Opportunity Drives Appetite

Hotel Management Contract Survey 2015

TAILORED HOSPITALITY SOLUTIONS

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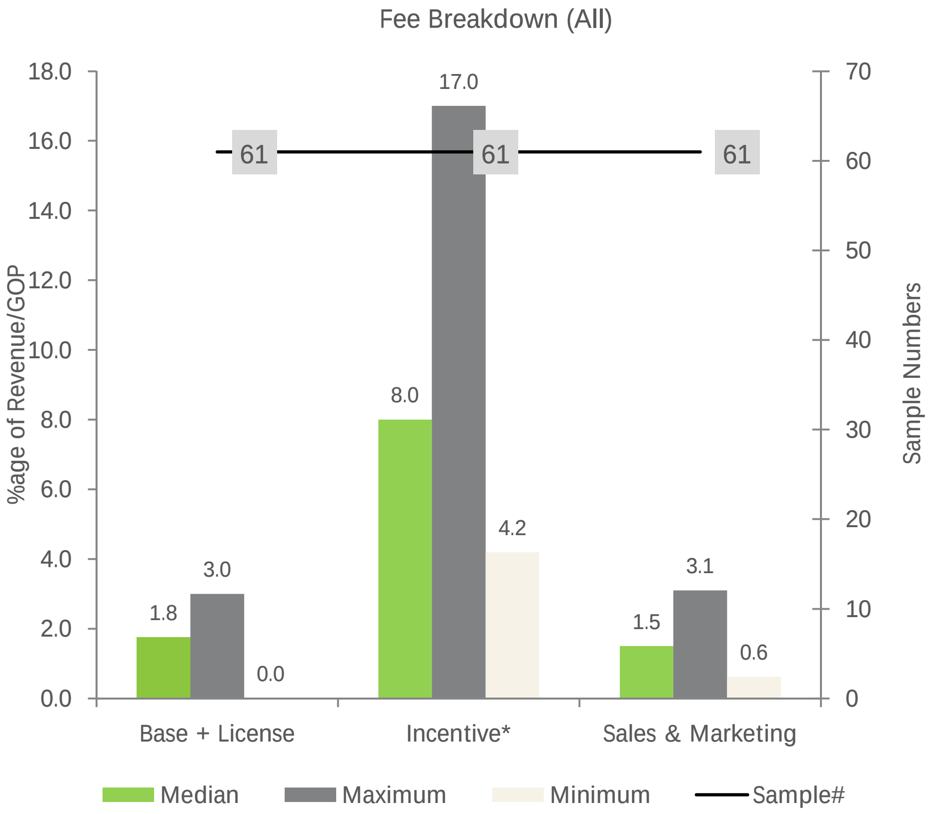
Hotel Development Resources has undertaken a comprehensive hotel management contract survey.

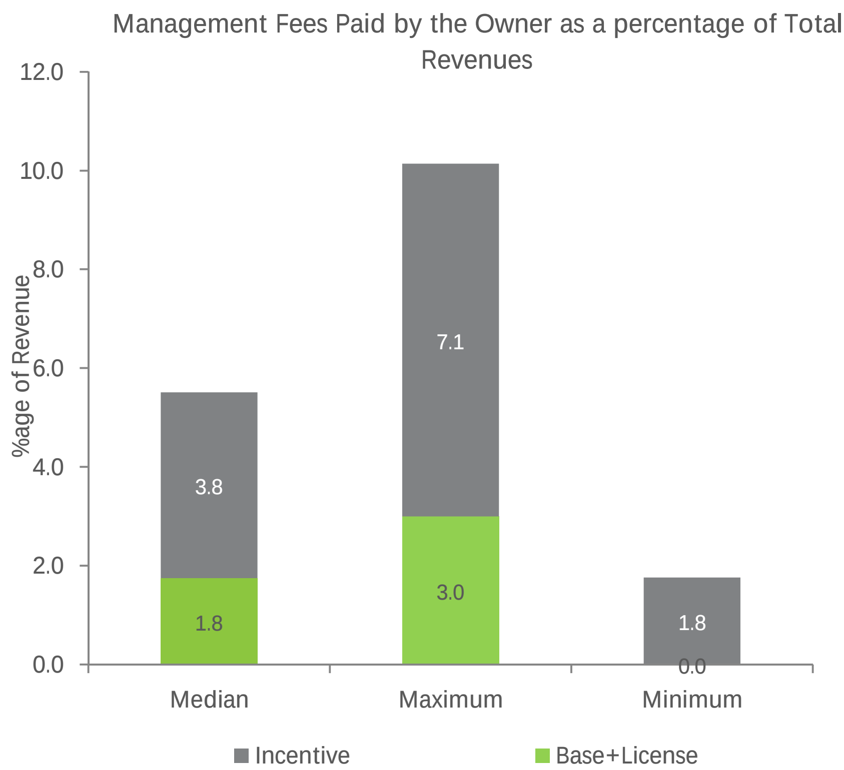
Rather than seeking to identify general trends within current management contract negotiations, our survey focuses on the key commercial terms contained within the 61 signed contracts sampled for the management of hotels in the GCC. The survey comprises hotels represented across all internationally recognised asset classes, from budget to luxury.

