RECENT TRENDS IN HOTEL MANAGEMENT CONTRACTS

An understanding of the key provisions in hotel management contracts and the issues that influence the negotiation of these contracts is essential to an effective evaluation of any hotel project.

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Since Hilton International started to expand its chain throughout the world and adopted a unique operating structure, whereby the property owner assumed the risks and the operator always made money, the hotel management contract has become the industry standard by which hotels are operated.

The financial success of any lodging facility is largely dependent on the skill and ability of management. Hotels require specialized management expertise in areas such as sales and marketing, financial controls, food and beverage operations, service, security, and personnel motivation. Properties are opened all the time and need constant attention and supervision. Large convention hotels are like small cities, employing thousands of people. While some small motel-type properties can survive without a professional operator, most midsize to large hotels use the services of hotel management companies.

Hotel management companies vary in size from several people to large public corporations with many layers of talent. They all offer the following advantages over independently operating properties:

- *Supervision.* A hotel requires full-time operational supervision with no interruptions. A management company usually has personnel on reserve to handle any situation immediately.
- *Expertise.* Most hotel management companies offer a depth of expertise that independently operated properties can seldom duplicate. Some of the specialized areas that are routinely covered by these operators include finance and accounting, food and beverage service, engineering, construction and renovation, decorating, sales, and marketing.

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- *Established methods and procedures.* Hotel management companies use proven techniques for operating their properties. Some can simply "plug their systems into place" and immediately increase efficiency and profitability.
- *Verifiable past performance.* The track record of success is measured by the financial performance of the property. A professional hotel management company can document its ability to produce long-term profits, a critical consideration when selecting an operator.

First- and Second-Tier

Hotel management companies are generally classified as either first- or second-tier.[1] 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 a national or regional identification or trade name. Marriott, Hilton, Hyatt, Sheraton, and Westin are examples of first-tier management companies. Second-tier management companies also operate lodging facilities for third parties and provide day-to-day supervision and management. They do not, however, offer any customer recognition through their corporate name, but make use of franchise affiliations to generate customer identity. Examples of second-tier management companies are HEI Hotels, Interstate Hotels, Metro Hotels, Winegardner and Hammons, and Richfield Management. Some of the advantages and disadvantages of first- and second-tier management companies are summarized in the following paragraphs.

Advantages of First-Tier Companies. There are several advantages for the first-tier company:

- *Cost.* The cost of a first-tier hotel management company is often less than that of a second-tier operator plus the requisite franchise affiliation.
- *Corporate identity.* Because some chains (e.g., Four Seasons and Ritz Carlton) do not franchise, a management contract is the only way of obtaining these affiliations.
- *Ease of financing.* Lenders tend to favor hotels operated by first-tier management companies because of their lower perceived risk.

Disadvantages of First-Tier Companies. However there may also be offsetting disadvantages:

- *Restriction on property size.* First-tier hotel companies typically will not operate smaller properties.
- *Restrictions on financial condition.* First-tier companies usually have stricter requirements concerning the owner's financial condition. They do not want to put their name on a hotel if they could have difficulty maintaining the facilities because of limited financial resources.
- *Restrictions on contract terms.* First-tier hotel companies generally require longer-term contracts and restrictions on termination. They do not want to suffer a loss in reputation by the premature removal of their sign from a property.
- *Less flexible in negotiations.* First-tier hotel companies are usually more rigid in their contract requirements. Since these operators possess a unique brand affiliation, they generally enjoy greater bargaining power.

The Management Contract

The terms under which a hotel management company is employed are set forth in the management contract. This document is the end result of hours of negotiations between the property owner and the operator. The exact provisions of the ultimate contract are the product of many external forces, including the economic climate and the skills and bargaining power of the participants. Typically, a hotel management contract contains the following 14 major contract terms:[2]

1. Initial term and renewals;
2. Management fee structure and amount;
3. Financial reporting requirements;
4. Extent of operator independence/owner control;
5. Termination options;
6. Operator capital contributions;
7. Allocation of home office expenses;
8. Restriction on sale;

9. Potential for other developments and/or management contracts;
10. Allocation of insurance/condemnation proceeds;
11. Owner versus operator as employer of personnel;
12. Reserve for replacement;
13. Restrictive covenants concerning other hotels and/or contracts; and
14. Indemnification.

