

Flexibility Key in New Management Deals

CON QUIGLEY examines trends in hotel management agreements



Like any commercial agreement, the terms of a hotel management contract are highly influenced by the balance of bargaining power between the parties. While the position had somewhat squared off to a more equitable sharing of risk and reward between hotel owner and operator, the economic downturn has caused a shift in lender and owner influence and a requirement for greater operator flexibility.

This turn of events and increased lender pressure on owners to secure a stable and sustainable cash flow is forcing the market to come up with new ways to handle key issues in management agreements.

The Lead-Up to 2008

Ownership and operations in the hotel sector underwent a seismic restructuring from 2004 when the major branded operators began to divest themselves of real estate ownership to focus on operational management and brand expansion. Sale-and-manage back deals such as IHG's £1bn divestment of 73 hotels to LRG Acquisition Ltd in 2005 and Marriott's exit under sale-and-manage back of 46 hotels from their joint venture with Whitbread to RBS in 2006 formed part of a wave of multiple management contract deals as brands keyed up to rapidly build market share without the risks of asset ownership.

In this spell of abundant debt and equity and record interest in hotel investment, the major hotel operators were supremely well placed to hoist their brand flags at the most prominent new hotel sites as well as bringing trading hotels within their brand stable at minimal risk, while owners competed for operators with established brand equity to add value to their investments.

The market matured to create a new community of hotel investors and owners and an increasingly sophisticated form of management agreement balancing the requirements of the lender, owner and operator with the objective of realising an increase in asset value and long-term partnership between the parties. As the major operators became less inclined to bear any balance sheet liabilities, the management agreement has become the default option, in some ways adopting provisions akin to a variable lease agreement, but with limited risk participation by the operator.

While agreements have become more complex, they did not envisage the economic downturn which has taken hold. And so, as circumstances put pressure on all parties involved, pressure has been brought to bear on the management contract itself and the implications of its terms. This is particularly illustrated

in the current Irish hotel market where hotel assets have come under strain and either been deflagged by the brand and the management agreement terminated or, more complexly, may fall to the National Asset Management Agency (NAMA) where new questions will arise about the understanding of this operational arrangement and whether NAMA is suitably placed to maximise the value of managed hotel assets.

Before exploring the impact, it is important to note the key issues which historically form part of a management agreement negotiation:

- **Term and renewal options:** Achieving a stable long-term relationship for all parties, permitting brand continuity balanced against the owner's need for flexibility should circumstances change.
- **Base and incentive fees:** Typically a percentage of gross revenue and gross operating profit respectively, meaning revenue changes directly amplify or dilute operator profitability and bottom line returns to the owner. With a weaker trading market and higher cost base, operator fees and owner returns have been seriously impacted to the detriment of both parties.
- **Termination provisions:** In the event of a breach of contract, insolvency of one party, or if the owner wishes to sell, these provisions regulate whether each party may terminate and any fees payable. Termination without cause provisions are now uncommon and operators may seek extensive compensation for an owner/lender instigated termination.
- **Equity contributions:** The extent to which the operator will participate in the investment. Very uncommon other than for highly strategic opportunities or trophy assets in key locations, e.g. London or Paris.
- **Guarantees and performance tests:** Major operators are generally reluctant to guarantee a level of performance which might give the owner some assurance. Guarantees are more likely from small to medium-sized operators looking to manage subject to a franchise, mostly for limited service/budget brands e.g. IHG's Express by Holiday Inn or Accor's Ibis. Performance tests enabling owner termination are highly caveated to significantly curtail operator liability and allow curing rights in respect of performance shortfalls, limiting owner protection.
- **Owner rights and approvals:** Specific owner rights, e.g. budgetary controls, access to information, limitation of operator's spending and owner approval rights for appointments such as the general manager. These rights were

very publicly contested recently by the owners of Dublin's five star Shelbourne Hotel who remain in dispute with operator Marriott over the running of the hotel.

- **Capital and maintenance expenditure:** Regulate maintenance of the asset to ensure brand standard compliance, repairs and longer term capital expenditure. Typically an FF&E (furniture, fixtures & equipment) reserve is established to which a percentage of gross revenue must be allocated.

Taking on the Downturn

The mass of management contracts executed during the boom spell have now come under close scrutiny as owners and their lenders seek to yield maximum returns on their investment in the face of falling revenues. I am increasingly working with newer, less experienced owners, greatly in need of expert hotel advisory services as they sustain lender pressure and grapple with the operational challenges of their managed hotels. Equally, as development pipelines have dried up due to lack of available debt and sector confidence, I see operators coming under strain to add further properties as brand growth and increased market share are being frustrated.

