AUGUST 2014

EXCERPTS

USA | EUROPE | APAC

HVS HOTEL MANAGEMENT CONTRACT SURVEY

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Foreword by Jan A. deRoos

Why does this Survey add to our Understanding of the Hotel Industry?

Never has there been a more diverse set of hotel management agreements in use. Management agreements were originally born of a desire to allow financial or passive owners to participate in the ownership of hotel real estate while contracting with branded managers to operate the hotel on the owners' behalf. This desire has evolved into a very sophisticated market in which owners of the real property contract with owners of intellectual capital over the use, branding, and long-term control of hotel assets. **It is clear that two fundamental forces drive management contract negotiation:** the experience gained from the recent economic stresses applied to the entire industry, and matters specific to a given hotel in a given location. The current and next generation of contracts must anticipate both forces.

Today's hotel owners include real estate investment trusts (REITs), real estate hedge funds, real estate private equity funds, sovereign wealth funds, life insurance companies, pension funds and private wealth clients. Operators include global corporations with multiple brands for each market, global single-brand companies, and regional operators (both with and without brands). **While the relative strengths of the parties have a great influence on contract negotiations, it is not necessarily the case that the party with the greatest market capitalisation has the greatest power in any given hotel at any given time.** With so many potential outcomes, how can one see the "big picture" and understand a contract's strategic levers?

Fortunately, a work like the "HVS Hotel Management Contract Survey" by Manav Thadani and Juie Mobar provides an excellent and invaluable survey that helps us understand the terms and language in contemporary hotel management agreements (HMAs). **Theirs is the first survey with a truly global perspective on the structure of management contracts.**

The authors present and address the unique features of HMAs in a direct and candid way providing owners, investors and lenders with a unique perspective that only comes from hands-on experience in the hotel sector over a long period of time. This depth of knowledge comes from a consulting and advisory team that works solely on hospitality assets. The authors provide insight into the five principal sections of a management contract: term and renewals, operator management fees, performance test, budget and expenditures, and termination of the contract by owner.

The authors' objective of providing insight into contemporary HMA practice is fully realised in this important work. In addition, by making this available for purchase via the **HVS Bookstore,** they have committed to educating a broad audience with relevant and current practice. I commend Thadani and Mobar for their excellent and invaluable survey.

Jan A. deRoos
Ithaca, New York
July 28, 2014

Jan A. deRoos is the HVS Professor of Hotel Finance and Real Estate at Cornell University's School of Hotel Administration. He is co-author of The Negotiation and Administration of Hotel Management Contracts, long considered to be the industry's leading reference on hotel management agreements. The current fourth edition (2009), co-authored with James Eyster, is available at: general_books@cornell.edu or (607) 255-2933.

HVS Hotel Management Contract Survey (HMCS) is an extensive collation and comparison of key terms and clauses of management contracts across the United States of America, Europe and the Asia Pacific region. While the full report presents the critical survey results in entirety, this document provides an introduction and some excerpts of the survey.

Survey Methodology

Data Compilation: Data collection for this survey was implemented using a combination of different ways. We looked at contracts from the HVS global database, dispatched an online self-reporting questionnaire, and held discussions with hotels owners as well as operators. Eventually, the universal survey sample set comprised **236 management contracts (57,055 rooms);** regional breakdown is depicted in Figure 1.

Figure 1: Survey Sample Set

Region	Contracts	Total Rooms Represented
USA	80	22,917
Europe	76	19,232
APAC	80	14,906
Universal	**236**	**57,055**

Figure 2: Primary Independent Variables

Independent Variable	Parameters	
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	

Figure 3: Additional Independent Variables

Other Variables	Parameters
Management	Brand Managed Franchised
Type of Property	New Existing
Year of Property Opening	Before Year 2005 In or After Year 2005
Location of the Property	By City By Country

Data Analysis: Primary **independent variables** (defined as inputs or causes) chosen for the data analysis are *Market Positioning, Room Inventory and Age of the Contract,* as highlighted in Figure 2. Here, it is important to note that the survey captured information on additional independent variables (Figure 3), which have been discussed in the full report to explain results "only" where applicable.

