have been detailed under Section I of this report. Hereunder, we have highlighted the survey results relating to the termination of the management contract upon hotel sale and at will/without cause based on the Canada sample set.

FIGURE 55: TERMINATION OF AGREEMENT



***Note:** Notably, 61% of the contracts that permit termination upon hotel sale and 80% of the contracts that allow termination without cause by the owner in the Canada sample set have been signed by second-tier operators.*

Furthermore, the ones that don't seek a termination fee for these two events are also inked by second-tier operators, which is in line with our findings relating to the USA sample set as well.

A higher percentage of contracts in the Canada sample set **(47%)** sanction **termination upon sale** of the hotel than the global ratio **(32%)**; however, a higher fraction of these seek a termination fee **(81%)** than what is found globally **(78%)**. Moreover, **58%** of such contracts were inked in or after Year 2005 and are chiefly for **conversion or rebranded** properties.

Conversely, **at will/without cause** termination of the agreement by the owner is uncommon in Canada, with just **26%** of the surveyed contracts permitting it; yet, this is still higher than the global sample set ratio **(17%)**. Of these Canadian contracts, **85%** require the owner to make a severance payment. Also, **80%** of them became effective in or after Year 2005, indicating the increased competitiveness in the marketplace resulting in higher bargaining power of the owner.

The **termination fee** applicable for the events mentioned above is mostly seen to be a multiple of the average management fees earned by the operator during the preceding 1-3 years of the date of termination. Others seek absolute monetary amounts as set forth in the contract. In some cases the termination fee has been sought only if the event occurs within the first few years of signing the agreement.

It is worthwhile to mention here that there are some Canadian contracts that do not permit a termination upon hotel sale, but still seek a **"transfer fee"** when the new owner assumes the responsibilities and obligations of the contract from the previous owner.

Lastly, all contracts that have a **performance-based termination provision** in the Canada sample set do not seek a termination fee from the owner should a test failure occur and be left uncured.

SECTION II-C | SOUTH AMERICA

Note from Richard Katzman

During the last decade, the hotel industry in South America showed significant changes, with numerous openings of quality properties, new players entering the market and the consolidation and entry of both national and international chains. The expansion of the various hotel agreements allowed passive and/or financial owners – including real estate investment trusts (REITs), private equity funds, sovereign wealth funds, life insurance companies, pension funds and private wealth clients – to participate in the hotel business.

This process of supply expansion and sophistication boosted the professionalization of the industry, allowing hotel contracts to evolve and become increasingly aligned to the profile of the properties and the markets of the region. More benchmarks became available to refer to, in terms of how the hotel chains structure their contracts in South America, allowing owners to demand provisions that were previously seldom offered by operators.

The international hotel chains entered the region initially in primary markets and through management agreements for luxury, upper upscale and upscale brands. However, in the last few years, franchise agreements have been gaining ground. This trend, that is expected to be accentuated in the future, may be explained by the following developments: increasing emphasis by the major chains on franchising for their expansion (mainly for mid market and economy products and for secondary and tertiary cities, with great potential for development in South America); the consolidation of quality second-tier/third-party operators; and the conversion of independent hotels into franchised branded properties, with the aim of improving their market positioning and performance.

The following pages present the survey results pertaining to the main terms and provisions of hotel management contracts for South America. These results are highly representative of the average terms commonly negotiated in the region. However, it is important to highlight that each negotiation is unique, involving an interplay of numerous factors that could result in a departure from standard practices or the terms mentioned in this report. The hotel chains may offer preferred terms to demonstrate their enthusiasm to be considered as candidates for the management of the properties. Depending on the project, city or owner profile, a chain can make many concessions.