Having analysed the terms contained in these contracts we conclude that there is no specific correlation between base fees and incentive fees or any trend in the ratio of these fees between the upscale/luxury properties and the midscale/budget ones.

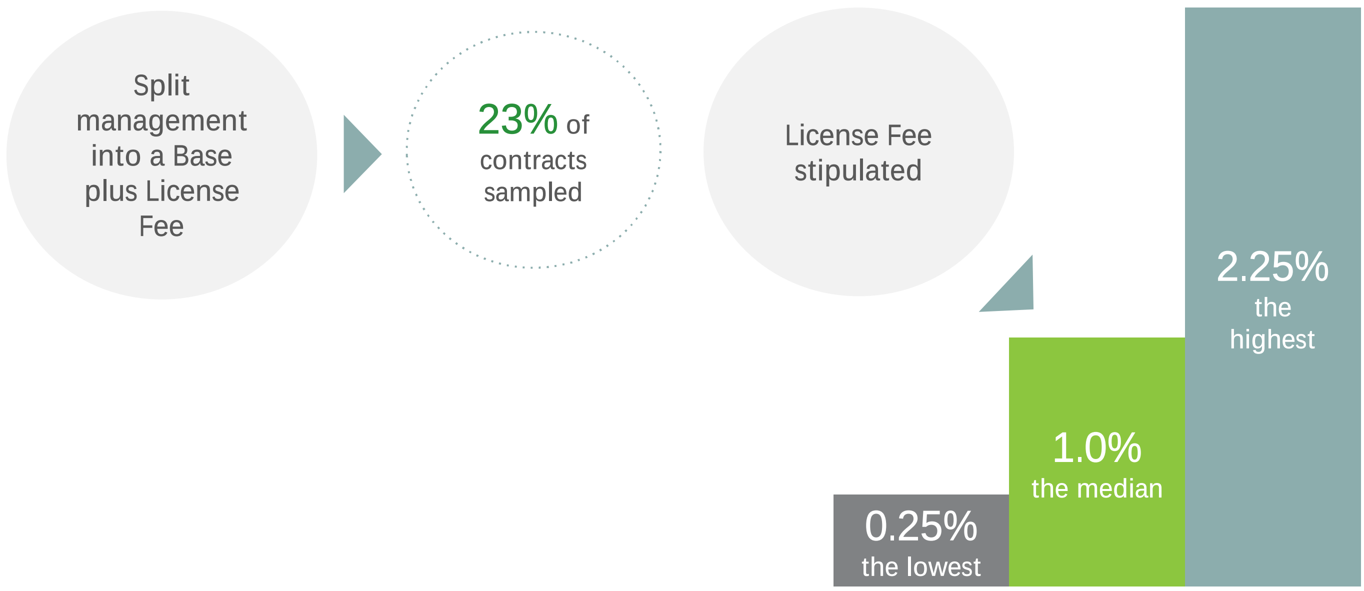
It is therefore the specific opportunity (e.g. location, positioning, concept, strategic) that tends to drive an operator's appetite and as a consequence, the fee level and other terms.

Although specific opportunities have resulted in a downward trend in base management fees, the same cannot be said for other terms such as performance or area exclusion where there appears to be a reluctance by operators to expose themselves to undue risk.

