HVS

CHAPTER 19

Property Management

¶ 19.01 Individual Managers vs. Management Companies 19-2
[1] Supervision 19-2
[2] Expertise 19-3
[3] Verifiable Past Performance 19-3
[4] Established Methods and Procedures 19-3

¶ 19.02 Total Property Leases. 19-4
[1] Rental Formulas. 19-4

EXHIBIT 19-1 25, 10, and 5 Leases 19-5

[2] REIT Structures 19-5
[3] Advantages and Disadvantages of Property Lease Agreements. . . 19-5

¶ 19.03 Development of Hotel Management Contracts 19-6

¶ 19.04 Property Leases vs. Management Contracts 19-7

EXHIBIT 19-2 Assumed Occupancy and Average Room Rates. 19-7

EXHIBIT 19-3 Hotel *A*—Projection of Income and Expense 19-9

EXHIBIT 19-4 Hotel *B*—Projection of Income and Expense 19-10

EXHIBIT 19-5 Projected Rent. 19-11

EXHIBIT 19-6 Division of Hotel *A* Net Income Under Property Lease 19-11

EXHIBIT 19-7 Division of Hotel *A* Net Income Under Management Contract 19-12

EXHIBIT 19-8 Hotel *A* Under Lease vs. Management Contract 19-12

EXHIBIT 19-9 Division of Hotel *B* Net Income Under Property Lease 19-12

EXHIBIT 19-10 Division of Hotel *B* Net Income Under Management Contract 19-12

EXHIBIT 19-11 Hotel *B* Under Lease vs. Management Contract 19-13

¶ 19.05 Types of Hotel Management Companies 19-13
[1] First-Tier and Second-Tier 19-13
[2] Pre-Opening and Technical Services. 19-13

¶ 19.06 Management Contracts. 19-13
[1] Advantages for Operator. 19-14
[a] Inexpensive, Rapid Expansion 19-14
[b] Low Downside Risk. 19-14
[c] Critical Mass. 19-14
[d] Quality Control 19-14
[e] No Depreciation Expense . . . 19-15
[2] Disadvantages for Operator 19-15
[a] Residual Benefits of Ownership Eliminated 19-15
[b] Minimal Input in Ownership Decisions 19-15
[c] Dependence of Finances of Owner 19-15
[d] Contract Termination. 19-16
[3] Advantages for Owner 19-16
[a] Acquisition of Operational Expertise 19-16
[b] Immediate Name Recognition 19-16
[c] Quality Management. 19-16
[4] Disadvantages for Owner 19-17
[a] Loss of Operational Control. . . 19-17
[b] Liability for All Ongoing Expenses 19-17
[c] Termination of Operator 19-17
[d] Sale of Property 19-18
[e] Cost of Management. 19-18
[f] High Downside Risks 19-18
[g] Operator May Favor Own Property 19-18

¶ 19.07 Management Companies 19-18
[1] Advantages of First-Tier Companies. 19-19
[a] Cost. 19-19
[b] Corporate Identity. 19-19
[c] *More Efficient Operations* . . . 19-19
[d] Convention and Group Sales Capability 19-19

[e] Ease of Financing 19-19
[2] Disadvantages of First-Tier Companies. 19-20
[a] Restrictions on Property Size 19-20
[b] Restrictions on Financial Condition 19-20
[c] Restrictions on Contract Terms. 19-20
[d] Restrictions on Terminatons 19-20
[e] Less Flexibility in Negotiations 19-21
[f] Difficulty of Negotiations 19-21
[g] Operating Information Difficult to Obtain 19-21
[3] Advantages of Second-Tier Companies. 19-21
[a] Flexibility in Negotiations. . . . 19-21
[b] Individual Attention 19-21
[4] Disadvantages of Second-Tier Companies. 19-22
[a] Financing More Difficult to Obtain 19-22
[b] Perceived Risk 19-22
[c] Possible High Cost 19-22
[d] Lack of Financial Strength. . . 19-22
¶ 19.08 Management Company Operating Philosophies 19-23
[1] Centralized Management 19-23
[2] Decentralized Management 19-23
¶ 19.09 Services Provided by Management Companies 19-24
¶ 19.10 Management Company Selection Process 19-25
[1] Analysis of Market Study 19-26
[2] Selection of First- or Second-Tier Company 19-27
[3] When a First-Tier Company is Chosen 19-27
[4] When a Second-Tier Company is Chosen 19-27
[5] Consultation With Project Team 19-28
[6] Issues During Management Company Selection 19-28
[a] Company Profile 19-28
[b] Operating Performance 19-28
[c] Qualification of Key Personnel. 19-28
[d] Central Services 19-28
[e] Reimbursable Expenses 19-29
[f] Sales and Marketing 19-29
[g] Operating Projections 19-29
[h] Miscellaneous Information. . . 19-29
[7] Selection Rating System. 19-30
EXHIBIT 19-12 Hotel Management Company Initial Selection Rating System 19-30
[8] Bargaining Positions. 19-32
[9] Issues During Negotiation. 19-34

» 19.01 INDIVIDUAL MANAGERS VS. MANAGEMENT COMPANIES

The financial success of any lodging facility is largely dependent on the skill and ability of on-site management. Hotel operators face a number of unique problems, ranging from booking convention business to running a high-energy lounge to installing night audit financial controls. While the skills needed to handle such problems can be acquired through college-level training and operational experience, it is the type of system used by management that usually determines how successfully personnel can apply their skills.

Historically, hotel owners have either hired individual on-site managers to operate their properties or have engaged the services of professional hotel companies through hotel operating agreements such as property leases 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.

[1] Supervision

All the employees of a lodging facility should be supervised to ensure that the integrity of the facility's financial control system is maintained. An individual general

manager often cannot provide the necessary level of direct supervision, whereas the structure of a hotel management company generally provides several layers of control over this aspect of the business. Furthermore, an individual general manager can be abruptly hired away by a competitor, or may quit because of a dispute. A hotel management company, on the other hand, can provide the back-up staff, logistical support, and uninterrupted supervision that is essential for a 24-hour-a-day, 365-day-a-year business. Unless ownership can assume total operational responsibility for the hotel on short notice and for extended periods, an individual general manager is often not a viable alternative for property management.

[2] Expertise

Many professional hotel management companies offer a range of expertise and experience that individual general managers cannot match. Management companies can assist hotel owners with property development, acquisition, and operation by providing such services as national advertising and reservation systems, interior decorating, and property engineering. Management companies are often also able to provide counseling and representation for labor negotiations, permit and license applications, and zoning and property tax proceedings.

[3] Verifiable Past Performance

A successful hotel management company should be able to document its past performance and provide references regarding its operations currently under contract. Verifiable information of this kind provides hotel operators with a basis for selecting a qualified operator. Individual managers, on the other hand, generally cannot document the effect of their management on a particular hotel. As a result, the selection of a qualified general manager usually must be made with very little assurance that the individual will be capable of successfully operating the property. At the least, poor selection results in confusion and loss of momentum until another manager is located and brought in to take over the operation. While vulnerable to the same problem, a management company is better able to handle a transition between general managers because it can provide trained interim personnel who can quickly assume necessary responsibilities within an established system, permitting continuous operation of all essential controls and procedures.

[4] Established Methods and Procedures

The major advantage in hiring a management company is that it can provide established, functional methods and procedures that constitute a complete system capable of handling the complex job of operating a lodging facility. In instances in which a takeover must be made rapidly, established management companies can bring in top-level management staff from other properties to train local personnel and implement proper operating systems and controls. For new lodging facilities, management companies can often provide valuable advice in the layout and design of the physical plant, and once the facility is completed, can institute their mode of operation and quickly bring on-line a fully functioning lodging facility. This experience and expertise saves time and reduces costly mistakes.

Most hotel management companies have developed procedure manuals and

training programs that cover all of the aspects of lodging facility operations. When nothing is left to chance and set methods are established for handling all foreseeable problems, the element of human error is greatly reduced and hotel guests receive a consistently high level of service.

The benefits of retaining a professional hotel management company usually far outweigh the alternative of employing an individual general manager, particularly when a hotel owner does not have the ability or desire to provide a high level of supervision, As a result of many investors reaching this conclusion, the number of hotel properties managed by third-party operators has grown significantly over the past twenty-five years. This trend is further substantiated by hotel lenders, underwriters, and rating agencies, who typically require that a competent hotel company be included in the project team.

» 19.02 TOTAL PROPERTY LEASES

The practice of using professional hotel companies to manage lodging facilities for property owners began in the early 1900s. During this period, hotels became larger and more complicated to operate and the benefit of chain identification became an important competitive factor as the general population gained mobility. Hotel chains such as Hilton, Statler, Manger, and Albert Pick began to expand throughout the United States, operating both their own properties and hotels owned by others.

At first, the most common method by which hotel companies furnished management services was through total property leases. Essentially, a total property lease is an agreement between a hotel company and a hotel property owner whereby the hotel company 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 of the losses when operating performance is not adequate. Because of the popularity of management contracts, hotel operating leases have all but disappeared. Only recently, with the resurgence of real estate investment trusts (REITs), have operating leases been reestablished.

[1] Rental Formulas

Many types of rental formulas were devised for total property lease agreements. In a typical arrangement, known as a "25, 10, and 5 lease," the rent was based on the total of the percentages of various revenues realized by the property. See Exhibit 19-1.

Under such an arrangement, the landlord, as owner of the land and improvements, was responsible for payment of real estate taxes. The tenant owned the personal property and paid all of the operating expenses incurred by the hotel. Sometimes the rental agreement also provided the landlord with a minimum rent to cover the debt service on any mortgages on the property. If such was the case, the tenant paid the greater of the minimum rent amount or the rental formula, such as that for a 25, 10, and 5 lease.

Exhibit 19-1 25, 10, and 5 Leases

	Percentage of Total
Rooms Revenue	25
Beverage Revenue	10
Food Revenue	5
Other Income	20

[2] REIT Structures

The use of real estate investment trusts (REITs) as an alternative for hotel acquisition, financing, and portfolio expansion has resulted in the increased popularity of hotel operating leases. To qualify for favorable REIT tax advantages, the owning company may not operate the properties—it must "lease" the hotels to an independent lessee. Typically, the lessee in turn contracts third-party management, in which management fees are subordinated to the minimum base fee paid to the company. Rents typically include a base and percentage fee or are the greater of the two. In these scenarios, the lessee assumes a majority of the downside risk and is often related to the chosen operator, effectively creating a total property lease.

As a result of REITs competing in the same arena as other fixed income securities, the life of a real estate investment trust fluctuates with the rise and fall of interest rates. For this reason, hotel operating leases may be limited to the few hotel-specific REITs created during periods of low interest rates.

[3] Advantages and Disadvantages of Property Lease Agreements

A property lease agreement contains advantages and disadvantages for both parties. A property owner realizes the following advantages:

1. The owner retains title to the property, which provides possession and creates residual value when the term of the lease expires.
2. The financial risk to the owner is minimized, particularly if the hotel company is creditworthy and has guaranteed a minimum rent.
3. The owner has no operational responsibilities. The

property owner faces the following disadvantages:

1. The operator has little incentive to maintain the property in top condition as the lease term nears its expiration date. For this reason, many hotels are returned to the owners in poor physical condition, as well as with a tainted reputation. Furthermore, because much of the existing business is often diverted to other hotels managed by the operator, few reservations are on the books for the owner or new tenant.
2. A hotel lease places the owner in a passive position. Under such an agreement, the owner has no input in the operations of the hotel or control over the hotel management. Little can be done if the property is not operated

in a profitable and appropriate manner unless the terms of the lease are violated.

3. If the hotel is extremely successful, the property owner does not participate in the financial rewards to the extent of an owner/operator. Thus, the potential for profit is somewhat limited.
4. Leases are difficult to terminate. Unlike a management contract, which is an agency agreement, a lease creates an encumbrance on the real estate that gives the tenant specific rights of possession.

There are several advantages in a property lease agreement for the hotel operator:

1. The operator has total control of the hotel during the term of the lease with very few approvals required from ownership.
2. A profitable hotel creates a leasehold value that can sometimes be mortgaged by the operator. If the terms of the lease permit a transfer, the leasehold value can also be realized through a sale.
3. The upside profit created by a successful hotel will solely benefit the operator, who receives whatever money remains after operating expenses and lease rental have been paid.

The disadvantages for a hotel operator are as follows:

1. The hotel operator loses possession of the property when the lease term expires.
2. The leasehold loses its value as the term of the lease expires.
3. The financial risks of operating the hotel are borne by the hotel company, so the operator must have a net worth great enough to be able to incur the exposure.
4. Leasehold interests create contingent liabilities on corporate balance sheets that can adversely affect the value of stock in publicly traded companies. Of course, because of the requirements for real estate investment trusts, hotel operating leases are a necessity.

» 19.03 DEVELOPMENT OF HOTEL MANAGEMENT CONTRACTS

Hotel management contracts came into use between 1950 and 1960. During that time, more and more Americans started traveling abroad, and foreign governments that were interested in attracting American tourists began encouraging U.S. hotel companies to develop hotels in their countries.

The concept of a worldwide lodging chain was appealing to a number of hotel companies, but many were reluctant to expose themselves to the development and operating risks associated with owning or leasing a hotel in a foreign country. Many factors, including governmental instability, fiscal uncertainty, and a lack of skilled labor led hotel companies to develop a replacement for the property lease that would shift the financial burden from the operator to the owner. The result of the hotel companies' efforts was the hotel management contract.

A management contract is essentially an agreement between a hotel management company and a hotel property owner whereby the management company 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 entirely on the owner, who enjoys the upside benefits of a successful property, but suffers the downside losses if the operation is not profitable. Under this arrangement, American hotel companies were eager to expand overseas because the foreign country assumed the financial risk for the benefit of developing tourism and the management company provided operational expertise and name recognition. Chains such as Hilton International, Hyatt, Sheraton, Western International (Westin), and Intercontinental were among the hotel companies that used management contracts to expand their bases of operations worldwide.

Once hotel companies discovered that they could make almost as much money with a management contract as with a property lease without assuming any of the financial risks, they started to change their modes of operation.

» 19.04 PROPERTY LEASES VS. MANAGEMENT CONTRACTS

Exhibit 19-2 illustrates the shifting of financial risks between the property owner and the hotel operator, using both a property lease and management contract structure. Two scenarios are set forth for a proposed 300-room, first-class hotel: one assumes a new property (Hotel A) with a normal occupancy build-up and the other assumes a new property of the same description but with a lower starting occupancy and a longer and slower build-up (Hotel *B*).

Exhibit 19-2 Assumed Occupancy and Average Room Rates

	Hotel *A* (Normal Occupancy Build-up)		Hotel *B* (Low Occupancy Build-Up)	
Year	**Occupancy**	**Average Rate**	**Occupancy**	**Average Rate**
1	58%	$95.00	45%	$95.00
2	65	101.65	48	101.65
3	70	107.75	50	107.75
4	73	113.14	52	113.14
5	73	117,66	53	117.66
6	73	122.37	54	122.37
7	73	127.26	55	127.26

As shown in Exhibit 19-2, Hotel *A* starts with a 58 percent occupancy in Year One and reaches a stabilized level of 73 percent in Year Four. Hotel *B* starts with an occupancy rate of 45 percent in Year One that grows slowly and stabilizes at 55 percent in Year Seven.

Seven-year projections of income and expense for each hotel based on these occupancy and average rate assumptions are shown in Exhibits 19-3 and 19-4. The data for operating ratios for controllable expenses have been adjusted to reflect differing levels of occupancy; fixed expenses such as property taxes and insurance have been

held constant except for inflationary increases. A basic management fee of 3.0 percent (based on total revenue) has been deducted as well as a 4.0 percent reserve for replacement (also based on total revenue) to provide a fund for the replacement of furniture, fixtures, and equipment.

A property lease and a management contract structure is assumed for each scenario in the Exhibits. The terms for these structures are based on typical provisions found in the marketplace. It should be noted that, beyond their use in REIT structures, hotel property leases are no longer common and therefore the assumed terms are based on the historic use of these instruments.

As stated previously, the rent paid under hotel property leases has typically been determined by the "25, 10 and 5" lease. The actual dollar amounts yielded by this formula for both hotels are shown in Exhibit 19-5.

Usually, under such an agreement the landlord owns the land and improvements and is responsible for the payment of real estate taxes. The tenant owns the personal property and pays all operating expenses.

Exhibit 19-6 shows how the net income realized by Hotel A is divided between the hotel company (tenant) and the property owner (landlord) under a property lease.

The net income realized by the tenant starts with the net income from the projection of income and expense. The landlord pays the real estate taxes out of the rent, so the amount deducted for real estate taxes can be added back to the net income. The rent is deducted from the net income and is calculated using the rental formula set forth above. The result of these calculations is the net to the tenant.

The net to the landlord is based on the previously calculated rent minus the property tax obligation. Because the tenant is assumed to own the furniture, fixtures, and equipment, a reserve for replacement has not been deducted from the net to the landlord.

The terms of the management contract assume a basic management fee of 3 percent of total revenue plus an incentive fee equal to 10 percent of house profit (income before fixed charges) after deducting the 3 percent base fee. Exhibit 19-7 shows how the net income for Hotel A is divided between the hotel company and the property owner under a management contract.

The net to the management company is the total of the basic management fee plus the incentive fee; the net to the owner is equal to the residual net income remaining after deducting the total management fee.

A comparison of each structure is made for Hotel A in Exhibit 19-8 by totaling the income to each party over a seven-year period assuming both a lease and management contract.

Hotel *B* has a lower starting occupancy and a longer and slower income buildup and as a consequence produces much different results from Hotel A. Exhibit 19-9 shows how the net income of Hotel *B* would be divided between the hotel company (tenant) and the property owner (landlord), assuming a property lease. As can be seen, the net income realized by the tenant is actually negative for the first four years, while the landlord, on the other hand, realizes a positive cash flow.

Exhibit 19-10 assumes a management contract structure for Hotel *B* and shows how the net income is shared between the hotel company and property owner. Exhibit 19-11 compares each structure by totaling the income to each party over the seven-year period.

In this scenario, the hotel company would want to operate the hotel with a management contract, while the property owner would realize more income from a lease. In fact, if the transaction were structured as a lease, the hotel company would have a cash flow shortfall of almost $4 million during the first seven years of operation. For many of the smaller hotel companies, this degree of exposure is not acceptable.

Comparing the economic benefits to the hotel company under a lease with those under a management contract, it becomes apparent that the potential upside benefit

Exhibit 19-3 Hotel *A*—Projection of Income and Expense

	Year #1	Year #2	Year #3	Year #4	Year #5	Year #6	Year #7
Number of Rooms	300	300	300	300	300	300	300
Occupancy	58.00%	65.00%	70.00%	73.00%	73.00%	73.00%	73.00%
Average Rate	$95.00	$101.65	$107.75	$113.14	$117.66	$122.37	$127.26
Days Open	365	365	365	365	365	365	365
Occupied Rooms	63,510	71,175	76,650	79,935	79,935	79,935	79,935

	Total $	% Gross	Total $	% Gross	Total $	% Gross	Total $	% Gross	Total $	% Gross	Total $	% Gross	Total $	% Gross
Revenue														
Rooms	6,033	54.9	7,235	56.4	8,259	57.3	9,044	58.0	9,405	58.0	9,782	58.0	10,173	58.0
Food	3,212	29.2	3,624	28.3	3,980	27.7	4,271	27.3	4,442	27.3	4,620	27.3	4,804	27.3
Beverage	1,285	11.7	1,450	11.3	1,592	11.1	1,708	10.9	1,777	10.9	1,848	10.9	1,922	10.9
Telephone	248	2.3	285	2.2	316	2.2	342	2.2	355	2.2	370	2.2	384	2.2
Other Income	214	1.9	229	1.8	243	1.7	256	1.6	267	1.6	277	1.6	288	1.6
Total	10,992	100.0	12,823	100.0	14,390	100.0	15,621	100.0	16,897	100.0	17,571	100.0	17,571	100
Departmental Expenses														
Rooms	1,505	24.9	1,631	22.5	1,745	21.1	1,845	20.4	1,919	20.4	1,996	20.4	2,075	20.4
Food and Beverage	3,562	79.2	3,833	75.5	4,082	73.3	4,305	72.0	4,478	72.0	4,657	72.0	4,843	72.0
Telephone	169	68.1	182	63.9	194	61.4	205	59.9	213	60.0	222	60.0	231	60.2
Other Income	134	62.6	141	61.6	147	60.5	154	60.2	160	59.9	166	59.9	173	60.1
Total	5,370	48.9	5,787	45.1	6,168	42.9	6,509	41.7	6,770	41.7	7,041	41.7	7,322	41.7
Departmental Income	5,622	51.1	7,036	54.9	8,222	57.1	9,112	58.3	9,476	58.3	9,856	58.3	10,249	58.3
Operating Expenses														
Administrative and General	953	8.7	1,022	8.0	1,087	7.6	1,145	7.3	1,191	7.3	1,239	7.3	1,288	7.3
Management Fee	330	3.0	385	3.0	432	3.0	469	3.0	487	3.0	507	3.0	527	3.0
Marketing	572	5.2	613	4.8	652	4.5	687	4.4	715	4.4	743	4.4	773	4.4
Franchise Fees	241	2.2	289	2.3	330	2.3	362	2.3	376	2.3	391	2.3	407	2.3
Property Operations and Maintenance	623	5.7	668	5.2	710	4.9	748	4.8	778	4.8	809	4.8	842	4.8
Energy	554	5.0	582	4.5	610	4.2	637	4.1	663	4.1	689	4.1	717	4.1
Total	3,273	29.8	3,559	27.8	3,821	26.5	4,048	25.9	4,210	25.9	4,378	25.9	4,554	25.9
House Profit	2,349	21.3	3,477	27.1	4,401	30.6	5,064	32.4	5,266	32.4	5,478	32.4	5,695	32.4
Fixed Expenses														
Property Taxes	349	3.2	363	2.8	378	2.6	393	2.5	409	2.5	425	2.5	442	2.5
Insurance	121	1.1	126	1.0	131	0.9	136	0.9	142	0.9	147	0.9	153	0.9
Reserve for Replacement	440	4.0	513	4.0	576	4.0	625	4.0	650	4.0	676	4.0	703	4.0
Total	910	8.3	1,002	7.8	1,085	7.5	1,154	7.4	1,201	7.4	1,248	7.4	1,298	7.4
Net Income	1,439	13.0	2,475	19.3	3,316	23.1	3,910	25.0	4,065	25.0	4,230	25.0	4,397	25.0

Exhibit 19-4 Hotel *B*—Projection of Income and Expense

	Year #1	Year #2	Year #3	Year #4	Year #5	Year #6	Year #7
Number of Rooms	300	300	300	300	300	300	300
Occupancy	45.00%	48.00%	50.00%	52.00%	52.00%	52.00%	52.00%
Average Rate	$95.00	$101.65	$107.75	$113.14	$117.66	$122.37	$127.26
Days Open	365	365	365	365	365	365	365
Occupied Rooms	49,275	52,560	54,750	56,940	56,940	56,940	56,940

	Total $	% Gross	Total $	% Gross	Total $	% Gross	Total $	% Gross	Total $	% Gross	Total $	% Gross	Total $	% Gross
Revenue														
Rooms	4,681	52.8	5,343	54.0	5,899	54.8	6,442	55.5	6,700	55.5	6,968	55.5	7,246	55.5
Food	2,705	30.5	2,935	29.7	3,136	29.2	3,350	28.8	3,484	28.8	3,623	28.8	3,768	28.8
Beverage	1,082	12.2	1,174	11.9	1,254	11.7	1,340	11.5	1,394	11.5	1,449	11.5	1,507	11.5
Telephone	199	2.2	219	2.2	235	2.2	253	2.2	263	2.2	274	2.2	285	2.2
Other Income	202	2.3	213	2.2	223	2.1	234	2.0	244	2.0	253	2.0	263	2.0
Total	8,869	100.0	9,884	100.0	10,747	100.0	11,619	100.0	12,085	100.0	12,567	100.0	13,069	100.0
Departmental Expenses														
Rooms	1,389	29.7	1,472	27.6	1,551	26.3	1,633	25.3	1,698	25.3	1,766	25.3	1,837	25.4
Food and Beverage	3,332	88.0	3,521	85.7	3,699	84.3	3,887	82.9	4,043	82.9	4,204	82.9	4,373	82.9
Telephone	157	78.9	166	75.8	175	74.5	184	72.7	191	72.6	199	72.6	207	72.6
Other Income	132	65.3	138	64.8	144	64.6	150	64.1	156	63.9	162	64.0	168	63.9
Total	5,010	56.5	5,297	53.6	5,569	51.8	5,854	50.4	6,088	50.4	6,331	50.4	6,585	50.4
Departmental Income	3,859	43.5	4,587	46.4	5,178	48.2	5,765	49.6	5,997	49.6	6,236	49.6	6,484	49.6
Operating Expenses														
Administrative and General	905	10.2	956	9.7	1,005	9.4	1,055	9.1	1,097	9.1	1,141	9.1	1,187	9.1
Management Fee	266	3.0	297	3.0	322	3.0	349	3.0	363	3.0	377	3.0	392	3.0
Marketing	543	6.1	574	5.8	603	5.6	633	5.4	658	5.4	685	5.5	712	5.4
Franchise Fees	187	2.1	214	2.2	236	2.2	258	2.2	268	2.2	279	2.2	290	2.2
Property Operations and Maintenance	591	6.7	625	6.3	657	6.1	689	5.9	717	5.9	746	5.9	775	5.9
Energy	545	6.1	570	5.8	595	5.5	620	5.3	645	5.3	671	5.3	698	5.3
Total	3,037	34.2	3,236	32.8	3,418	31.8	3,604	30.9	3,748	30.9	3,899	31.0	4,054	30.9
House Profit	822	9.3	1,351	13.6	1,760	16.4	2,161	18.7	2,249	18.7	2,337	18.6	2,430	18.7
Fixed Expenses														
Property Taxes	349	3.9	363	3.7	378	3.5	393	3.4	409	3.4	425	3.4	442	3.4
Insurance	121	1.4	126	1.3	131	1.2	136	1.2	142	1.2	147	1.2	153	1.2
Reserve for Replacement	355	4.0	395	4.0	430	34.0	465	4.0	483	4.0	503	4.0	523	4.0
Total	825	9.3	884	9.0	939	8.7	994	8.6	1,034	8.6	1.075	8.6	1,118	8.6
Net Income	(3)	0.0	467	4.6	821	7.7	1,167	10.1	1,215	10.1	1,262	10.0	1,312	10.1

from the lease is limited while the downside risk is significant. At the same time, the hotel company is exposed to an actual cash loss with a property lease if the hotel experiences a slow occupancy build-up. The limited upside benefits afforded by total property leases have led hotel companies in recent years to avoid this structure and enter instead into either management contracts or property ownership.