Richard Katzman, Managing Director, HVS Latin America
rkatzman@hvs.com

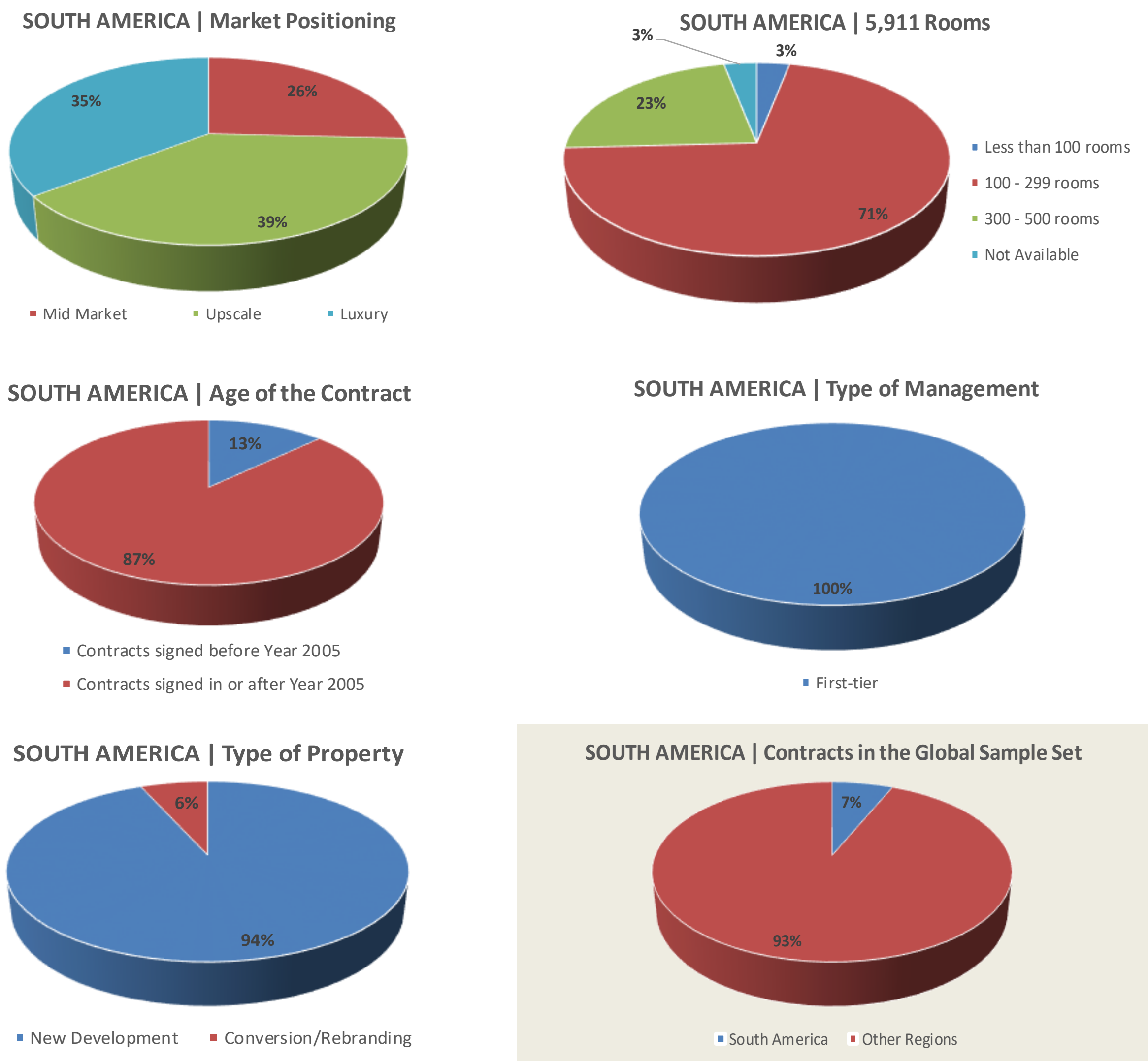
SOUTH AMERICA SAMPLE SET PROFILE

The South America sample set has a greater representation from:

- Contracts for hotels with an upscale-luxury positioning **(74%)**
- Contracts for hotels having less than 300 rooms **(74%)**, with the **average rooms per hotel being 191**
- Hotels that are new developments **(94%)**
- Properties managed by first-tier/branded operators **(100%)**
- Contracts that were signed in or after Year 2005 **(87%)**

Figure 56 shows the South America sample set profile by the major independent variables considered in this survey.

FIGURE 56: SOUTH AMERICA SAMPLE SET PROFILE



SOUTH AMERICA SAMPLE SET SURVEY RESULTS

Survey results pertaining to the main terms and provisions of hotel management contracts for the South America sample set have been presented in this sub-section.

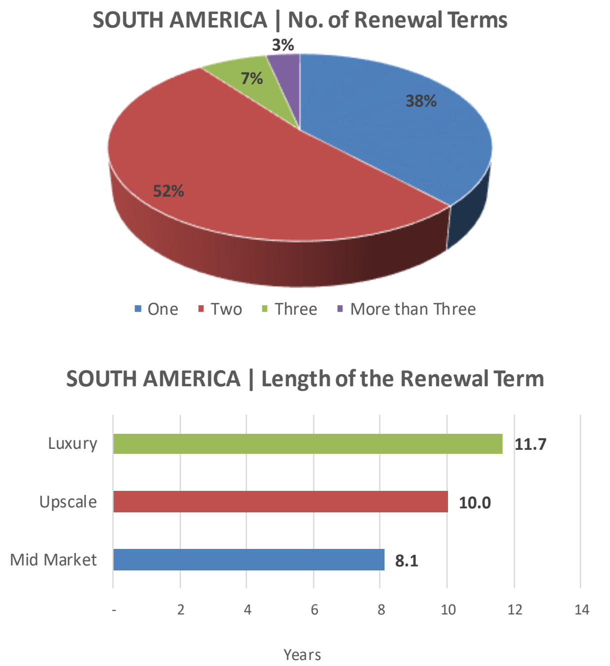
For **definitions and a deeper explanation of the terms and clauses** discussed herein, we urge readers to refer to **Section I** of this report that presents the global sample set results.