Report Presentation: The full survey report consists of **six major sections**, which are recognised to be significant areas for owner-operator negotiations.

Figure 4: Survey Sections and Report Presentation

Section	Principal Discussion	Key Areas
I	**Management Contract Term**	• Length of the Initial Term • Number of Renewals/Extensions • Length of the Renewed/Extended Term • Provision for Area of Protection/ Restricted Area/Non-Compete Area
II	**Operator Fees**	• Initiation/Joining/Commitment Fee • Technical Services Fee and Pre-Opening Fee • Base Management Fee • Owner's Priority • Incentive Management Fee • Reservation, Marketing, Loyalty Program and Training Fees
III	**Operator Performance Test**	• Commencement Year • Test Period • Type of Test (GOP/RevPAR/Both) • Performance Thresholds • Provision for Operator to Cure
IV	**Budget and Expenditure**	• FF&E Reserve Contribution • Control of Receipt/Operating/Revenue Account • Expenditure Thresholds
V	**Contract Termination by Owner**	• Operator Non-Performance (No Cure Made) • Upon Hotel Sale • Without Cause • Termination Fee Payable to the Operator
VI	**Others**	• Operator Key Money • Senior Hire

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Hotel Companies Represented In This Survey

Totally, **38** branded hotel companies have been represented in this survey, in addition to a few independent operators and several third-party management companies.

Figure 5: Hotel Companies (Branded) Represented in the Survey

Accor	La Quinta Inns and Suites
Aman Resorts	Louvre Hotels
Americas Best Value Inn (Vantage)	Mandarin Oriental Hotel Group
Banyan Tree Hotels and Resorts	Marriott International
Best Western	Minor Hotel Group
Caesars Entertainment	Moevenpick Hotels and Resorts
Carlson Rezidor	Omni Hotels and Resorts
Choice Hotels	One&Only Luxury Resorts
Club Méditerranée	Peninsula Hotels (HSH Group)
Concept Hospitality	Premier Inn (Whitbread)
Dusit Hotels and Resorts	Rosewood Hotels and Resorts
Fairmont Raffles Hotels International	Sarovar Hotels and Resorts
Four Seasons Hotels and Resorts	Shangri-La Hotels and Resorts
Fortune Hotels and Resorts (ITC)	Six Senses Hotels, Resorts and Spas
Hilton Worldwide	Starwood Hotels and Resorts
Hyatt Hotels Corporation	Taj Group
InterContinental Hotels Group	The Leela Palaces, Hotels and Resorts
Jumeirah Group	Trump International
Kempinski Hotels	Wyndham Worldwide

Report Purchase And Ordering Instructions

The full survey report comprising around 35 pages can be purchased for **US$ 2,000**. To procure the same, please log on to the HVS Bookstore. The report will be available both in PDF (soft copy) as well as in print (hard copy). The purchaser will be allowed to choose the preferred format, post which a personalised copy of the report will be sent across.

For ordering instructions or any other assistance, please contact:

Juie S. Mobar
Associate Director – Special Projects
HVS
Email: jmobar@hvs.com

Data confidentiality has been strictly maintained throughout this survey, with results in the report being presented only in aggregate and no individual contract details being revealed.

EXCERPT I

Length of the Initial Term

The initial term of a management contract for a new/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 universal sample set is 18.3 years.**