The owner and operator bring a different perspective to each of these items, in terms of both desired outcome and the relative importance of each point. As with any negotiation, the resolution of each of these issues and the overall character of the contract in general is determined primarily by the relative strength of each party's bargaining position.

From the late 1970s when hotel management contracts started to really flourish until the mid-1980s, the bargaining power was largely in the hands of the hotel companies. It was not unusual for management companies to enjoy 20- to 30-year terms, fees based solely on a percentage of revenue, no termination provision, and very few restrictions of any type. These were the golden years for hotel management companies.

Overview: 1970s to the Present

An overview of the of the US lodging industry at that time shows why hotel management companies held such great power.

The late 1970s and early to mid-1980s was a period of dynamic growth for the lodging industry. Hotels were viewed as excellent investment opportunities, providing revenue in two forms: initial fees or profits, and ongoing cash flow from operations. The potential for additional profit from the ultimate sale of the asset was considered in investment analyses. However, while investment analysts recognized the validity of the ultimate sale of the investment, most hotel owners considered this eventuality to be a more theoretical than realistic possibility, as resale was not generally a specific investor goal (particularly for tax-oriented syndicators). For the most part, an investment in a hotel was seen as an open-ended proposition, an opportunity to own an asset that had the potential to generate cash flow over the long-term future. Given this expectation, which was bolstered by economic and inflationary trends as well as the tax code, the market did not contemplate a situation in which a sale would be desirable. Rather, a sale was viewed as a safety net, to be exercised not in the event of a failure of the property, but in the event of a change in the owner's priorities or goals.

Negotiating Positions. This frame of reference materially influenced the negotiating posture of the parties involved on several of the contract terms described previously. Because a sale was not generally contemplated, the factors relating to and potentially influencing a sale were given lower priority by the owner, and thus tended to be resolved in favor of the operators. Specifically, terms relating to the restrictions on sale, such as the operator's desire to have the right of first refusal, as well as the potential to terminate a contract upon sale as opposed to drafting a contract that survives a sale, were most often resolved in the operators' interests.

This circumstance also affected the negotiation of the initial term and renewals of the contract. The operator desired an extended initial term, with multiple renewal options at the operator's discretion. The typical resolution of this issue was with relatively long terms and multiple renewals, sometimes totaling 50 or more years. The only recognition of the owner's interest that was at all common was a clause providing for the renewals to be at the owner's option. However, this feature was by no means present in a majority of the contracts dating from that period.

Management Fees. The expectation of continued profitability also affected the resolution of other issues. First and foremost was the management fee. While the amount of the fee was always a material point of negotiation, the form of the fee was not. The distinction between a fee tied to profitability (i.e., net income) and one tied to revenues (i.e., gross sales) was less significant in the face of the expectation of endless profitability. This expectation also undermined the perceived importance of provisions dealing with performance standards.

The cash flow motivations influencing the owner also affected other terms related to profits. Owners were reluctant to mandate any expenses that would affect the bottom line and

thus hurt debt coverage and profitability levels. The most notable example of this is the reserve for replacement allocation. This line item, which was generally not a current cash expense, was typically calculated as 3% of gross revenues. Deducting this amount from a bottom line that ranged from 15% to 30% of gross revenue, could equal as much as 10% to 20% of the cash flow before debt service.

The vast majority of management contracts signed during this period involved new properties. The owner was most commonly the developer of the hotel and was strongly motivated to "get the deal done" in order to realize the profits associated with completion of a project. Successful completion was contingent upon obtaining financing, in the form of both debt and equity funds (frequently through syndication). Both the debt and equity markets placed a high degree of importance on the brand name and management affiliation of the property. Essentially, in order to be financeable, the property had to be affiliated with a major national lodging chain. This circumstance, combined with the fact that the number of "acceptable" brand names available was limited, gave the management companies an advantage in the negotiation process.