Management companies eager to secure a particular location or property have offered guarantees to the ownership, effectively reducing the risk to ownership while allowing the operator to participate in the upside potential.

Exhibit 19-5 Projected Rent

Hotel *A* (normal occupancy build-up) ($000)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Rooms	$1,508	$1,809	$2,065	$2,261	$2,351	$2,446	$2,543
Food	161	181	199	214	222	231	240
Beverage	129	145	159	171	178	185	192
Other Income	92	103	112	120	124	129	134
Total Rent	$1,890	$2,238	$2,535	$2,765	$2,875	$2,991	$3,110

Hotel *B* (normal occupancy build-up) ($000)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Rooms	$1,170	$1,336	$1,475	$1,611	$1,675	$1,742	$1,812
Food	135	147	157	168	174	181	188
Beverage	108	117	125	134	139	145	151
Other Income	80	86	92	97	101	105	110
Total Rent	$1,494	$1,686	$1,849	$2,009	$2,090	$2,173	$2,260

Exhibit 19-6 Division of Hotel *A* Net Income Under Property Lease

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Net Income	$1,439	$2,475	$3,316	$3,910	$4,065	$4,230	$4,397
Plus RE Tax	349	363	378	393	409	425	442
Less Rent	1,890	2,238	2,535	2,765	2,875	2,991	3,110
Net to Tenant	($102)	$600	$1,159	$1,538	$1,599	$1,664	$1,729
Rent	1,890	2,238	2,535	2,765	2,875	2,991	3,110
Less RE Tax	349	363	378	393	409	425	442
Net to Landlord	$1,541	$1,875	$2,157	$2,372	$2,466	$2,566	$2,668

Exhibit 19-7 Division of Hotel *A* Net Income Under Management Contract ($000)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Basic Fee	$330	$385	$432	$469	$487	$507	$527
Plus Incentive Fee	235	348	440	506	527	548	570
Net to Management Company	$565	$733	$872	$975	$1,014	$1,055	$1,097
Net Income	1,439	2,475	3,316	3,910	4,065	4,230	4,397
Less Management Fee	330	385	432	469	487	507	527
Net to Owner	$1,109	$2,090	$2,884	$3,441	$3,578	$3,723	$3,870

Exhibit 19-8 Hotel *A* Under Lease vs. Management Contract

	Management Company	Property Owner
Lease	$8,188,000	$15,644,000
Management Contract	6,310,000	20,695,000

Exhibit 19-9 Division of Hotel *B* Net Income Under Property Lease ($000)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Net Income	($3)	$467	$821	$1,167	$1,215	$1,262	$1,312
Plus RE Tax	349	363	378	393	409	425	442
Less Rent	1,494	1,686	1,849	2,009	2,090	2,173	2,260
Net to Tenant	($1,148)	($856)	($650)	($449)	($466)	($486)	($506)
Rent	1,494	1,686	1,849	2,009	2,090	2,173	2,260
Less RE Tax	349	363	378	393	409	425	442
Net to Landlord	$1,145	$1,323	$1,471	$1,616	$1,681	$1,748	$1,818

Exhibit 19-10 Division of Hotel *B* Net Income Under Management Contract ($000)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Basic Fee	$266	$297	$322	$349	$363	$377	$392
Plus Incentive Fee	82	135	176	216	225	234	243
Net to Management Company	$348	$432	$498	$565	$588	$611	$635
Net Income	(3)	467	821	1,167	1,215	1,262	1,312
Less Management Fee	266	297	322	349	363	377	392
Net to Owner	($269)	$170	$499	$818	$852	$885	$920

Exhibit 19-11 Hotel *B* Under Lease vs. Management Contract

	Management Company	Property Owner
Lease	($4,562,000)	$10,803,000
Management Contract	$3,677,000	$3,875,000

» 19.05 TYPES OF HOTEL MANAGEMENT COMPANIES

[1] First-Tier and Second-Tier

The management companies that enter into management contracts with hotel owners are generally classified as either first-tier or second-tier. First-tier companies operate lodging facilities for third parties under management contracts and provide day-today operational supervision and property management as well as national or regional customer recognition through their trade names. Hilton, Hyatt, Marriott, and Sheraton 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, provide any customer recognition through their corporate name, but make use of franchise affiliations to generate customer identification. Examples of second-tier management companies are Interstate Hotels, American General Hospitality, Richfield Hospitality, and Hospitality Equity Investors.

[2] Pre-Opening and Technical Services

In addition to daily operations, management companies also frequently contract to provide pre-opening services and technical services. Pre-opening services are provided by the management company before the opening of a facility to the public. Typical services include a pre-opening plan and budget, personnel recruiting and training, sales and advertising, purchasing, and establishing an account system and controls. Pre-opening services may be used at both newly developed hotels and existing properties that change ownership. Fees for such services are generally separate from and in addition to those charged for management supervision.

Technical services are provided by hotel management companies during the planning, design, and construction stages of a new hotel development. These services include design and facilities planning, architectural assistance and review, interior design and lighting recommendations, and mechanical and food facilities installation. Technical services are also available for the expansion and renovation of existing properties. As is the case with pre-opening services, fees for technical services are generally separate from and in addition to fees charged for management supervision.

» 19.06 MANAGEMENT CONTRACTS

Management contracts have certain advantages and disadvantages to both the hotel company and property owner. In order to negotiate and structure an equitable agree-

ment, both parties should understand each other's motivations for entering into a management contract.

[1] Advantages for Operator

[a] Inexpensive, Rapid Expansion

Because management contracts typically require very little in the way of capital outlay on the part of the operator, their use can make possible inexpensive and rapid chain expansion with a low level of investment. In fact, on occasion, in order to secure a management contract, hotel companies contribute working capital in the form of a loan or some other small good-faith investment. As mentioned previously, management companies may also extend guarantees to ownership, but are typically paid a higher incentive fee if this is the case. The management fee set by the contract is generally structured so that the basic fee, which is a guaranteed flow of income computed as a percentage of total revenue, is more than sufficient to cover the hotel company's home office overhead and operating expenses. The lead time involved with developing new hotels is eliminated for operators willing to take over existing properties. Additional supervisory staff and some home office overhead is all that is required in order to do so.

[b] Low Downside Risk

Under a typical management contract, the hotel owner is financially responsible for all working capital, operating expenses, and debt service. The management company has no financial exposure and essentially covers its operating expenses and makes a small profit from the basic management fee and makes an even larger profit from any incentive fee.

[c] Critical Mass

While the actual operating expense and home office cost of providing hotel management services is minimal, a critical mass of properties under contract is necessary in order to cover the cost of key operational executives and home office and support staff and still generate acceptable profits. First-tier management companies also usually offer a computerized reservation system, so their fixed overhead is generally greater than that of a second-tier operator. The size of the critical mass varies depending on the class and types of hotels operated, along with the nature of the services offered by the management company. The typical range of critical mass for a first-tier company is forty to fifty hotels under contract; for second-tier companies, the range is usually ten to fifteen hotels.

Luxury hotels require a greater critical mass than budget operations because home office support must be more extensive. Similarly, convention-oriented chains with extensive group marketing needs require a larger critical mass than chains catering primarily to commercial travelers.

[d] Quality Control

Management contracts allow hotel companies to maintain control of both physical and operational quality. Hotel companies, particularly the more well-known first-tier chains, are always concerned about maintaining a favorable public image. A hard-

earned reputation can be tarnished quickly if a single property suffers from physical and managerial neglect. Consequently, a management contract provides the necessary level of quality control for a hotel operator. With an unrestricted management policy and an adequately funded reserve for replacement, a management company has almost total control of the quality and image of its properties. In a franchise relationship, on the other hand, where a hotel merely carries a chain identification and there is no central managerial control, it is much more difficult to maintain a uniform level of quality. Several hotel chains, including Hyatt, Four Seasons, and Motel 6, follow a general policy of not franchising in order to have total quality and operational control over their hotels.

[e] No Depreciation Expense

Management contracts are attractive to public hotel companies because the cash flow they realize is often close to what ownership of a property would provide, yet they allow the company to avoid the depreciation expenses for which a property owner is liable. Management fees paid to hotel companies are considered ordinary income for income tax purposes, but if a hotel company owns a hotel, the income it realizes is eroded by depreciation expenses required for both the improvements and the personal property under current tax regulations.

Publicly held hotel companies find management contracts particularly rewarding because they can minimize the amount of depreciation expenses shown on their income statements, thus enhancing their price/earnings ratio and making their stock more attractive to investors.

[2] Disadvantages for Operators

[a] Residual Benefits of Ownership Eliminated

Any increase in the value of a hotel generated by the management company over the course of a management contract accrues to the benefit of the owner when the hotel is sold or refinanced.

During the early 1990s, many second-tier hotel companies provided short-term management contracts to lending institutions in order to assist with their distressed foreclosures. Many of the management companies that successfully reestablished cash flow and economic value in problem hotels were rewarded by losing their contracts when the properties were sold to new owners.

[b] Minimal input in Ownership Decisions

Most management agreements apply minimal restrictions on the owner's ability to transfer ownership to another party. An undercapitalized owner, for example, can restrict cash needed to cover shortfalls and adversely affect the operation and quality of the property. Also, as with any relationship, a management contract requires cooperation from both parties; a difficult owner can make life miserable for a management company by imposing any number of unreasonable demands.

[c] Dependence on Finances of Owner

If the cash flow generated by a hotel operation is not sufficient to cover operating expenses and debt services, the hotel operator is totally dependent on the owner for pro-

viding necessary funds. No matter how thoroughly a management company investigates the creditworthiness of a hotel owner prior to entering into an agreement, adverse circumstances can quickly deplete anyone's financial resources. The risk to a hotel management company goes beyond the inconvenience of insufficient operating capital or a deferral of needed furniture replacement; it could ultimately result in the loss of a management contract as a result of bankruptcy or foreclosure. Beside the negative effect on a management company's income and reputation, such a cancellation (on the part of a bankruptcy court or foreclosing lender) seldom involves payment of a cancellation fee to the management company.

[d] Contract Termination

Hotel management contracts often contain cancellation provisions, typically upon a sale, that allow owners to terminate the agreement upon payment of a stipulated cancellation fee. The disruption in management deployment and public identity, however, can be damaging especially to a first-tier operator.

[3] Advantages for Owner

[a] Acquisition of Operational Expertise

Hotel management contracts provide owners with the essential operational expertise necessary for establishing and preserving the long-term profitability of their investment. At the same time, a management contract allows owners to keep such ownership benefits as cash flow, depreciation deductions, tax benefits, value enhancement, refinancing opportunities, and possession of the property after the contract expires.

[b] Immediate Name Recognition

A management contract with a first-tier management company immediately gives the owner's hotel a national or regional identification. This recognition is achievable only through a second-tier management company if coupled with a franchise affiliation.

[c] Quality Management

In recent years, hotel lenders and investors have become more knowledgeable about the industry. One aspect of this increased sophistication is the emphasis now placed on quality management as a key component of a successful hotel venture. In addition to evaluating the local market for transient accommodations, the area and neighborhood characteristics, and the actual real estate itself, hotel lenders and investors take great interest in the ability and financial track record of a proposed operator. Most lenders and investors require that an established hotel management company be put in charge of the day-to-day operations of any hotel in which they have an interest. Some even demand that a professional hotel asset manager supervise the hotel company.

If the operator is a second-tier company, it generally must have a franchise affiliation in order to attract the necessary financing. While including a nationally known hotel company as part of the project team does not guarantee financing, it does show positive interest on the part of the operator that can favorably influence the investment decisions of the lender.

[4] Disadvantages for Owner

[a] Loss of Operational Control

A management contract gives the operator total operational control of the property. If the management company operates the hotel in a competent manner, this loss of control is not a problem. However, if the property is mismanaged, the owner may find it very difficult to remove the incompetent operator. As a result, a greater number of management agreements have included specific standards that allow owners to terminate operators who do not achieve certain levels of performance. However, even with stringent performance criteria, the process of removing a poor management company must be timely; the reputation of the hotel can be badly damaged if new management is not quickly in place.

[b] Liability for All Ongoing Expenses

The owner of a hotel under a management contract is financially liable for all costs and expenses, including fixed charges and debt service. This means that even though the manager's neglect or incompetence may actually cause the financial loss, the owner is still ultimately responsible for funding the negative cash flow. For this reason, a well-structured management contract should contain incentives for the operator to maximize revenues and minimize expenses. Deferring a portion of the management fee to be paid as a percentage of a defined level of profit creates a financial incentive for an operator to manage efficiently. Essentially, through an incentive management fee, the management company's earnings become directly tied to the profits of the hotel. The actual contractual structure of the operator's incentive fee can often create greater or less incentive. For example, if an incentive fee is based on 10 percent of income before fixed charges and paid only if sufficient income remains after debt service, the operator would have a greater incentive to maximize revenue and minimize expenses than if the incentive fee was payable whether or not a positive cash flow was generated. This formula can be further modified to produce even greater operator incentive by requiring the management company to forever forfeit the incentive fee if the income after debt service is insufficient, rather than merely deferring and accumulating the fee until repayment can be made from future cash flows.

[c] Termination of Operator

Most management agreements are difficult for owners to terminate prematurely or without a sale. First-tier management companies, concerned about adverse publicity from losing their identification within a particular market generally require a non-cancelable contract that exceeds ten years in length, in addition to one or more extension clauses. Second-tier operators usually accept a shorter relationship, but often insist on provisions limiting the owner's ability to terminate at an earlier date. The inability of an owner to unilaterally terminate a hotel management contract for poor performance can significantly increase its exposure to financial loss. To reduce these risks, management contracts should be written with specific performance standards tied to cancellation provisions. In addition, owners often negotiate an all-purpose contract buy-out clause that allows for the removal of the management company at any time upon payment of a stipulated amount.

[d] Sale of Property

The sale of a hotel property is often much more difficult if it must be sold subject to 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 this reason, the sale of a hotel with management in place often brings a lower price than if the property were sold without management. A buy-out provision gives an owner the option of selling the hotel subject to the existing agreement or purchasing the contract and selling the hotel unencumbered by management. (See Chapter 20 for a discussion of such provisions.)

[e] Cost of Management

The cost of management can absorb a substantial portion of the cash generated by a hotel. Simply put, quality hotel management is expensive. Depending on the operator and the terms of the management contract, the total management fee, expressed as a percentage of the cash flow after debt service, can be as much as 70 to 85 percent. If the occupancy level is low, as in the case of a newly opened hotel, the total management fee could exceed the cash flow after debt service, meaning the owner would have to contribute additional capital to the venture. To assist owners during start-up periods and provide lenders with an additional debt service cushion, most hotel management companies will subordinate their incentive fee to debt service. This means that if the income before debt service is insufficient to cover the mortgage payment, the management company would either forgo or defer their incentive management fee.

[f] High Downside Risks

Owners of lodging facilities face downside risks that are due to the high amount of fixed costs associated with the operation of a hotel or motel. As occupancies drop, losses escalate rapidly because many of the fixed hotel expenses cannot be cut back. The use of property leases shifts this downside risk from the owner to the operator, but under a management contract, any negative cash flow is the responsibility of the owner.

[g] Operator May Favor Own Property

A conflict of interest always exists when a hotel company both owns and operates properties for its own account and operates hotels for nonrelated third parties. Because a hotel company generally receives a greater economic benefit from sending guests to its owned hotels rather than to properties it manages, the possibility for unfair practices is always present. Owners should be aware of this basic conflict and be sure that management agreements include provisions restricting possible abuse.

» 19.07 MANAGEMENT COMPANIES

Once an owner has decided to use the services of a hotel management company, a decision must be made as to whether a first- or second-tier operator should be selected, A first-tier hotel management company provides the owner with a publicly identifi-

able name (e.g., Hilton, Sheraton, or Marriott) and management expertise. A second-tier management company has no "brand-name" image and therefore can offer only management expertise.

[1] Advantages of First-Tier Companies

[a] Cost

The cost of a first-tier management company is often less than that of a second-tier operator and the requisite franchise affiliation. Second-tier management companies provide no national identification, so the cost of a franchise affiliation must be added to the second-tier management fee in order to reflect the same benefits of a first-tier company.

[b] Corporate Identity

First-tier companies have a strong interest in running successful operations. Consequently, some chain affiliations, as previously noted, are available only by management contract. The primary reason these companies have for not franchising is the desire to maintain total control over the operational and physical quality of the property.

[c] More Efficient Operations

First-tier companies, perhaps because they are complete operating entities, tend to be more unified and seem to have a better ability to implement company managerial and operational philosophies than do second-tier companies operating under a franchise affiliation. For example, on-site first-tier management personnel are often more familiar with the chain's home office systems, procedures, and personnel and can take greater advantage of the various services offered than can second-tier personnel in a similar situation. A franchise affiliation tends to be more detached and the productive interaction between the property and home office is frequently reduced.

[d] Convention and Group Sales Capability

Convention and group sales require a very specialized form of marketing that necessitates a massive capital investment in order to gather information detailing the specific meeting requirements of associations, organizations, corporations, and groups. It takes years of effort to assemble this information into a usable format. Since the data is so specialized, only a few hotel chains (e.g., Marriott, Sheraton, Hilton, and Hyatt) have made this infrastructure investment and effectively use it for group sales. Most franchise organizations and second-tier hotel operators do not accumulate the information that would enable them to compete in the convention and group sales markets with first-tier companies.

[e] Ease of Financing

First-tier hotel management companies tend to be more "financible"; that is, lenders in the hotel field, as well as equity investors, are often more comfortable lending money to projects operated by recognizable, "brand-name" management companies. Whether the perception that a name operator reduces risk is correct or not, first-tier

hotel management companies usually find it easier to acquire financing than do most second-tier operators.

[2] Disadvantages of First-Tier Companies

[a] Restrictions on Property Size

First-tier hotel management companies do not often manage smaller properties; most first-tier companies have size requirements for the hotels they will operate under a management contract. Generally, hotels of fewer than 200 units are considered too small by these operators. First-tier companies believe that their organizational structure and overhead cannot be sustained by such smaller properties. Exceptions are made, however, for factors such as desirable locations or unique property characteristics that would make a particular contract attractive to a management company.

[b] Restrictions on Financial Condition

First-tier hotel management companies are concerned about their image and the negative effect that adverse publicity might have on their name and reputation. For this reason, first-tier companies generally avoid involvement with financially distressed hotels because of the increased likelihood that their name might be associated with a bankruptcy or foreclosure.

[c] Restrictions on Contract Terms

The term of contract for a first-tier management company is typically longer than that for a company in the second tier. Most first-tier companies require contract terms of at least ten years. Because a first-tier operator is actually granting a license for the use of its name, management contracts with first-tier operators incorporate many of the same provisions as a franchise agreement. First-tier lodging chains operating under a nationally recognizable trade name generally want to maintain a presence at a particular location for an extended period of time. A short-term contract, which would allow the removal of the trade name of the first-tier company from the property after a relatively short amount of time, might result in an appearance of instability and thus undermine the traveling public's image of the company.

[d] Restrictions on Terminations

Termination provisions are often more difficult to obtain from a first-tier hotel management company because it has its name, and therefore its reputation, prominently displayed on the hotels it manages. Given this stake, first-tier companies must be careful to present to their customers the appearance of long-term stability. Because early contract termination generates adverse publicity for the operator, management companies are reluctant to provide the property owner with any form of termination provision that might end a contract early. During the past several years, the use of performance termination standards has become more common by both first- and second-tier companies. Generally tied to some specified level of profits, these performance criteria allow owners to terminate operators who fail to achieve satisfactory results.

[e] Less Flexibility in Negotiations

First-tier hotel companies typically have more rigid requirements than do second-tier companies when it comes to the specific terms of a management contract. Provisions such as a reduced length of term, performance cancellations, contract buy-out, and exclusive operating territories are more difficult to obtain. This inflexibility might be attributable to the general sense that first-tier hotel companies have a stronger bargaining position and can impose stricter terms on less experienced owners.

[f] Difficulty of Negotiations

The actual negotiating process between a first-tier hotel company and a property owner can be longer and more difficult than that involving most second-tier operators. Large hotel companies usually use experienced mid- to upper-level executives to perform the actual negotiating, and while these employees have the authority to develop the specific terms of an agreement, the final structure is generally subject to the approval of a higher-level executive committee. Often this committee will want to make changes to the agreement, and the negotiating process must then be resumed. Second-tier hotel companies are generally smaller and usually less formal in their negotiating procedures, so property owners can often deal directly with the company's decision maker, facilitating the approval process considerably.

[g] Operating Information Difficult to Obtain

Some of the most critical information needed to fully evaluate the ability of a hotel management company is actual operating data (specifically, profit and loss statements) from properties similar to the hotel under consideration. Without these statements, a property owner cannot verify that the management company is capable of running an efficient operation. Most hotel companies that have proven track records find little difficulty in allowing owners to confidentially review their financial statements.

First-tier management companies tend to be more restrictive than second-tier companies in releasing operating information and other data pertaining to their management ability. Again, this seeming lack of cooperation may be attributable to a sense of superior bargaining power, but it should not be permitted to lead to refusal of an owner's legitimate request for necessary information.

[3] Advantages of Second-Tier Companies

[a] Flexibility in Negotiations

Second-tier management companies are basically less strict in their overall requirements than first-tier companies. In particular, they are more likely to accept shorter contract terms, agree to more demanding performance criteria, and allow more reasonable buy-out provisions. This flexibility, in addition to a general willingness to quickly structure management contracts and take over a wide variety of operations, causes them to be preferred by lenders looking for interim hotel management after a foreclosure.

[b] Individual Attention

Smaller management companies are likely to give properties more individual attention. Most second-tier hotel management companies are smaller than first-tier opera-

tors, so they often can provide a hotel with more, individual high-level management attention. This ability is important for distressed hotels that require specialized work-out experience (i.e., experience with improving poor operating performance) not typically available from most property-level general managers. Unique properties facing unusual markets and/or competition can also benefit from smaller management companies that are capable of providing intensive expertise.

Second-tier hotel management companies are thus more likely to manage the more unique hotels: those that are, for example, small, distressed, in specialized markets, or in secondary locations. First-tier hotel companies do not generally become involved with such properties, because they do not fit their quality level or style of operation. As a result, they generally pass up opportunities involving distressed hotels or those properties for which the chance for success is either limited or in doubt. One change that has taken place recently with larger chains is that their minimum size requirements have begun to shrink as increased competition forces them to downscale their products and consider penetrating the secondary and tertiary lodging markets.

[4] Disadvantages off Second-Tier Companies

[a] Financing More Difficult to Obtain

Most second-tier management companies are not as attractive to lenders as first-tier operators. Lenders and institutional investors usually try to minimize their exposure to risk by always using the services of a "name brand." They believe that if a known hotel company is operating their property, they cannot be blamed for selecting an incompetent operator should the project encounter financial difficulties.

[b] Perceived Risk

The perceived risk of using a second-tier management company is higher for much the same reason as the lack of available financing. First-tier hotel companies have a name recognition benefit that gives them a low-risk image. Whether or not this is justified, it does create the perception that second-tier operators will make a project more risky. Higher perceived risks are more difficult to finance and generally increase the cost and decrease the availability of both debt and equity capital.