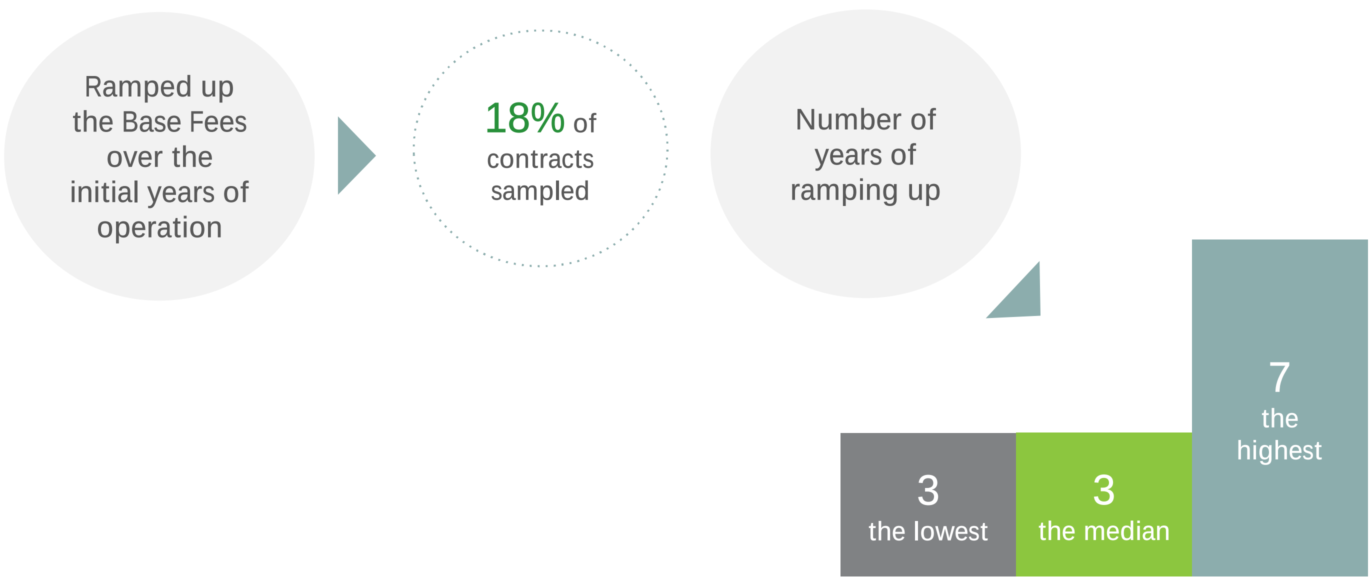




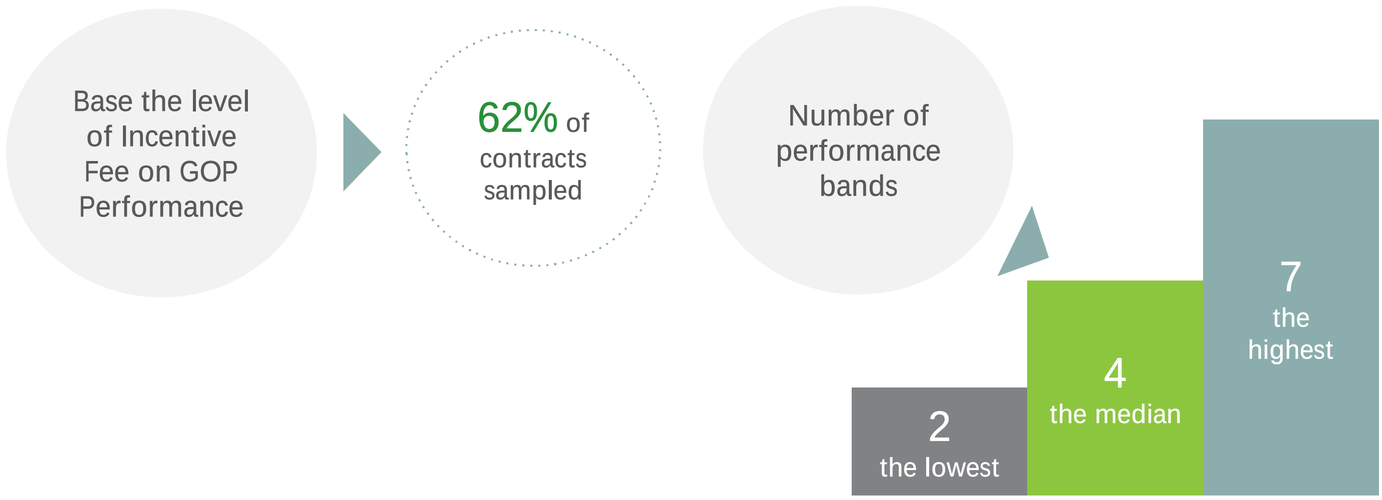
§ 23% of the sample, from 14 different operators, present management fees as a mixture of base fees and licence fees. Normally the licence fees are remitted to another entity and are not negotiable. Licence fees vary from 0.25% to 2.25% of revenue with a median of 1%.