As a result, operators are prioritising the continuation of their existing management contract base and contract tenure is now a critical negotiation point. The majority of management contracts in Europe now have an initial term of 15-20 years, with operator renewals available for up to 10 years. There is an increased trend for short terms to give greater owner flexibility.

Lenders and administrators are looking for more flexible shorter agreements where a hotel is in difficulty and an interim management solution is needed while a hotel is sold or repositioned. For example, the administration of Pantin Hotels last summer saw the newly opened Ellington Hotel in Leeds sold and signed up by Bespoke Hotels, a UK management services company offering more flexible deal terms on shorter tenure.

Shorter term management companies tend to participate more in the risk of the enterprise, have lower overheads and offer a variety of forms of operational agreement, acting more as asset manager, honing the hotel's performance in the shorter term. For a lender, the priority is maximum flexibility, and as lenders learn the difficulty of trading encumbered assets, it is likely that more permissive termination provisions will be sought in the future enabling an owner/lender to terminate on a more objective basis.

There is much speculation in the Irish market as to whether hotel assets falling to NAMA might also sustain change of management or cessation of existing arrangements with major operators. Celebrated hotel assets such as Dublin's Shelbourne Hotel (managed by Marriott as a Renaissance), Ritz-Carlton Powerscourt Wicklow (also Marriott) and the Radisson Blu Galway (managed by Rezidor Hotel Group) may all be transferred to NAMA as it takes control over the debt arrangements to which these hotels are subject.

We are yet to see how NAMA would approach the asset management of what represents some of Ireland's most attractive hotel real estate. Since the downturn, a number of brands have also exited the market, including the Mount Juliet in Co Kilkenny which parted ways with Hilton in October 2009 as one of 20

Conrad Hilton properties, the former Limerick Marriott, rebranded The Savoy in 2009, and Hilton also left Limerick in 2008, ceasing management of The Strand Hotel after only 18 months.

The current market has ultimately delivered greater bargaining power to owners and the lending community and a need for operator flexibility. Nevertheless, at the most critical issue of financing, the major branded operators continue their policy of staying asset-lite and have not yet shown willing to resume an equity position, or even offer guarantees. It is questionable whether the need to proliferate their brands and regain traction will require mainstream operators to reposition their asset ownership strategy and contrive to deliver fresh terms in management agreements entailing equity participation.

In the meantime, I have seen a number of small to medium-sized hotel companies attempting to fill the void by offering a more flexible alternative, perhaps with guarantees or fee subordination for a management contract on a short or longer term basis. This delivers a platform of management expertise with an experienced operator which may be operated independently or with the benefit of a franchised brand offering greater brand identity and access to global distribution systems. Examples include Scottish hotel company Chardon Hotel Management, which recently captured 12 management contracts for Express by Holiday Inns across the UK from Morethanhotels, and Pat McCann's Maldron Hotels, now operating 16 hotels across Ireland as a combination of Maldron branded and individually named hotels.

Another example is Great National Hotels, established by David Byrne, David Collins and James Sullivan, which represents 11 UK and Irish hotels on a managed or affiliated basis offering a hybrid management option with greater contractual flexibility and ownership participation in equity and profit. In its brand affiliation agreements, hotels join at a comparably low cost of entry and fees are performance based so both parties are striving for increased revenues.

Change may also come to bear on operator performance tests. As lenders and owners increasingly look for opportunities to terminate a non-performing hotel, operators look to widen further external factors curtailing their liability. While they may face owner resistance, it is anticipated operators will seek to extend their 'get-out' clauses for performance failure by 'force majeure' to include future serious economic crises.

Finally, brand standards and capital investment have become more prominent as owners are unable or reluctant to further capitalise their investments to accommodate operators' changing requirements. While existing agreements are fairly stringent in terms of FF&E contributions and owner acceptance of proposed capital expenditure, market conditions may force greater flexibility to allow postponement of certain enhancements or a relaxation of brand standards in certain circumstances. Owners may even look for longer term influence on brand changes if they realise that some previously prescribed costs could be avoided in future.

Ultimately the overall principles and fine detail of a management contract require careful consideration by all parties and I strongly advise both owners and lenders in particular to seek specialist advice when either concluding a contract, managing their asset or addressing issues arising where the hotel is distressed or subject to a dispute. ♦

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