Management Contract Term

The South American sample set has the longest length of the **initial term** among all the regions surveyed in this edition, averaging **21.5 years**. Significantly, **74%** of the contracts have a 20-year term, with another **19%** having a duration of 25 years or more (Figure 57, alongside). One must note that there are no budget hotels in the region's sample set, which may have contributed to the average term being as long. Furthermore, the sample set is completely represented by **first-tier/branded hotel management companies**, who tend to negotiate a longer initial term than second-tier/third-party operators. And not to forget that **94%** of the sample set comprises contracts for new hotel developments that typically have a longer initial term than conversion properties, globally.

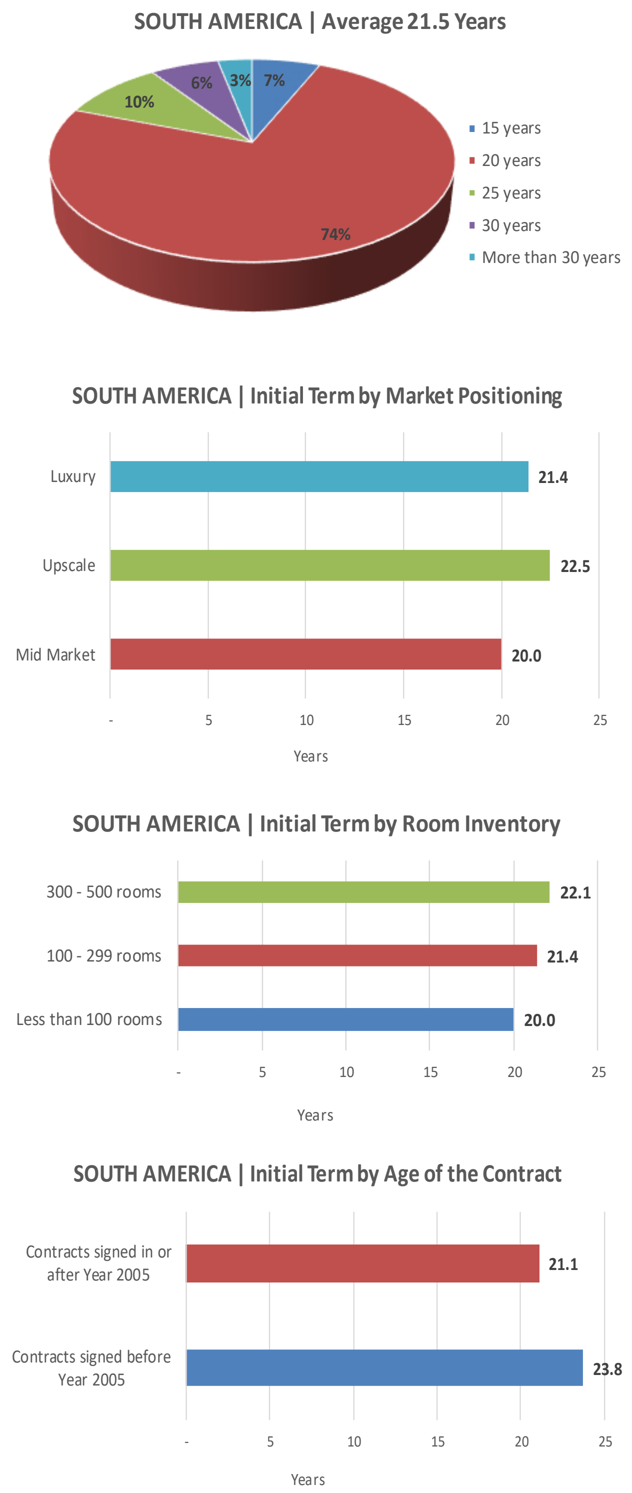
The average length of the **renewal term** for the surveyed South American contracts is **10 years**. Figure 58, below, highlights the regional sample set trends pertaining to the renewal term.

FIGURE 58: RENEWAL TERM



Evidently, **one or two renewal terms** are more common here, with the majority of agreements being extended automatically after the expiry of the initial term or at the election of the operator. Nonetheless, from our discussions with brand representatives we gather that renewal on mutual consent of the owner and the operator is on the rise as is a shorter length of the initial term.

FIGURE 57: LENGTH OF THE INITIAL TERM

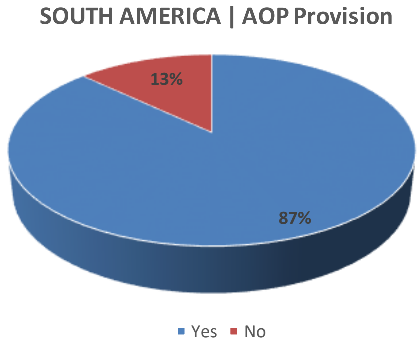


Note: *Unlike North America (USA and Canada), there is not much of a difference in the length of the initial term of contracts across the various market positioning in South America. This may have to do with the latter being a developing hotel market, with operators having more opportunities and thereby a higher bargaining power than owners. Notwithstanding, in line with the global trend, the initial term can be seen reducing in length in recent contracts signed in South America as the market slowly evolves.*

Area of Protection

A large number of South American contracts offer territorial restrictions or an area of protection (AOP) as has been highlighted in Figure 59, below. Notably, all of these **have been signed by first-tier operators** whose corporate name has a public identity, and placing too many hotels with the same branding in the market area can dilute potential room night demand for existing properties. Furthermore, based on additional research we gather that the AOP in this region is usually for a long duration, even lasting the entire length of the initial term. Though the provision is market driven, the typical radius is 3-5 kilometers, up to 10 kilometers, with resort properties being offered a larger restricted area.