[c] Possible High Cost

As previously mentioned, the services of a second-tier hotel management company, combined with a national franchise, can sometimes cost more than a first-tier operator that provides both operational expertise and name recognition in one package. In addition, some second-tier management companies believe that they can structure a management fee formula on the same basis as a first-tier operator. Consequently, the resulting compensation is often not commensurate with the benefits provided.

[d] Lack of Financial Strength

Second-tier hotel companies do not always have the necessary financial strength to make meaningful investments in a property or to guarantee operating results. The current investment climate, in which tax benefits have been greatly reduced, has caused many property owners to require that hotel management companies make some form

of capital contribution in order to obtain a management contract. This investment can take many forms, including pre-opening services; initial inventories and operating supplies; working capital; furniture; fixtures; and equipment; operating losses during start-up; and debt service guarantees. The net worth of the smaller second-tier hotel companies often does not allow this type of investment and therefore they have a difficult time obtaining a financial interest in property. In addition, many owners believe that an operating company should have a monetary commitment in the property in order to have a sufficient incentive to do well.

» 19.08 MANAGEMENT COMPANY OPERATINO PHILOSOPHIES

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

[1] Centralized Management

An example of a highly centralized hotel management company is the Marriott Corporation. Marriott employs thousands of people to supervise the management of its hotels and restaurants. All aspects of Marriott's hotel management system are contained in manuals that cover every conceivable eventuality. These reference guides provide on-site management with information regarding such topics 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. This sort of centralized operating philosophy leaves little to chance or human error, because virtually everything involving the operation of a hotel has already been thought through and the proper solution set forth in clear language. Employees on 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. The most significant drawback to a highly centralized hotel management philosophy is that it can be difficult to modify procedures in order to meet local conditions or customs.

Marriott Corporation has one of the most centralized hotel operating systems in the industry. The massive layer of operational control, which has been developed over the past thirty years, has enabled Marriott to expand rapidly while maintaining a consistent product and an extremely profitable company.

[2] Decentralized Management

On the opposite end of the spectrum is another respected, highly successful hotel management company, the Hyatt Corporation, which runs its hotels in a very decen-

tralized manner. In the Hyatt system, on-site managers are given a broad latitude in forming property-level operating systems and procedures. Hyatt does provide general guidelines from its home office, but managers are allowed wide discretion regarding the manner in which they operate their property. The primary advantage of a decentralized operating philosophy is that it encourages individual creativity, which can be beneficial in the hospitality industry. Hyatt employees are encouraged to constantly modify and update their methods in order to meet the changing needs and expectations of the market.

Most hotel management companies tend toward decentralized management. Hotel owners should be aware, however, that some operators employ this type of structure out of necessity, if they do not have the personnel and resources to develop and implement even a partially centralized format. These companies often operate without any set system, even on the property level, so general managers must establish and implement all operating policies. Hotel companies that fall into this category cannot provide the services normally expected from a professional hotel management company and should be compensated accordingly.

» 19.09 SERVICES PROVIDED BY MANAGEMENT COMPANIES

When selecting a management company and negotiating the management fee to be paid to it, the owner should be aware of the services that are normally provided by most hotel companies and should be able to tell when the services that a particular company offers are unique. The following list contains the various services that are usually offered by most companies.

- Management supervision
- Implementation and maintenance of systems, procedures, and controls for:
  - —Accounting and bookkeeping
  - —Audit and control procedures
  - —Budgeting
  - —Marketing
  - — Purchasing
  - —Advertising and promotion
  - —Maintenance
  - —Personnel
- Selection, training, and supervision of all employees
- Establishment of all prices and charges
- Preparation of monthly and annual financial statements
- Applications for and maintenance of all licenses and permits
- Negotiation for and granting of all concessions and leases
- Negotiation of service contracts
- Purchase of inventories, supplies, and equipment
- Establishment of bank accounts
- Maintenance of insurance policies
- Institution of any necessary legal action

- Supervision of building repair and maintenance and replacement of furniture, fixtures, and equipment
- Preparation of budgets and operating plans
- Planning and implementation of advertising, promotion, and marketing

First-tier hotel management companies generally provide significant additional services that generally include:

- Regional or national trade names and identification
- Trademarks, logos, trade phrases, and service marks
- Centralized reservation systems
- Chain and group advertising programs
- Frequent guest programs

There are a number of unique services that are offered by some management companies—for example:

- Centralized purchasing with group discounts
- Centralized personnel and recruiting
- Centralized reservations
- Centralized marketing and promotion
- Property tax representation
- Insurance assistance and package rates
- Energy management systems
- Preventive maintenance systems
- Centralized accounting
- Centralized employee education and training
- Labor relations assistance
- Site and building engineering assistance
- Architectural design
- Interior design
- Convention and group sales
- Frequent guest programs
- National and regional sales offices
- Pre-opening services
- Technical services
- Auditing
- Market demand studies

» 19.10 MANAGEMENT COMPANY SELECTION PROCESS

Selecting a hotel management company with the specific capabilities necessary for running a particular property is one of the key steps in a hotel investment. While

location, product, and image of the facility are important ingredients, the ability of the on-site and supervisory management is what holds the operation together and makes it work. The following section describes the selection process for finding, negotiating, and retaining the hotel management company best suited for a particular project.

[1] Analysis of Market Study

The first step in selecting a hotel management company is to analyze the findings of the market study for the project in order to determine the type, class, and market position of the subject property. The findings of the market study that bear most closely on the selection of a management company are the following:

- Current and future demand for transient accommodations, including probable demand growth rates
- Characteristics of demand, including market segmentation, rate categories, average length of stay, seasonality, special requirements, and facility needs
- Current and future supply of transient accommodations (competition)
- Characteristics of supply, including market segments, rate categories, facilities, location, image, and reputation

Several basic characteristics of the subject property can be determined from these areas of the market study. In turn, these characteristics are used to determine the sort of management company best suited to the property. The following characteristics are analyzed in this regard.

Market segment. The primary and secondary market segments (i.e., commercial, meeting and convention, and leisure) that are expected to be captured by the facility must be identified, with an estimate as to what percentage each segment will represent as part of the whole. Information pertaining to the potential future growth of each segment and the expected competition is also useful. The data serves as a basis for determining the facilities and amenities needed to attract the intended market segment.

Class of facilities and level of service. Competitive lodging facilities operating within the market should be investigated to determine the level of services offered (i.e., economy, standard, first class, luxury). The market position best suited for the subject property's particular location and the correct class for the subject property can be established on the basis of this information. In addition, the level of services and types of amenities must also be defined in order to create a complete and competitive project.

Extent of facilities. The facilities (e.g., food, beverage, meeting and banquet, recreational, amenities, and shops) within a hotel project must be as carefully evaluated as the number of guest rooms. Building more facilities than are actually needed will reduce profit potential. Too few facilities will not satisfy the market and could reduce the competitive standing of the property.

Room count or size of hotel. Many factors go into establishing optimum size. For example, site and zoning restrictions can place limits on the permitted number of buildable units. Market-related supply and demand considerations will also either push the size upward or will hold it down depending on future expectations. Finally, economic influences such as land values, construction costs, a property's critical mass, and economies of scale will affect the final room count.

The purpose of this stage of analysis is to define broad project parameters, rather than specific guidelines. The actual layout and design of the subject property should be done in conjunction with the hotel management company ultimately retained to manage the project. The management company will be responsible for generating profits, so the hotel should be specifically planned to fit its mode and style of operation.

[2] Selection of First- or Second-Tier Company

To narrow the search for a management company, the owner should decide as early in the selection process as possible whether a first-tier or second-tier operator would be the most appropriate choice to manage the subject property. In some instances, the owner may choose a first-tier company, but find that a suitable candidate is not available. If this happens, the owner must be prepared to quickly turn to a review of possible second-tier operators.

[3] When a First-Tier Company is Chosen

If the owner decides to use a first-tier management company or franchise affiliation, the first step that should be taken in order to choose a particular operator or franchise is to determine what operators and franchises are already in the market. Generally, companies not currently represented are the most likely candidates, but a particular company should not be ruled out if it is active in the market; occasionally, a company will make a move in favor of a better project.

The owner should look for operators or franchises that have a high level of recognition and market identification in the segments and class determined to be best suited for the subject property by the market study. A commercially oriented chain, for example, would not be likely to have the marketing infrastructure to succeed with a convention hotel. Owners should look for operators and franchisors with similar properties situated in feeder cities that have established reputations and identifications to the local residents who are likely to travel to the area of the subject property.

[4] When a Second-Tier Company is Chosen

If a second-tier company is the best choice to manage a property, the owner should look for an operator with a proven ability to manage hotels with a market orientation and class similar to the subject property. Another feature that is desirable for a second-tier company (though not as important as it is for first-tier companies) is representation in feeder cities.

Owners should bear in mind that some franchises are available only to certain operators. Marriott, for example, will grant franchises only to a select group of approved operators. In any event, owners should give preference to second-tier operators that have actual experience operating under the specific franchise selected for the property. An operator who is familiar to the franchisor can sometimes expedite the franchise application process.

The key to the entire selection process is to match the various proposed elements of the subject property (i.e., size, class, image, location, market segments served and facilities offered) with the operator that has the most experience and best track record in handling these elements in a profitable manner.

[5] Consultation With Project Team

Before narrowing down the field of candidates, the owner should consult with members of the subject property project team and ask for their suggestions. This step is particularly important if the project investors can be identified at this stage. Experienced hotel investors can have definite opinions as to which operator would be best suited for a project, and as a result, considerable time can be saved if their input is solicited early in the selection process. However, owners should not select a hotel operator purely on an investor's recommendation and without performing the necessary review and due diligence process.

[6] Issues During Management Company Selection

[a] Company Profile

The profile should contain a description of the present status of the company and its management's plans for the future. The profile should also contain information regarding the number of properties currently under contract, their locations, chain affiliations, facilities, amenities, ages, market orientations, number of years under contract, the identities of the owners, and, finally, whether the operator has an equity interest. The same information should be given for properties not currently under contract that the hotel company has managed over the past five years. The operator should describe the circumstances of the management agreement terminations.

[b] Operating Performance

One of the most important issues in the hotel management company selection process is whether a particular management company can make money for the owner. The most efficient method of evaluating the operational expertise of a hotel management company is to examine the actual financial performance of properties they operate.

[c] Qualifications of Key Personnel

A hotel management company is, of course, no better than the actual staff that provides management services. Problems such as high turnover and difficulty in recruiting qualified individuals are cause for concern. Any individuals whose employment is critical to the continued success of the management company should be identified.

[d] Central Services

The various off-property services provided by the hotel management company are called central services. These include accounting, reservations, engineering, architectural design, labor relations, insurance, purchasing, and the like. The owner should identify and compare the services offered by each operator and determine whether they are included in the management fee or are charged back separately to the property. The costs of some central services, such as reservation systems, are charged back to the individual properties within the chain on a pro-rata formula basis.

[e] Reimbursable Expenses

Reimbursable operator expenses are the various expenses that are incurred in the operation of the property but are not included in the management fee and that are therefore reimbursable to the management company. For example, the travel expense incurred by the management company's home office personnel when visiting a property is often a reimbursable expense chargeable to that property. This data is necessary in order to accurately compare the relative costs of the management companies under consideration.

[f] Sales and Marketing

One of the most important considerations in the selection of a hotel management company is the ability of a company to generate business through various sales and marketing programs. Some of the components of a sales and marketing structure include central and regional sales offices, a reservation system, frequent guest programs, a convention and group sales data base, marketing organization, and various public relations and publicity functions.

[g] Operating Projections

The preparation of a ten-year projection of income and expense (including management fee) for the subject property should be considered. The purpose of this is twofold. First, the projection establishes a basis for judging the hotel company's future management performance. A performance standard can be established from these projections and incorporated into the management contract, with termination provisions keyed directly to projected operating levels. Second, it pinpoints the operator's anticipated earnings from the management contract. This information is useful when negotiating the fee structure portions of the agreement.

Most operators faced with a request for a ten-year projection of income and expense will probably comply reluctantly. It is important for the hotel owner that a hotel management company commit to a set of operating projections; consequently, a refusal to agree to this request should be considered a "deal breaker." For the operator, the projections clearly have a catch-22 quality. If the operator is optimistic in projecting profit, that operator might appear to be a favorable choice compared with other management companies. If the owner ties the performance cancellation clause to this set of optimistic projections, however, the operator could quickly lose the contract. On the other hand, if the operator is overly conservative in the projection of income and expense, the owner could use the dollar amount of the projected management fee (which would probably be low) as the basis for estimating what the hotel company would be looking for as overall compensation. The projection of income and expense prepared by the management company should be checked against the actual operating performance shown in the financial statements of the comparable hotels to verify that the results are achievable. The quality of these projections is often a good indication of the skills and expertise of the management company.

[h] Miscellaneous Information

The following miscellaneous information should be considered:

- List of references from the management company
- Audited financial statements and projected budgets

- Description of any existing or pending litigation against the management company
- Description of the company's operating manuals
- Outline of the company's supervisory infrastructure
- Description of the company's personnel, training, and recruiting practices
- The availability of group or blanket insurance through the company

[7] Selection Rating System

Exhibit 19-12 contains a system made up of a series of questions whose answers consist of responses supplemented by some investigation into the background, structure, and integrity of the management company. Each question has several possible responses, which are assigned a value that ranges from -4' to +4. The total of all of the values for the responses chosen represents the overall rating of the management company.

Exhibit 19-12 Hotel Management Company Initial Selection Rating System

Characteristic	Score
Comparing the size of the hotels managed by the operator to the subject, most are:	
Larger	-1
The same size	0
Smaller	-1
Comparing the chain affiliations of the hotels managed by the operator, most are:	
Same affiliation	1
Similar affiliation	0
Dissimilar or no affiliation	-1
If the operator manages other hotels in the same market area, are these considered to be:	
Directly competitive	-4
Somewhat competitive	-2
Non-competitive	-1
Experience of the management company:	
New company—limited experience	-1
Moderate experience	0
Established—extensive experience	2
Management company's financial resources (ability to invest funds in the property):	
Limited—no investment potential	-1
Moderate—token investments	0
Strong—meaningful investments	2

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Exhibit 19-12 (cont.)

Characteristic	Score
Operator shows willingness to invest funds in the property as a loan (double amounts if funds are contributed as equity):	
Initial inventories	1
Working capital	1
Pre-opening expenses	2
FF&E	3
Debt service guarantees	3
Management company has extensive experience in one of the following specialized areas that would directly benefit the operation of the subject property:	
Destination resort operation	2
Major convention operation	2
Unique market	1
Major food and/or beverage operation	2
Development assistance	2
Opening new hotel	2
Distressed property (turnaround)	2
Bankruptcy	2
Unions	1
Operating in secondary cities	1
Property ownership	2
Management company appears to be flexible in accommodating the following specialized needs of the owner:	
Short-term contract	2
Termination buy-out provision	2
Management company's ability to generate profits (based on actual performance):	
Normal—competent management	0
Better than average	5
Exceptional operating ability	10
Management company offers:	
Ability to obtain specialized identification	2
Ability to obtain financing	4
Feeder city representation	2
Track record of success	2
Management company has exceptional expertise or offers specialized services in the following areas:	
Centralized reservation system	2
Centralized sales and marketing	1
Regional sales offices	1
Convention and group sales	1

Exhibit 19-12 (cont.)

Characteristic	Score
Frequent traveler program	1
National advertising program	1
Top-level personnel	1
Financial systems and controls	1
Other specialized services	1
Personnel relations	1
Development capability	1
If management company is a first-tier operator, its identity is:	
Wide-spread	2
Positive	1
Management company has the following deficiencies:	
Poor references	-3
Lost contracts (deduct for each loss)	-1
Limited home office structure	-1
High management turnover	-2
No growth plans	-1
Excessive growth plans	-1
Will not subordinate incentive fee	-3
Unwilling to provide restrictive covenant	-3
Fee based entirely on percentage of total revenue	-3
Showed professional effort in:	
Preparing operating budget	1
Preparing sample marketing plan	1
Gut feeling:	
You can get along with this company	3

[8] Bargaining Positions

Once the number of management companies has been reduced to a manageable two or three, the bargaining positions of each party should be assessed in order to determine their basic negotiation strategies. The key to this exercise is to determine which party has the strongest position. Generally, the party with the strongest position will be able to negotiate an agreement that is favorable to itself. If the relative bargaining positions are understood, however, the final outcome can sometimes be altered in favor of the weaker position. The following sections outline the various elements that can produce a strong operator bargaining position or a strong owner bargaining position. (The listing of bargaining power factors is based on material presented in *The Negotiation and Administration of Hotel and Restaurant Management Contracts*, by James J. Eyster (School of Hotel Administration, Cornell University, 1988), p. 21,730.)

Strong Operator Position:

1. The property serves a specialized market that requires unique expertise possessed by operator.
2. The market is served by few national names not already in use. Many market areas have representation from most of the major hotel chains. Those operators offering an identification not already in use have a competitive advantage.
3. The operator is willing to take over distressed properties (e.g., those involved in bankruptcies, foreclosures, union problems, or that have poor reputations).
4. The operator is willing to accept contracts containing special requirements—for example, short operating terms or unique franchise and lender requirements (subordination, special approvals, and notices), cancellation or buy-out provisions.
5. Few other operators are interested in the hotel.
6. A limited opportunity exists for the operator to obtain additional management contracts from the owner.
7. The operator has other hotels in feeder cities.
8. The operator has a strong track record of success.
9. The operator is willing to engage in a joint venture, invest capital, or make performance guarantees.
10. The operator is able to secure financing for owner.
11. The operator has specialized expertise or services—for example, centralized reservations, national and regional sales offices, successful frequent traveler programs, national advertising, strong home office support staff with complete management supervision system in place, ability to provide a wide range of in-house support services (e.g., property tax consulting, interior design, engineering, and development counseling).

Strong Owner Position:

1. The hotel has a highly visible location that would provide the operator with extensive local exposure. This is a form of free advertising and promotion for the management company, particularly if it is a first-tier operation.
2. The subject market has strong barriers to entry against new development. Therefore, the operator may not have another opportunity to enter the market. New York City is currently an example of a very strong hotel market in which it is difficult to develop new lodging facilities because of high construction costs. Almost every national or international hotel chain would like to have representation in New York City, but few are able to enter this market.
3. The property is a famous existing hotel. Some hotels are landmarks to the traveling public. Properties such as the Ritz-Carlton in Boston; the Plaza in New York City; the Madison in Washington, DC; the Drake in Chicago; the Royale Orleans in New Orleans; the Arizona Biltmore in Phoenix; the Bel Air in Los Angeles; and the Stanford Court in San Francisco are examples of hotels that would be most attractive to any hotel management company.
4. The owner has a strong track record of other successful hotels. Hotel management companies like to team up with owners and developers that are

likely to create many hotel projects. If the operator can anticipate the possibility of obtaining several contracts from the same owner over a period of time, a favorable package deal can often be negotiated.

5. The owner has a strong financial statement. The owner's ability to finance new projects as well as maintain existing properties is important to hotel management companies.
6. The owner does not require capital from the management company. If the owner has a strong financial position and does not require capital from the management company, the pool of potential operators is greatly enlarged. Many excellent hotel chains are either unable or unwilling to make capital investments in projects they manage for third parties, so an owner's need for capital would eliminate these operators from consideration.
7. Many other management companies are interested in the subject property. Some highly desirable hotels are often sought after by several hotel chains.
8. Opportunity exists to obtain other management contracts. One management contract often leads to others. If the operator can see the potential for more business, the owner often picks up some bargaining power.
9. The management company is new and has limited experience and resources. Any time an operator has less to offer than competing hotel companies, the owner gains leverage in contract negotiations. New hotel companies or those with limited resources or home office infrastructure are more likely to offer an owner a more favorable contract.

[9] Issues During Negotiation

Prior to actually presenting an opening offer, both the owner and the operator should determine their basic negotiation strategy for the major terms of the contract. Although hotel management contracts contain numerous clauses and provisions, there are usually fourteen major terms that form the basis of the agreement and are primary issues in the negotiations. The following list describes these fourteen major terms and the basic objective of the owner and operator in negotiations concerning them. These management contract provisions were identified in James Eyster's *Negotiation and Administration of Hotel and Restaurant Management Contracts* (p. 35,736) as the provisions most likely to generate concerns for owners and operators and to be the focus of contract negotiations.

1. Contract term:
   - Owner—Obtain a contract term for as short a period as possible with renewals at the option of the owner.
   - Operator—Obtain a contract term for as long a period as possible with renewals at the option of the operator.
2. Management fee:
   - Owner—Base the fee solely on a percentage of net income after debt service and a minimum return on equity. Attempt to minimize the amount of this percentage.
   - Operator—Base the fee solely on a percentage of total revenue. Attempt to maximize the amount of this percentage.

3. Reporting requirements:
   - Owner—Require extensive written financial reporting and frequent budget updates and meetings with owner.
   - Operator—Minimize as much as possible the reporting of operating results and budgets to owner.

4. Approvals:
   - Owner—Structure contract so owner has the right to approve all aspects of hotel operation.
   - Operator—Structure contract so operator has total discretion with no approvals of any sort required from owner.

5. Termination:
   - Owner—Ensure owner's right to terminate management contract immediately upon written notice.
   - Operator—Under no circumstances allow the operator to be terminated before the expiration of the contract.

6. Operator's investment in the property:
   - Owner—Stipulate that operator buy right to manage hotel (i.e., invests capital or services) or make performance guarantees to obtain the management contract.
   - Operator—Stipulate that operator have no investment in the property.

7. Operator's home office expenses:
   - Owner—Make all home office expenses of operator reimbursable from management fee, with no expenses to be charged to property.
   - Operator—Stipulate that the pro rata share of all of operator's home office expenses plus all direct expenses be chargeable to the property.

8. Transfer of ownership:
   - Owner—Ensure that owner may transfer ownership of hotel to anyone at any time.
   - Operator—Ensure that owner cannot transfer ownership of property without operator's approval and that operator is allowed right of first refusal.

9. Exclusivity:
   - Owner—Establish owner's right to develop or own any hotel managed by operator.
   - Operator—Establish operator's right to manage any hotels developed or owned by owner.

10. Insurance and condemnation proceeds:
   - Owner—Exclude operator from participation in any insurance or condemnation proceeds.
   - Operator—Stipulate that operator be entitled to a pro rata share of all insurance and condemnation proceeds.

11. Hotel personnel:
   - Owner—Ensure that all hotel personnel will be employees of operator.
   - Operator—Ensure that all hotel personnel will be employees of owner.

12. Reserve for replacement:
    - Owner—Agree to fund capital replacements (furniture, fixtures, and equipment) on an as-needed basis.
    - Operator—Establish the right to establish a reserve for replacement funded by the owner that is as large as possible.
13. Restrictions:
    - Owner—Stipulate that operator cannot own, manage, or franchise another hotel within the same market as the subject.
    - Operator—Refuse restrictions on ownership, management, or franchising by the operator in the same market as the subject.
14. Indemnity:
    - Owner—Ensure that operator will indemnify owner for all actions against operator.
    - Operator—Ensure that owner will indemnify operator for all actions against operator.

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CHAPTER 20

Hotel Management Contracts and Related Documents

¶ 20.01 Introduction 20-2

¶ 20.02 Contract Term 20-2

¶ 20.03 Management Fee 20-3
- [1] Basic Fee. 20-3
- [2] Incentive Fee 20-4
- [3] Owner and Operator Requirements. 20-4

EXHIBIT 20-1 Hotel Income Statement. 20-5

EXHIBIT 20-2 Percentages Required to Yield Management Fee. 20-6

¶ 20.04 Financial Reporting 20-6

EXHIBIT 20-3 Comparing Operating Statistics of Two Properties. 20-7

¶ 20.05 Annual Plans 20-8
- [1] Forecast of Income and Expense 20-8
- [2] Budgets for Capital Expenditure and Repair and Maintenance . . . 20-9
- [3] Marketing Plan 20-9
- [4] Other Reports 20-10

¶ 20.06 Budget Approval Process 20-10
- [1] Arbitration Procedures 20-11
- [2] Ownership Control 20-11

¶ 20.07 Owner Approvals 20-12

¶ 20.08 Termination of Agreement. 20-13
- [1] Bankruptcy. 20-14
- [2] Material Breach of Contract 20-14
- [3] Revocation of License or Franchise. 20-14
- [4] Condemnation or Casualty 20-15
- [5] Operator's Failure to Achieve Performance Levels 20-15
- [6] Operator Buy-Out. 20-18
- [7] Operator Misconduct or Fraud . . . 20-18
- [8] Cessation of Operator Activity in the Hotel Business 20-18
- [9] Owner's Failure to Provide Adequate Funds. 20-19
- [10] Mortgage or Lease Default Including Foreclosure 20-19

¶ 20.09 Operator Investment in Property 20-19

EXHIBIT 20-4 Costs for Pre-Opening Services 20-20

EXHIBIT 20-5 Working Capital Costs 20-20

EXHIBIT 20-6 Furniture, Fixtures, and Equipment (FF&E) Costs 20-20

¶ 20.10 Operator Expenses 20-21
- [1] Home Office Expenses. 20-21
- [2] System Reimbursable Charges. 20-22
- [3] Payment of Expenses and Charges. 20-22

¶ 20.11 Transfer of Ownership. 20-23

¶ 20.12 Insurance or Condemnation Proceeds 20-24

¶ 20.13 Employees. 20-25

¶ 20.14 Reserve for Replacement 20-25

EXHIBIT 20-7 Useful Lives of FF&E Components 20-27

¶ 20.15 Area Restrictions for Operator. 20-27

¶ 20.16 Indemnification. 20-28

¶ 20.17 Pre-Opening Management Services 20-29

¶ 20.18 Technical Service Assistance 20-30

EXHIBIT 20-8 Hotel Management Contract. . . . 20-33

» 20.01 INTRODUCTION

The proper execution of a management contract between the hotel owner and the management company is a vital step in the development of a successful hotel venture. The management contract spells out the basic relationship between the owner and the operator. For example, it might specify who is responsible for the provision of operating capital, the payment of property taxes, or the employment of the general manager and other key executives. Great care should be taken in putting together the management contract, since an agreement that is overly favorable to one party can result in a contentious relationship between the owner and the operator, with potentially disastrous results for the hotel.