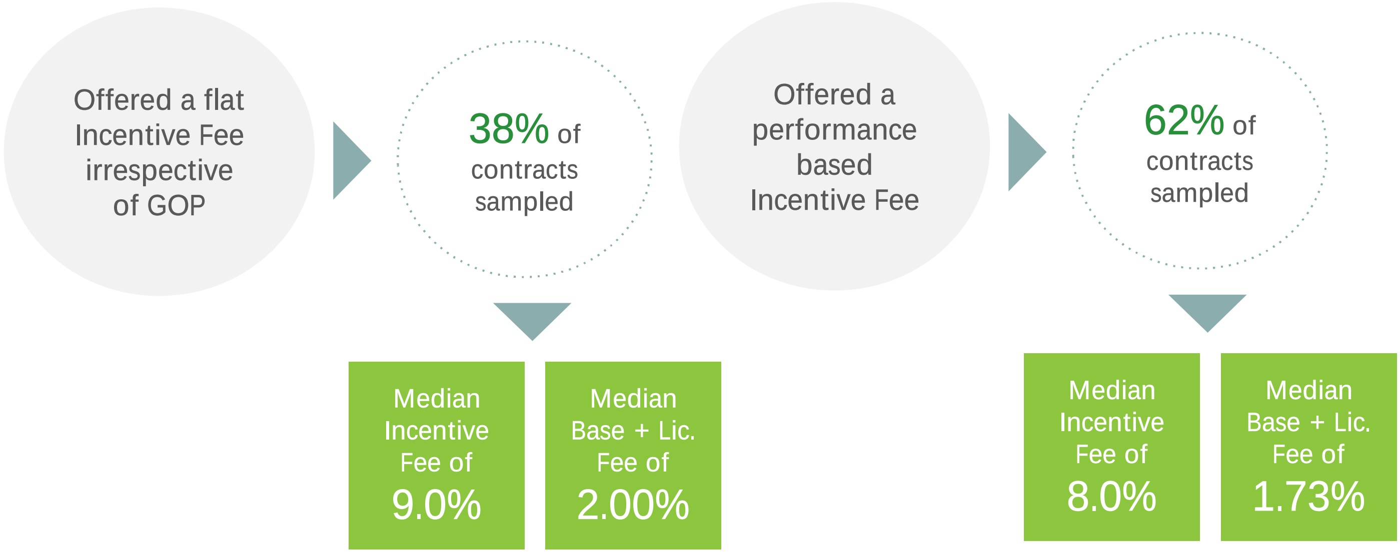
§ Operators can support the property in the crucial initial years of operation by ramping up the base management fees. We found that 11 management contracts, representing 18% of the sample, had such a fee ramp-up ranging over 3 to 7 years, by which time the property would have reached a stabilised operating performance.



- Incentive fees are calculated as a percentage of the Gross Operating Profit. Whereas the base fees incentivise the Operator to maximise revenues, the incentive fee focuses on the operating profit, and in theory incentivise the Operator to optimise costs and consequently improve the Owner's return.
- By linking the level of fee to GOP performance, the fees can be incentivised further although it was found that a significant percentage (38%) of the contracts sampled did not incorporate this.



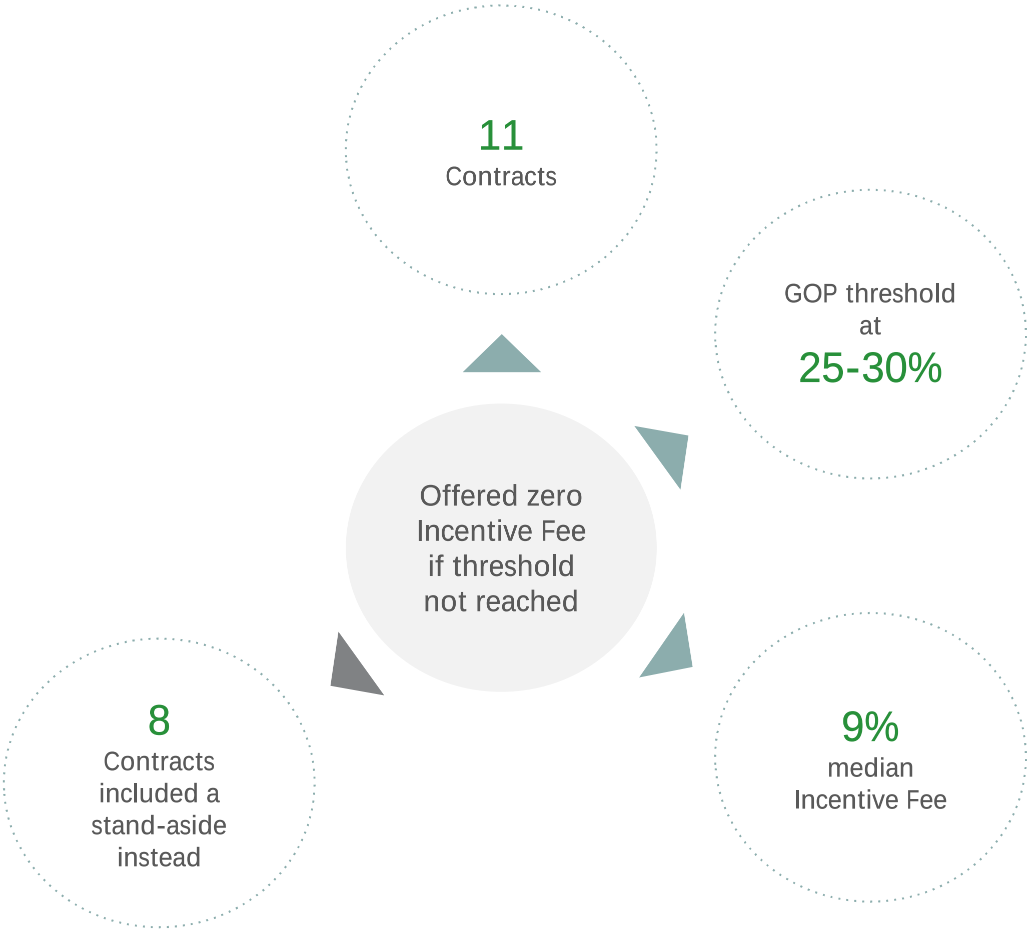
- Although performance based incentive fees have tended to attract lower base (plus licence) fees, this is probably a feature of the specific opportunity rather than a trend.
- Assuming average market-wide GOP performance levels, flat incentive fees tend to be higher (9% of GOP as opposed to a median of 8% for performance based incentive fees) since operators are incentivised by the level of fees once they achieve performance levels that are higher than the market norm.
- Despite the median, there is wide variance in incentive fees, with the lowest end at 4.2% of GOP and the highest end at 17% of GOP, although in this particular case there was no base/licence fee applicable.