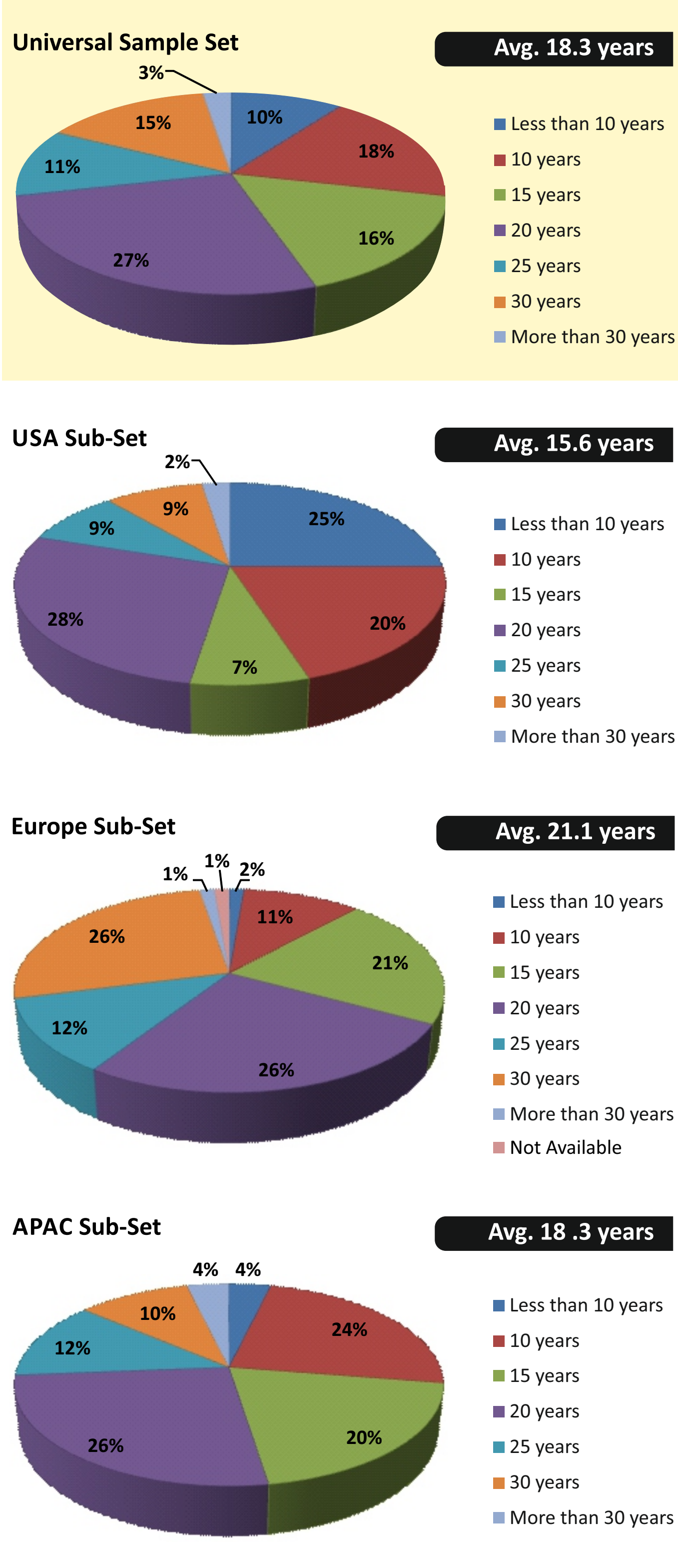
It is common understanding that operators prefer a longer contract term with automatic renewal options (or those excercisable by the operator) citing the need for stability, to protect their brand image as well as to obtain the desired return on their investment. On the other hand, owners prefer a shorter initial term with multiple renewal options on mutual consent, seeking flexibility. **In addition to which side of the table you are on, the length of the initial term is also dependent on the region of operation (Figure 6), hotel's market positioning, room inventory and the year of signing the contract, among others.**

The average length of the initial term for **existing hotels** (50% of the universal sample set) is found to be **17.7 years** vis-a-vis **new properties** (48% of the universal sample set) that have a longer average term of **19.1 years**. This data is particularly important when one considers the survey results by region in Figure 6. USA, a matured hotel market with 73% of the sub-set being represented by existing hotels, has contracts with a shorter initial term than those in the APAC region, which is a developing/emerging hotel market with 74% of the sub-set corresponding to new hotels.

Additionally, it has been observed that in recent times, increased competition owing to more number of players in developing/emerging hotel markets, besides the rising awareness amongst hotel owners, have resulted in management contracts with a shorter initial term (safeguarding the interest of both parties should disappointing market conditions occur).

The full survey report provides details on the length of the initial term by hotel market positioning, room inventory and year of signing the contract, besides elaborating on renewal/extensions and area of protection/restricted area/non-compete area.

