HVS

Hotel Management Contracts in Russia and the CIS

October 3, 2011 / By Alexey Korobkin

Click here to view the Russian Language version of this article

A management contract is an agreement between the management company (operator) and a property owner (investor), whereby the operator assumes complete responsibility for managing the asset. For this service, the operator is paid a fee based on a prescribed formula. The owner retains limited control over the operation of the asset often through measurable performance standards; even though the owner retains more risk under a management agreement (than for example a lease), he may also benefit from greater returns.

A hotel management company can be classified as either a first or second-tier management company. A first-tier management company handles the day-to-day operations of the asset and also provides an affiliation with the chain. Some examples of a first-tier management company include Accor, Hilton, Hyatt, IHG, Marriott, Rezidor, and Starwood. A second-tier management company only offers the day-to-day operational supervision and offers no chain affiliation. Second-tier management companies often use hotel franchises for identification. Interstate Hotels is a good example of a second-tier management company.

As the table below highlights, using either a first or second-tier hotel management company has both advantages and disadvantages. The ultimate choice should be determined by the best-fit scenario.

Table 1 – Advantages and Disadvantages of First and Second-Tier Management Companies

	First-tier Management Company	Second-tier Management Company
Advantage	• Often less, expensive as no franchise is required • Combines operational company with the brand, thus more unified management	• More likely to manage smaller property • More flexible towards the owner
Disadvantage	• Sometimes not available for smaller properties • Usually longer term of contract	• Can be more expensive, as franchise is required • Perceived risk of company is higher

Management Contract Terms

A typical hotel management contract is a mix of commercial and legal terms. Some of these terms have an immediate and lasting effect on the likely cash flow to the owner and the performance and the manageability of the selected operator. We have highlighted some of the main terms of a management contract which often draw the owners' attention. Please note that the terms and definitions provided below are broad indications and that any of these terms can vary depending on various factors, which may include location, brand, positioning, and competitive environment among others. Each management contract is unique and is individually negotiated.

- Term

Summary

Due to increased hotel development in Russia and the CIS, it is important for owners to better understand different types of relations with the hotel operators. In this article we address some of the main terms of a typical management contract.

Comments

FILED UNDER CATEGORIES

Hotel Brands
Hotel Companies
Hotel Management
Management Contracts
Europe

- Operating Fees
- Performance Measures
- Capital Expenditure
- Non-Compete Clause
- Termination

Term

The **initial term** of a management contract is the length of the time that the agreement is to remain in effect. Initial terms in Russia and the CIS are typically in the range of 20 to 30 years, depending on the brand and positioning of the selected operator. Luxury operators usually tend to offer much longer contracts in the initial term. By contrast, the initial term in Europe is 15 to 20 years.

The **renewal terms** extend the initial terms of the contract and are usually done by mutual consent. In Russia and the CIS, the renewal terms are usually around ten years and sometimes two terms are offered. Renewal terms are usually decided six months prior to the end of the initial term on the condition that a written notice is provided. European renewal terms tend to occur in multiples of 5 years.

Operating Fees

An operator receives remuneration from the owner for the services provided. The fee structure is made up from various components.

The **base fee** is typically based on a percentage of the gross revenue and is usually in the range of 2.5-4%.

In addition to the base fee, the operator will usually charge an **incentive fee** based on the percentage of either Gross Operating Profit (GOP) or Adjusted GOP (calculated by deducting the base fee from the GOP). This fee usually ranges from 8% to 12% and can be flat or tier based. A tier-based fee implies that the amount of the incentive fee will depend on the GOP or AGOP of the hotel.

Some hotel management contracts include **owner priority returns**, which reflect a hurdle to the incentive fee. If the owner is not able to pay the incentive fee due to lack of funds, the 'stand aside' clause is exercised. This means that the fee is to be paid to the operator at a later date, when future profits cover the shortfall. It is important to note that owner priority returns are not common in hotel management contracts in Russia and the CIS. This could signify lower confidence levels in the market.