3. Incentive Fees...contd.

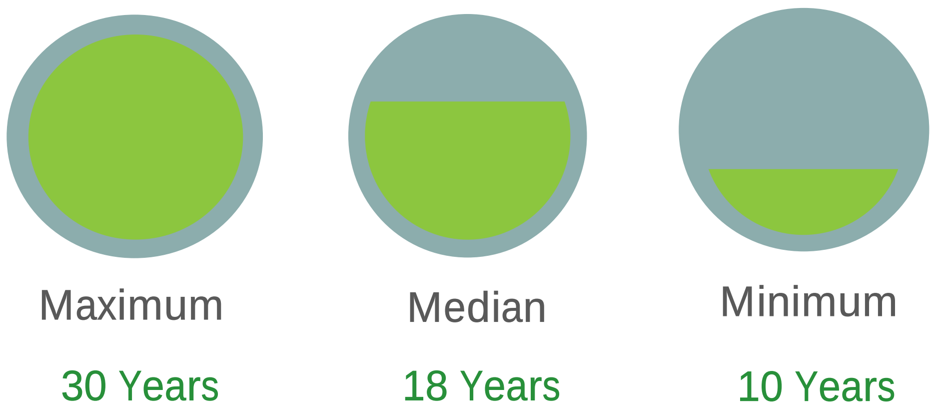
- According to the Uniform System of Accounts for the Lodging Industry (USALI), the GOP line includes operational revenues and expenses (including centralised marketing fees) but does not include non-operating income and expenses such as :
  - Base management fees
  - FF&E reserve
  - Buildings insurance premium
  - Debt service
- Ideally, the incentive fee should be calculated from adjusted gross operating profit which is defined after deduction of the above expenses from the GOP. Although these expenses do not make a huge impact on the incentive fee (0.1% of gross revenue), it is worth taking into consideration during the negotiation process.

- Owners bear the brunt of the business risk and will often seek support from the Operator in meeting fundamental obligations such as debt service, something which banks are increasingly scrutinising in order to approve long-term funding and manage their risk.
- Operators can help by offering to subordinate their incentive fee to a minimum owner's return. The options for this are:
  - Zero incentive fee if a threshold GOP is not reached; this was found in 18% (11) of the sample with the GOP percentage varying from 25% to 30%
  - Stand-aside the incentive fees if a threshold GOP or monetary amount is not reached; offered for just 13% of the contracts surveyed. Note that all of these contained a "claw-back" provision whereby the fee would be remitted to the Operator in subsequent years once the hotel performance allowed it.
- Obviously the former is preferable as the Owner's return is supported in absolute terms, however there is marked reluctance from operators to assume this business risk, despite pressure from financing sources on the Owner to guarantee certain levels of performance.