This chapter discusses the basic provisions that are found in management contracts, as well as some of the more common variations. Included in this discussion are such topics as fee structures, contract termination, operator expenses, owner approvals, and other significant areas relating to management contracts. The chapter also includes a discussion of the annual plan and the budget approval process, two areas that are usually set forth in great detail in the management contract. The author wishes to acknowledge the research and findings of management contracts contained in James Eyster's *Negotiation and Administration of Hotel and Restaurant Management Contracts*, p. 41,779.

» 20.02 CONTRACT TERM

The term of a management contract is the length of time for which 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 (e.g., what does "officially open for business" really mean?).

The contract term may comprise an initial term and one or more additional renewal terms that extend the total length of the agreement.

Ideally, owners want an initial term that is as brief as possible, and the option of numerous short renewal terms. This arrangement permits the owner to tie the operator to the contract for an extended period of time while allowing the owner to terminate the contract upon relatively short notice should the management company prove ineffective or the owner want to sell the property unencumbered by a management contract.

The contract term provision affects the hotel operator by limiting the period during which the property can be operated and a management fee collected, 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 result, it may take an operator several years to achieve the level of profits needed to earn a reasonable amount of compensation. For first-tier hotel management companies, the length of the contract term has additional importance because of their public name recognition. 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.

The contract term, from an owner's point of view, is directly related to two other important provisions: termination for nonperformance and contract buy-out. If the owner is able to negotiate a satisfactory provision for quickly terminating an incom-

petent operator along with buying out the contract for a reasonable price, then the length of the contract term becomes less important.

First-tier hotel companies generally insist on long initial contract terms because of the high start-up costs associated with such agreements. Therefore, contracts with first-tier operators usually run for an initial term of between ten and fifteen years. On the other hand, second-tier operators are typically more willing to accept shorter agreements. Contracts with these operators commonly specify an initial term of between three and ten years.

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 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.

Renewal terms extend the contract for a stated period beyond the initial term. The renewal term is typically structured as a contract extension option that may be exercised by either the operator or the owner acting alone or in agreement. The renewal term need not contain the same provisions (e.g., the management fee) as the initial term.

Most management contracts include some form of renewal provision. In most cases, the agreement allows for a specified number of renewal terms. The permitted number of renewals is usually between one and three, while the length of the terms is commonly from five to ten years. Some agreements allow for an unlimited number of renewals on a more frequent basis, usually yearly.

The primary difference in the renewal terms for first- and second-tier hotel operators is that first-tier companies are generally less likely to offer such terms, 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. First-tier operators are more likely to control the option to renew than are owners, but renewals generally are a matter of agreement between the two parties,

» 20.03 MANAGEMENT FEE

A management fee is the compensation a hotel company receives for providing the various services called for in a management contract. For first-tier hotel companies, the management fee covers both their management services and the value of their chain identity; second-tier 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.

From an owner's point of view, the management fee represents an operating expense, something that should be controlled and minimized. However, management 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 the hotel operations. The ability and efforts of the management company have a direct impact on whether the hotel is able to realize this goal.

[1] Basic Fee

Under the arrangement known as the basic fee, the management fee is determined solely by a percentage of gross revenue, creating an incentive for the operator to in-

crease 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.

[2] Incentive Fee

In another type of management fee, known as the incentive fee, the fee paid to the management company is based on a specified percentage of a defined net income, usually determined by sales volume and expense control. Therefore, incentive fee rewards the operator for efficient, profitable management.

Hotel owners generally want to have all or at least 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 referred to as a low-level line item.

For example, consider a 300-room hotel that is currently operating at a 73 percent stabilized occupancy with an average rate of $113.14, as shown in Exhibit 20-1, The format shown here is standard for such income statements.

Assume that the hotel will be operated by a first-tier management company and the owner believes that 5 percent of total annual revenue, or $781,000, is fair compensation for the services and chain identity of the management company. The owner is willing to pay 3 percent of total revenue ($469,000) as a basic fee, but wants the remaining portion of the total fee ($312,000) paid on an incentive basis and calculated as a percentage of a defined profit, such as one of the standard profit line items shown in Exhibit 20-1: Income Before Fixed Charges, Income Before Debt Service, or Income After Debt Service. (In addition to the use of these standard line item definitions, many other definitions can be developed, such as "Income Before Fixed Charges but After Reserve for Replacement" or "Income After Fixed Charges but Before Property Taxes.")

Exhibit 20-2 gives the percentages of standard line items that are needed to yield the required additional management fee of $322,000.

If the incentive fee is calculated as a percentage of Income Before Fixed Charges, it would have to be 6.2 percent of the line item in order to yield the required $312,000. If the calculation is made using Income After Debt Service, the necessary percentage would be 17.8 percent.

From an owner's viewpoint, the incentive fee should be calculated as far down the income statement as possible. For example, any payment from the Income After Debt Service line erodes only the return on equity rather than funds available for operating expenses, fixed charges, and debt service. A similar result can be achieved by calculating the incentive portion of the management fee using an item before debt service, but paying it only if there are sufficient funds to cover debt service, which is known as subordinating the incentive fee to debt service.

[3] Owner and Operator Requirements

From the operator's point of view, the management fee represents compensation for services rendered. The fee must be enough to both cover the management company's operating expenses and provide an adequate profit.

Operators understand the need of owners to receive the maximum net income possible from hotel operations, but they also realize that in some instances they have

little control over operating results. In overbuilt markets or depressed economies, even the best management companies find it difficult to generate suitable profits. In such situations a management company might be unfairly penalized if its entire fee is calculated as a percentage of a defined profit. The same is true for new hotels, for which a period of occupancy build-up and initial operating losses are expected.

Exhibit 20-1 Hotel Income Statement

Number of Rooms: 300 Stabilized Occupancy: 73% Average Rate: $113.14

	($000)	Percentage of Total Revenue
Revenues		
Rooms	$9,044	57.6
Food	4,318	27.5
Beverage	1,727	11.0
Telephone	344	2.2
Other Income	260	1.7
Total	15,693	100.0
Departmental Expenses		
Rooms	1,908	21.1*
Food and Beverages	4,685	77.5*
Telephone	348	101.2*
Other Income	157	60.3*
Total	7,098	45.2
Departmental Income	8,598	54.8
Undistributed Operating Expenses		
Administrative and General	1,236	7.9
Management Fee	471	3.0
Marketing	741	4.7
Property Operations and Maintenance	770	4.9
Energy	713	4.5
Total	3,931	25.0
Income Before Fixed Charges	4,664	29.8
Fixed Charges		
Property Taxes	405	2.6
Insurance	135	0.9
Reserve for Replacement	392	2.5
Total	932	6.0
Income Before Debt Service	3,732	23.8
Debt Service	2,415	15.4
Income After Debt Service	$1,317	8.4

*Percentage of departmental revenue

Exhibit 20-2 Percentages Required to Yield Management Fee

Line Hem	Required Management Fee	Line Item amount	Required percentage
Income before fixed charges	$312,000	$5,064,000	6.2%
Income before debt service	$312,000	$3,910,000	8.0%
Income after debt service	$312,000	$1,752,000	17.8%

To protect themselves from these uncontrollable external factors, management companies seek to have the bulk of their fees calculated as a percentage of revenue (usually total revenue), which may decline somewhat when adverse conditions affect the property, but is never totally eliminated.

Most management companies are able to cover their actual operating (i.e., home office and supervision) expenses with the basic portion of the fee. Expressed as a percentage of total gross revenue, the operating expenses to the management company generally range from 1 percent to 2 percent. A basic fee of 3 percent of total revenue will cover all of the operator's costs and leave an adequate profit. The incentive portion is therefore largely profit for a second-tier operator and profit and identity compensation (e.g., for trademarks and public image) for a first-tier operator.

It must be recognized that a sizable portion of the total operating costs for a management company are incurred during the initial part of the contract term. During the start-up phase for a newly opened hotel or the takeover phase for an existing property, the operator must devote a significant amount of supervisory time to institute new systems, procedures, and controls. This phase also entails greater efforts in recruiting, training, marketing, purchasing, and accounting. Some management companies will even temporarily relocate skilled personnel from other properties to insure a smooth opening or takeover. In order for a contract to be attractive to an operator, there should be some reasonable expectation that these initial costs can be recovered over the contractual term.

» 20.04 FINANCIAL REPORTING

The complete, accurate, and timely reporting of financial operating results is one of the most important services provided by a hotel management company, because it is the only real measure available to a hotel owner to evaluate the performance and effectiveness of the management company. Management contracts should detail (1) the types of financial reports that the operator must prepare, (2) how they should be prepared, and (3) when they should be submitted. Financial reports must be organized in a uniform manner and in sufficient detail so that results can be quickly evaluated and any deficiencies immediately spotted; they must be accurately compiled by knowl-edgeable accountants and audited periodically; and they must be issued in a timely manner. Every day a report is delayed reduces the opportunity for correcting a problem. Owners and operators must communicate financial information quickly in order to manage effectively.

The first requirement of a financial reporting system is a uniform accounting procedure that allows for easy comparisons between financial reports within the same property, along with the operating results of other,' similar hotels. To facilitate these comparisons, the hotel industry has adopted the Uniform System of Accounts for Hotels (Hotel Association of New York City, Inc., *Uniform System of Accounts for Hotels* (8th ed.) HANYC, Inc. (1986)) which is a standard chart of accounts detail-

ing exactly how each item of revenue and expense should be posted. This system allows the comparison of operating statistics among one or more properties.

For example, assume Hotels A and *B* are located in the same market area, serve similar customer segments, and both follow the Uniform System of Accounts for Hotels. The respective management companies for the hotels report the statistics pertaining to the operating expense account entitled "Administrative and General," as shown in Exhibit 20-3.

Exhibit 20-3 Comparing Operating Statistics of Two Properties

	Administrative & General	
Unit of Comparison	**Hotel *A***	**Hotel *B***
Dollars per available room	$2,659	$2,915
Dollars per occupied room	$10.01	$9.45
Percent of total revenue	9.2%	8.3%
Percent of rooms revenue	20.7%	14.1%

On the basis of the unit of comparison, dollars per available room, Hotel *A* appears to have Administrative and General expenses under better control. This conclusion, however, is not supported by the rest of the data, which show Hotel *B* performing better in dollars per occupied room, percentage of total revenue, and percentage of rooms revenue. The reason for this is that Hotel *B* probably has a somewhat higher level of occupancy and is managing the Administrative and General expense category more efficiently.

The types and formats of financial reports prepared by the hotel company should be investigated during the operator selection process to ensure that sufficient financial data will be generated and that it will be presented in a usable format. Some of the financial reports typically provided by the management company include daily, monthly, annual, and miscellaneous reports. These are described in the following paragraphs.

Daily reports. These reports should provide information regarding revenues and occupancy and should include details of all authorized complimentary rooms.

Monthly reports. These reports should include an income and expense statement with full supporting schedules calculated on the accrual method and statistical data that details revenues by outlet, occupied rooms by market segments, food and beverage covers by outlet, and labor utilization by department. These reports should provide data for the current month, current month's budget, current year-to-date, current year-to-date budget, last year's month, and last year's year-to-date budgets, and in addition should provide a balance sheet, identification of sources and uses of funds, details of capital expenditures, and a Manager's summary and overview of operations.

Annual reports. These reports must contain an income and expense statement, a balance sheet, and documentation of the sources and uses of funds, all of which should be audited.

Optional reports. These reports, to be issued at the request of the owner, include information regarding the aging of accounts receivable, schedules of payables, and schedules of supplies and inventory, as well as reports on occupancy, labor utilization, and insurance claims.

All financial reports should be prepared by the operator either locally on the property or centrally at the hotel company's central offices. The operator should maintain a strong control system in order to prevent theft and embezzlement and to ensure that all transactions are properly accounted for and reported. The entire system, along with all financial reports, should be audited at least annually, and more often if accounting problems are expected. Financial reports must be prepared on a timely basis to be of the greatest value to the owner and operator.

Financial reporting provisions are useful for both hotel owner and operator. Complete, accurate, and timely financial operating data is necessary for both parties because the information is critical for evaluating and improving operating efficiencies.

Hotel owners should be aware that significant costs are involved in preparing financial reports and should refrain from needlessly burdening an operator with unnecessary requests for information. The level of financial reporting detailed in this section should not, however, be a problem for any competent hotel management company, which should have accounting systems and procedures in place that can handle normal requirements. If, during the negotiation process, the operator has any difficulty in agreeing to provide this level of financial reporting, reason exists to question the overall competency of the company.

The bargaining power of either party should not play a part in determining the scope and quality of a financial reporting system. If, during the negotiation process, either the owner or the operator is not fully satisfied with the financial reporting requirements proposed by the other party, all attempts should be made to rectify the situation. If a satisfactory solution is unobtainable, it is probably best to look elsewhere for a deal.

» 20.05 ANNUAL PLANS

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

Given the terms of the management contract, the owner either has no 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. Generally, the owner has some power to approve the budget.

Under normal circumstances, a management company submits an annual plan to the owner that comprises a number of budgets, reports, and plans detailing the expectations of the management company for the subject property over the following twelve 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.

[1] Forecast of Income and Expenses

Perhaps the most important element of an annual plan is a month-by-month forecast of income and expense. This forecast should include full supporting schedules of each revenue and expense category. All standard budget items, including reserves for replacement, property taxes, equipment leases, and debt service, should be projected.

[2] 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 sort 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.

[3] Marketing Plan

The marketing plan should be a comprehensive description of the operating company's marketing efforts on behalf of the subject property. The plan should contain the following:

1. An analysis of the current status of the market position of the hotel, including:
   - Average rates and occupancies of all competitive hotels, including their market segmentations and the levels of food, beverage, and banquet competition that they generate.
   - Identification of new competition, either proposed or under construction.
   - An assessment of the economic health of the market area and its possible future effect on transient visitation and food and beverage demand.
   - Descriptions of any other factors that could affect the local hotel and restaurant markets and that would be important for developing a marketing strategy.
2. An analysis of the current status of any marketing efforts in progress, including:
   - A description of all marketing programs underway and an evaluation of their effectiveness.
   - The number of room-nights already on the books, broken down by month and market segment.
   - The reservation report from hotel chain or franchise system.
   - An analysis of food, beverage, and banquet marketing efforts.
3. An overview of long-term marketing strategy for the next three to five years.
4. A description of the marketing program for the next twelve months, detailing:
   - Plans for enabling the short-term marketing program to meet the goals of the long-term strategy.
   - Marketing efforts, by month, for advertising and promotion, and staffing requirements for these areas.
   - Budget requirements, divided by month and broken down to show the exact manner in which the funds will be spent.
   - Projections of room-nights captured, by month, broken down by market segment, along with expected average rate.

• Projections of food, beverage, and banquet covers, by month, by outlet, along with average checks.

[4] Other Reports

Among the other reports that the hotel management company must prepare and update annually for the owner are the following: (1) an engineering status report; (2) a leasing plan for commercial space; and (3) a staffing and salary report. The first of these, the engineering report, is issued by the engineering department and details the status of all engineering systems within the property and any expected maintenance or alterations that will be required over the next twelve months. The leasing report describes the status of any leased space on the property for which tenant leases will expire during the next twelve months. In addition to describing the current rent roll, the report should provide information regarding the market rent for similar leases in the local market area. The staffing and salary report should provide an analysis of current and contemplated staffing requirements along with recommendations for adjustments in pay scales and employee benefits. This report should also contain a review of the pay and benefit practices of other hotels in the market area.

» 20.06 BUDGET APPROVAL PROCESS

The budget approval process is the procedure by which hotel budgets are prepared, submitted to the owner, reviewed, modified, and put into effect. It is also the means by which the owner exerts influence over the expenditures of, and thus the operation of, the hotel. This process is generally clearly defined in the management agreement.

The budget approval process generally begins about four months before the start of a new operational year, and, much like an annual plan, is put together by the hotel department heads and is supervised by the general manager. Most operators have a multi-step approval process that takes the proposed plan up their corporate ladder. The property owner generally has no input in the process during this initial preparation phase.

Once the annual plan has made it through the internal approval process of the management company, it is submitted to the property owner, usually within sixty to ninety days of the start of a new operating year. The property owner should require ample time to review the plan, develop a critique, and resolve any differences before the time at which the budgets become effective. In practice, however, the owner approval process differs widely from one contract to another. In some cases, the owner is merely given a copy of the final annual plan, and it becomes effective immediately with no approval required. This extreme gives the owner no input in the operation of the hotel of control over the management company. A procedure more oriented to the owner's interest allows the owner an opportunity to review the annual plan, make comments, and approve either certain specific aspects of the plan or the entire plan. This method can, and often does, result in disagreements.

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 automatically adjusted by a factor such as the Consumer Price Index (CPI). 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 (thirty to sixty days), the parties still cannot agree on the annual plan, some contracts will give the deciding vote to one of the parties involved. Obviously, the so-called approval process under these types of management contracts are meaningless for the party that does not have the veto power.

[1] Arbitration Procedures

A more equitable arrangement for resolving disputes involving annual plans is some form of arbitration. Arbitration procedures have several clear advantages over litigation. Such matters can be settled relatively quickly because there is no wait for time in a court calendar, and because all decisions are final, there can be no appeal. Arbitration proceedings are not public hearings, so confidential information can be discussed without risk of its release to the public. The arbitrator can be chosen on the basis of specific experience and expertise in the area of the dispute. Last, but not least in significance, is that because an arbitration hearing does not require legal representation or extensive preparation, it is much less expensive than litigation.

The only occasional disadvantage to an arbitration proceeding is that it can take fifteen to thirty days to organize and conclude. While not approaching the time involved in a court case, even this delay can sometimes create operational problems when important budget provisions are involved.

To make the arbitration process as efficient as possible, one or more of the following conditions should be incorporated into the clause that provides for such a procedure in the management contract:

- A definition of the specific qualification requirements of the arbitrator (e.g., a national hotel consultant with fifteen years of experience).
- Time limits on the process (e.g., five days to select an arbitrator, five days to hear the case, and three days to render a decision).
- The use of the "best offer" approach: both parties are required to put their best offer on the table during the arbitration, and the arbitrator then must accept one offer and reject the other. By eliminating the option of "splitting the difference," the parties will come closer to an agreement.
- The use of a plan, provided by the American Arbitration Association (AAA), for conducting the entire arbitration process. This service is available for a nominal fee and is well worth using.

[2] Ownership Control

The extent of control by the owner of the final form of the annual plan has a bearing on the operation of the hotel. For example, if the owner has veto power over important expenditures, it can maintain a certain amount of financial control over the management company and ultimately gains a greater say in the overall operation.

The fact that the approval of the owner is 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. For example, if the owner turns down a guestroom refurbishment program proposed in the annual plan, but the operator can circumvent the disapproval by merely increasing the property operations and

maintenance expenditures (even if doing so exceeds the approved budgeted amount), thereby accomplishing the same upgrade, the threat of a budget rejection carries little weight.

Control over the annual plan is one of the key provisions owners should attempt to secure when drafting a management agreement. Veto power over the use of funds can often swing operational control away from the operator and to the owner. First-tier management companies seldom, however, allow owners to have such power over annual plans. Occasionally, first-tier companies permit arbitration, but not for every item in the budget. For example, they might arbitrate a disagreement over how much should be spent on newspaper advertising, but would demand total control over funds derived from the reserve for replacement. Second-tier operators, who generally have much less bargaining power, are much more likely to allow greater ownership participation.

As stated previously, the budget process usually commences about four months prior to the start of a new operational year, when the operator prepares and delivers to the owner the proposed annual plan. The timing of this delivery is important. The owner must have sufficient opportunity to thoroughly review the findings and recommendations contained in the plan and must have enough additional time to negotiate any necessary changes. The lead time for submitting the annual plan to the owner can range from 30 to 120 days. In general, second-tier operators must submit their plans slightly earlier than first-tier operators.

Once the annual plan has been approved, the management company must operate within its budgetary limits. However, unforeseen events and emergencies may cause the operator to exceed such limits. Many management contracts have some form of restriction on spending over and above the amounts specified in the annual plan. In some instances, the agreement requires the owner's approval for any expenses in excess of the budgeted amount. Other agreements specify a percentage (usually between 5 and 25 percent) by which the operator may exceed a budgeted amount without owner approval. A specific dollar amount (e.g., $20,000) can be used in place of a percentage, but such an amount must be regularly revised to account for inflation.

» 20.07 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, most 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 contains some of the elements of a hotel operation that may be subject to approval by the owner.

- 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
- Use of the operator's central services, the cost of which is not included in the normal management fee
- Use of outside consultants

- Expenditures for service contracts
- Changes in room rates and food and beverage pricing
- Leases and concessions
- Plans to dispose of property
- 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 hotel companies provide the owner with very few opportunities to review and approve their actions. Second-tier 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 an owner can exert over a management company, the greater say it has in the hotel's overall operation.

» 20.08 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 fails to meet its contractual obligations 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. Circumstances that can trigger termination by the owner include:

- Bankruptcy of the operator
- Failure to achieve specific level of performance (usually a defined profit)
- Operator buy-out
- Operator's material breach of the contract
- Operator's misconduct or fraud (such as misappropriation or diversion of funds)
- Operator revocation of license
- Operator termination of the franchise

- Cessation of operator activity in the hotel business
- Condemnation or casualty

Events that can bring about termination proceedings by the operator include:

- Bankruptcy of the owner
- Owner's material breach of the contract
- Owner revocation of license
- Owner's failure to provide adequate funds (or nonpayment of the operator)
- Mortgage or lease default
- Condemnation or casualty
- Foreclosure

The key to any termination clause is that it should allow for the rapid and conclusive removal of the party at fault. 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.

[1] Bankruptcy

Although most management contracts permit either party to terminate the agreement in the event the other enters into bankruptcy, it is usually the bankruptcy court that ultimately decides whether the operator will continue or be replaced, since the court can override the terms of the contract. Any time a hotel is involved in a bankruptcy, its reputation suffers, and the long-term negative effect can often be difficult to overcome.

[2] Material Breach of Contract

The material breach of one or more contract provisions 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 ten to twenty days of the breach; the party then has thirty to forty-five 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.

[3] Revocation of License or Franchise

Most management contracts contain provisions protecting licenses and franchise documents by holding either party to be in default for causing a license or franchise to be revoked. Both the owner and operator should monitor this provision carefully to ensure that a potential default caused by the other party is corrected before final action takes place. Notice of a default in any critical license or franchise should be sent to both parties so corrective action can be taken.

[4] Condemnation or Casualty

The taking of a hotel through eminent domain or by some form of destructive casualty generally permits either the owner or operator to terminate the agreement. A partial taking or casualty produces several issues that must be addressed when the management contract is drafted:

- At what point is a hotel rendered unusable by a partial taking or casualty?
- Does the owner or operator decide whether the facilities should continue to be operated?
- Is the operator entitled to a portion of the condemnation award or insurance proceeds?
- Is the operator entitled to collect a contract termination fee in the event the property is rendered unusable by a condemnation or casualty?

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. Some contracts, for example, cite circumstances such as those in the following list, that would render a hotel inoperative and thereby allow either the owner or the operator to terminate the agreement.

- The cost of necessary repairs exceeds 85 percent of the hotel's replacement cost.
- The food and beverage facilities are rendered unusable during the last eighteen months of the contract term.
- Fifty-five percent of the guestrooms are destroyed within the last five years of the contract term.
- Forty percent of the guestrooms are destroyed within the last four years of the contract term.
- Thirty percent of the guestrooms are destroyed within the last three years of the contract term.
- Twenty percent of the guestrooms are destroyed within the last two years of the contract term.
- Ten percent of the guestrooms are destroyed within the last year of the contract term.
- More than 30 percent of the hotel is destroyed by an uninsured casualty.