FIGURE 59: AREA OF PROTECTION PROVISION

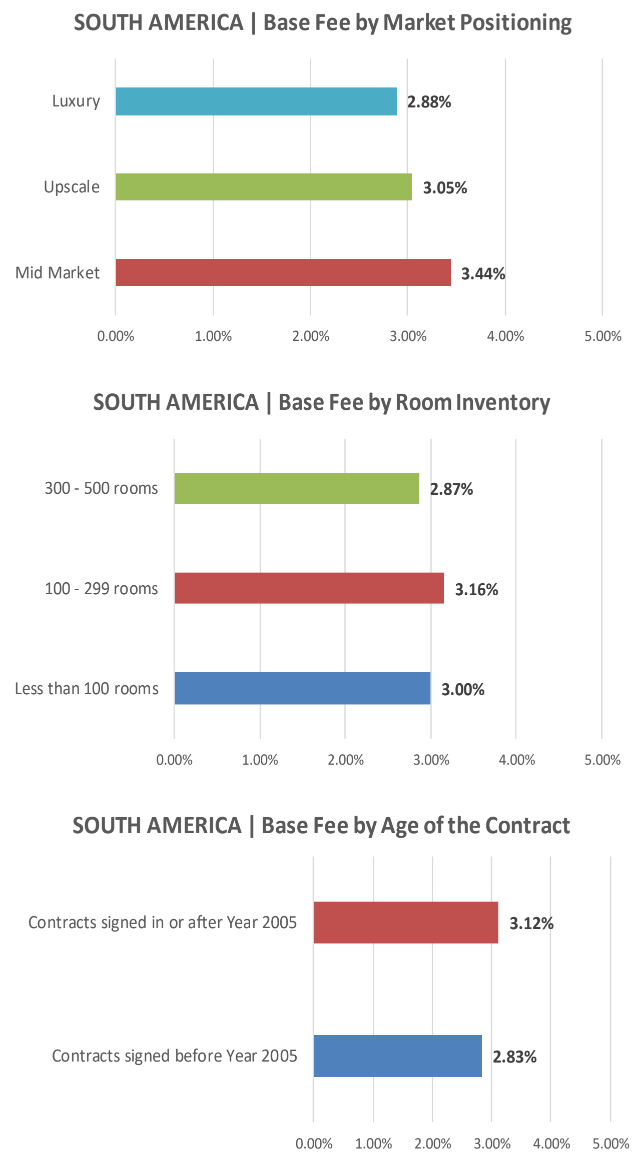


Operator Fees

Among the various operator fees applicable, only the ***base and incentive management fees have been discussed in this sub-section****, as the others such as those for technical services and centralized services generally have a standard charging mechanism in place worldwide (see* ***Section I****), with regional variations (if at all) being driven by the number of hotels existing and/or in the pipeline of the management company.*

The **average base management fee** charged by the contracts surveyed in South America is **3.09%**, higher than the global average of **2.81%**, with **77% of the sample set charging 3.00% or higher**. Interestingly, unlike North America, where the higher base fee is mostly owing to being bundled along with the charges for centralized services, or it is balanced with either no incentive fee being charged or the latter being linked to the available cash flow of the hotel, in South America, no such trend can be found. In fact, here the incentive fee is perhaps the highest of all regions surveyed as has been elaborated on the next page.

FIGURE 60: BASE MANAGEMENT FEE



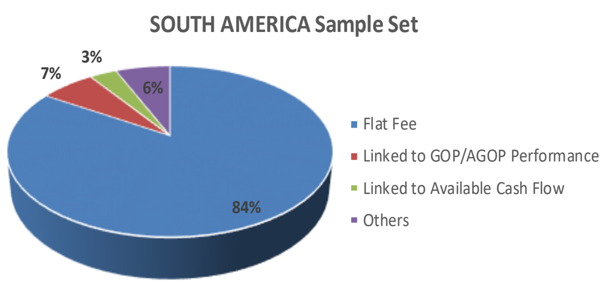
Note: *The base management fee in the South American contracts can be seen decreasing with an increase in market positioning, similar to the global sample set results. Also, hotels with 300 rooms or more are charged a lower base management fee in percentage terms than smaller hotels with less than 100 rooms.*

But, different from the global trend, this fee is higher in more recent contracts signed in or after Year 2005 than those signed prior. This may have to do with the fact that most of the recent contracts signed in the region offer key money incentive. As has been discussed in Section I of this report, when operators make such investments in a property, they commonly seek a higher fee and a longer term. Understandably, the owner loses some control over the negotiations in these circumstances.