As a result of these circumstances, the general character of a majority of contracts signed in the late 1970s and 1980s favored the operator. The terms tended to be long, and fees were largely based upon a percentage of gross revenues. Termination provisions and performance standards were rarely evident; in many cases, the contract survived any event except bankruptcy. As a rule, the operators also enjoyed a high degree of freedom with respect to reporting and control issues and expense allocation and were rarely required to provide any capital or cash flow contributions.

Hotel Management Contracts in the 1990s

In contrast to the overriding sense of optimism that suffused the industry in the 1970s and 1980s, the prevailing industry attitude during the first several years of the 1990s was pessimism. Lodging was no longer seen as a developing, growth industry, but rather as one that was deeply troubled. The problems were perceived as fundamental flaws, arising out of the very sense of optimism that perpetuated the actions of the 1980s. Thus, the response was generally to adopt a position that was essentially the opposite of that prevailing in the earlier period.

Workout Context. A majority of the hotel management contracts negotiated in the early 1990s were in the context of a workout involving distressed hotels. Usually, the owner was a lending institution that was now an owner by default. Frequently, these owners had neither the desire nor the capacity to function as long-term owners. Therefore, their frame of reference was a much shorter one. Rather than generating cash flow over the long term, they were interested in a scenario that would enable them to recover as much value as possible as quickly as possible. While the specific time frame varied from institution to institution and, to a lesser degree, from property to property, the time frame rarely exceeded two to three years, and was frequently measured in months.

This orientation also influenced the issues relating to control over the operations and, ultimately, the ability to sell the asset unencumbered by a management contract. As a result, owners were placing top priority on the ability to terminate the contract upon sale. They were also seeking contracts that were short-term, either specifically or effectively, by virtue of the termination clause.

Cash Flow Motivation. The generation of cash flow was also a priority to these owners. In contrast to the profit motive that previously prevailed, cash flow was seen now as a necessary element in the creation of value upon sale. The specific performance of the management company was therefore an issue, and management companies were being asked to prove themselves both initially, as candidates, and on an ongoing basis, as operators.

As was the case in the 1980s, the management companies were seeking new contracts as a means of expanding their operations and income. However, unlike the 1980s, the opportunities for new contracts were relatively limited, with the potential for new development almost nonexistent.

Moreover, the number of management companies seeking these opportunities had increased dramatically, with the result that the market for contracts was highly competitive. As is frequently the case in the hotel industry, this rivalry took the form of price competition, putting downward pressure on management fees. Another feature was the requirement that management companies contribute monies in conjunction with

obtaining a new contract, either in the form of a loan or by the assumption of an equity position.

Brand Names Negated. Compounding the difficult position of the hotel management companies is the fact that the pool of owners has become more educated with respect to the relative merits of various chain affiliations and management styles. In addition, with chain affiliations being made increasingly through franchises, the advantages formerly accruing to the larger brand-name hotel companies were substantially negated.

Finally, the hotel management companies were at a further disadvantage by virtue of the defensive position in which they, as a group, found themselves. Whatever the merits, one of the prevailing perceptions was that prior or sloppy management was responsible to some extent for the circumstances in which the industry as a whole found itself. This perception compelled owners to require a high degree of reporting and oversight requirements with which the management companies had to strategically agree.

Hotel Management Contracts Today

Today, the hotel industry is rapidly recovering. Occupancies, room rates, and values have increased dramatically during the past several years. Bankruptcies and foreclosures have fallen, and formerly distressed properties are now healthy. New hotel development has commenced in the economy segment, and more upscale projects are on the drawing boards. The balance of power, which shifted from the operator to the owner, is still on the owner's side. The negotiating position of management companies has been seriously eroded while that of the owners has been enhanced. The result is management contracts that primarily serve the purposes of the owner. Terms are short, and many contracts are subject to termination, at least upon sale if not simply upon notice. Management fees have been reduced and restructured, with more emphasis on an incentive fee tied to profitability and subordinated, to a certain degree, to the owner's return. And finally, owners enjoy an improved degree of control over ongoing operations of the property.

Focusing on some of the 14 major contract terms, will illustrate the shift of power from the hotel operator to the owner and provide a benchmark of what provisions are typically achieved today.