In most instances, operators will attempt to reopen a lodging facility that has been partially condemned or destroyed by a casualty. When negotiating the contract, owners should be aware of this inclination and insist that the agreement be worded in such a way as to prevent the rebuilding of a facility when doing so does not represent the best use of the condemnation or insurance proceeds.

[5] Operator's Failure to Achieve Performance Levels

One of the most important provisions 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. Generally, the best measure of

operating performance is profitability. Owners invest in hotels in order 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. Among the important issues that should be addressed in a performance clause are the following:

- Performance criteria should be clearly defined so that both the owner and operator understand the specific goals. Stating, for example, that the hotel must be operated in "a profitable manner" does not provide the operator with a specific level of performance.
- The failure to achieve the desired level of performance should be recognizable early enough to prevent the hotel from suffering undue financial hardship from an incompetent operator. The performance criteria should also, however, address the possibility that the operator is a competent manager but external circumstances, such is a declining economy or overbuilt market, make the performance level impossible to reach.
- The performance criteria should take into account unique circumstances, such as that a new hotel typically experiences a period of build-up, during which both occupancy and profits grow; that a seasonal hotel is often less profitable than one that operates year-round; and that unions, high energy costs, excessive property taxes, and difficult maintenance problems are unpredictable elements that will often reduce profits.
- The termination process should provide the operator with an opportunity to remedy the lack of performance by contributing or lending the necessary funds to the owner in order to correct the deficiency and bring the level of performance in line with the stated criteria.
- The performance criteria should reflect the fact that a management contract generally runs for an extended period of time and as the financial structure of the property (i.e., financing, equity and ownership) changes, the intended performance provisions should remain intact. For example, if the performance criteria establishes a level of profit after debt service, and at some time in the future the mortgage is restructured, thereby reducing the annual payments, the operator will directly benefit because the margin of profit will automatically rise through no effort on the part of the operator.

Setting specific performance criteria often becomes one of the key elements in the management contract negotiation process. The operator generally opens discussions by stating that any form of operator performance criteria are inappropriate and unnecessary. The owner generally counters with provisions that permit swift operator removal for any deficiency in performance. The final contract, which reflects the bargaining power of each party, will be the result of some compromise between these two opening positions.

From the owner's point of view, the easiest way to establish appropriate criteria for operating performance is to use the income and expense projections developed by the operator during the management company selection process. Owners assume that if the management company was attempting to sell its services on the basis of such projections, it should be willing to have them used as a performance standard. Management contracts that use this approach typically set forth a defined level of profit, such as income before debt service, and list by year the minimum dollar amount that the operator must generate in order to conform with the performance standard. Other performance criteria sometimes used in hotel management agreements include:

- *Revenue figures from a market study performed by a hotel appraisal firm.* These serve as a basis for negotiation.
- *The income after debt service realized by the subject property.* This performance standard requires the operator to generate a net income that covers, at a minimum, the debt service for the property. The specific amount of debt service should be set forth in the contract, because with floating loans, refinancing, and subordinate mortgages, the actual payments may vary over the life of the contract.
- *Specified return on equity funds.* This criterion is similar to the income after debt service standard except that the operator must generate a sufficient profit to not only cover debt service but also provide a minimum return on equity. In the event that additional equity funds must be invested in the property, such as monies to cover initial cash shortfalls, this type of clause allows the owner to impose a higher standard on the operator.
- *Percentage of gross operating profit.* This standard establishes the right of the owner to terminate the agreement if a certain percentage (e.g., 80 percent) of the gross operating profit does not equal a certain percentage (e.g., 15 percent) of the equity funds invested in the hotel.
- *Percentage of an approved budgeted amount.* This standard is based on an approved operating budget and holds that the operator must achieve a certain percentage of a stipulated profit line in the budget, such as 80 percent of the gross operating profit. The key to this criterion is the budget approval process and how much input the owner has in establishing a realistic level of performance. The advantage of this procedure is that the performance criteria can be adjusted on a yearly basis (through the annual budget approval process) to reflect local market and operating cost conditions.

Performance criteria generally do not become effective for two to four years after the opening of a hotel. This delay is particularly important for newly opened properties, whose operating performance is difficult to judge during the first few years as the business builds up. In addition to a delay for the start-up period, most performance clauses allow a new operator two to three years to achieve the necessary level of profit. A typical performance clause, for example, states that the owner may terminate the agreement if the operator fails to achieve a positive income after debt service after three consecutive years. Often, the management company must fall short of the performance standard for two or more consecutive years before the owner can terminate for poor performance. In general, performance standards start later and require more consecutive years of nonperformance for first-tier operators than for second-tier operators.

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. By advancing the needed capital, the operator is allowed to continue managing the property until another performance test is made (usually one year later). The monies funded by the operator may take one of two forms; they may be treated as merely cash advanced with no provision for repayment, or they may be loaned by the operator (with or without interest) to be repaid at some future date. Any repayment of funds advanced by the operator to meet a performance criteria is generally subordinated to debt service as well as a return on equity funds.

To protect the operator from external circumstances that could adversely affect a hotel's operating performance and thereby subject the management company to ter-

mination, 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.

[6] Operator Buy-Out

A buy-out clause enables the hotel owner to terminate the management contract at any time for any reason by merely paying a specified dollar amount. 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.

Although a buy-out clause can greatly benefit the owner, such provisions are rarely available from first-tier operators. Hotel chains with a recognized trade name are often reluctant to enter into agreements that could be easily terminated by the owners and possibly create adverse customer publicity.

The actual termination charge reflects the value of the management contract to the operator. Theoretically, the amount of the payment should approximate the discounted value of the anticipated management fee income over the contract's remaining term. Typical termination charges range from two to four times the total management fee paid to the operator over the previous twelve-month period. This calculation equates to a 25 percent to 50 percent discount rate, which is generally appropriate for gross rather than net income to the management company.

[7] Operator Misconduct or Fraud

Any operator misconduct, including fraud or the misappropriation of funds, constitutes a major breach of trust and warrants the operator's immediate termination. Care must be taken to determine that such an occurrence was attributed to the operator rather than to an employee acting without the management company's knowledge or approval. Individual breaches should be insured against by appropriate fidelity bonds.

[8] Cessation off Operator Activity in the Hotel Business

Because some management contracts extend for long periods of time, owners usually seek to protect themselves from operators who become significantly less active in managing hotels and, by doing so, reduce the benefits of being part of a lodging chain. Some contract clauses allow the owner to terminate if the operator ceases to manage a specified number of hotel properties. Other clauses stipulate a dollar volume amount that hotel operations must represent as a percentage of the company's total revenue.

[9] Owner's Failure to Provide Adequate Funds

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 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.

[10] 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 staff, 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.

» 20.09 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 operators than with second-tier operators. Hotel management companies generally pursue one of the following options if an investment in the property is required:

- *Deferred incentive management fees.* The deferral or outright forgiveness of all or a portion of the incentive management fee is actually a form of capital investment on the part of the operator. Most management companies 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 some time in the future, the actual cost to the operator is minimal. If the deferred incentive fee accrues without interest, the operator loses the time value of money but generally receives full payment at some point in the future. Occa-

sionally, fee structures are negotiated that stipulate than 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.

Pre-opening services. Owners are often able to negotiate reduced charges for the pre-opening services of operators in the case of a new hotel. The typical range of these costs is shown in Exhibit 20-4.

Exhibit 20-4 Costs for Pre-Opening Services

Class of Hotel	Amount per Room
Luxury	$4,100 to $6,400
Standard	$2,500 to $4,800
Economy	$1,600 to $2,300

- *Working capital.* All hotels require working capital to purchase inventories and operating supplies and to fund other types of start-up costs. The typical range of these costs is shown in Exhibit 20-5.

Exhibit 20-5 Working Capital Costs

Class of Hotel	Amount per Room
Luxury	$2,900 to $4,000
Standard	$1,900 to $3,100
Economy	$1,300 to $1,800

- *Furniture, fixtures, and equipment (FF&E).* If required, this outlay can represent a significant investment on the part of the operator. FF&E costs typically range as shown in Exhibit 20-6.

Exhibit 20-6 Furniture, Fixtures, and Equipment (FF&E) Costs

Class of Hotel	Amount per Room
Luxury	$14,800 to $32,300
Standard	$10,400 to $18,300
Economy	$5,400 to $9,900

- *Outright payment of key money.* In some highly desirable hotel markets (e.g., New York City), hotel management companies sometimes pay what is known as key money to obtain the right to put their name on and manage a hotel. In effect, the company purchases the management contract for the hotel.
- *Other operator investments.* Management companies sometimes provide funds in the following formats: reduced fees, group purchasing advantages, and profit guarantees.

The fact that a management company is willing to make a capital contribution is sometimes meaningless when the form of the contribution does not expose the operator to any monetary loss. For example, if the contribution of capital takes the form of a loan that is repaid over time with interest, the operator has not really made a significant investment. 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 forms described previously), with the expectation of receiving a return pan passu to the other equity funds, can the investment be considered meaningful. The usual forms of operator capital contributions are as follows:

- *Loan of capital.* The operator contributes capital in the form of a note that is repaid with interest, generally out of cash flow. The note is usually unsecured and subordinated to mortgage debt service.
- *First take-out of equity.* The operator receives all of the property's cash flow after debt service until the equity contribution is recovered. The owner then receives the cash flow until -the remainder of the equity investment is recovered. Any subsequent cash flow is divided according to an agreed-upon percentage.
- *Outright equity contribution.* The operator and owner enter into a joint venture partnership and split all cash flow after debt service in accordance with an agreed-on percentage.

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. An operator's capital contribution in the form of equity, which carries no stated rate of return, can also be costly. Since many operators have limited resources to invest in hotel properties they generally seek cash-on-cash returns on their equity of 12 to 20 percent.

» 20.10 OPERATOR EXPENSES

Hotel management companies generally incur two types of expenses during the process of operating hotels either for their own account or for third parties. These expenses are known as home office expense and system reimbursable charges.

[1] Home Office Expenses

Home office expense includes all the costs of operating the home and regional offices of the management company. These consist of salaries and benefits for executive personnel and support staff; office operating expenses such as rent, office equipment, telephone and supplies; and administrative expenses including insurance, bookkeeping, and legal, which are limited to the administration of the management company rather than the hotel properties themselves. Depending on the size of the management

company and the types of management services provided, the extent of the home office expense may range from modest to extensive.

[2] System Reimbursable Charges

System reimbursable charges are expenses paid by the hotel owner for centralized services provided by the management company. Centralized services include system-wide advertising, national and regional sales offices, reservation accounting, management information and purchasing systems, and education and training programs. Most first-tier management companies offer extensive centralized services, while second-tier operators generally have limited capabilities.

[3] Payment of Expenses and Charges

Home office expenses are typically included in the management fee and are not charged or allocated to any of the properties under contract. These costs represent the normal overhead expense of operating a hotel management company. While home office costs are not usually allocated among the chain's hotels, some operators charge individual properties the travel expense when home office personnel make periodic visits. Occasionally, the salaries of these individuals may also be charged to a hotel when specialized services are being performed.

When negotiating a management contract, the hotel owner should request a detailed description of the home office expenses that will be included in the management fee and those that will be charged to the property. Some operators attempt to allocate a portion of the normal home office overhead to individual properties through excessive charges for home office services. This procedure allows hotel companies to offer fee structures that appear extremely competitive but, when the total costs are calculated, are often economically unattractive.

System reimbursable charges are generally allocated to all the properties within the system according to a specified formula. Some of the methods currently in use include:

- *Percentage of revenue.* The cost of a centralized reservation system is often 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 percent occupancy with a $100 average rate would pay the same amount as a 300-room hotel with a 60 percent occupancy and a $85 average rate. Furthermore, this method also does not take into account the actual usage and bene-

fit 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 $4.50 per reservation received. Properties that obtain a greater number of reservations from the system pay a larger share of the centralized costs. Care must be taken when using this allocation method to make some provision for no-shows, that is, reservations made and thus charged to the property that represent customers who either subsequently cancel or do not show at the property. Administration of this method of centralized expense allocation is obviously more difficult.

The methods used by a hotel management company to allocate system reimbursable charges are generally pre-established by the management company and are subject to negotiation for individual management contracts. The property owner should request documentation as to the management company's historical allocation procedures and costs for these charges so that projections can be made for the subject property,

» 20.11 TRANSFER OF OWNERSHIP

The ability of both the hotel owner and the hotel operator to easily transfer ownership (i.e., by the owner selling the hotel or the operator selling the management company) is desirable because it allows the selling party to actually realize the value of the enterprise. Any prohibitions that make a sale more difficult can reduce the obtainable value. There is good reason for establishing conditions to a transfer, however, because the party remaining after a sale is dependent on the abilities and resources of the new owner for future success. To protect the hotel owner and operator, many management agreements incorporate specific restrictions on the transfer of ownership. There are basically two types of such restrictions: approval requirements and the right of first refusal.

The remaining party can receive protection through a variety of approval requirements to which both the parties buying and selling must adhere in order for the transaction to take place. Generally, the more protection the remaining party receives, the more restrictive the transfer process becomes. Transfer approval requirements can generally be divided into three levels, depending on the degree of restrictiveness imposed by the remaining party: those that give the remaining party total veto power;
those that establish specific approval criteria; and those that stipulate that approval cannot be unreasonably withheld.

A total veto provision gives absolute power to the remaining party to either accept or reject the buyer proposed by the seller. This level obviously provides the greatest protection to the remaining party, but it can seriously inhibit the marketability of the enterprise should the veto be used in an unreasonable manner.

Some management agreements incorporate specific approval criteria that must be met before a transfer is approved. Depending on whether the transfer is made by the owner or the operator, the criteria can relate to items such as net worth, integrity, experience, references, or possible conflicts of interest. By establishing specific approval criteria, both the seller and a qualified buyer are able to move toward a transaction knowing that they will be approved by the remaining party.

A common provision in management agreements is that a specific approval cannot be unreasonably withheld. While this stipulation might provide some comfort to

the prospective buyer and seller, the interpretation of "unreasonably" can subject the entire transaction to ruinous litigation.

In addition to specific approval requirements on the transfer of ownership, most hotel management contracts contain a right of first refusal. Under a right of first refusal, the party to remain with the hotel has the right to match the offer made by the buyer and accepted by the seller. This provision not only allows the remaining party to acquire a full interest in the property, but alleviates the need to invoke one of the approval requirements in the event the remaining party does not want to become a partner with the potential buyer. While the right of first refusal should not take the place of specific transfer approval requirements, it provides another form of protection.

A right of first refusal can by itself inhibit the sale of a hotel. Potential buyers, knowing that they may not ultimately succeed in purchasing a property because of the rights vested in the remaining party, may not spend the time and effort necessary to pursue the transaction. This may limit the number of potential buyers, which can in turn adversely affect the marketability of a property.

An important component of a right of first refusal provision is the length of time the remaining party has to consider matching the offer of the buyer. Naturally, the seller wants this time period to be kept to a minimum while the remaining party wants as much time as possible to review the offer and secure necessary financing. The length of time allowed to consider such offers generally ranges from forty-five to ninety days, but in most instances, the remaining party is permitted sixty days to consider an offer.

While the transfer of ownership is generally not an immediate concern when a hotel management agreement is drafted, the structure of these provisions 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 transfer from the standpoint of all parties involved in order to achieve an equitable contractual structure.

» 20.12 INSURANCE AND CONDEMNATION PROCEEDS

After a casualty or condemnation, the property owner is generally compensated for the loss by either the insurance company or the condemning authority. In the event of casualty, depending on the type of insurance coverage, the owner usually receives the replacement cost of the property destroyed, so that the damaged hotel can be reconstructed. In a condemnation, the compensation is typically based on the market value of the property taken. Business value is rarely considered by either the insurance company or the condemning authority, with the exception of insurance that covers a business interruption.

Most hotel operators want management contract provisions that require insurance and condemnation proceeds to be used to reconstruct the hotel. Some management companies, however, want to receive a portion of any insurance or condemnation proceeds as compensation for the loss of management fee income along with the other benefits of operating the hotel. For example, an agreement may stipulate that the operator receive a portion of the residual compensation left after the property is rebuilt, calculated by taking 20 percent of the fraction of which the numerator is the number of years remaining in the management contract and the denominator is the number of years in the hotel's remaining useful life, and multiplying this percentage by the residual compensation. Although management companies with strong bargaining positions are sometimes able to obtain these provisions, the sharing of insurance or condemnation proceeds is usually not justified unless the insur-

ance company or condemning authority makes an unusual special award for a business-related loss.

Hotel owners generally insist on retaining all the proceeds from an insurance or condemnation award. If this right is unacceptable to the operator, a compromise provision is sometimes agreed to that allows the management company to make its own claim for compensation, but only if the owner can be satisfied that such a claim may be made separately and any award would not adversely affect the timing or amount of the proceeds to which the owner is entitled.

Although a destructive casualty or condemnation is an unlikely occurrence during the life of a management contract, any clauses relating to these events become extremely important if in fact the property is destroyed or taken. Both parties must be aware of how insurance or condemnation compensation is calculated so an agreement can be properly structured.

» 20.13 EMPLOYEES

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 workers to be employees of the operator and operators want the owner to be the employer. The basis of this issue is primarily liability; the employer is directly responsible for withholding taxes and social security and, ultimately, making timely payments to the IRS. Sometimes, when cash flow is tight, the money for these federal taxes is diverted to other, more pressing uses. If the cash flow does not recover in time to allow the fulfillment of the government obligations, the employer becomes subject to penalties, interest, and even criminal prosecution. In addition to this employee tax liability, an employer faces various types of personnel liabilities, 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, since 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.

From the perspective of the management company, another cause for concern regarding the employee issue arises when a company finds itself in a hotel ownership position on a short-term basis. For example, when a lending institution forecloses on a hotel and becomes the employer of the property's personnel, it may be forced to provide pay and benefits equal those received by other employees of the bank. These benefits can be very expensive and are not a desirable option for a short-term owner.

Occasionally, the management company will request that top-level personnel be employed by the operator 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.

» 20.14 RESERVE FOR REPLACEMENT

A reserve for replacement is a fund set up to accumulate capital for the periodic replacement of FF&E. Hotel FF&E should generally be replaced on an average of once

every eight to ten years, so the reserve for replacement must be of adequate size to meet these requirements. Hotel owners that are also operators usually do not actually establish a fund for this purpose, but rather contribute capital at the time that FF&E replacements are required. Depending on the owner's financial situation at the time FF&E funds are needed, they may come from the hotel's cash flow, additional borrowings, or new equity contributions. Occasionally, these sources of funds are not available and the FF&E replacements must be postponed.

A hotel management company has a vested interest in maintaining the hotel in top physical condition, so it does not want to be in a position where adequate funds are not available to make necessary replacements. A worn-out facility negatively affects profitability as well as the image and reputation of the operator. To provide protection against such an occurrence, hotel management companies generally require that an actual reserve for replacement fund be established, coupled with contractual obligations for regularly depositing capital. The management company typically opens a separate reserve for replacement bank account and administers its activity. Deposits are made by the operator directly from cash flow (or from ownership shortfall capital if cash flow is insufficient). Withdrawals from the fund are to be used only for replacement of FF&E and generally only with the approval of the operator. Depending on how the budgeting process is structured, FF&E replacement may require ownership approval or it may be at the operator's sole discretion.

Many different formulas are used to establish the amount of money that must be contributed each year to the reserve for replacement fund. The primary objective of any of them is to create a fund that adequately covers future replacement needs without needlessly putting aside too much money. The following list describes some of the formulas used for this purpose by hotel management companies.

- *Percentage of revenue.* Most hotel management contracts base the annual reserve for replacement contribution on a specified percentage of total revenue. This advantage of this formula is that it automatically adjusts for different factors, such as varying occupancy levels, changes in average room rates, increases or decreases in food and beverage volume, and external inflationary factors. For example, if a hotel experiences higher levels of occupancy, the total revenue increases and the reserve for replacement based on a percentage of revenue follows suit. The reserve fund grows more rapidly and replacements can be made sooner to offset the effects of the greater use. The actual percentages used in this formula generally range from 1 to 6 percent of total revenue (rooms, food, beverage, telephone, and other income). Some contracts call for a fixed percentage that stays constant over the life of the agreement, while others use differing percentages that increase periodically. The fixed percentage formula works well for both new and existing hotels. The step percentage is generally used for new properties.
- *Annual fixed dollar amount.* Some management contracts specify that a fixed dollar amount be contributed to the reserve for replacement fund on an annual basis. The size of the annual contribution is calculated by estimating the total future replacement cost in today's dollars and dividing this amount by the number of years remaining until the replacement is required. In order to adjust for inflation, a factor based on the Consumer Price Index (CPI) is usually incorporated into the calculation. The difficulty with this approach is estimating the number of years between replacements. A particularly successful hotel with a high occupancy may require an FF&E replacement long before the originally scheduled date. If this occurs, the fund would not be sufficient to complete the necessary replacements. This method is rarely used alone. Instead, it is commonly used in conjunction with the percentage of revenue method.

- *Negotiated yearly amount.* Some management contracts structure the reserve for replacement contribution on the basis of an annual amount negotiated between the hotel owner and operator. However, most operators want a more definite formula that provides assurance that an adequate reserve fund will be available to make necessary replacements.

Because items of FF&E have a relatively short life, contributions to the reserve for replacement fund must be made annually starting with the first year of operation. Some owners of new hotels attempt to negotiate a formula that incorporates a waiting period, thinking that early contributions are unnecessary because the FP&E is in new condition. If this approach is used, it is likely that there will not be sufficient capital in the fund when shortlife replacements must be made. What must be realized is that even though FF&E has an average useful life of eight to ten years, many of the components have lives that are much shorter. Exhibit 20-7 shows the typical useful lives of various FF&E components.

Exhibit 20-7 Useful Lives of FF&E Components

Item	Years of Useful Life
Furnishings	
Lobby	5–12
Restaurant	5–12
Guestrooms	
Casepieces	8–15
Mattresses	5–18
Carpet	
Lobby	3–6
Corridor	2–4
Guestrooms	4–8
Drapes	4–8
Bedspreads	3–6
Kitchen Equipment	8–25

As the exhibit shows, FF&E replacement could start as early as the second year for a new hotel. Additional replacements are then necessary almost every year thereafter. Replacement is an ongoing process, so the accumulated dollar amount in the reserve fund is generally minimal; this means that a sinking fund arrangement (i.e., the use of segregated assets and their proceeds to fund the replacement) is inappropriate because the yearly fund balance is probably insignificant and the compounding interest benefit does not generate any appreciable growth.

» 20.15 AREA RESTRICTIONS FOR OPERATOR

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. 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 hotels within a market area, some hotel management contracts provide for area restrictions. Basically, area restrictions limit a hotel company from owning, leasing, operating, or franchising other lodging facilities within a defined geographic area surrounding the subject property. This owner-oriented provision is most important when the operator is a first-tier management company whose corporate name has a public identity. The act of placing the chain's name and trademarks on other hotels within the same market area can dilute potential room-night demand and reduce operating levels for existing properties. Second-tier hotel operators, 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. However, even if the public is not aware that two hotels of differing chain names are under identical management, the potential for a conflict of interest and favoritism is always present. This is particularly true if the management company has an ownership interest in the competitive hotel. For these reasons, hotel owners generally attempt to negotiate some form of area restriction.

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. An area restriction clause must provide two important pieces of information. First, the primary market area must be clearly defined so there is no spillover into other nearby areas that are not directly competitive. Several formats are available to achieve this objective. Some contracts utilize a specific radius to outline the perimeter of the market area. Other contracts provide street names to outline the protected territory or use the boundaries of a city or other established area. Second, the clause must specify the duration of the restriction. Restricted market areas are sometimes redefined over time. A circle with a radius of ten miles might be used for the first five years, shrinking in size to a five-mile radius for the next five years and then eliminated for the remaining term of the agreement.

Operators who consent to an area restriction generally look for ways either to have the protected territory reduced in size over time or to incorporate a provision that will allow the restriction to be lifted if sufficient local area demand can be proven. The best way to demonstrate that the impact of another hotel carrying the operator's trade name or management will be minimal is to establish a minimum level of occupancy requirement 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 percent for two consecutive years. Whatever the occupancy level selected, it should be high enough to demonstrate that there is sufficient area lodging demand to support another property carrying the same trade name.

Some hotel companies use the services of hotel consulting firms to perform impact studies that assess the negative effect on the subject property if the operator adds another lodging facility to the market area. As with any study of this type, the quality of results are directly related to the skills of the consultant performing the work and the ultimate determination is still largely subjective and prone to dispute.