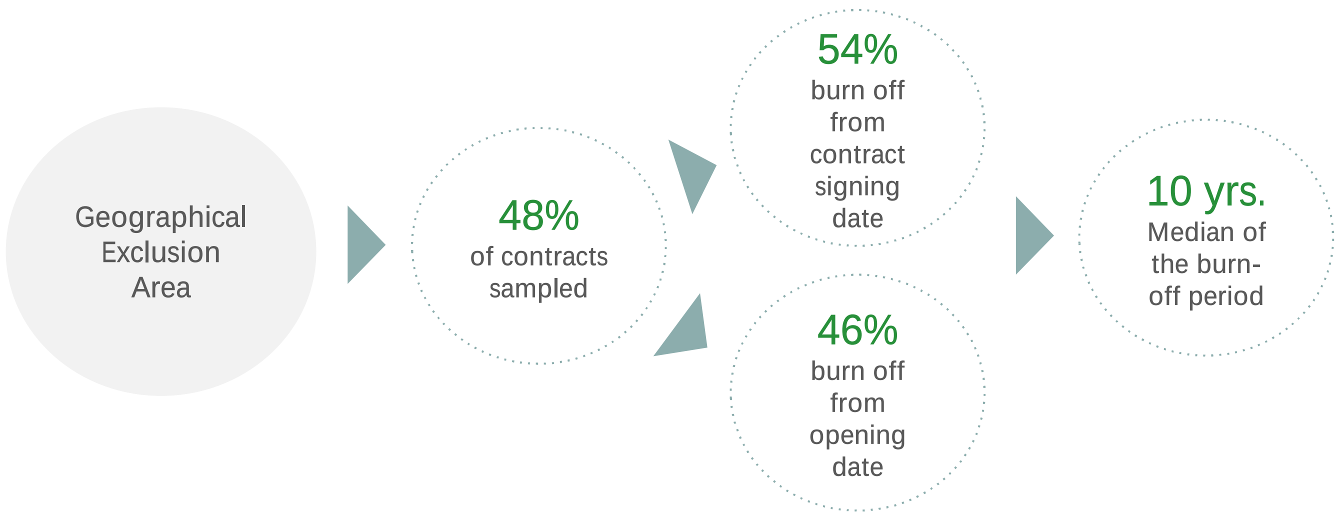


- Although most (90%) of the contracts in our sample incorporate term extensions that are subject to mutual discretion, this leaves 10% at the Operator's discretion, albeit with some performance target in the final years. This means that in these cases the Owner effectively has no authority to terminate the contract at the end of the initial term. Additionally, some contracts stipulate that the term commences as from the date of signing the contract, not the opening date.