Furthermore, like other regions, the base management fee charged by South American contracts is often tiered, ramping up before stabilizing by Year 4 or 5.

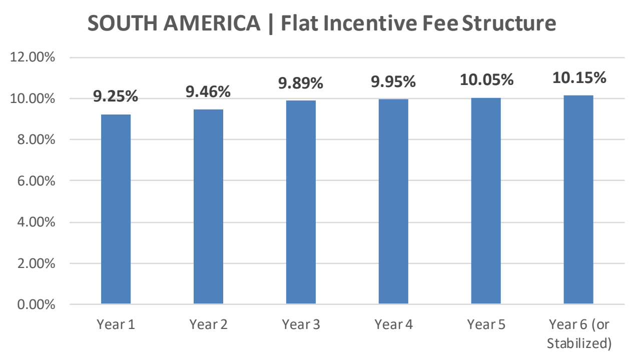
In terms of operators offering an **owner's priority** return, just **26%** of the surveyed South American contracts have this provision. Consequently, the **incentive management fee** is hardly ever linked to the available cash flow of the hotel being subordinated to the owner's priority return (Figure 61). Instead, **84% of the contracts offer a flat fee structure**, with the stabilized fee levels being as high as **10.15% of the GOP/AGOP** on an average, leading all regions covered in this survey. The few that have a linked fee structure based on the GOP/AGOP margin performance of the hotel, seek a stabilized incentive management fee of **11.00%** of the operating profit on an average. Figure 62, below, presents these.

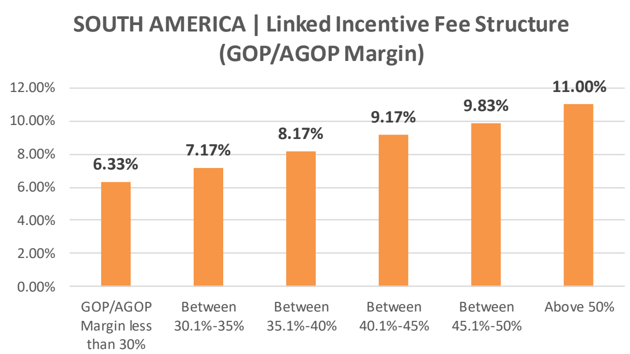
FIGURE 61: TYPES OF INCENTIVE MANAGEMENT FEE STRUCTURE



"Others" in the chart above represents customized calculations of the incentive management fee such as a combination of flat and linked fee structures.

FIGURE 62: INCENTIVE FEE RANGE





Operator Performance Test

The majority of South American contracts **(81%)** include a performance-based termination clause that permits the owner to terminate the agreement should the operator fail the test(s) and leave it uncured. A large number of these correspond to **upscale-luxury** positioned hotel assets.

In addition, like North America (USA and Canada), a **collective test** requiring the operator to fail both the budget/profit-oriented test "and" the RevPAR test is frequently found in South American contracts **(64%).** Also, the **separate test** structure is quite uncommon here as well with just **4%** of the sample set offering it.

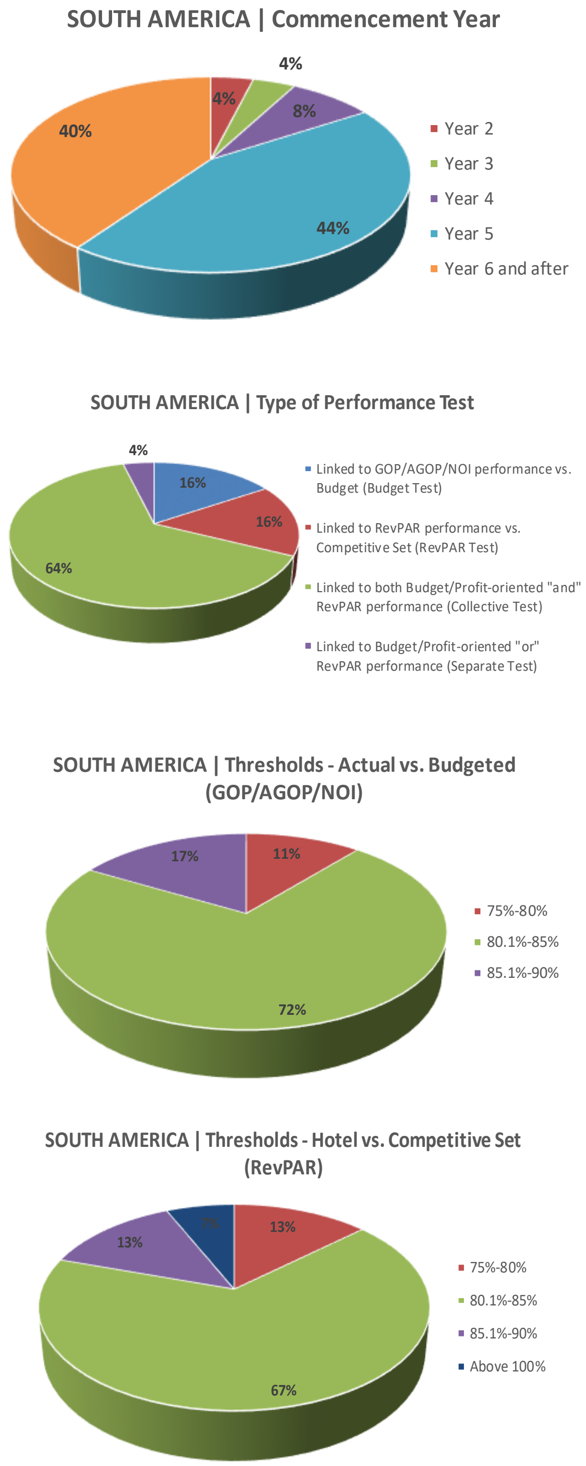
Now, in a striking contrast to contracts from North America, only **17%** of the surveyed contracts that have a budget test here require the operator to attain higher than **85% of the budgeted GOP/AGOP/NOI**, and just **20%** with a RevPAR test require the operator to record a hotel RevPAR **that exceeds 85% of the weighted average RevPAR** of the defined competitive set during the test period; these ratios are much lower than USA and Canada. In fact, most of the contracts have a performance threshold of 85% for both the budget and RevPAR tests in South America. Figure 63, overleaf, presents these results.