Management Fees. As has historically been the case, the management fee typically consists of a two-tiered structure: a base fee and an incentive fee. The base fee is commonly defined as a percentage of gross revenues, while the incentive fee is tied to some profit criteria.

Historically (in the 1970s and 1980s), the base fee ranged from 3% to 5% of gross revenues and constituted the greater part of the compensation achieved by the operator. Incentive fees were typically defined as a percentage of defined net operating income. This amount was sometimes subordinated to debt service, but often subject also to accruals. In virtually all cases, the revenue derived from the base fee was significantly greater than the revenue derived from the incentive fee.

Common examples from this period include typical Marriott contracts that generally provided for a base fee of 3% of gross revenues plus an incentive fee of 20% of defined net income that, if deferred, was often subject to accruals. Typical Hyatt contracts dating from this period provided for a management fee equal to the greater of 5% of gross revenues or 20% of net income. As this structure required the management company to achieve a net income level of 25% of gross revenues in order to have the incentive fee surpass the base fee, the incentive factor was somewhat limited.

Today, the emphasis has shifted dramatically from the base to the incentive fee. Base fees now range from 1.5% to 4% of gross revenues, with the most common range being 2.0% to 3.0%. With the higher base fees (3.0% and above), it is not uncommon for a portion of the base fee to be subordinated to debt service and/or some owner's priority whereby the operator receives a reduced management fee if certain objectives are not achieved. Incentive fees are now very deal-specific, as opposed to being based on a standardized formula. Common structures include a percentage of gross operating profit over a defined amount (hurdle), usually related to the historic or budgeted performance of the property. Depending on the threshold, these fees range from 10% to 25% of the defined amount. Moreover, incentive fees are virtually always subordinate to debt service and, in many cases, also to an owner's priority return. These amounts may be influential in determining the hurdle for the incentive fee to be earned. The strategy behind these structures is to align the operator with the

owner's position by exposing the operator to a similar level of risk as related to both the operation and the capital structure of the deal.

Termination Provisions. Termination provisions set forth the circumstances in which a management contract may be canceled, by either the owner or the operator. Termination provisions may be generally divided into two categories: those related to the ownership of the hotel, and those that are "for cause." While there are many specific terms that may influence termination "for cause," the most common are related to the performance of the two parties in fulfilling their obligations under the contract.

Historically, termination provisions in hotel management contracts were extremely limited and were related to the financial health of the parties to the contract. The most common opportunity for termination was the bankruptcy or other financial breach by one of the parties. With respect to termination upon the sale of the property, such provisions, when included, usually addressed the operator's right to terminate the contract upon the sale of the hotel; typically, the owner had no such right. Some contracts also provided the owner with the right to terminate in the event that the operator did not perform to some standard. In some instances, the standard was defined on the basis of performance as compared to operating history or budget, or in terms of market share. However, more often these clauses were ill-defined and difficult to enforce. One common clause was "failure to operate and maintain the hotel in a first-class manner," or some similar vague language, which could result in years of dispute.

In management contracts that are currently being negotiated, the termination provision is often the most crucial clause. In many cases, the owner has the right to terminate the contract upon sale of the property, with minimal notice (30 to 60 days). This clause is of particular importance to the owner in terms of enhancing the salability of the hotel by enabling another hotel operator to bid on the property. In the early 1990s, many contracts (particularly those of the second-tier companies) also provided the owner the right to terminate with minimal notice, for no specific cause (i.e., without the sale of the property). Today, these latter provisions are tempered by buy-out clauses, whereby the owner may terminate the contract on short notice but must make a payment to the management company—generally, 0.5 to three times the management fee paid during the past 12 months.

Term of the Contract. The term of the contract refers to the time for which the contract will be in force. Included in this category are renewals of the initial term, which may be at the owner's or operator's behest.

Given the prevalence of termination provisions, the significance of the term of the contract has been somewhat undermined. During the recent past, some contracts were written with relatively short terms, ranging from one to five years, with no renewal provision. The majority of these were shorter (one to two years); some were actually month-to-month. This is in dramatic contrast to the long terms of 10 to 30 years, with as many as 50 years in renewal, that historically prevailed.