Figure 6: Length Of The Initial Term



Region: *In USA, the operators appear more comfortable with a shorter initial term, with 25% of the contracts offering less than 10 years. However, in case of APAC, relatively a developing hotel market, this carve is only 4%.* ***Also, an initial term of 20 years is most common across all regions.***

Note: *87% of the Europe sub-set comprises contracts for upscale/upper upscale/luxury hotels, which could be the reason behind fewer contracts offering a shorter initial term.*

EXCERPT II

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.

Base Management Fee: The base fee is usually **calculated as a percentage of the hotel's Gross Operating Revenue**. It could either be a single fee, or a sum of licensing/royalty fee and operating fee. Moreover, the base fee 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 rise over the initial years, gradually stabilising for the remainder term of the contract. **The scaled up average base fee for the universal sample set is 2.65% (Year 6 onwards).**

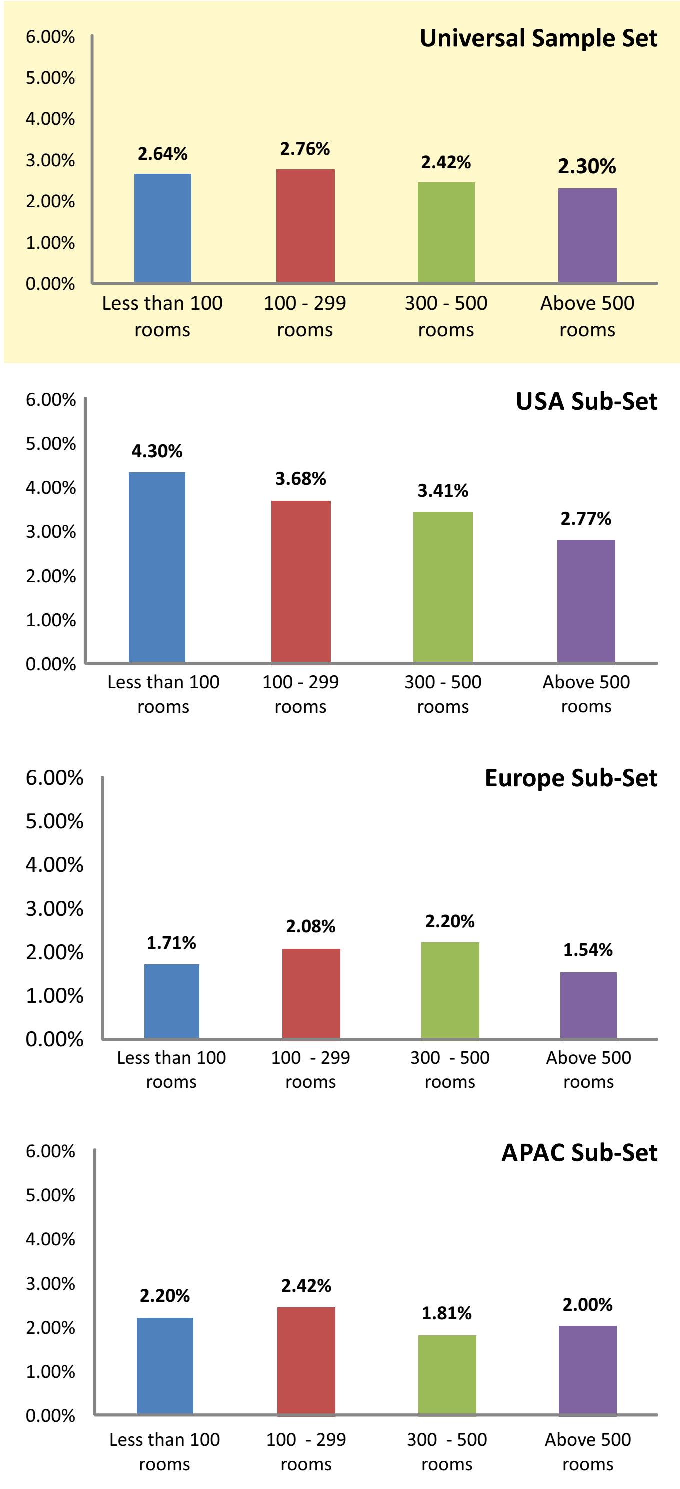
Figure 7 discusses the survey results pertaining to this fee by room inventory. The following information must be borne in mind while reviewing this figure – **(i) 24% of the European contracts** do not provide complete details on the base fee, lowering the average, as we do not have the Licensing/Royalty agreements for these; **(ii) 10% 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 **(iii)** overall, the base fee for existing hotels **(2.86%)** is found to be higher than that for new hotels **(2.42%)**.