The test period is generally **two consecutive years**, although three consecutive years, and two out of every three consecutive years can also be found.

In addition, the majority of South American contracts **(96%)** having a performance test allow the operator to cure the failure upon receipt of the termination notice from the owner. Figure 64, on the following page, shows the **number of cures** permitted by them, and notably **84%** of these allow the operator the option to cure the failure **thrice or more** during the initial term of the contract – much higher than those offered by contracts in USA and Canada.

Figures 63 and 64, on the next page, illustrate the survey results for this regional sample set, offering evidence for our argument that operators have a definite upper hand in the negotiations of management agreements in South America. **Late commencement** of the performance test(s), **low performance thresholds** and an apparently **high number of cures** allowed to the operator, make the termination of the agreement under this provision more unlikely than it already is.

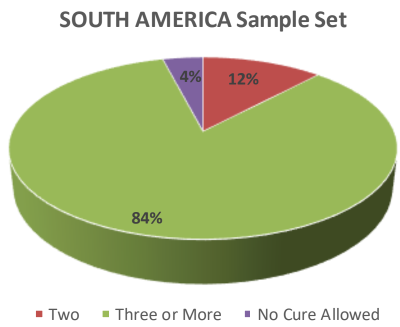
FIGURE 63: OPERATOR PERFORMANCE TEST



Note: *Remarkably, only 16% of the contracts with an operator performance test provision have the test beginning in or before the fourth year – a larger number of contracts have the commencement year as Year 5 or 6. This is in complete contrast to the results from USA and Canada, where the test is applicable much earlier, including in the first year of operations.*

Also, notably, there are no customized test structures in the surveyed South American contracts.

FIGURE 64: PROVISION FOR OPERATOR TO CURE

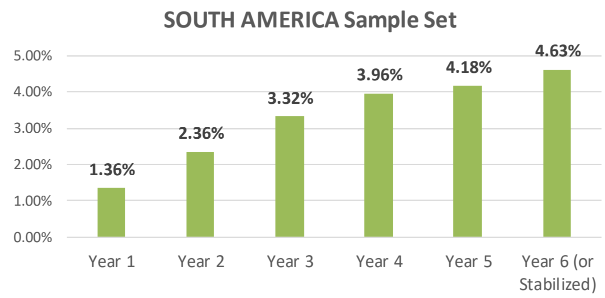


*We have not delved into the **annual plan** approval process and the nature of **expenditure thresholds** specified in contracts on a regional basis. We urge the reader to refer to **Section I** of this report that discusses the global sample set results for an overview of these provisions of a management contract.*

FF&E Reserve Contribution

The **FF&E reserve contribution** sought by operators in South America averages at **4.63%** of the Gross Operating Revenue of the hotel on a stabilized basis – the highest among all regions surveyed in this edition (Figure 65, below). Although, **94%** of the sample set corresponds to new hotel developments that typically have a lower FF&E reserve contribution than conversion properties, the high representation of upscale-luxury properties (**74%** of the regional sample set) may have influenced the average.

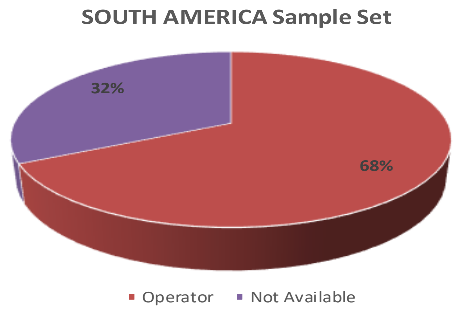
FIGURE 65: FF&E RESERVE CONTRIBUTION



Control of Operating Account

In line with the global trend, operators in South America like to have complete control of the hotel's **receipt/operating/revenue account**, with its designees being the only persons authorized to make withdrawals (Figure 66, overleaf). However, all of them mention certain expenditure thresholds beyond which the operator is required to obtain the owner's prior consent.