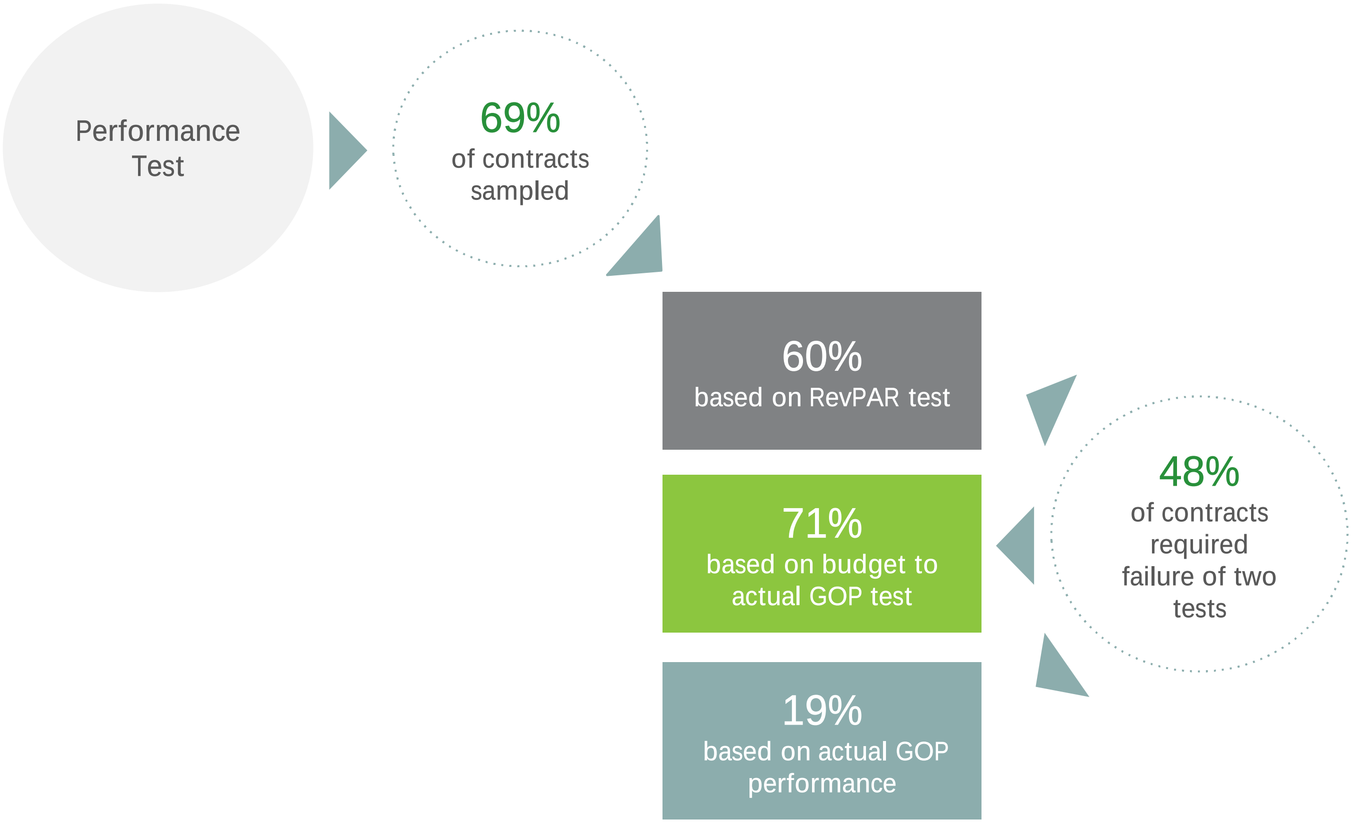
TERM



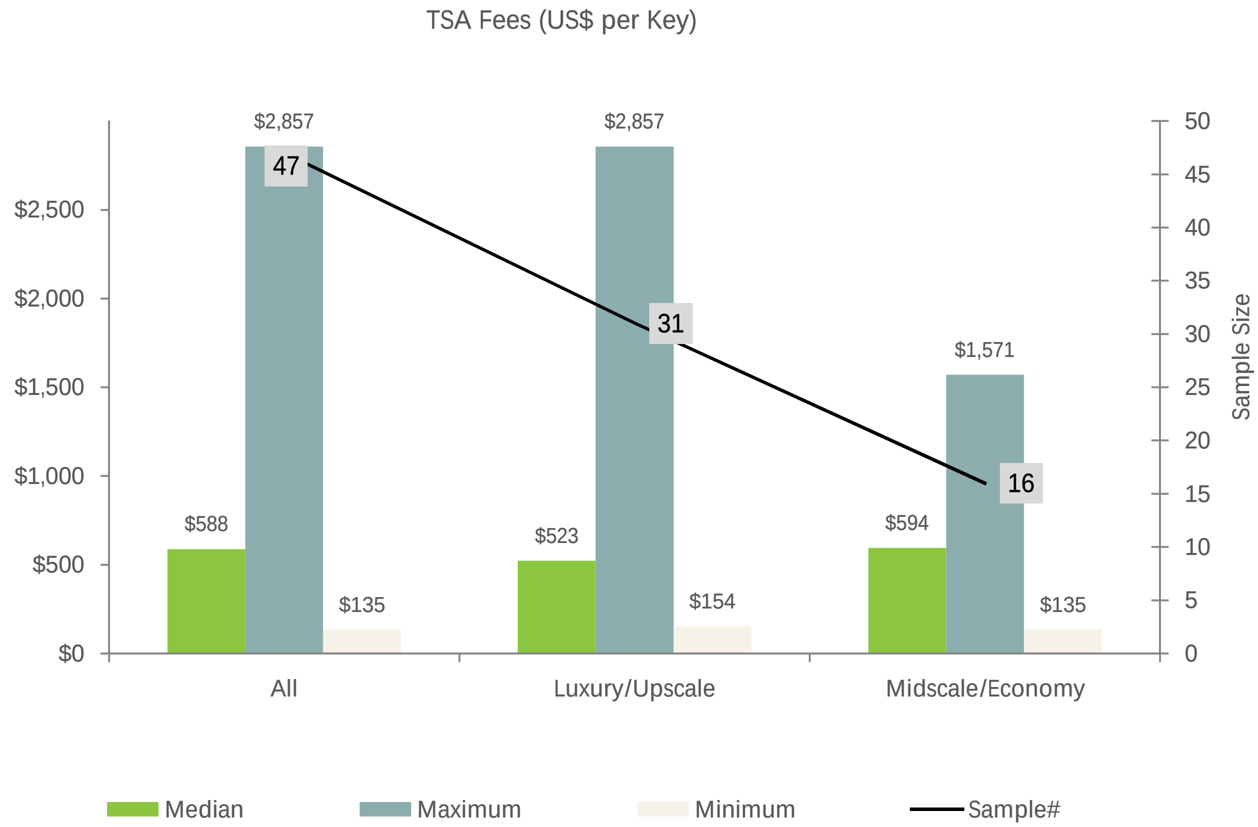
- With increasing sophistication and proliferation of properties in the region there is a trend towards limiting the geographic area of exclusivity as well as the period that exclusivity applies (burn-off period), subject to defined performance criteria in the final years.