The full survey report features exhaustive information on the Base Fee highlighting how it varies by market positioning, room inventory and age of the contract, in addition to relevant details on the other operator fees.

Incentive Management Fee: In addition to the base fee, an operator usually receives an incentive fee, which is linked to the hotel's operating profit. Therefore, while the former motivates the operator to focus on the top-line, the latter ensures that there is an incentive towards controlling expenses as well. Most operators prefer linking this fee to either the Gross Operating Profit (GOP) or the Adjusted GOP (AGOP, which is inclusive of the base fee and also known as Income Before Fixed Charges). Expenses beyond this level in a P&L (up to the EBIDTA line item per the Uniform System of Accounts for the Lodging Industry), are Fixed Costs pertaining to Rent, Property Insurance, Property Tax and Reserve for Replacement, which are arguably beyond the control of the Operator.

However, exceptions to linking this fee to GOP/AGOP can depend on the owner-operator negotiations and asset-specific considerations.

Figure 7: Base Management Fee By Room Inventory



***Room Inventory:** It is important to correlate the data in this figure with hotel market positioning. The < 100 rooms group in the USA sub-set is mostly **(90%)** represented by budget/mid market hotels that tend to have a higher base fee than upscale/luxury hotels. The situation is reversed in the case of the Europe sub-set with this inventory group corresponding to only upscale/upper upscale/luxury hotels. As for the APAC contracts, they together represent a near equal mix of lower and higher ranges of positioning.*

*On the other hand, **95% of the > 500** rooms group for the universal sample set relates to upscale/luxury hotels.*

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

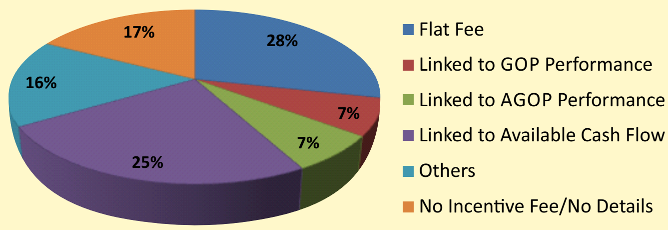
- **Flat Fee Structure:** Incentive fee is expressed as a percentage of the annual operating profit (defined differently across contracts). This percentage could either remain constant or could scale upwards through the term of the contract – lower in the initial years and peaking from Year 5 or 6 onwards. For example, Operating Years 1-4 could have an incentive fee of 6%, and for the remainder of the term it could equal 8%.
- **Linked to the GOP/AGOP performance of the Hotel:** Incentive fee is defined as a percentage of the annual operating profit (defined differently across contracts), with it being dependent on the pre-defined ranges of GOP/AGOP Margin. For example, incentive fee could equal 8% of GOP/AGOP, if the hotel achieves a GOP/AGOP Margin between 35%-40%; and it could equal 10% of GOP/AGOP for a Margin >40%.
- **Linked to Available Cash Flow of the Hotel:** Where applicable, Incentive Fee is typically subordinated to the Owner's Priority (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.
- **Others:** This type is represented by contracts that either have a combination of Flat and Linked Fee structures or present a very customised calculation of the incentive fee. For example, incentive fee could equal 2% of Gross Revenues or 20% of the Available Cash Flow, whichever is the lesser of the two.

Figure 8 depicts the types of incentive fee structures prevailing in the universal and regional sample sets.