» 20.16 INDEMNIFICATION

Most hotel management contracts contain clauses that indemnify each party from various liabilities and losses. Owners and operators face different risks in their respec-

tive capacities, so indemnification provisions are variously structured in order to meet each party's need to reduce their exposure. The major types of indemnification clauses are as follows:

Indemnification provided by the owner. Generally, the operator wants indemnity from all liability, loss, damage, cost, or expense relating to or arising from the operation of the hotel. This coverage usually also includes any act or omission, negligence, tortious or otherwise, of any agent or employee of the operator. 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. Most management contracts include some sort of indemnification for the operator.

Indemnification provided by the 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 modify the impact of these clauses by adding modifying terms, such as "material" breach of the management contract and "willful" misconduct.

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.

» 20.17 PRE-OPENING MANAGEMENT SERVICES

Since most hotel management agreements are structured primarily for operating lodging facilities, hotel companies that are taking over a newly-constructed hotel generally draw up an additional contract to cover pre-opening management services. The period known as the pre-opening phase of a hotel's development generally begins with the employment of a sales staff or the general manager and extends to the actual opening day. Depending on the type of hotel and the need for pre-opening sales activity, the pre-opening service can start between three months to three years prior to the opening. Convention hotels, which attract groups that book several years in advance, usually require long lead times in their sales efforts. Some of the services the hotel operator typically provides during the pre-opening period include:

- *Pre-opening budget:* Preparation of comprehensive, detailed estimates as to what capital is required to fund all the pre-opening services.
- *Personnel services:* Recruiting, training, directing, and employing the initial staff.
- *Advertising and promotion:* Initiating and conducting such advertising and promotion necessary to attract guests to the hotel.
- *Leases and agreements:* Entering into agreement for leases, licenses, and concessions for stores and other rental space in the hotel.

- *Licenses and permits:* Application for and procurement of all licenses and permits required for the operation of the hotel and its related facilities, including liquor and restaurant licenses.
- *Purchasing:* Purchase of all initial inventories and operating supplies.
- *Installation:* Supervision of the delivery, installation, and acceptance of operating equipment, furnishings, equipment, and consumable supplies.
- *Sales and marketing:* Hiring and supervision of the hotel's sales staff and conducting the sales and marketing efforts, including developing a marketing plan.
- *Financial systems and controls:* Setting up all financial accounting systems and controls, including developing initial budgets and operating projections.
- *Coordination:* Assistance in coordinating the efforts and activities of the architect, interior designer, and all other consultants retained by the owner in connection with the planning and development of the hotel. If the operator is required, in addition to coordinating the various consultants, to review and critique their output, a separate contract, known as a technical services agreement, is generally used.

Compensation for pre-opening services can be structured in various ways. It is difficult to define a typical pre-opening fee, because many operators are willing to provide these services at or near their cost in order to obtain a long-term management contract; consequently, provisions for them are generally negotiated concurrently with the management contract. The following is a list of several formats commonly used for establishing the compensation for pre-opening services.

- *Amount per room:* A schedule of pre-opening fees based on a certain amount per room that provides increased compensation as the hotel gets larger. It also sets a standard fixed rate for the fee, which need not be negotiated with each transaction thereafter.
- *Flat amount:* A lump sum for all pre-opening services determined through negotiations, generally paid in several installments. The primary advantage of the amount per room or the flat amount relates to the fact that the compensation is established and fixed at a specific level that provides a firm budgeted amount and forces the operator to absorb any pre-opening cost overruns.
- *Actual costs:* A provision that the operator will be reimbursed for all expenses incurred during the pre-opening phase of the hotel development. These costs generally include the payroll of the management company personnel assigned to the specific hotel.
- *Actual cost plus.* Same as actual cost, but with the addition by the operator of a profit factor, such as 2.5 times the payroll expense.
- *Percent of cost.* A percentage of the total project cost.
- *Per month or per diem.* Compensation based on a specific amount per month, per day, or per hour.

» 20.18 TECHNICAL SERVICE ASSISTANCE

One of the additional services provided by some hotel management companies prior to and during the pre-opening phase of a hotel development is called technical ser-

vice assistance. These activities encompass the technical aspects of hotel layout, design, construction and furnishing. Some of the technical assistance offered by hotel management companies who have this specialized in-house capability are as follows:

- *Initial design:* Providing the property owner with guidelines and specifications relating to the hotel's concept, layout, design, and decor, and recommendation and sizing of facilities.
- *Architecture and facilities design.* Working with the project architect, engineer, designer, and other development consultants to create working plans and specifications. Specific areas to be covered include:
  —Architecture
  —Mechanical work
  —Electrical and plumbing systems
  —Interior design
  —Operational design
  — Communications
  —Fire safety
  —Computer systems
  —Telephone systems
  —Food facilities design
  —Laundry design and equipment
  —Lighting
  —FF&E specifications
- *Final design:* Review by the operator of all plans and specifications prepared by the various development consultants. Based on the critique and recommendations made by the operator, the plans and specifications are revised and approved when acceptable.
- *Project supervision:* Provision by the management company of some level of project supervision to see that the plans and specifications are followed during the actual construction of the hotel. This supervision also includes the installation of furniture, fixtures, and equipment. The project supervision offered by a hotel management company rarely suffice to replace a full-time project manager, general contractor, or developer.
- *Other services.* Other technical services sometimes offered by the operator, including:
  —Project feasibility (either preparing or reviewing market studies and appraisals)
  —Franchise affiliation (assistance to the owner by second-tier management companies in obtaining a franchise affiliation)
  —Project financing (assistance in securing debt and equity financing)

Not every hotel management company has the in-house capability and expertise to provide technical assistance. 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. Compensation for technical service assistance is generally a negotiated flat fee paid in stages over the development phase.

These services are usually considered separate and distinct from the pre-opening services because they require a specialized level of expertise.

The hotel owner should exercise particular care when entering into a technical service agreement with a hotel management company. The in-house capabilities of the operator must be carefully evaluated in order 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. 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.

Exhibit 20-8 Hotel Management Contract

Agreement made _____ *[Date]*, between the owner of _____ *[name of hotel or motel]*, of_____ *[address]*, _____ *[city]*, _____ County, _____ *[state]*, referred to as owner, and _____ *[hotel management company]*, a corporation organized under the laws of _____ *[state]*, having its principal office at _____ *[address]*, _____ *[city]*, _____ County, _____ *[state]*, referred to as manager.

RECITALS

1. Owner owns the _____ *[hotel or motel]* and parking lot situated at _____ *[address]*, _____ *[city]*, _____ County, _____ *[state]*, referred to as _____ *[hotel or motel}*, together with all furniture, fixtures, machinery, appliances, operating equipment, books, records, and other personal property used in the operation of the _____ *[hotel or motel}*.

2. Owner desires the benefit of the experience and the services of manager on the terms set forth in this agreement, and manager is willing to accept employment on the terms set forth in this agreement.

For the reasons set forth above and in consideration of the promises of the parties, the parties agree as follows:

SECTION ONE

TERM OF AGREEMENT

The term of this agreement shall extend from _____ *[Date}*, to _____ *[Date}*.

SECTION TWO

TERMINATION OF AGREEMENT

This agreement may be canceled at any time by mutual agreement of owner and manager, and this agreement may also be terminated by owner in accordance with the provisions set forth below.

SECTION THREE

ACCEPTANCE OF EMPLOYMENT

Owner employs manager to operate _____ *[hotel or motel}* and render the services stated in this agreement, and manager accepts such employment and shall discharge such duties all in accordance with the terms set forth in this agreement.

SECTION FOUR

SERVICES OF MANAGER

Manager shall be the exclusive manager of _____ *[hotel or motel},* and manager shall provide owner with the services customarily provided for in such instances, including the following:

a. Accounting. Manager shall keep all accounts and supervise all audits and bookkeeping and submit monthly statements to owner showing the details of

_____ *[hotel's or motel's]* operations. All records shall be open to the inspection of owner or owner's agents, counsel, or auditors at all reasonable hours.

b. Buying. Manager shall make available to _____ *[hotel or motel}* its buying power, without profit on any purchase which may be made.

c. Referrals and advertising. Manager shall exert reasonable efforts to direct patronage from other hotels and motels that it manages to owner's _____ *[hotel or motel]*, and will follow a program of displaying advertising of hotels or motels it manages, including owner's _____ *[hotel or motel]*, in the lobbies or public rooms of other hotels and motels it manages.

d. Resident manager. Manager will appoint a capable resident manager and necessary department heads, deemed capable of maintaining and operating owner's property as a first-class hotel or motel. If a resident manager shall not prove to be satisfactory to owner, owner may in writing request manager to discharge a resident manager, setting forth the reasons for the action. If the grounds of the removal set forth by owner shall be sufficient to constitute a violation of the terms of this agreement, a resident manager shall be discharged by manager. If manager does not consider the validity of the objections to be sufficient, then the dispute shall be submitted to arbitration, as provided for in Section Sixteen.

SECTION FIVE

BONDING OF EMPLOYEES

Manager shall maintain adequate fidelity bonds on employees engaged in the operation of _____ *[hotel or motel},* the premiums for which shall be charged as operating costs.

SECTION SIX

INSURANCE

Subject to the approval of owner, manager shall secure all insurance policies necessary to the proper maintenance and preservation of _____ *[hotel or motel}.* The proceeds of all insurance policies shall be payable to owner. And in the event of an insurance payment for casualties suffered from fire or other cause, owner shall have the sole right to determine how the proceeds shall be reinvested in _____ *[hotel or motel}.*

SECTION SEVEN

DEPOSIT OF FUNDS

All funds derived from the operation of _____ *[hotel or motel]* shall be deposited by manager in _____ *[bank]*. The funds shall be expended by manager on the operation of _____ *[hotel or motel]* and on the payment of taxes, insurance, and workmen's compensation and liability premiums. Any excess funds are to be duly accounted for _____ *[quarterly]* to owner in accordance with the provisions of this agreement.

On or before the _____ day of each month, manager shall deposit in _____ *[bank]* to the joint accounts of both parties, a sum of money equal to one-twelfth of the ad valorem taxes assessed against _____ *[hotel or motel}* _____ *[if appropriate, add: and one-twelfth of the interest and principal due on the* _____ *(mortgage or deed of trust) for the current year}.* The funds so deposited shall be used to pay the taxes as they mature _____ *[if appropriate, add:*

and to pay the current interest and principal requirements on the _____ (hotel or motel) _____ (mortgage or deed of trust)].

If required by owner, manager shall furnish an adequate fidelity bond not in excess of _____ Dollars ($_____) requiring manager to _____ *[quarterly]* account for such revenues in accordance with the provisions of this agreement. The premiums for the bond shall be paid by owner.

SECTION EIGHT

CONTROL OF EMPLOYEES

Manager shall have full power and authority to take all actions to bring about an efficient operation of _____ *[hotel or motel]* and to maintain it as a first-class _____ *[hotel or motel],* except for actions specifically prohibited in this agreement. Manager shall have exclusive authority to hire and discharge all employees necessary for the operation of _____ *[hotel or mote!}* and to fix their compensation, to approve allowances for rooms, food, and privileges to officers and employees of owner and manager. But manager shall not enter into any labor agreement without the express written consent of owner.

SECTION NINE

LIABILITY FOR LOSSES

All expenses or damages incurred in the operations of _____ *[hotel or motel]* shall be paid by manager from the funds which may be derived from the operation of _____ *[hotel or motel]*. Manager shall be liable only for the loss or damage sustained by reason of the dishonesty or the willful gross negligence on the part of its officers.

SECTION TEN

CIVIC DUTIES OF MANAGER

It is understood and agreed between owner and manager that manager shall discharge its civic duties to the citizenship of _____ *[city]* with reference to those activities which it is generally considered must be carried out for the general benefit of the community, such as, reasonable contributions to the local Chamber of Commerce, _____ *[charitable organization],* and other civic organizations. It is considered to be to the best interest of both parties that _____ *[hotel or motel]* shall constitute an integral part of the civic and commercial activities of _____ *[city],* Contributions must first be approved by owner and shall be treated as an expense of operation to _____ *[hotel or motel}.*

SECTION ELEVEN

MANAGER'S COMPENSATION

As compensation for services to be rendered in accordance with this agreement, manager shall receive a fixed annual management fee of _____ Dollars ($_____) payable in equal monthly installments. Manager shall also receive a portion of the net cash receipts derived from the operation of _____ *[hotel or motel]* as set forth in this agreement. The portion of the net cash receipts to be paid to manager in addition to the fixed annual management fee shall be the following percentages of excess receipts above the cost of operation, taxes, insurance, interest and principal requirements, as set forth:

a. _____ Percent (_____%) of the first _____ Dollars ($_____) or any portion thereof;

b. If such excess receipts shall exceed _____ Dollars ($_____), then manager shall receive _____ percent (_____%) of the next _____ Dollars ($_____); and

c. If such excess receipts shall exceed _____ Dollars ($_____), then manager shall receive _____ per cent (_____%) of all the excess receipts above _____ Dollars ($_____).

The term "excess receipts," as used above, is defined to mean all sums received in the operation of_____ *[hotel or motel}* after payment of: *(1)* all operating expenses, including cost of maintenance, repairs and replacements of operating equipment and fixed annual management fee, (2) ad valorem taxes assessed in respect of _____ *[hotel or motel],* and *(3)* premiums on insurance, worker's compensation and liability policies and fidelity bonds.

SECTION TWELVE

MAINTENANCE OF OPERATING EQUIPMENT

_____ *[Hotel or Motel]* property and all furniture, fixtures, machinery, appliances, operating equipment, and all personal property used in the operation of _____ *[hotel or motel}* shall be maintained in first-class repair, and in such condition that the equipment shall be satisfactory for the operation of a first-class _____ *[hotel or motel}.* Manager may expend from the funds derived from the operation of _____ *[hotel or motel}* an amount adequate for these purposes.

SECTION THIRTEEN

ACCOUNTING PERIOD

The net cash receipts derived from the operation of _____ *[hotel or motel}* shall be determined at the termination of annual periods, the first to be the period beginning _____ *[Date},* and terminating _____ *[Date}.* Subsequent annual periods shall begin on the first day of _____ *[month}* thereafter and terminate on the _____ day of _____ *[month}.* The periods shall be referred to as "accounting periods." Promptly on the expiration of each accounting period, or as soon as may be practicable, manager shall cause to be prepared an accurate statement of all transactions relating to the operation of _____ *[hotel or motel}* for the preceding accounting period, and submit the statement to owner. On the determination of the amount of excess receipts, settlement shall promptly be made between owner and manager. Any compensation paid to the directors, officers, or employees of owner shall not be included in operating expenses as that term is used in this agreement, but this provision shall not prevent owner from including the expenses for purposes of income tax returns.

SECTION FOURTEEN

TERMINATION

This management contract shall be subject to termination by the owner in the event manager shall violate any one or more of the terms of this contract, which violation shall result in inefficient management or other conditions detrimental to the operation of _____ *[hotel or motel}* as a first-class _____ *[hotel or motel}.* If owner deems that manager has violated the terms of this contract or that this contract

is subject to termination for any reason stated in this contract, it shall give manager written notice, specifying the manner in which this contract has been violated and granting manager _____ days within which to comply with the objection or objections. If manager shall fail or refuse to comply with any valid objection so made within _____ days from receipt of the written notice, owner may terminate this contract. Any notice shall be delivered to the president or vice-president of manager and may be delivered in person or by registered mail, addressed to such address as may be furnished by manager.

SECTION FIFTEEN

ARBITRATION

In case of dispute as to the validity of any cause for termination of this agreement, the removal of resident manager, or the interpretation of any provision of this agreement, the dispute shall be settled by arbitration. Owner shall appoint one arbitrator, manager shall appoint another arbitrator, and the two arbitrators so appointed shall appoint a third impartial and disinterested arbitrator/The decision of the majority of the arbitrators shall in the absence of fraud or concealment be binding on both parties.

SECTION SIXTEEN

TERMINATION UPON INSUFFICIENT REVENUE

If the revenues derived from the operation of _____ *[hotel or motel]* shall be insufficient to pay and discharge all items of expense, interest, and principal requirements specified in subdivisions 1 to 4 in Section Twelve, this agreement may be terminated by owner unless manager advances the necessary funds to meet the expenses. Should manager advance any funds necessary for this purpose, manager shall be reimbursed for the advances out of future receipts derived from the operation of _____ *[hotel or motel]* before excess receipts are divided between owner and manager.

SECTION SEVENTEEN

RESTRICTIVE COVENANT

Manager shall not have any interest in any other _____ *[hotel or motel]* within the radius of _____ miles of _____ *[hotel or motel]* during the term of this agreement.

SECTION EIGHTEEN

ASSIGNMENT

Manager may not assign this agreement or any of the rights and duties expressed in this agreement. Owner shall have the right to assign this agreement only on the sale of _____ *[hotel or motel]* to a third party.

The parties have executed this agreement at _____ *[designate place of execution]* on _____ *[Date]*.

[Signatures]

[Acknowledgments]

HVS

CHAPTER 21

Hotel Development

¶ 21.01 Introduction 21-1

EXHIBIT 21-1 Developing a Time-Line for a 200-Room Commercial Hotel 21-2

¶ 21.02 Location Strategies. 21-2
[1] Where to Develop. 21-2
[2] Segment and Brand 21-3
[3] The Financial Factors 21-3

¶ 21.03 Timing Strategies 21-4
[1] When Is the Market Strongest?. . . 21-5

EXHIBIT 21-2 Scenario 1—Subject Property Occupancy Assuming January 1998 Opening 21-6

EXHIBIT 21-3 Scenario 2—Subject Property Occupancy Assuming January 1999 Opening 21-6

EXHIBIT 21-4 Scenario 3—Subject Property Occupancy Assuming January 2000 Opening 21-6
[2] When to Build?. 21-7

EXHIBIT 21-5 Scenario 1—Immediate Development 21-8

EXHIBIT 21-6 Scenario 2—Open in 1999 21-9

EXHIBIT 21-7 Scenario 3—Open in 2000 21-10
[3] Is the Future Really That Clear? . . . 21-11
[4] Waiting for the Economy to Change 21-11

EXHIBIT 21-8 First-Year Occupancy and Average Rate Analysis. 21-11

¶ 21.04 The Development Team 21-12

¶ 21.05 The Contracting Process 21-12

¶ 21.06 Evaluating Project Feasibility. 21-13
[1] Design Phase 21-13
[2] The Construction Phase 21-14

¶ 21.07 Pre-Opening/Opening. 21-15

¶ 21.08 Project Finance 21-15

¶ 21.09 Factors Supporting the Urban Core Hotel Development Boom 21-17
[1] The Developers and the Risks . . . 21-17
[2] Understanding the Risks. 21-18
[3] History of Downtown Hotels 21-19
[4] Hotel Segmentation 21-19

EXHIBIT 21-9 Urban vs. Suburban Performance 21-20

EXHIBIT 21-10 Urban (Chicago) vs. Suburban Performance 21-22
[5] Development vs. Renovation Costs in the Urban Core 21-23
[6] Mixed-Use Solution. 21-23

» 21.01 INTRODUCTION

The hotel development process is multi-dimensional and is driven by market dynamics (demand characteristics and potential performance), land and development costs, and selection of the appropriate type of facility and brand under which the hotel will operate. No one aspect of development can be considered without regard to the others.

Each phase of the process will be identified and discussed in this chapter. Exhibit 21-1 delineates the process in sequential stages.

Exhibit 21-1 Developing a Time-Line for a 200-Room Commercial Hotel

Months From Opening	Event
17	Perform a market analysis and select a market suited for hotel development
16	Narrow focus to a particular site
16	Determine best type of hotel product for specific site
15	Prepare preliminary economic market study and appraisal
15	Negotiate the price and terms for acquiring site. Tie up site with as many contingencies as possible
14	Start zoning approval process and verify availability of all necessary licenses and permits
14	Line up architect and work on preliminary layout and concepts
14	Line up franchise affiliation
14	Line up hotel management company
13	Start preparing working architectural plans and specifications
13	Start lining up debt and equity financing
11	Start pro-selling efforts
11	Line up development team and request construction bids
10	Start construction
5	Start pre-opening functions
0	Open hotel

» 21.02 LOCATION STRATEGIES

[1] Where To Develop

Fundamental to hotel development is a complete and comprehensive understanding of the site location process. Like retail siting, lodging is a location-driven business. Hotel siting consists of (1) identifying appropriate market(s) for property development, analyzing demand generators within each market to select trade areas that will optimize occupancy potential; and (2) selecting a specific location affording the greatest possible visibility and accessibility for potential guests. Brand selection and positioning of product relative to industry segmentation have a direct bearing on location strategies.

The location paradigm for proper lodging site selection is directly dependent on "lodging demand generators" located within a one- to three-mile radius of a proposed facility. Excepting those who stop mid-trip for a break in a journey, commercial and leisure travelers typically have a reason for traveling to, and the need for lodging accommodations in, a given area. Major commercial centers, universities, retail complexes, hospitals, airports, and resort/tourist destinations are some but not all of the room right generators.

In siting it is important to look not only to an existing room base, but also, particularly in emerging growth markets, for those businesses, facilities, or other factors that will draw travelers into the market and result in demand for hotel rooms. Industry feasibility experts possess the analytical tools and data bases to assess potential demand based upon product type within a given trade area. An assessment of market potential will test site suitability for demand level, estimated change in demand and the resultant impact of that change on rate and occupancy, and special project location characteristics.

With the site identified and the demand generators validated and quantified into achievable property performance, the developer must not forget visibility and acceptability. Will the facility and its signage be clearly visible from a major traffic arterial? How accessible will the property be from the road on which it is located? Many hotel siting authorities believe that if the hotel can be seen, the traveler will "find the way."

[2] Segment and Brand

Segment and brand are important factors for the developer for at least three reasons. First, segment differentiates on price. As land prices increase, economic justification of a project may require higher achievable room rates. Second, the higher the brand penetration in a given geographical area, the greater the probability that that brand will maximize operating revenues. Third, consumer acceptance of the brand and segment selection must be viewed in light of the targeted guest base. While certain mid-priced or economy brands are generally well accepted, the target customer for a specified location may require a full-service facility to meet guest expectations and amenity requirements.

[3] The Financial Factors

With full deference to the maxim that hotel development is a location-driven endeavor, the ability of a proposed project to meet economic feasibility requirements is fundamental to its viability. When assessing room demand, the developer must consider the following:

- The realistically achievable rate and occupancy possible for the type of lodging facility proposed
- The relative competition
- Trends within the trade area selected
- Future changes in conditions within the market that can positively or negatively affect projected performance

Consider the early-to-mid 1980s, when conditions favored hotel development. Advantageous tax laws, aggressive lending practices and a prevailing view that performance measures would stay favorable forever led to a massive building boom in all tiers of the industry. Excess profits led to ruinous competition. No matter how many rooms at a given intersection, there was always room for 100 more. The building frenzy stopped only after the collapse of the real estate markets, chaos within the savings and loan industry, and a severe recession. Developers paid no heed to demand factors associated with supply.

As the lodging industry has matured, developers have been forced to confront the realities of price competitiveness, branding, existing supply and its condition, and trend factors.

An integral part of the equation is the proposed total project capital cost. The site may satisfy all of the visibility and accessibility factors but be priced in excess of permissible levels to support the project. Alternatively, site preparation expenses or building design modifications for site adaptation may be cost-prohibitive given achievable performance levels.

In assessing the economic feasibility of a project, the developer must acknowledge the interrelationship of a multitude of variables, including the following.

- Project cost estimate, which includes:
  - —Land
  - —Site preparation
  - —Construction
  - —Furniture and equipment
  - —Professional fees
  - —Development fee
  - —Transaction and loan fees
- Projected performance, including:
  - —Achievable rate
  - —Achievable occupancy
  - —Expense factors

No simple means of assessment exists to allow for the proper analysis of both the cost components and performance expectations. However, if the highest and best use of a site is lodging, then the factors to support that decision will be a function of capital expenses to achievable revenue.

Developers evaluate hotel performance in a number of ways. Some of the more common approaches include evaluating cash on cash returns after ramp-up and stabilization or internal rates of return assuming a sale at the end of the tenth full year of operations. Discounted cash flow analyses are also used, but more to rank the viability of and prioritize multiple projects.

For the entrepreneur or hotel franchisee company, the ability to assess market demand and demographics and match those factors to an appropriate product type and brand is important. Land and site preparation costs are the most important variable to control.

» 21.03 TIME STRATEGIES

In the world of sports, it is a disciplined rule that being first also means being best; in the competitive world of business, this rule often rings true as well. So, when it comes to hotel development, should we not also strive to be first? Not when being first may mean losing the game. In the game of hotels and hotel development, sometimes the winner is second, third or even fourth.

As the financing spigot for hotel construction remains wide open, the industry is witnessing development levels unmatched since the 1980s. With the threat of overbuilding in certain markets, no developer wants his hotel to be the last to open its doors for fear of missing out on demand capture to other new hotels. However, is it better to be the first to open, only to have supply continually increase and erode all of the demand? Timing can play an essential role in the feasibility of a project.