Other fees usually relate to marketing, advertising, reservation or central services. The structure of these fees depends on the operator and the type of fees. Marketing fees are usually charged as a percentage of rooms or gross revenues and vary between 1% and 4%. Reservation fees can be based on "per reservation" basis or as a percentage of rooms revenue.

Even though **technical services** fees are not part of management contracts, we deem them necessary to address. Management companies charge this fee to cover the support of the technical services team during the construction of the hotel. Technical services are usually charged on a 'per room' basis and can start anywhere in the range of €1 000 per room. Some operators prefer to charge a fixed upfront fee.

Performance Measures

There are two types of performance tests and often both are used jointly:

1. Revenue per available room (RevPAR) in relation to the mutually agreed competitive set
2. GOP achieved for an operating year

Performance measures are usually applicable after the hotel has achieved its stabilised year of operation. However, if a force majeure or other similar event happened that is beyond the operator's control then the performance test may not be applicable to that year.

Default at the hand of the operator is possible if two consecutive performance tests have been failed over two consecutive years. However, operators try to negotiate a "right to cure" clause, allowing the payment of funds required to achieve the minimum GOP.

Capital Expenditure

The furniture, fixture, and equipment (FF&E) of a hotel are often heavily used and require frequent replacement. FF&E replacements are essential to maintain the hotel's image, quality and income. For this purpose a fund is set up to accumulate capital for the periodic replacements of FF&E. Most operators charge close to 5% of gross revenue as FF&E reserve. The amount of the FF&E reserve is ramped up progressively with the period of operation, for example 1% in Year 1, 2% in Year 2 and so on.

Typically, capital improvements are divided into routine capital improvements (funded through the FF&E reserve account), which are required to maintain revenues and profits at their present levels, and discretionary capital improvements (also called ROI capital improvements). These latter capital improvements are investments that are undertaken in order to generate more revenue and profits, such as the conversion of offices into meeting rooms. The latter require owner approval and are in addition to the funds expended from the reserve account.

Within a management contract the obligation falls upon the owner to provide funds to maintain the hotel according to the relevant brand standards. If management elects to postpone a required repair, they have not eliminated or saved the expenditure, but merely deferred payment until a later date. A hotel that has operated with a lower than normal maintenance budget is likely to have accumulated a considerable amount of deferred maintenance. An insufficient FF&E reserve will eventually negatively impact the standard or grading of a property, and may also lead to a decline in the hotel's performance and its value.

Non-Compete Clause

An integral component of a market area's supply and demand relationship that has a direct impact on performance is the current and anticipated supply of competitive hotel facilities. By including a non-compete clause in a management contract, an owner has an assurance that no other property with the same brand is allowed to open in order to avoid cannibalisation of business.

Non-compete clauses are individual to each property and may include some of the following aspects:

- Those brands that will be included in the exclusion clause
- The term of the exclusion period
- The geographical area (either radius around the hotel or the whole city)

Termination

Hotel management agreements may include a clause providing each party the opportunity to terminate the agreement. We focus on two of these: termination on sale and buyout clause.

Termination on sale provides the owner the opportunity to release the investment and sell the hotel. This clause is usually negotiated by the owner to provide more flexibility in the future.

Buyout clause allows the owner to sever the agreement by compensating the management company based usually on a multiple of average annual fees earned.

Both of the above mentioned clauses are almost never exercised in Russia and CIS. Normally the hotel operator cannot be "disturbed" or bought out during the entire term of the agreement.

Conclusion

Today’s interest in the hotel markets of Russia and the CIS from the management companies enables owners to choose from a large variety of operators. Owners should retain professional hospitality consulting companies to assist in management agreements negotiations, to achieve the most desirable terms.

The management agreement factors mentioned in this article only cover some of the major aspects of the contract. These documents are complex legal documents that should be carefully addressed with assistance of legal advisors. All values mentioned in the article are aggregated averages for Russia and the CIS. Actual contract terms depend on the individual hotel projects and negotiations.

For more information, questions and comments please contact Alexey Korobkin at *******.*