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EXCERPT

HVS GUIDE TO CANADIAN HOTEL MANAGEMENT CONTRACTS

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FOREWORD

The HVS Guide to Canadian Hotel Management Contracts presents the results of an extensive review of hotel management agreements conducted across Canada, in addition to offering an in-depth understanding of the key terms and clauses of such agreements. All the management contracts analyzed for this survey were in place prior to the COVID-19 pandemic. At this stage, given the disruption to the industry and the unprecedented levels of distress, current events may have a longer-term impact on the key terms of management contracts and owner-operator relationships, most importantly on the concept of “force majeure.”

In Canada, 70% of hotels, representing roughly half of all guestroom inventory, are currently independent. However, most of the new hotels now being developed are associated with a brand. Consequently, the percentage of the supply that is branded is growing. The emergence of soft brands as an option for both established independent hotels and new developments is also contributing to the growth in branded supply. Given the number of first-time hotel developers that have entered the Canadian hotel industry, the need for education on the highly complex terms of management contracts and assistance in the negotiation process is greater than ever.

Hotel management contracts involve either brand management, in which the franchise company provides both the brand and management services, or third-party hotel management, whereby a hotel management company provides just management services for independent or franchised hotels. For full-service, upper-upscale, and luxury properties, international brands provide management services and forgo the royalty portion of their franchise fees in favour of a base management fee and an incentive management fee. Recently, brands have also begun offering management services in the limited- and select-service upscale hotel tier because there is a dearth of third-party hotel management companies in Canada.

Third-party management companies offer their services for a predetermined time period in exchange for a base management fee and an incentive fee. Currently, there are only a handful of third-party management companies in Canada, many with their roots in the United States. Given the recent growth in hotel development, often involving first-time developers, successful hotel owners in Canada are offering their local expertise through third-party management services in an effort to also 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 ensure that they are receiving customized, fair, and equitable hotel management terms based on the merits of the specific development.

The 2020 HVS Guide to Canadian Hotel Management Contracts by Monique Rosszell and Anastasia Ivanova is intended as a reference document for the key terms, clauses, and trends in management contracts found across the country. We hope this guide can serve the industry as a reference to make better decisions and building more balanced relationships between owners and operators.

SURVEY METHODOLOGY

Data Compilation. We selected more than 80 management contracts from the HVS Canada database that have been signed or amended since 2000. These contracts collectively govern nearly 19,500 Canadian hotel rooms. The goal of this guide is to interpret the terms and trends that prevail in today's operating environment.

Data Analyses. The primary independent variables (inputs) that were chosen for the data analyses are market positioning, room inventory, type of management, and type of property.

Figure 1 – Primary Variables of Analysis

Independent Variables	Parameters
Market Positioning	Economy, Upper Midscale, Upscale, Upper Upscale, Luxury
Room Inventory	< 100 Rooms, 100–199 Rooms, 200–299 Rooms, 300–500 Rooms, > 500 Rooms
Type of Management	First-Tier, Second-Tier
Type of Property	New Development, Existing Property

Report Presentation. The major terms and provisions of the hotel management contracts in the sample set were analyzed; these terms and provisions are critical areas for owner-operator negotiations.

Figure 2 – Principal Areas of Discussion

Principal Discussion Areas	Key Aspects
Management Contract Term	Initial Term Renewal Terms
Area of Protection	Geographic Area
Operator Fees	Technical Services Fee and Pre-Opening Fee Base Management Fee Owner's Priority Return Incentive Management Fee Other Fees
Operator Performance Test	Commencement Year Test Period Provision for Operator to Cure Type of Test Performance Thresholds
Budgeting	Annual Plan Expenditure Thresholds FF&E Reserve Contribution Control of Operating Account
Owner Approvals	Miscellaneous Approvals Senior Management Hiring Process Competitive Set Approvals
Indemnification	Indemnification by Owner Indemnification by Operator
Operator Investment in Property	Key Money Deferred Fees Owner's Priority Return & Operator Profit Guarantees Others
Termination of Agreement	Standard Conditions Termination by Owner Termination by Operator Termination Fee
Trends in Management Agreement Terr	"Manchise" Agreements Past, Present and Future Trends

CANADA SAMPLE SET PROFILE

The sample set has greater representation from:

- Contracts for hotels with an upscale to luxury positioning (78% of the contracts)
- Contracts for hotels with less than 200 rooms (66% of the contracts), with the average number of rooms per hotel being 232
- Contracts signed for new properties (57% of the contracts)
- Properties managed by first-tier operators (56% of the contracts)