The current standard has shifted away from the extreme short term, and now ranges from 3 to 10 years. Renewals are most commonly subject to negotiation within the year prior to the expiration of the original term. These more extended terms recognize the benefit of long-term, consistent management and are often seen as a way to "reward" the management company for good performance. However, discussions with the parties to these contracts indicate that the sale of the asset within the foreseeable future, which is generally less than or equal to the term of the contract, is seen as a likely event, if not an owner's goal. Thus, the importance of renewal terms is minimized in the minds of the negotiating parties.

Other Contract Issues. The following issues are also subject to negotiation in hotel management contracts. The ranges and standards set forth represent the terms currently employed in today's hotel management contracts:

- *Financial reporting requirements.* Monthly statements should be provided within 10 to 15 days. Annual budgets should be prepared for owner review and approval 60 days in advance.
- *Operator independence/owner control.* Owner should have right of approval of budget and any expenditures exceeding a defined amount ($10,000 to $20,000 depending on the size of the hotel).
- *Owner versus operator as employer of personnel.* This issue is generally dictated by the specific circumstances of the owner, as well

as the structure of the management company. Institutional owners typically require all employees be the personnel of the operator.

- *Allocation of home office expense.* The current standards indicate a wide range of fees charged under this heading. These charges typically include reservation fees, central marketing expense, charges for frequent guest programs, and possibly some accounting or computer use fees. Reservation fees are most often charged on a dollar-per-reservation transaction, which can include both the making of and the canceling of a reservation. These charges range from $4.00 to $6.00 per reservation. Central marketing fees typically range from 2% to 3% of revenue, and may be supplemented by the cost of participation in select (voluntary) marketing programs. The cost of frequent guest programs varies dramatically depending on the nature of the program and cannot be standardized. Similarly, the accounting and computer use fees vary from chain to chain; the latter are usually relatively minimal and depend on the sophistication of the management company's MIS systems.
- *Reserve for replacement.* This is one area where owners and operators are increasingly in agreement, as both parties recognize the necessity and importance of maintaining the asset in marketable condition. Although most contracts now provide a reserve for replacement equal to a minimum of 3% of gross revenues, we have also seen 4% and 5% reserve with increasing frequency.
- *Capital contributions by the operator.* In today's highly competitive market for management contracts, a number of operators now assume an actual ownership position in the hotel. Thus, capital contributions may be seen as crucial to the successful attainment of a management contract.
- *Restrictive covenants concerning other hotels and contracts.* This issue is most important in the case of first-tier management companies, and generally depends on the likelihood that multiple hotels with the same brand will be located in a given market area. Restrictive covenants are still used, but the specific scope of the restriction is subject to negotiation based on market circumstances and the strength of the brand.

Conclusion

The inference that the hotel management contracts signed in the 1970s and the 1980s favored the operator is a subjective one, and is made in the context of the 1990s. During the earlier period, the prevailing standards, which are reflected in a majority of those contracts, met the needs and criteria of the owners, the operators, and the lenders. It is only in hindsight that the magnitude of the imbalance appears clear. However, the conclusion that these contracts were in some way, or in large measure, responsible for the problems that are now affecting the industry is both inappropriate and unfair. The problems of the industry were the result of a convergence of influences and factors, of which management issues represented only one.

A review of the management contracts being negotiated today suggests that some of the same general circumstances that prevailed during the 1980s persist but that the position of strength now rests with the owners. Equally, current contracts may also be said to meet the perceived needs of the industry as a whole in the context of the 1990s. The question that remains, however, is whether this circumstance will prove to be in the best interest of the industry over the long term. Or is this a case of a reactionary trend, with the pendulum swinging too far in the opposite direction. While we will undoubtedly have to wait until the next cycle of the industry for our hindsight to be 20/20, recognition of the fundamental lesson of the 1980s is warranted: Any agreement founded largely on the requirements of one of the two parties runs the risk of ultimately satisfying neither. ■

Notes

[1] Stephen Rushmore, *Hotel Investments: A Guide for Lenders and Owners* (Warren, Gorham & Lamont, 1990).

[2] These management contract provisions were identified in James Eyster, *Negotiation and Administration of Hotel and Restaurant Management Contracts* 35–36 (1988).