FIGURE 66: CONTROL OF OPERATING ACCOUNT



Senior Hire Approval

Operators in South America are most accepting of the owner having approval rights for the appointment of the **General Manager** of the hotel, followed by the **Financial Controller** and then, the **Head of Sales and Marketing** (Figure 67, below). The owner is not offered any approval or consulation rights for any other senior management position.

FIGURE 67: SENIOR HIRE | OWNER'S RIGHTS

Employee	Approval	Consultation	No Rights	NA
General Manager	71%	3%	13%	13%
Financial Controller	58%	3%	26%	13%
Head of Sales and Marketing	16%	3%	68%	13%
Head of F&B	-	-	87%	13%
Executive Chef	-	-	87%	13%
Head of Purchase	-	-	87%	13%
Head of Human Resources	-	-	87%	13%
Expatriates	-	-	87%	13%
Others	-	-	87%	13%

Key Money

***Types of operator investment in property** have been elaborated under **Section I** of this report. At a regional level, we have shared the survey results pertaining to the key money incentive and operator loans.*

Exceptionally, **key money incentive has been offered in over half of the surveyed contracts from the region (52%)**, ranging from US$0.60 million-US$7.50 million. This is the highest ratio recorded of all the regions surveyed. As mentioned previously, the acceptance of key money by the owner has a considerable impact in the negotiation of the management agreement, tilting the scale in favor of the operator – which is quite evident from the other survey results for the region.

On the other hand, **operator loan** has been offered by **6%** of the contracts primarily to fund the costs and expenses of pre-opening.

Termination of Agreement

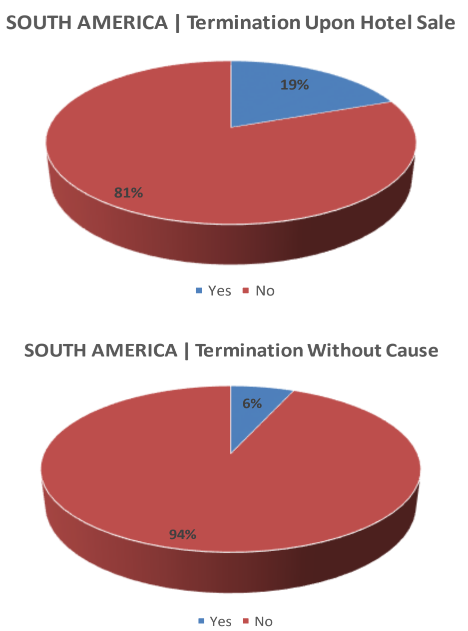
***Standard conditions for termination of the hotel management agreement** have been detailed under **Section I** of this report. Hereunder, we have highlighted the survey results relating to the termination of the management contract upon hotel sale and without cause based on the South America sample set.*

A substantially lower percentage of contracts in the South America sample set **(19%)** allow **termination upon sale** of the hotel than the global percentage **(32%)** even as **all of these seek a termination fee** from the owner on occurrence of such an event. Moreover, **at will/without cause** termination of the agreement by the owner is extremely rare in the region with just **6%** of the contracts permitting it; notably lower than the global sample set ratio **(17%).** Again, **all of these contracts** require the owner to make a severance payment on such occurrence.

The applicable **termination fee** is mostly seen to be a multiple of the average management fees earned by the operator during the preceding 1-3 years of the date of termination. Others seek absolute monetary amounts as set forth in the contract. In some cases the termination fee is sought only if the event occurs within the first few years of signing the agreement.

Lastly, all contracts that have a **performance-based termination provision** in the South America sample set do not seek a termination fee from the owner should a test failure occur and be left uncured.

FIGURE 68: TERMINATION OF AGREEMENT



ACKNOWLEDGEMENTS

First and foremost, we are very thankful to the various **hotel owners and operators** who frequently shared their views with us, enabling us to present a balanced outlook of critical negotiation elements of a hotel management contract.

Additionally, this guide and survey report is a global research document, which wouldn't have been possible to create without collaborating with various **HVS offices.** We appreciate the support extended by all the regional experts.

About HVS

HVS, the world's leading consulting and services organization focused on the hotel, mixed-use, shared ownership, gaming, and leisure industries, celebrated its 35th anniversary in 2015.

Established in 1980, the company performs 4,500+ assignments each year for hotel and real estate owners, operators, and developers worldwide. HVS principals are regarded as the leading experts in their respective regions of the globe.

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Who is Steve Rushmore?

Steve Rushmore, MAI, CHA, Founder of HVS, has provided consultation services for more than 15,000 hotels during his 50-year career and specializes in complex issues involving hotel valuation, feasibility, and financing.

As a leading authority and prolific author on the topic of hotel valuations, Steve has written all five hotel valuation textbooks and two seminars for the Appraisal Institute and is known as the "Creator of the Modern Hotel Valuation Methodology." He has also authored three reference books on hotel investing and has published more than 300 articles. Steve developed the Hotel Market Analysis & Valuation Software used by HVS and thousands of hotel appraisers/consultants, owners, and lenders throughout the world.