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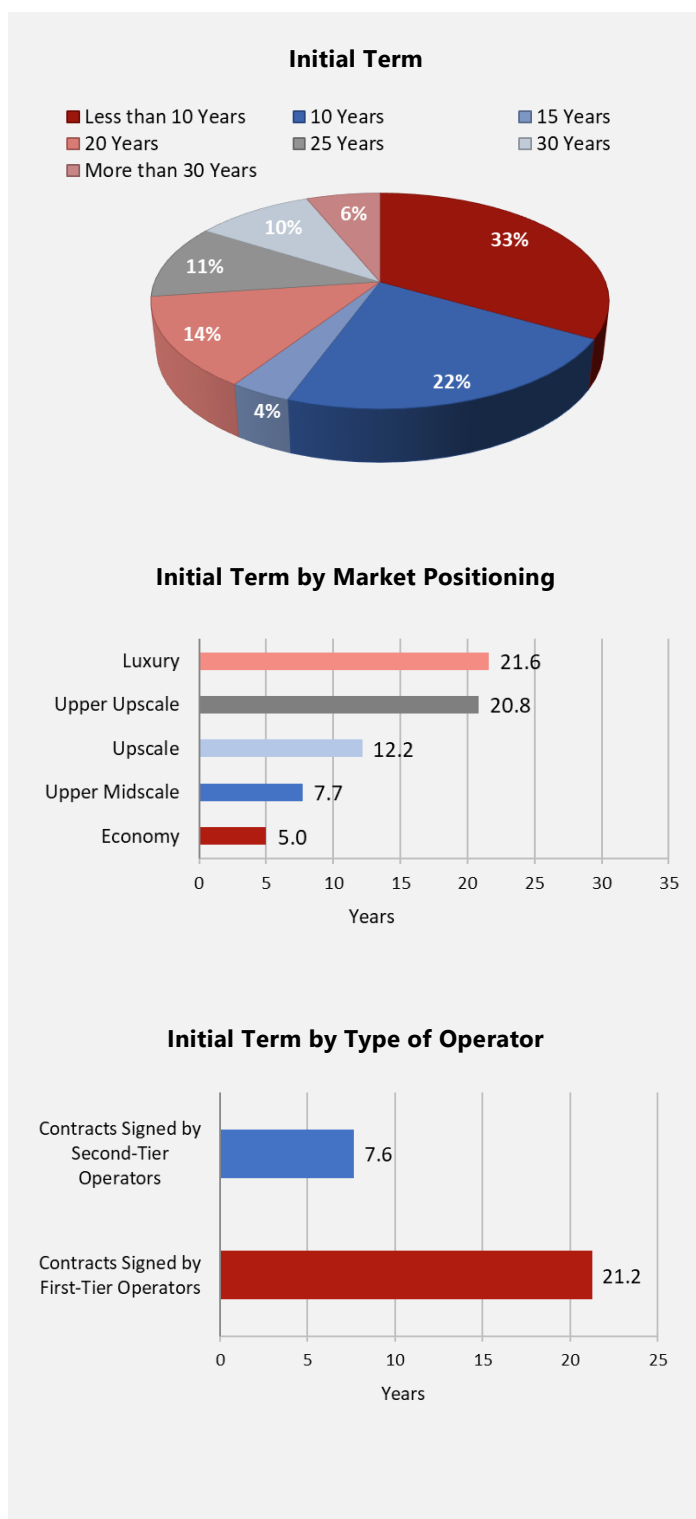
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EXCERPT SURVEY RESULTS – MANAGEMENT CONTRACT TERM



The initial term of a management contract typically commences from the effective date and continues until the expiration of a specified number of years. More than half (55%) of the sampled Canadian management contracts have an initial term of 10 years or less. Across the sample, the average length of the initial term is 15 years.

In the sample, hotels with a room inventory above 500 have the longest initial term of 30.8 years because they are all upper-upscale or luxury hotels that are signed to first-tier hotel operators.

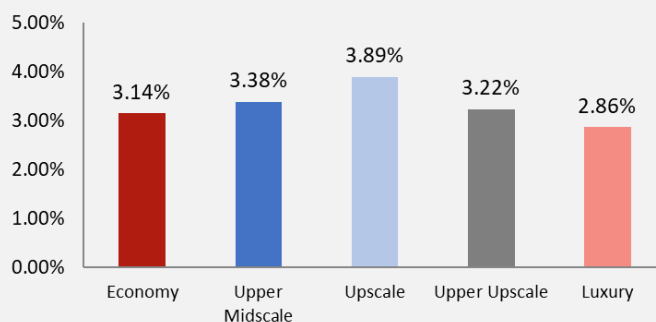
The average length of the initial term signed by second-tier operators was 7.6 years, approximately 13.6 years shorter than the initial term of first-year operators, which was 21.2 years. The contracts signed for new properties were approximately 5 years shorter than those signed for existing hotels.