The question of when to build is often determined by the developer, who typically has timetables set forth for the project. Very rarely does this timetable incorporate a holding period to allow for market demand increases or to await the absorption of other new supply. Rather, the developer typically specifies the earliest possible opening date, hoping to be the early bird who gets the most of the worm before there's no worm left. Many developers feel that by publicly marketing their proposed development immediately, other potential projects may be dissuaded from entering

the market. However, a new project announcement may well induce other developers to take interest in the market. It is the responsibility of the appraiser to determine the highest and best use of the subject parcel, and that consideration includes the timing of the use. If the determination of the highest and best use is hotel development, it is possible that a calculated delay in the construction of the property could return a higher present value to the land than would immediate development.

[1] When Is the Market Strongest?

The basic premise on which delayed timing becomes viable holds that the net present value of the future returns of the proposed hotel, built immediately, is less than that of the returns based on a predetermined future construction of the hotel, less discounted holding period costs. A determination of the proper holding period of vacant land can be accomplished through an iterative calculation using variable opening dates. The Appraisal Institute's "Highest & Best Use and Market Analysis" stresses the importance of timing in determining a parcel's optimal use.

To better illustrate the impact of timing considerations, we will use the example of a 3-acre parcel of vacant land proposed for the development of 150-room all-suite hotel, A market analysis conducted in January 1997 indicated that 12 hotels existed in the market that would be competitive with the subject property, each weighted based on their assumed competitive degree to the subject. It was further determined that aside from the subject property, two other competitive hotels were anticipated to enter the market within the next year, one in February 1997 and one in April 1997. The developer indicated that the subject property could be open and operational by January 1998. Other determinations from the market analysis concluded that the market was stable, with occupancies approximately 75 percent and average rates in the low $100s, and that some unaccommodated demand existed in the commercial segment because of the substantial weight that this market segment represented. Average rate growth was currently 10 percent, but is expected to assume inflationary levels as new supply enters the market.

After assigning degrees of competitiveness to the proposed subject property based on its facilities, franchise affiliation, and market segmentation, the subject property's occupancy levels were forecasted for Scenario 1 (Exhibit 21-2), which assumes the original project timing (i.e., to be open by January 1998). The process of occupancy projection accounts for projected market changes, the entrance of other competitors to the area, and the absorption of unaccommodated demand. The results of the occupancy forecast are shown in Exhibit 21-2.

The subject property is affected in 1998 as it enters the market, primarily because of the recent opening of two other competitors in the market. Its occupancy then ramps up as increased market demand accommodates the new hotel rooms. The subject property then stabilizes at a "normalized" level in the fifth year, which reflects the anticipated results of the property during its remaining economic life, given any and all changes in the life cycle of the hotel.

A second scenario can then be envisioned whereby the developer of the subject property allows the market more time to absorb the other new supply before developing its own product (the cost of holding the land will be considered in a financial analysis presented later in this article). Assuming an opening date of January 1999, and assuming the subject property to contain the same degree of competitiveness used in Scenario 1, a new forecast of occupancy may be calculated, the results of which are shown in Exhibit 21-3.

Exhibit 21-2 Scenario 1—Subject Property Occupancy Assuming January 1998 Opening

Source: HVS International

Year	Occupancy
1998	66%
1999	71
2000	76
2001	78
Stabilized	76

Exhibit 21-3 Scenario 2—Subject Property Occupancy Assuming January 1999 Opening

Source: *HVS International*

Year	Occupancy
1998	Holding period
1999	67%
2000	73
2001	78
2002	80
Stabilized	76

Exhibit 21-4 Scenario 3—Subject Property Occupancy Assuming January 2000 Opening

Source: HVS International

Year	Occupancy
1998	Holding period
1999	Holding period
2000	69%
2001	75
2002	80
2003	82
Stabilized	76

Using the same variables as in Scenario 1, Scenario 2 shows greater occupancy potential for the subject property based on its later opening date. At the time of its opening, the two other market entrants have had more time to stabilize in the market, allowing demand levels to increase slightly before the subject property opens. The subject property is then stabilized at the same occupancy as in Scenario 1, which again serves to incorporate future upward and downward fluctuations in the market. Having the subject property wait yet one more year produces predictable results for a third scenario, as shown in Exhibit 21-4.

It should be noted that the subject property is considered equally competitive relative to the market in each of the three scenarios; however, the hotel achieves greatest occupancy levels in its initial years of operation in Scenario 3 by waiting for the impact of other new competition to subside.

[2] When to Build?

After a first glance at all three scenarios, one may infer that waiting a few years before development may be the highest and best use of the land. However, as the highest and best use is concerned with the present return of future earnings to the land, the cost of holding the land and the cost of discounting income back from later years may be greater than the additional benefits achieved by higher initial occupancy levels, To test its correctness, each scenario's occupancy forecast may be input to a forecast of income and expense. Discounting the net income and construction costs to the present allows the appraiser to calculate which scenario results in the greatest net present residual land value.

In a forecast of income and expense for the subject property, we have analyzed operating statements from similar, all-suite properties in order to determine proposed income and expense levels. The average rate for the subject property was positioned in current dollars, and then inflated according to marketwide growth projections. (Hence, each scenario will have different first-year average rate levels, but different only by inflationary factors.).

Income and expense statements can then be formed using the comparable operating statements and a fixed-and-variable model. The fixed-and-variable model was developed by HVS International and is based on the premise that hotel revenues and expenses have one component that is fixed and another that varies directly with occupancy and facility use. A projection can be made by taking a known level of revenue or expense and calculating its fixed and variable components.

This model has been used to develop a five-year forecast of income and expense based on each of the three scenarios, with the development of the property (cost outlay) occurring in Year One.

Year One represents the period subsequent to any holding period used by the scenario, and a sixth year net operating income, incorporating the same stabilized occupancy level for each scenario, is then calculated for reversionary purposes. The construction costs and cash flows are then discounted back to the present to determine the current residual land value, thus determining the highest and best use timing for the project development. The following assumptions were set forth for these models:

- Inflation for revenues, expenses, land holding costs, and construction costs is set at 3.5 percent.
- The discount rate is determined to be 13.0 percent in each scenario.
- Rooms revenue was calculated through the previous derivation of occupancy and average rate in each scenario. Income and expense levels were calculated through the fixed-and-variable process described earlier, with inflationary gains noted subsequent to the stabilized year.
- A terminal capitalization of 11.0 percent was used for reversionary calculations in Scenario 1; 25 basis points were added to this in each subsequent scenario to adjust for the inherent risk of a more distant reversionary period.

Exhibits 21-5, 21-6, and 21-7 detail each scenario's calculation of residual land value. The residual land calculations show that the present return to the land is greatest in Scenario 2. Thus, the conclusion in this analysis is that the development of the subject property should be delayed one year, allowing the market to absorb new supply anticipated in the immediate future; however, the delay is not so long as to be affected by the increased risk inherent in long-term delays. An iteration may be done to more precisely determine appropriate development timing.

HVS

Exhibit 21-5 Scenario 1—Immediate Development

Source; *HVS International*

Year Ending:	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Total Rooms:	0	150	150	150	150	150
Occupied Rooms:	0	36,135	38,872	41,610	42,705	41,610
Days Open:	0	365	365	365	365	365
Occupancy:	0.0%	66.0%	71.0%	76.0%	78.0%	76.0%
Average Rate:	$0.00	$122.61	$126.90	$131.34	$135.94	$140.69
	Total $	**Total $**	**Total $**	**Total $**	**Total $**	**Total $**
Revenue*						
Rooms	$0	$4,431	$4,933	$5,465	$5,805	$5,854
Food	0	201	219	239	252	256
Beverage	0	40	44	48	50	51
Telephone	0	122	135	148	157	159
Other Income	0	32	34	36	37	38
Total	0	4,826	5,365	5,936	6,301	6,358
Departmental Expenses						
Rooms	0	1,221	1,299	1,381	1,444	1,479
Food and Beverage	0	230	244	258	269	276
Telephone	0	72	77	81	85	87
Total	0	1,523	1,620	1,720	1,798	1,842
Departmental Income	**0**	**3,303**	**3,745**	**4,216**	**4,503**	**4,516**
Operating Expenses						
Administrative and General	0	399	421	444	463	475
Management Pee	0	217	241	267	284	286
Marketing	0	192	202	213	223	229
Franchise Fees	0	310	345	383	406	410
Property Operation and Maintenance	0	214	251	265	276	283
Energy	0	233	243	253	263	271
Total	0	1,565	1.703	1,825	1,915	1,954
House Profit	**0**	**1,738**	**2,042**	**2,391**	**2,588**	**2,562**
Fixed Expenses						
Property Taxes	0	139	144	149	154	160
Insurance	0	48	50	52	53	55
Reserve for Replacement	0	145	161	178	189	191
Land Holding Costs (Taxes and Insurance)	15	0	0	0	0	0
Total	15	332	355	379	396	406
Net Income	**$(15)**	**$1,406**	**$1,687**	**$2,012**	**$2,192**	**$2,156**
Less: Development Costs (excluding land)	$(13,000)					
Plus: Reversion (11.0% terminal cap)						
Property Sale					$19,601	
Less: Fees and Commissions (3.0%)					588	
Net Reversion:					$19,013	
Total Property Cash Plow:	$(13,015)	$1,406	$1,687	$2,024	$20,373	
Present Value of Cash Flows @ 13.0%:	$(11,518)	$1,101	$1,169	$1,241	$11,057	
Residual Land Value:	$3,051					

*AII income, expense, cash flow, and value figures are expressed in 1,000s.

HVS

Exhibit 21-6 Scenario 2—Open in 1999

Source: HVS International

Year Ending:	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Total Rooms:	0	0	150	150	150	150	150
Occupied Rooms:	0	0	36,682	39,968	42,705	43,800	41,610
Days Open:	0	0	365	365	365	365	365
Occupancy:	0.0%	0.0%	67.0%	73.0%	78.0%	80.0%	76.0%
Average Rate:	$0.00	$0.00	$126.90	$131.34	$135.94	$140.69	$145.62
	Total $	**Total $**	**Total $**	**Total $**	**Total $**	**Total $**	**Total $**
Revenue*							
Rooms	$0	$0	$4,655	$5,249	$5,805	$6,162	$6,059
Food	0	0	209	231	251	265	263
Beverage	0	0	42	46	50	53	53
Telephone	0	0	127	142	156	165	163
Other Income	0	0	33	35	37	39	40
Total	0	0	5,066	5,703	6,299	6,684	6,578
Departmental Expenses							
Rooms	0	0	1,265	1,352	1,437	1,503	1,523
Food and Beverage	0	0	238	253	268	280	284
Telephone	0	0	75	80	85	88	90
Total	0	0	1,578	1,685	1,790	1,187	1,897
Departmental Income	**0**	**0**	**3,488**	**4,018**	**4,509**	**4,813**	**4,681**
Operating Expenses							
Administrative and	0	0	413	437	461	481	490
Management Fee	0	0	228	257	283	301	296
Marketing	0	0	198	210	222	231	236
Franchise Fees	0	0	326	367	406	431	424
Property Operation and Maintenance	0	0	246	261	275	287	292
Energy	0	0	241	251	262	271	280
Total	0	0	1,652	1,783	1,909	2,002	2,018
House Profit	**0**	**0**	**1,836**	**2,235**	**2,600**	**2,811**	**2,663**
Fixed Expenses							
Property Taxes	0	0	143	148	154	159	165
Insurance	0	0	50	51	53	55	57
Reserve for Replacement	0	0	152	171	189	201	197
Land Holding Costs (Taxes and Insurance)	15	16	0	0	0	0	0
Total	15	16	345	370	396	415	419
Net Income	**$(15)**	**$(16)**	**$1,491**	**$1,865**	**$2,204**	**$2,396**	**$2,244**
Less: Development Costs (excluding land)			$(13,455)				
Plus: Reversion (11.25% terminal cap)							
Property Sale						$19,949	
Less: Fees and Commissions (3.0%)						598	
Net Reversion:						$19,350	
Total Property Cash Flow:	$(15)	$(13,471)	$1,491	$1,865	$2,204	$21,746	
Present Value of Cash Flows @ 13.0%;	$(13)	$(10,549)	$1,033	$1,144	$1,196	$10,445	
Residual Land Value:	$3,256						

*All income, expense, cash flow, and value figures are expressed in 1,000s.

HVS

Exhibit 21-7 Scenario 3—Open In 2000

Source: HVS International

Year Ending:	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Total Rooms:	0	0	0	150	150	150	150	150
Occupied Rooms:	0	0	0	37,778	41,062	43,800	44,895	41,610
Days Open:	0	0	0	365	365	365	365	365
Occupancy:	0.0%	0.0%	0.0%	69.0%	75.0%	80.0%	82.0%	76.0%
Average Rate:	$0.00	$0.00	$0.00	$131.34	$135.94	$140.69	$145.62	$150.7
Total $		Total$	Total $	Total $	Total $	Total $	Total $	Total $
Revenue*								
Rooms	$0	$0	$0	$4,962	$5,582	$6,162	$6,537	$6,271
Food	0	0	0	221	244	265	279	273
Beverage	0	0	0	44	49	53	56	55
Telephone	0	0	0	135	151	165	175	169
Other Income	0	0	0	35	37	39	40	41
Total	0	0	0	5,397	6,063	6,684	7,087	6,809
Departmental Expenses								
Rooms	0	0	0	1,323	1,414	1,503	1,571	1,577
Food and Beverage	0	0	0	248	265	280	292	295
Telephone	0	0	0	78	84	88	92	93
Total	0	0	0	1,649	1,763	1,871	1,955	1,965
Departmental Income	**0**	**0**	**0**	**3,748**	**4,300**	**4,813**	**5,132**	**4,844**
Operating Expenses								
Administrative and General	0	0	0	430	456	481	502	508
Management Fee	0	0	0	243	273	301	319	306
Marketing	0	0	0	207	219	231	241	244
Franchise Fees	0	0	0	347	391	431	458	439
Property Operation and Maintenance	0	0	0	257	272	287	299	303
Energy	0	0	0	250	261	271	282	289
Total	0	0	0	1,734	1,872	2,002	2,101	2,089
House Profit	**0**	**0**	**0**	**2,014**	**2,428**	**2,811**	**3,031**	**2,755**
Fixed Expenses								
Property Taxes	0	0	0	148	154	159	165	170
Insurance	0	0	0	51	53	55	57	59
Reserve for Replacement	0	0	0	162	182	201	213	204
Land Holding Costs (Taxes and Insurance)	15	16	16	0	0	0	0	0
Total	15	16	16	361	389	415	435	433
Net Income	**$(15)**	**$(16)**	**$(16)**	**$1,653**	**$2,039**	**$2,396**	**$2,596**	**$2,322**
Less: Development Costs (excluding land)			$(13,926)					
Plus: Reversion (11.5% terminal cap) Property Sale	$20,194							
Less: Fees and Commissions (3.0%)								606
New Reversion:	$19,588							
Total Property Cash Flow:	$(15)	$(16)	$(13,942)	$1,653	$2,039	$2,396	$22,184	
Present Value of Cash Flows @ 13.0%:	$(13)	$(12)	$(9,663)	$1,014	$1,107	$1,151	$9,430	
Residual Land Value:	$3,013							

•All income, expense, cash flow, and value figures are expressed in 1,000s.

[3] Is the Future Really That Clear?

Obviously, this analysis is subject to come limitations. Some of these limitations include the following;

- The uncertainty of other possible hotel developments in future years.
- The subjectivity inherent in determining appropriate terminal capitalization rate increases. Does a 0.25 percent increase for each delayed year of opening appropriately reflect increased risk in the project?
- The degree to which other factors may be held constant in each scenario. For example, an adjustment to the subject property's average rate of growth may be warranted in one scenario and not another.
- The determination of whether or not the same discount rate is appropriate in each scenario. While some developers may feel that immediate development lowers risk because their project may dissuade other development, other developers believe that one new project actually induces others to build.

Each of these considerations in market specific and must be adequately judged by the appraiser on a case-by-case basis.

[4] Waiting for the Economy to Change

Finally, the speed at which the subject property reaches a stabilized occupancy also affects the feasibility of the project. In this sense, general economic conditions can also dictate optimal development timing for hotels. Hotels that may have been marginally feasible for development in 1994 may have been more viable if they were developed in 1996, based solely on economic conditions prevailing in the market area. To illustrate this point, we have analyzed the first year occupancy and average rate performance for 24 Residence Inns by Marriott that have opened during the past 3 years. These figures are presented in Exhibit 21-8.

Exhibit 21-8 First-Year Occupancy and Average Analysis

Source: HVS International

	1994	1995	1996
Occupancy	68%	77%	82%
Average Rate	$63	$82	$86

The revenue per available room (RevPAR) performance of the hotels that opened in 1996 was approximately 65 percent greater than the same hotel types that opened in 1994, indicating, perhaps, that more favorable economic conditions may have warranted delayed construction for projects proposed for 1994. Although this is a simplified comparison between hotel starts, it does serve to illustrate the potential benefits inherent in delayed development.

The consideration of development timing in the hotel industry is critical in this current era of available financing. With the proliferation of new construction (particularly in the limited-service segment and in markets containing limited barriers to entry), the analysis of when to build plays an important role in the valuation process. As may have been proved in certain markets, sometimes it's better just to wait.

» 21.04 THE DEVELOPMENT TEAM

Having carefully selected a market and a trade area within the market, and having identified a site that on a preliminary basis is determined to support the proposed project, the developer contractually commits to a site, subject to favorable due diligence. The process after site selection is divided into the Design Phase and the Construction Phase. The developer works with a number of different people in these phases, including the following.

Architect/engineer. Working as a team both the project architect and engineer undertake a myriad of responsibilities to determine (i) whether the site as selected will accommodate the proposed facility, (ii) the extent of governmental requirements for project approval, (iii) easements, set-back requirements and other burdens on the land affecting project lay-out and efficient utilization of the site, and (iv) any cost implication of the foregoing on the overall project. The "Design Phase" team is charged in all respects with determining land use requirements with respect to the specific project and how those requirements affect the project.

Real estate counsel. Working with the engineer, the attorney assists in negotiating and preparing contracts, locating easements that affect the site, and vacating or relocating those easements. Should the zoning classification affecting the proposed site not accommodate lodging, counsel can be of assistance in an initiative to rezone the property. Variances to building and zoning codes may be required, for example to reduce the requisite number of parking spaces or landscape buffers. Counsel can play an active role in those endeavors.

Project manager. For the inexperienced developer, a project management firm can provide valued, cost-saving advice through both the Design and Construction Phases of the project. Project management services are more prevalent in the development of larger full service hotels.

Interior design specialist. Depending on the size and type of project, the services of an interior design firm may be required to achieve a well coordinated "look" and "feel" for the proposed facility.

Food service equipment consultants. If a full-service facility or a mid-priced hotel with food service is proposed, proper planning of food service layout and equipment is vital to efficiency of operations.

In some instances, particularly when governmental restrictions require specific studies, environmental engineers or special project facilitators may be hired to assist in obtaining the necessary entitlements from governmental agencies. This is particularly true in Florida, California, and other coastal regions or other environmentally- sensitive areas of the country. Also, certain areas of the country may require impact studies relating to traffic, hospitals, schools, or other social or public improvements. Specific project management firms can be of assistance to the developer in expediting the review process.

» 21.05 THE CONTRACTING PROCESS

After preliminary investigation has been performed on a specific site, and early indications are that the project will meet both financial and development feasibility tests, it is imperative that the site be properly secured by a contract. The developer's counsel should prepare a form of land purchase agreement that allows the developer a sufficient period of time in which to perform additional studies to ensure that the site and the market dynamics will in fact support the project. Typically, land sellers will allow the purchaser up to 180 days within which it can conclude the necessary development, market, and economic feasibility studies and also to complete design of the facility.

The experienced legal artisan will prepare on behalf of the developer a contract that allows a "Preliminary Requirements Period" during which the developer can complete the necessary studies and make the necessary investigations to determine his ability to develop the site. This preliminary requirements period usually lasts from 60 to 120 days. While the contract document may require the posting of an earnest money deposit upon its full execution, typically the earnest money is not at risk (i.e., subject to forfeiture) if the developer elects to abort the project at any time during the Preliminary Requirements Period.

Thereafter, the final phase of diligence would subject the developer to placing his earnest money at risk. It is during that period that the developer has sufficient information to warrant going forward with the project. Also during that period the plans are finalized and submitted to the local governmental authorities for review, approval, and the issuance of permits.

The sophisticated developer together with his lawyer and architect should be in a position to complete diligence, complete design of the facility, obtain the necessary plan review by governmental authorities, and obtain permits prior to land closing. It is smart to minimize the holding period on the land and thereby avoid associated carrying costs.

» 21.06 EVALUATING PROJECT FEASIBILITY

[1] Design Phase

Necessary steps during the design phase include:

- Preparing a preliminary site plan.
- Obtaining both a boundary and topographic survey of the property.
- Obtaining a soils report of the property from a certified soils engineer.
- Conducting necessary environmental tests on the property to ensure that no soils contamination is present.
- Reviewing and updating the site plan so that it reflects information provided by the preceding tests and reports.

The following factors could have a significant cost impact on the project if not carefully reviewed and analyzed.

Utilities availability. During the design phase the project engineer should determine that all utilities required to support the project be at one or more of the boundaries of the property. The failure of any utility to be at the boundary of the property typically means that an extension of that utility must be made by the seller at the seller's expense.

Easements and setbacks. The project engineer, in conjunction with the title examining attorney, should review all easements and setback requirements imposed either by legal document or by applicable zoning law or other governmental regulations. In many instances, setback requirements preclude the construction of the facility as contemplated or severely cut into required parking spaces. Additionally, landscape or other buffers required by governmental authority may have an impact on the land use planning of the specific site. Finally, easements that impact the property will have a bearing on the ability to develop, construct and operate the proposed improvements. Hence, both engineer and lawyer need to carefully review all easements which burden the property being reviewed for purchase.

Topographic condition. The project engineer, in conjunction with the architect, needs to determine whether the topographic conditions of the property will accommodate the proposed improvements, or if changes to the property need to be made and, if so, at what expense. In many instances properties with a severe slope require retaining walls, or the slope will need to be cut by major excavation of the site—all resulting in increased cost to the facility.

Soil and the conditions of soil. In many places in the country, soils conditions are unacceptable to support certain types of construction. A licensed, competent soils engineer must evaluate the conditions of soils based upon the intended location of the improvements as shown by the preliminary site plan. If the soils condition will not support the improvements, a determination must be made if the soils can be corrected and at what cost to the project.

The site plan needs to be reviewed to ensure that any of the problems revealed during the design feasibility period do not adversely affect the proposed location of the facility.

Assuming no major problems, the architect and engineer prepare working drawings and plans and specifications for the improvements for submission to the local governmental agencies for review, comment, revision, and approval. Once this has been accomplished, the project will be ready for bidding. The developer will select a list of competent contractors to whom to submit the plans and specifications for bidding. At this point, the project moves to the construction phase.

[2] The Construction Phase

Upon review and acceptance of the appropriate bid from a licensed general contractor, the developer is ready to proceed with the construction of the improvements. Again the architect and attorney should carefully assist the developer in protecting the developer's interest in the contracting phase. Hotel development can last as little as seven months or as long as 18 months, depending on the type of facility. During that period, presumably, financing will come from interim sources. It is in the developer's best financial interest to ensure timely completion of the project, thereby minimizing construction-related interest.

Many developers in the industry today are using risk reward contracts, which reward contractors for early completion of a facility and penalize those who are unable to complete on a timely basis absent delays associated with acts of God, force majeure or governmental impositions. The industry commonly sees three types of contracting arrangements between the developer and general contractor.

1. Competitively bid situation for qualified general contractors who are asked to bid the job employing their own subs.
2. Negotiated contract with a general contractor who may have been utilized in the past by the developer.
3. Developer acts as general contractor and bids out various aspects of the construction project to appropriate sub-contractors.

In certain instances, when the facility's construction time is critical to certain performance attributes, developers will enter into a design build arrangement with a general contractor. Typically, this arrangement is not favorable unless the developer has extensive experience with the contractor. The developer should carefully review with his attorney and architect the merits of requiring the contractor to bond the project. Typically the benefits outweigh the costs.

» 21.07 PRE-OPENING/OPENING

The final months of construction are generally hectic, often not allowing the developer enough time to devote attention to the myriad tasks associated with opening of the facility to the public. It is imperative for the developer to have his pre-opening team on site as much as eight weeks but certainly not later than six weeks prior to the scheduled opening. The pre-opening team will assist in the hiring and training of the support staff, oversee the final furnishing and punch out of the guest rooms and other guest-sensitive areas and begin an aggressive marketing program in anticipation of the scheduled opening of the property.

All too often the pre-opening and opening activities associated with the proposed lodging facility take a back seat to the development process. This is a mistake. Pre-opening and opening activities can play a major role in enhancing the revenue stream from the day the property opens its doors to accept guests; marketing dollars spent on pre-opening usually prove to be a good investment in revenue production.