- Performance clauses which allow the Owner to choose to terminate a contract, tend to be rather weak and in normal circumstances only come into effect in conditions of very poor hotel performance, by which time the Owner/Operator relationship will have probably suffered irreparable harm. These test the performance of the hotel after a period of stabilisation (3-5 years) for a test period (2-3 years) in the following categories:
  - RevPAR performance against an average of a competitive set of around 4 properties;
  - Actual GOP performance against budget, although many operators are resistant, especially if the Owner has right of approval over the Annual Operating Plan; and
  - To a lesser extent based on actual GOP performance threshold.
- The tests are often watered down by stipulating that:
  - the test is subject to failure of both conditions;
  - the test criterion should be within a percentage of the competitive average (median 85%); and
  - Allows the Operator to "cure" by supplementing the difference, usually for an unlimited number of times.
- It is therefore rare to witness these clauses being successfully invoked and an owner, who typically requires a level of return on his investment that is far higher than these performance clause levels, is forced to seek more arduous legal remedies for non-performance.



- Although operators usually quote technical services fees as an amount per key, most are amenable to capping that fee. The median fee level in the sample of 47 contracts that identified a TSA fee, was US$170,000, working out to US$588 per key.
- There is trend to fix the duration that technical services will be offered for the fee (i.e. period to opening) with additional technical services fees being charged for delays in opening the property.
- Some operators levy additional fees that are payable during the pre-opening period. These have a number of different reasons, in some cases termed as a commitment fee, in other cases a management fee for the period when there are no revenues. In general, operators are amenable to a negotiation of these fees, in some cases offering a rebate from the management fees once the property has opened. In our survey we identified 9 contracts that stipulated a Pre-Opening fee ranging from US$10,000 to US$150,000.
- In addition, operators are increasingly defining specific fees during the pre-opening period, such as IT services fees, which vary considerably and should form part of the pre-opening budget, although their inclusion in the management contract precludes the Owner's approval.



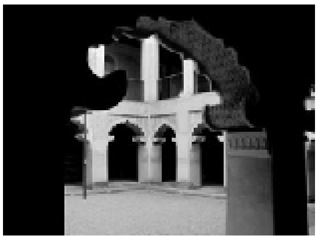
Management Contract	The contract between the Owner of the Hotel and the Management Company. This is an agency agreement where the Management Company (Operator) has little or no risk in the enterprise.
Management Fee	This is the compensation that the Operator receives for managing the hotel as a whole. Modern contracts tend to apportion the fees thus:
§ Base Management Fee	Based solely as a percentage of gross revenue, it incentivises the Operator to maximise revenues.
§ Licence Fee	The Base management fee is sometimes split into an additional license fee. Often this is remitted to a separate, legal entity and usually not negotiable.
§ Incentive Management Fee	This fee is based on the operating profit of the hotel and thus incentivises the operator accordingly. Depending on one's point of view this may either maximise profits, or minimise costs.
Sales & Marketing Fee	Management companies undertake various centralised advertising, marketing and sales activities at a corporate level for the brand as a whole. The cost of this is usually shared out among participating hotels and charged as a percentage of rooms revenues, appearing as an operating cost.
Gross Revenues	(Total Operating Revenue) is the sum of all hotel revenues, i.e. Rooms, Food and Beverage, other departments (such as golf course, spa, parking) and miscellaneous income (such as space rental, commissions and interest income).
Gross Operating Profit	This is calculated by subtracting the total operating expenses from the Gross Revenues. Note that this doesn't include Owner specific costs such as FF&E reserve, Incentive Management fees and since the eleventh revised edition of the Uniform System of Accounts for the Lodging Industry, Base Management Fees.
Adjusted Gross Operating Profit	This is the GOP less any other deductions (usually Base Management fee) agreed between the Owner and the Operator.

... Hotel Development Resources (HDR) provides potential investors, owners, developers and operators support in reaching critical milestones and decisions during the hotel development process.

... Our goal is to assist and guide our clients throughout the hotel development cycle, helping them to make internal decisions and interact with other service providers on their behalf in order to drive the most informed investment strategy.

... We deliver specifically researched and evaluated reports on the hotel industry and provide due diligence and quality review through the development, operation and acquisition phases.

... Via HDR's strategic relationships with other service providers, we provide services throughout the hotel lifecycle.



... The Partners have been directly responsible for managing the hotel operator selection process on behalf of numerous clients and have directly assisted contractual negotiations via the Letter of Intent and Management Agreement stages. In addition they have provided ad-hoc advisory assistance to many other hotel operator selection and appointment services throughout the GCC region and have therefore had dealings with the majority of the well-known international hotel management companies in the Middle East, Europe, Asia and the US.

Having been involved in the hospitality industry in the Middle East since 2002, the Partners exposure to hotel operators, their brands and contractual terms leaves them very well placed to bring insightful and balanced opinion and guidance to the hotel operator selection and negotiation process.

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