The full report addresses the following aspects of management contract terms:

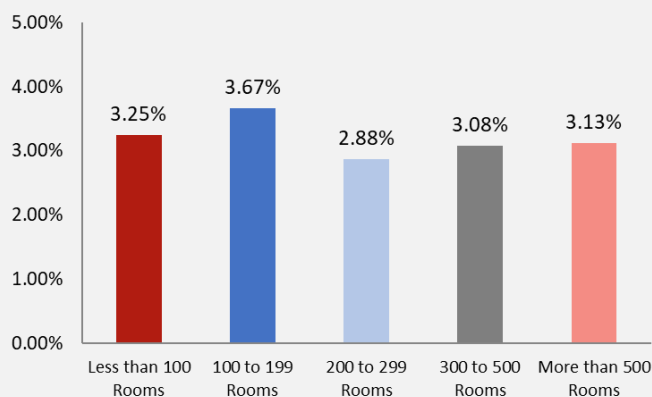
- **Length of Initial Term**
- **Number of Renewal Terms**
- **Length of Renewal Term**
- **Area of Protection Provision**

EXCERPT SURVEY RESULTS – OPERATOR FEES

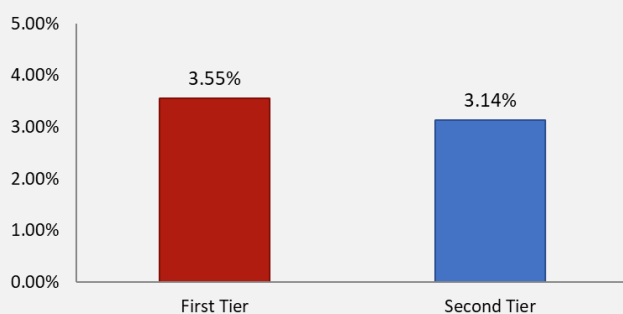
Average Base Management Fee by Market Positioning



Average Base Management Fee by Room Inventory



Average Base Management Fee by Operator



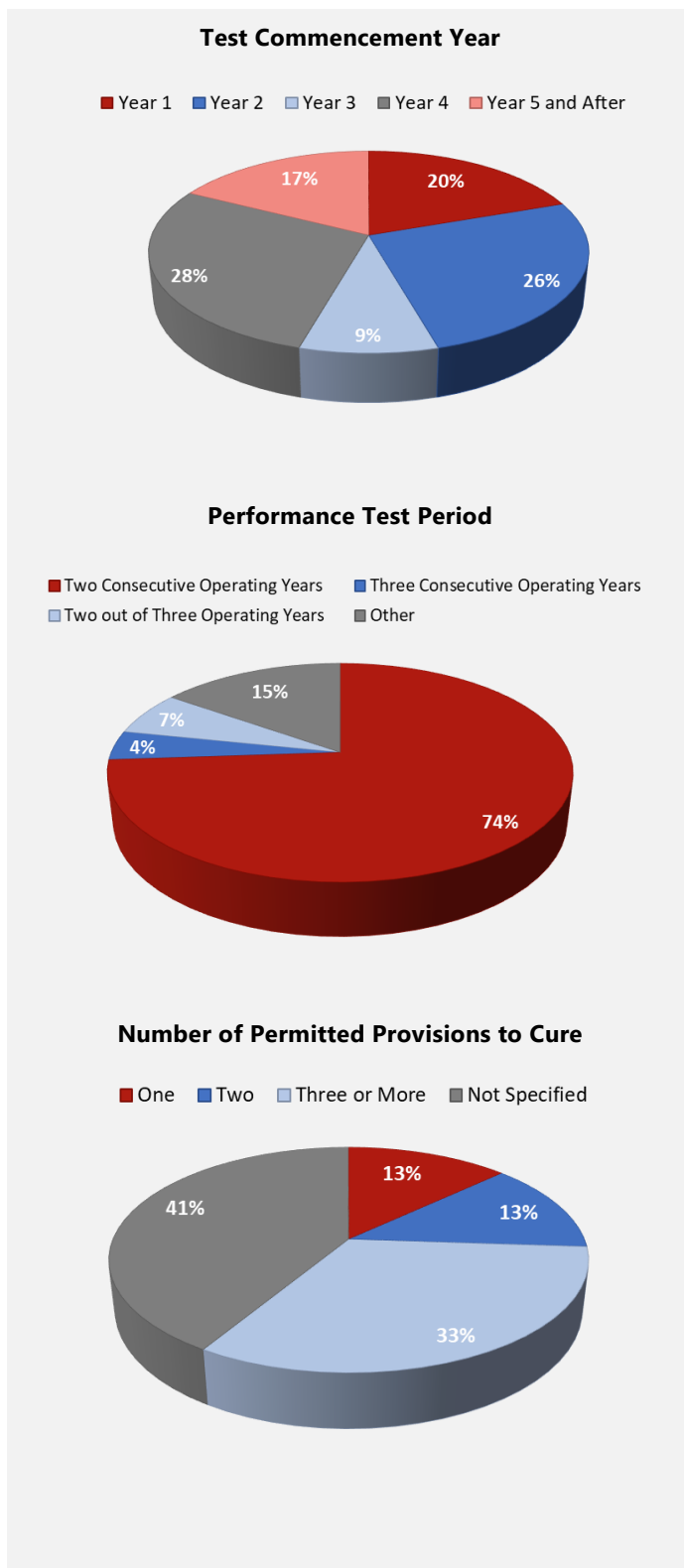
The base fee and the incentive fee together make up the management fee portion that the operator charges in exchange for performing the duties specified in the contract. The base management fee is calculated as a percentage of the hotel's gross operating revenue. This creates an incentive for the operator to maximize marketing efforts and other activities that increase sales volume. The drawback to this arrangement is that the base fee provides no incentive to minimize operating expenses and increase the bottom line. The average stabilized base management fee for the Canadian sample set is 3.30%.