» 21.08 PROJECT FINANCE

The project has been analyzed, its market feasibility attributes discussed, the developability of the project has been assured, and now the ultimate questions are regarding project finance. What type of financing will be available to the developer to allow him to conclude the project on economically feasible terms? As we noted earlier, there is a relationship between project cost and achievable rates and occupancies to determine project performance. Similarly, in the area of project finance, the amount of money that will be available (i.e., what percentage of the project cost can be financed) and the applicable rate of interest (i.e., what is the debt service on the project going to be) have a bearing on the feasibility of a proposed lodging facility.

Prior to the debacle in the industry of the late 1980s and early 1990s, real estate financing remained an orderly, standardized practice that matched developers with investors and lenders. As the lodging industry matured in the late 70s and early 1980s, the financing process, stimulated by favorable tax incentives and high inflation rates, increasingly involved financial institutions becoming equity or quasi-equity partners.

When the impact of overbuilding in all areas of real estate, including hotels, made itself felt in the late 1980s and early 1990s, financial institutions and lenders of all kinds found themselves reluctant owners of properties for which there was no market, except at drastically reduced prices. This situation gave rise to the fall of the savings and loan industry and the collapse of many long-recognized commercial banking institutions. Many hotel properties found themselves in the hands of regulators with the FDIC, FSLIC, or the Resolution Trust Corporation (RTC). It was not until the mid 1990s that much of the distressed hotel inventory was sold off and prices began to stabilize in stronger markets. With the revival in the industry, new construction has once again begun and lenders, albeit slowly, are returning to the marketplace. In addition to the traditional sources of funding, mortgage conduits and other forms of debt are being provided to the lodging industry through Wall Street sources.

Financing of lodging properties does not resemble that of office, industrial or residential projects. Lodging properties rely on the success of a business. They are often viewed as high-risk investments with potentially tremendous up-side potential. Lenders, therefore, tend to concentrate on those projects that are well-conceived, well-located and that involve experienced developers and operating companies. The cash flow from a lodging property available for debt service depends on local and national economic conditions, quality of management and unpredictable travel patterns.

The type of project financing depends upon the specific project and the needs of the developers, Typically, developers will secure 100% of their project cost through construction or interim financing, assuming that there is a take-out or some form of permanent financing with a loan-to-value ratio of 75% or less. The most common short-to-intermediate-term debt instruments available for financing hotel projects today include the following: construction loans, combined construction and term loans, and term and bullet loans.

The six major long term debt instruments include convertible mortgages, land sale lease backs and leasehold loans, permanent loans, mortgages with a kicker, wrap around mortgages and other long term debt instruments. Briefly, the type of financing provided by each of the aforementioned instruments is as follows:

- *Convertible mortgages.* One hundred percent of the project's development cost is provided to the developer, as is control of the property for a definitive term of years. The loan, while either at or below market rate, provides for the lender to receive a fixed interest return with a participation (usually 10 to 50%) of the cash flow after debt service. Additionally, the lender would receive the right to convert the mortgage into 50% of the equity at an agreed upon conversion date. This type of instrument is used more by insurance companies, pension funds and foreign trusts as opposed to more conventional and commercial lending institutions.
- *Land sale leasebacks and leasehold loans.* Under this scenario, the lender acquires from the developer the land at market value and then leases it back at a low rate (10 percent to 13 percent of the land value; 3 percent to 4 percent of gross room sales) for forty to fifty years. The lender participates in loan term capital appreciation through payments by the developer of future cash flows and a share of the property's appreciation.
- *Permanent loans.* Permanent financing takes all forms in today's environment, ranging in term length from as few as three years to as many as thirty. In some cases, the longer the term, the greater the requirement on the part of the lender to participate in cash flows. Loan principle amounts depend on a debt coverage ratio usually of 1.10 to 1.35 times the projected cash flow before debt service. In some cases shorter term loans have bullet provisions with interest only payments for five to seven years with the principle balance being due and payable at the end of the term.
- *Mortgages with a kicker.* This financing method provides the developer with a loan at market or below market rate but with a long or extra long term. The amount of the loan depends on the coverage. The lender will participate not only in future cash flows (10 to 50%), but also in part of the residuals or, in some cases both.
- *Wrap-around mortgages.* Typically, this type of financing is provided by sellers or credit companies and entail a fixed rate on the underlying wrap mortgage plus a share of the residuals, a kicker, or both.
- *Other long-term debt instruments.* These types of financing include seller financings, exchanges, second mortgages and standby mortgages. In most cases, these forms of financing are primarily used when other, more favorable, financing methods will not cover all development costs, operating deficits, cost overruns or land acquisition costs.

Sound feasibility attributes, realistic performance projections evidencing sup-portable coverage ratios combined with sound credentials for the hotel operator are all essential to obtaining project financing in today's environment. Lenders want as-

surances that debt service payments are achievable not only during good economic times, but also during adverse times. While project finance is not the topic of this chapter, the components of financing must be part of the overall equation in the final analysis of project feasibility.

» 21.09 FACTORS SUPPORTING THE URBAN CORE HOTEL DEVELOPMENT BOOM

Moderately priced downtown hotel development and redevelopment is, suddenly, quite the rage. Due in equal part to strong real estate economics and wishful thinking, urban core hotel development has become a central theme in the downtown rescue remedies of many urban planners, downtown development agencies, and, not least, developers. This section reviews some of the factors that have spawned this urban core mid-market hotel boom and reviews current statistics that seem to corroborate the downtown development play.

In broad review, the stars that have aligned themselves for the current hotel development syzygy are, briefly, as follows:

- A lack of mid-priced hotel rooms in most North American downtowns and hoteliers' realization of the premium that a mid-market hotel can achieve vis a vis the same suburban properties;
- The closing window of opportunity to acquire underutilized, convertible historic, and class "B" and "C" buildings;
- The returning appeal and rediscovery of many North American downtowns;
- The pressure that cities have applied to utilize and reinvigorate "blighted" areas of downtowns;
- The return of fundamental strength in the demand for hotel rooms;
- Developers' decreasing fear of development in urban core locations;
- The force of equity and debt looking for larger-sized deals, propelled in part by agents like Starwood Lodging, Patriot American, and other REITs;
- The attempts of hotel franchisers to keep up with competitors by securing distribution channels through developing hotel rooms under their "flag";
- A competitive investment market for Historic Tax Credits that, spun off by some developments, are often the IRR-push that make deals conceivable, and;
- A suburban-based lodging boom of epic, pre-RTC proportions, the enormity of which may cause even the most imperious of developers to turn introspective.

[1] The Developers and the Risks

If this partial list seems monumental, consider the legion of developers pursuing development in downtowns. Developers—from ex-Studio 54 impresario lan Shrager, ex-investment banker Robert Kimpton, and night club operator House of Blues, to more pedestrian developers of Marriott, Hampton Inns, and Embassy Suites—are acquiring existing, non-lodging assets to redevelop as hotels.

Is this spate of development misguided? Certainly not. The majority of these developments are well conceived and will perform on an income-before-debt-service-basis. The question of their financial success (income *after* debt service) will hang in

the balance, awaiting the jury's return from the next real estate cycle. Is this to say that the current tide of optimism on which downtowns are riding is ephemeral? Again, certainly not. Many observers feel that the decline that downtowns suffered in the past 40 years is an aberration, simply a temporary adjustment to factors such as suburban development precipitated by the post-war development of the federal Interstate system. If risks exist in the development, ownership, and operation of an urban core hotel, then what compelling reasons are there to pursue a downtown hotel deal? In short, because there are potentially fewer risks and greater returns than investing in suburban hotel development. "Potentially" because the money in an urban core hotel development is made in the pre-development and construction phases, not in operation. If care, restraint and circumspection are not deployed in pre-development, the hotel could fail no matter how well the hotel penetrates demand.

[2] Understanding the Risks

The keys to the successful urban-core hotel project are completing thorough market due diligence, lowering of costs, and reduction of development and construction risks. The steps include:

- *Market selection.* Selecting and studying a market that has long-term durability of demand based on residential activity, tourism, general strength of the downtown, office space absorption, job creation, and other tangible and intangible measures;
- *Supply and demand.* A clear understanding of both urban and suburban, room night demand and the market position, rate, occupancy, and market segmentation of primary and secondary competitor hotels; understanding of all planned supply in the suburbs and urban core;
- *Property inventory.* A thorough review of the convertible building and devel-opable land inventory in the urban core;
- *Failed deals.* An understanding of who has tried to put deals together at what locations for hotels and apartments and why they failed, if not completed;
- *Successful deals.* For those completed projects, a thorough understanding of development costs, how and to whom they sold rooms after opening, how rate structure changed over time;
- *Development team.* Selection of a development team of architect and general contractor, both of whom should have broad ground-up hotel and renovation experience;
- *Target property.* Identification of suitable convertible buildings and/or devel-opable land;
- *Building program.* Based on the above due diligence, making studied decisions as to building program, types of rooms, levels of service and, if opted, franchise;
- *Budget pricing.* Program sketches and general contractor's budget pricing of identified properties;
- *Development challenges.* Discussions with lenders, franchisers, and city officials to understand development challenges;
- *Purchase and sale.* Negotiating a purchase and sale agreement that provides ample time for continued building and market due diligence and, most importantly, time to receive a building permit;

- *Thorough property analysis.* Conducting thorough property analysis, prior to risking any hard funds, that includes: legal, zoning, structural, state/local historic, asbestos, lead paint, Phase One and Two, parking, traffic and retail market review.

Urban core hotel development is dramatically more dynamic than suburban development. Sponsors whose deals get done have one common attribute; flexibility. Complete understanding of the above issues enhances this flexibility.

[3] History of Downtown Hotels

But what are the underlying reasons for the sudden interest in urban hotel development? The answer lies in the review of twentieth century urban real estate. Downtowns have been the centers of commerce, entertainment and education for millennia. For the first half of this century downtowns were primarily the place to stay at a full-service hotel; namely one that provides food and beverage and extensive meeting areas and public space. Turn-of-the-century high-rise downtown hotels, whose development was made possible by the elevator, created critical density to justify high downtown land prices and the costly level of services that the full-service or convention hotel provides. With mass transportation spokes feeding the downtown hub, hotels provided a convenient meeting place and temporary residence for business travelers and tourists, and full-time residences to the well-heeled. The cost to develop these large hotels was great. The competition was limited, prior to the 1960s, to other downtown hotels since suburban hotel development was not then significant. Choice in the type of hotels was limited to luxury, convention, first class, or, farther from the core, economy properties.

[4] Hotel Segmentation

Market segmentation occurred later after the advent of chain affiliation. The 1970s ushered in a period of large-scale franchising of hotels. Prior to the 1970s chain affiliation was limited. Yet to be created were lodging options such as mid-market, extended-stay, or limited-service properties.

Several events occurred that had an impact on the lodging landscape:

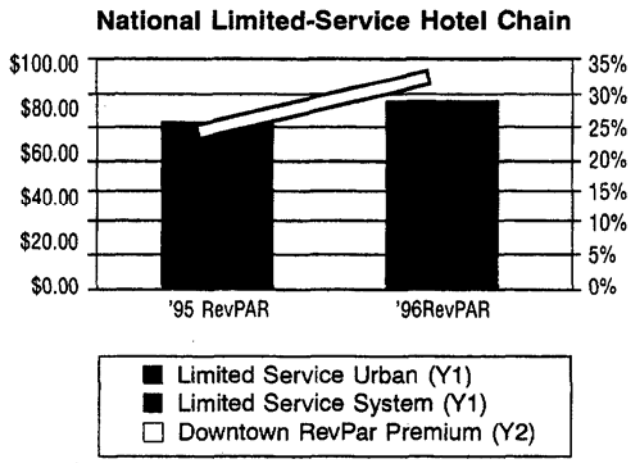
- America became more mobile, spawning increased room night demand from business and family travel;
- In response, chain affiliations offered the traveling public recognized names and relatively consistent guest experiences at anticipated levels of service. With this came the proverbial two-story, rambling, "down and out" Holiday Inn, where the car-driving business traveler could back their car to the room and be assured, generally, of a consistent, predictable hotel stay;
- The post-war suburban development boom of the fifties and sixties led to development of suburban hotels, which, due to lower land costs, could build horizontally less expensively than building vertically in the downtown, thus providing a price advantage;
- Cities entered a period of urban flight, losing population and industrial employment, promulgated by suburban development of less expensive residential units and modern, less costly industrial and office space;
- Perceptions of cities' safety and vitality turned pejorative;

• The development of urban-core hotels declined by the late 1960s as hotel development focused on the suburbs.

If one views the hotel industry as evolutionary, periodically rolling out new concepts and products, these factors left downtowns with outdated products and properties. The trend of hotel "roll-outs," like smaller, limited-service hotels, started in the late 1970s, accelerated into the eighties and was perfected solely in the suburbs. Downtowns were largely, if not virtually, ignored in this boom.

What started in the late 1970s as a means by hotel franchisers to attract more room nights became "segmentation," the still-prevailing trend of differentiation among hotels. Twenty-five years ago the hotel traveler had four options in his choice of hotels: luxury, convention, first-class, and economy. Hotels at that time tried to be all things to all people. With the concept of segmentation came the attempt to appeal to a certain group of guests with certain specific needs.

Exhibit 21-9 Urban vs. Suburban Performance



One of the clearest shifts in this new segmentation was the removal of restaurants and meeting space. Costly to construct and expensive to staff and operate, these elements were eliminated by the full-service hotel companies that began to develop "limited-service" hotels. Major hotel companies like Holiday Inn and Marriott began to tinker with their full-service concepts and found that people who didn't use restaurants, concierges, meeting spaces, and retail spaces didn't want to pay a room rate as if they had.

Hoteliers found an untapped market: guests that don't want to pay for services they won't use. Developers found there to be a less resistance from banks to borrow funds to develop these limited-service and mid-market hotels since the construction cost was substantially less without restaurants, bars, retail, and meeting spaces. These hotels most often had fewer rooms and employees and generally ran at higher occupancies and lower break-even points than full-service hotels.

Because of higher land and construction costs in the downtown, these newly segmented hotels were built in the suburbs, which in the seventies and eighties were often the economic engines of a market. Brands like Hampton Inn, Courtyard, Wyndham, Embassy Suites, Residence Inn, Fairfield Inn, and a multitude of others, got their start in the 1980s. (It is interesting to note that the personal computer and Courtyard by Marriott both received their introduction in 1984; both the limited-service hotel and the computer have become a ubiquitous part of American life in 14 years.)

Since the inception of the limited-service hotel in 1984 there now exist well over 10,000 such properties with well in excess of 1.2 million rooms; according to Coopers and Lybrand, an additional 105,000 to 125,000 hotel rooms will be built in each of the next four years. The vast majority of these are limited-service and limited-service extended-stay properties; 95 percent will be built in the suburbs. As a comparison, approximately 152,000 rooms were added in 1986.

This was the first limited-service boom, and it was abbreviated by the savings and loan crisis. Development of all hotels nearly ceased from the late 1980s through the early-1990s as the post-savings-and-loan glut of overbuilt hotels was sold off, often priced at 30 to 50 percent of replacement cost. Rarely were hotels built in urban cores during this post-RTC period. The exceptions were those that were the centerpieces to civic redevelopments and received substantial subsidies.

On the coattails of the early 1990s' economic expansion came a real estate recovery in which hotel occupancies and rates rebounded from the dismal levels of the late 1980s. A subsequent limited service development boom, the second development boom for limited-service hotels, ensued as lenders, comforted by the simpler operations, brand strength, and lower per-room development cost of limited-service hotels, made construction and take-out debt available, though with considerably more strings attached than were attached to loans in the last development cycle. With equity plentiful (and fully invested in deals) lenders embraced certain limited-service chains. Limited-service hotel development has proliferated from the early-1990s. The epicenter of this development was again the suburbs, where cheap land, continued strengthening room-night demand, and unabated suburban development made a compelling story to lenders and equity, alike.

The supply of lower-priced rooms in the suburbs created a rate imbalance between suburb and city. Though both suburban and urban occupancies improved during the recovery, the *average daily rate* of downtowns rocketed. As cities like San Antonio, Seattle, Chicago, New York, and Denver recast themselves and regained their attractiveness to residents, businesses, tourists, and conventioneers, hotel occupancy and rates soared. Because of this more even mix of demand, downtowns often had less seasonality and more consistency in weekday versus weekend demand than the suburbs, due in large part to elements like:

- New downtown sports stadiums and arenas that boost weekend occupancy and mid-week rates;
- Tourist attractions, museums, parks, and waterfronts that attract individuals and families and, more importantly, groups that eat up hotel rooms and create scarcity, propelling rates quickly;
- A return and strengthening of downtown residential development that often is the unsung cornerstone of a city's rebirth;
- Convention and special events that, once again, are held in downtowns, creating longer guest stays as conventioneers lingered in the city's core to enjoy a more unique shopping and entertainment experience than that of the suburbs.

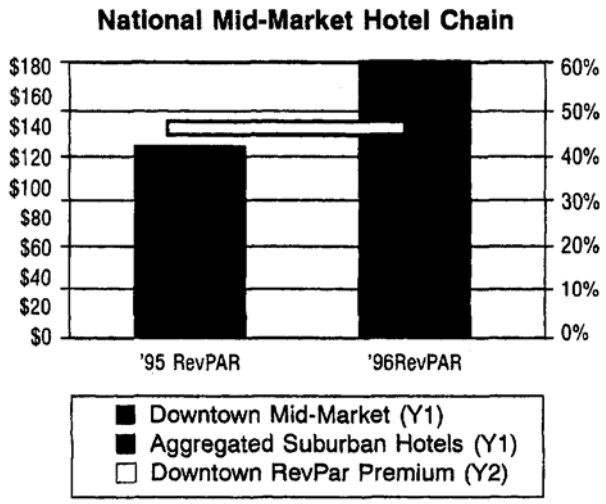
Building limited-service or mid-market hotels in certain downtowns seemed to make "rate" sense. A higher average daily rate should be achieved in the downtown limited-service hotel than in the comparable suburban property since the average daily rate of downtowns is generally higher than in the suburbs, and the competitors in the downtown are generally higher-priced full-service properties. Downtown's existing older, poorer, and less competitive properties were able to ride the coattails of the higher-rated downtown properties and achieve rates often unimaginable for a comparable facility in the suburbs. With no new development, the downtowns had become bifurcated markets based on quality of the hotel asset.

Therefore, following the limited-service precepts, wouldn't there be room night demand in the downtown that *didn't* want to pay for concierge services, meeting, and restaurant space? If so, this room night demand would expect to pay less than at a full-service property. But how much less was the key since, though the rate for a downtown limited-service property would be more than for its suburban counterpart, the rate may not have been enough to justify ground-up development. This was the question that we asked as we studied what we thought was a market opportunity to develop a limited-service hotel in downtown Denver in 1995. Statistics collected and models created, clear trends emerged suggesting that we could determine:

- The premium that a downtown limited-service hotel would achieve over the same suburban brand;
- The discount that the downtown limited-service hotel would surrender to its full-service competitors.

Generally, the limited-service or mid-market hotel flags could achieve a 30 to 50 percent RevPAR premium (Average Daily Rate times occupancy) over their suburban counterparts. (See Exhibit 21-10.) These same limited-service and mid-market hotels would operate at a 25 to 40 percent discount when compared to Average Daily Rate of the "first-class" downtown hotels. The basis for this high level of performance relative to the suburban property goes to the heart of the issue of this article. While new, lower price-point hotel concepts were routinely and efficiently unveiled and built in the suburbs, downtowns were nearly entirely neglected in the last two hotel development cycles. This dynamic created a gap in the downtown hotel brand continuum relative to the suburbs that continues to this day. The premiums that limited-service and mid-market hotels receive in downtowns are illustrative of the lack of less-expensive hotels in the downtown.

Exhibit 21-10 Urban (Chicago) vs. Suburban Performance



It became clear that nearly any commercially acceptable suburban franchise would receive a hefty premium if operated in the downtown. This was the case with a moderately priced limited-service brand that, in the handful of markets where a downtown property was built, received a 30 to 40 percent premium over the nearest suburban hotels of the same brand. This was also the case with urban core extended-

stay properties in comparison to that chain's predominantly suburban properties. Although not as great a premium as the limited-service and mid-market properties, this chain of extended-stay properties still achieved approximately a 20 percent premium to the rest of the suburban system.

In short, this analysis corroborated the fact that a large premium existed for operating a suburban-based property in the downtown. Because of the greater barriers to entry and higher entry costs associated with downtown hotel development, this premium may remain fairly certain.

This being said, the downtown lower-priced hotel will not be entirely immune from the effects of over-supply in the suburbs, should this occur again as it did in the late 1980s. Until this time and perhaps beyond, these franchised properties will continue to outperform their suburban kin.

[5] Development vs. Renovation Costs in the Urban Core

The question of market rate feasibility now established, the question of development cost and financial feasibility needed determining. The first step is to determine the site for development. This question needs to be refined to buying land for development or buying an existing building for redevelopment. Somewhat surprisingly, the spread between new construction and renovation aren't as great as one might expect.

Land prices in downtowns clearly are greater than in the suburbs. But consider the land economy of building up rather than out. Land for a suburban limited-service property ranges from $7,000 to $15,000 per room based on land prices of $6 to $15 per square foot for three and a half acres. Even with land costs in downtowns rebounding to a range between $50 to $200 per square foot, the downtown hotel needs only a $15,000 square foot building foot print (excluding parking). This yields a per-room land cost of $5,000 to $20,000 per room, not that terribly different from the suburban range. Since the downtown guest will expect a higher level of finish, the furniture, fixtures, and equipment will be 10 to 30 percent more expensive than the suburban property.

The greatest difference in cost is the premium for high-rise construction; stick-built or steel stud horizontal construction in the suburbs is far less expensive than building with concrete in the downtown. Fire refuge areas, sprinkler systems, fire command stations, back-up generators, and other conditions imposed by mid- or high-rise construction add approximately 20 percent to the cost of a downtown project.

The ultimate development cost for the suburban limited-service mid-market property is in the range of $50,000 to $85,000 per room. The corresponding cost of a ground-up downtown mid-market property is approximately $150,000 to $200,000.

To be feasible, the average daily rate at a hotel built for $150,000 per room must exceed $160. This high an average daily rate for a mid-market property would be unattainable in most downtowns. Generally, therefore, the concept of ground-up development in the urban core is not feasible. The feasible average daily rate for the limited-service property is approximately $90 to $140. Backing into a feasible development cost, the project can support a total development cost of up to $130,000 per room.

This new-construction per-room cost cannot often be achieved in the downtown. The way to achieve this development cost is to acquire an existing building and convert it. In short, though not as great as one might imagine, the discount on development costs in renovation versus new construction is approximately 20 to 25 percent. Considering the benefits of historic tax credits, the discount may exceed 30 percent. In the broadest measure, the tax credit of 20 percent of all approved development costs, in practice, pays for the cost of the building.

[6] Mixed-Use Solution

In order for the downtown hotel project to get built, given all of its complexities and greater costs, it often takes creativity and an ability to layer on income streams from uses other than the hotel. In effect, the project that started purely as a downtown hotel metamorphoses, along the path of pre-development, to embrace other components. Uses like retail, parking, and office add revenue strength to the project and make use of less-utilized space within the building. Symbiotic uses to the business traveler range from the obvious, like restaurants, business centers, and coffee shops, to the merely convenient, like office uses.

The 450,000-square-foot Macmillan Building on Third Avenue in Manhattan typifies the creativity of the hotel developer. The building will be condominiumized into three units and converted retail, office, and hotel uses. The developer is left with the space for a 320-room Courtyard by Marriott. But a 320-room property would only require approximately 230,000 square feet of space, leaving the developer with nearly half of the space uncommitted in a building purchased for $100 per foot. The developer needed to realize value in the uncommitted space. Therefore, the developer attempted to recapture some of the acquisition cost by condominiumizing and selling off two of the three condo units. The first two floors of the building are to be purchased as one condo and leased as retail space. The Marriott Courtyard will occupy the top half of the building in its condo unit. This condo unit will extend to the first floor, which affords it street access for an entry foyer. The middle condo unit will be purchased by Sloan-Kettering Cancer Center as a midtown office. Sloan-Kettering will convert the space in its own condo unit to a medical office.

Downtown hotel development, though seemingly all the rage, is based on solid fundamentals. Current fundamentals, like the premium that urban limited-service properties enjoy over their suburban kin, present a compelling case for urban core development. This fact has not been lost on developers who have seized it, capitalized on the returning luster of downtowns, and packaged it to lenders and investors hungry to invest cash. The unlikely set of concurrent circumstances that have fostered this development boom are based more on maximizing arbitrage in current economics of urban real estate than on hotel operations or branding.

The issue, in the end, may turn out to be a bad arbitrage play, but that unbridled suburban hotel development added too many rooms, and the whole market, urban and suburban, suffered. If suburban development creates disequilibrium in the suburban market, it will likely have a negative rate impact on urban hotels. This is one of nagging specters that will continue to lurk until the hotel industry begins the downslope of the current development cycle and the jury returns from its real estate deliberations.