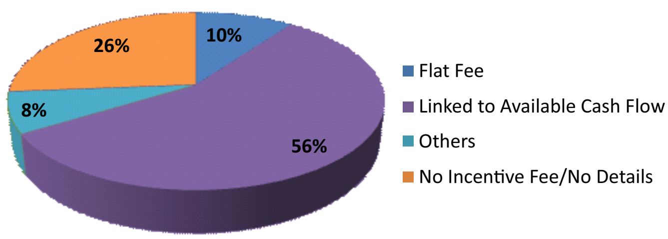
The full survey report provides comprehensive data on owner's priority in addition to discussing the incentive fee ranges across the three different fee structures.

Figure 8: Types Of Incentive Fee Structures

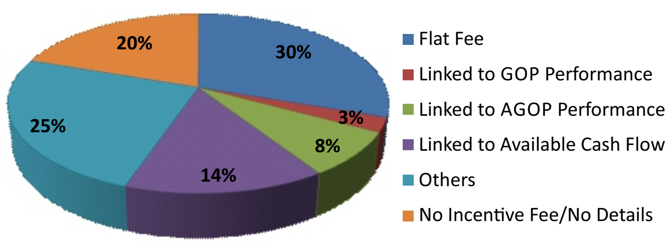
Universal Sample Set



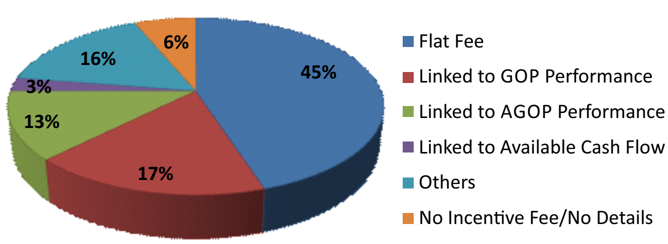
USA Sub-Set



Europe Sub-Set



APAC Sub-Set



***Incentive Fee Structure**: Notably, the flat fee structure along with linking the incentive fee to GOP/AGOP Margin are most prevalent in the APAC region, while it is more customary in USA to link the incentive fee to the hotel's available cash flow. Considering that the provision for an owner's priority is new to the APAC region, it is not surprising that the only two contracts in the subject sub-set offering an incentive fee linked to the hotel's available cash flow were signed as recently as in 2012.*

European contracts, in contrast, have the maximum customised calculations for incentive fee among the three regions.

About HVS

HVS is the world's leading consulting and services organisation focused on the hotel, mixed-use, shared ownership, gaming, and leisure industries. Established in 1980, the company performs 4500+ 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. Through a network of more than 30 offices and 450 professionals, HVS provides an unparalleled range of complementary services for the hospitality industry. **HVS.com**

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HVS Consulting & Valuation enjoys impeccable worldwide reputation for credibility, excellence and thoroughness. With offices strategically located throughout North and South America, Asia, Europe and the Middle East, our clients benefit from local insights and international expertise.

About the Authors

Manav Thadani, MRICS, Chairman, Asia Pacific, HVS founded the New Delhi office in 1997. He is actively involved in operator search/management contract negotiations and provides strategic advice to key clients. He additionally serves as a mentor to other HVS verticals in the APAC region, and is the global head of HVS Sustainability. Moreover, Manav oversees the planning and implementation of the regional HVS conferences, including Hotel Investment Conference – South Asia (HICSA); Tourism, Hotel Investment & Networking Conference (THINC) Indonesia; and the China Hotel Investment Conference (CHIC). On a personal level, Manav co-founded SAMHI in 2011, a leading Indian hotel investment and development firm with focus on ownership of branded hotels in the mid-scale/economy segments across key cities.
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Juie S. Mobar is Associate Director - Special Projects with HVS' New Delhi office. She has spent five years with the company starting as a Consulting & Valuation Analyst. In addition to having worked on feasibility studies, valuations, market studies and operational audits in the past, Juie has been actively involved in operator search and management contract negotiations, research-based assignments and select work for HVS Sustainability. She completed her Management Trainee Program with the Taj Group in 2006, and holds a BA (Hon) in Hotel Management from the Institute of Hotel Management Aurangabad (University of Huddersfield, UK) and Bachelors in Business Administration from Marathwada University.
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