The purpose of the incentive fee is to encourage the efficient operation of a hotel and reward the operator for the profitability of a hotel operation. Owners want this compensation to be based on a defined net income that appears as low in the hotel's income statement as possible. Almost half of all surveyed contracts had incentive fee linked to Gross Operating Profit (GOP)/NOI with an Owner's Priority Threshold.

The full report addresses the following aspects of operator fees:

- **Technical Services Fee and Pre-Opening Fee**
- **Base Management Fee**
- **Owner's Priority Return**
- **Incentive Management Fee**
- **Other Fees**

EXCERPT SURVEY RESULTS – OPERATOR PERFORMANCE TEST



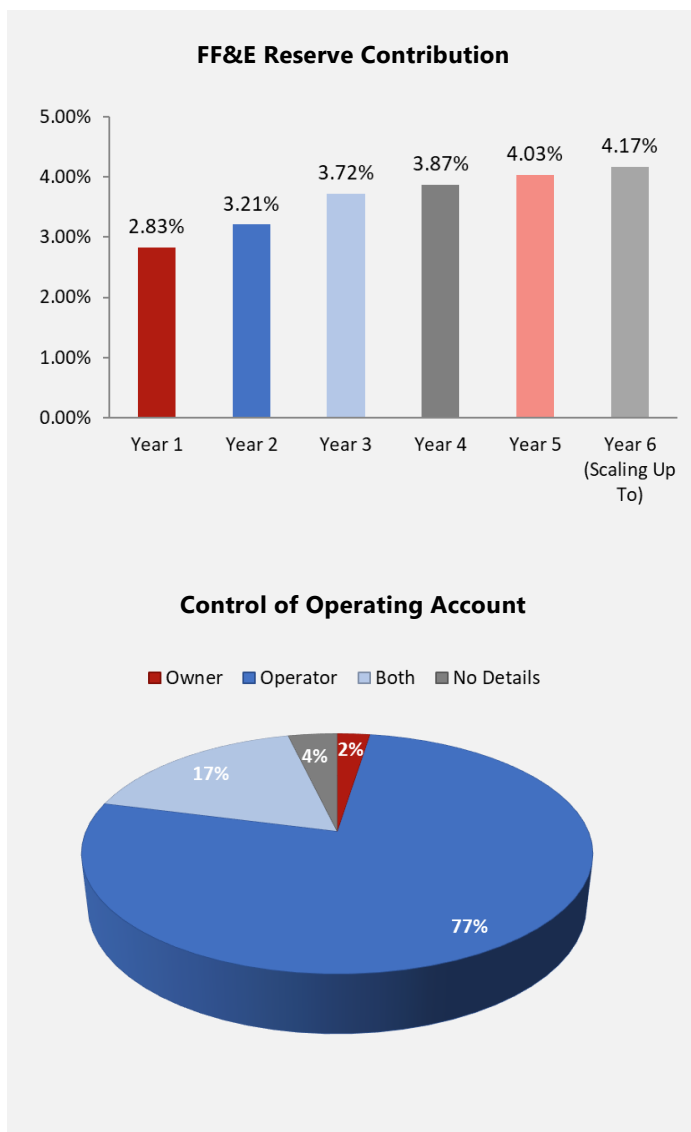
From an owner’s point of view, one of the most important provisions of a management contract is a performance clause that sets specific operating standards that the management company must meet to remain as the operator of the property. More than half of the contracts in the Canadian sample set provide an operator performance test clause.