Steve lectures extensively on hotel valuations and has taught hundreds of classes and seminars to more than 20,000 industry professionals. He is also a frequent lecturer at major hotel schools and universities including Cornell, Glion, Hong Kong Polytechnic, EHL, Florida International University, IMHI, Michigan State, Penn State, Houston, NYU, and the Harvard Business School.

Steve's most recent contribution to hotel valuation education is his online course- "How to Value a Hotel." Designed for experienced appraisers looking to specialize in valuing hotels or new valuers starting their careers, the course provides all the knowledge and tools needed to evaluate hotel markets, forecast income and expense, and value all types of hotels. For the final project, students value an actual hotel. Upon successfully completing Steve's course- students receive the Certified Hotel Appraiser (CHA) or Certified Hotel Valuer (CHV) certification recognizing their unique knowledge and skills used to value hotels.

Steve has a BS degree from the Cornell Hotel School, an MBA from the University of Buffalo, and attended the OPM program at the Harvard Business School. He held the MAI and FRICS appraisal designations and is a CHA (certified hotel administrator).

In his free time, Steve enjoys tennis, skiing, hiking, diving, sailing, and cooking with his wife (who is a trained Chef). He holds a commercial pilot's license with instrument, multi-engine, and seaplane ratings.

For more information as to what Steve is up to these days- <u>www.steverushmore.com</u>

Hotel Valuation Software- For Performing Hotel Market Analyses, Financial Projections and Valuations

Hotel Market Analysis & Valuation Software was developed by **Steve Rushmore** for his firm- HVS. It was then enhanced by Professor Jan deRoos of the Cornell Hotel School. This software has been the most downloaded product on the Cornell website and is used by thousands of hotel professionals around the world. It consists of three models:

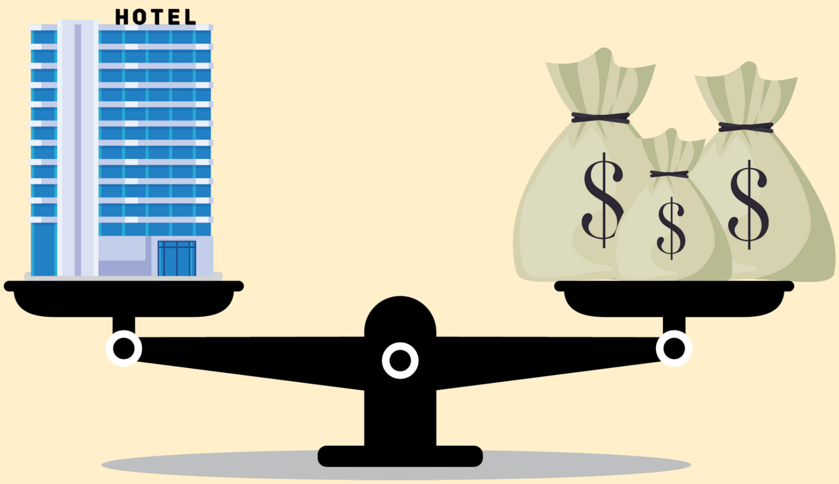
- **Hotel Market Analysis and ADR Forecasting Model**
- **Hotel Revenue and Expense Forecasting Model**
- **Hotel Mortgage Equity Valuation Model.**

This software package also provides answers to a wide range of key hotel investment questions such as How much is my hotel worth? What can I do to maximize value? What is the likely impact of new competition? How much value will a refurbishment add? Is my market strong enough to support adding more hotel rooms? What is the impact of my brand adding another hotel to the market?

If your role includes responsibility for performing hotel valuations and associated financial analyses- you need to include this software in your business toolbox.

Hotel Market Analysis & Valuation Software v. 6.0 is written as Microsoft Excel files (which runs on both Windows and Apple OS X operating systems) and comes with a detailed users' guide and case study. Version 6.0 contains significant enhancements over Version 5.0 which is no longer distributed.

HOTEL VALUATION SOFTWARE



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You will be working with the latest version (6.0) of my **Hotel Market Analysis and Valuation Software-** three powerful software models that have become the hotel industry standard for hotel valuations and investment analysis throughout the world. By the end of the course, you will be able to perform your own hotel market analysis and valuation plus many other applications.

The course consists of video lectures, readings, hands-on software case studies, quizzes, and a final project valuing an actual hotel. It should take about 20-35 hours to complete.

Most importantly, I will play a vital role during your learning process- through the wonders of Zoom- you can reach out to me with your questions and I will personally assist. After completing the course, I will also be available to mentor your professional development. Hopefully, this will be the start of a long-term friendship.

Upon successfully completing the course and final project you will receive the **Certified Hotel Appraiser (CHA)** or a **Certified Hotel Valuer (CHV)** certification. These certifications recognizing your hotel valuation skills will set you apart from other appraisers and consultants. For more information: www.hotel-learning-online.com