The performance test clause tends to favour the operator, and the termination of the contract under this provision is uncommon. As such, the owner’s right of termination is generally not exercisable should the performance test failure occur as a result of a force majeure/extraordinary event; the renovation of the subject hotel; material default by owner impacting the operator’s ability to perform; damage to the hotel; or any other reason that may have been defined in the contract. Interestingly, “global pandemic” is not listed as a force majeure event in the management contracts in our sample. Given the absence of this specification, we anticipate that some owners may try to terminate their existing management agreements based on operator non-performance that has been caused by the COVID-19 pandemic.

The full report addresses the following aspects of operator performance test:

- **Commencement Year**
- **Test Period**
- **Type of Test**
- **Performance Thresholds**
- **Provision for Operator to Cure**

EXCERPT SURVEY RESULTS – BUDGET AND EXPENDITURE



The budgeting process is one of the most collaborative activities between an owner and an operator in the life of a management contract. For both parties, budgeting activity helps indicate the amount the operator could receive as fees, the owner’s share of profit, the threshold amounts linked with operator performance tests, and the extent of capital expenditures to be incurred for the coming year. Since the operator usually has greater control over the bank accounts of the hotel than the owner, owners need to have expenditure thresholds defined in the contract.

The FF&E reserve, also referred to as the reserve for replacement, is an annual monetary allocation/contribution to fund future expenditures related to the replacement of FF&E. The average FF&E reserve contribution is 4.17% of gross operating revenue on a stabilized basis.

The remaining sections of the report include the following:

- **Owner Approvals**
- **Indemnification**
- **Operator Investment in Property**
- **Termination of the Agreement**
- **Trends in Management Agreement Terms**

The full report addresses the following aspects of budget and expenditure:

- **Annual Plan Approval**
- **Expenditure Thresholds**
- **FF&E Reserve Contribution**
- **Control of Operating Account**



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About HVS

HVS, the world's leading consulting and services organization focussed on the hotel, mixed-use, shared ownership, gaming, and leisure industries, celebrated its 40th anniversary in 2020. Each year, HVS performs more than 4,500 assignments for hotel and real estate owners, operators, and developers around the world. HVS principals are regarded as the leading experts in their respective regions of the globe. Through a network of more than 50 offices and 350 professionals, HVS provides an unparalleled range of complementary services for the hospitality industry.

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HVS Canada performs major portfolio and single-asset consulting assignments and appraisals from coast to coast. HVS Canada celebrated its 27th year in 2020. Our professional team of close to 20 members are experts in appraisal work, feasibility studies, market studies, portfolio valuation, strategic business planning, and litigation support. The Managing Partners and senior members in the Calgary, Montreal, Toronto, and Vancouver practices have their AACI, MAI, and MRICS/FRICS appraisal designations, and all associates are candidate members of the Appraisal Institute of Canada. HVS partners and associates are also members of the Appraisal Institutes of Alberta, New Brunswick, and Nova Scotia. Our bilingual associates enable us to work in French, which is of utmost importance in the provinces of Quebec and New Brunswick.

About the Authors



Monique Rosszell is the Senior Managing Partner of HVS Toronto and Montreal. Upon attaining a bachelor's degree in economics from Queen's University, she subsequently enrolled in the Master's program in Hotel and Restaurant Management at the Ecole Hôtelière de Lausanne and then attained both her AACI and her MRICS appraisal designations in Canada. She is also a member of the International Society for Hospitality Consultants (ISHC). Monique has completed hundreds of valuations and feasibility studies throughout Canada, including transaction and portfolio valuations. She also offers litigation and expert witness support, speaks at numerous conferences, and is a trusted advisor within the lodging industry in Eastern Canada.

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Anastasia Ivanova, a Vice President with HVS Toronto, conducts site inspections, market analyses, economic feasibility studies and comprehensive appraisals for hotels. Anastasia covers Northern and Eastern Ontario and select Maritimes hotel markets. Before joining HVS, Anastasia spent over three years working for Maple Leaf Sports and Entertainment, in a role of a Food and Beverage Supervisor at various venues. Anastasia earned her Hon. Bachelor of Commerce from the Ted Rogers School of Management at Ryerson University. Anastasia became an AIC Candidate Member in 2015 and is working towards her AACI designation.

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