2009 HOSPITALITY LAW CONFERENCE

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THE INCENTIVE FEE IN HOTEL MANAGEMENT AGREEMENTS

IT'S ALL NEGOTIABLE

Presenters

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- Partner and Chair of the Hotels and Resorts Practice
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- Previously Executive Vice President, General Counsel and Secretary, Inter-Continental Hotels (1988-98)

- Represents owners and developers of hotels and resorts and hotel management companies

- Has written extensively on hotel development and the negotiation of management agreements and related topics

Standard Dual Fee Formula (Full Service Hotel)

- **The Base Fee**
  - % hotel's total or gross revenue
- **The Incentive Fee**
  - % operating income after "deductions"
  - % gross operating profit ("GOP")
  - Gross Revenue – Departmental Expenses = GOP

Operating Expenses

- Cost of sales
- Payroll and related costs:
  - salaries
  - workers' compensation contributions
  - social security and other taxes and charges
  - benefits and related administration costs (including employer contributions to retirement plans
  - tax equalization benefits
  - overseas premiums
  - cost of living allowances
  - mobilization
  - demobilization, and relocation costs
  - fees and costs related to visas, residence and work permits for hotel employees and their dependents
  - employee housing

Operating Expenses (continued)

- Departmental expenses
- Administrative and general expenses
- Locally-generated advertising, marketing and business promotion incurred by the Hotel
- Utilities, including heat, light, power, air conditioning, water, and sewage treatment and disposal
- Computer line charges
- Routine repairs, routine maintenance and minor alterations
- Cost of Inventories and Fixed Asset Supplies used and consumed in the operation of the Hotel
- Reasonable reserve for uncollectible accounts receivable as determined by Manager
- Costs and fees of independent professionals or other third parties who are retained by Manager to perform services
- Certain CC&Rs
- Certain Owning Company Expenses

Non-Operating Expenses
(Owner obligations that are not “deductions”)

- Debt service payments pursuant under any mortgage
- Ground lease rent
- Payments pursuant to equipment leases or other forms of financing obtained for the FF&E located in or connected with the Hotel, rental payments pursuant to any lease, right of way, right of use, or similar arrangement applicable to the Site or the Hotel
- Depreciation on the Hotel or any of its contents and amortization of good will on the Hotel
- Income taxes imposed by tax authorities on the Management Fee paid by Owner (or by Manager on Owner’s behalf) (Owners often agree to gross up fees that are subject to local withholding taxes)
- Transfers into the FF&E Reserve (this one is often negotiated to be a “deduction”)
- Capital Expenditures
- Pre-Opening Expenses
- Property Insurance
- Occupancy permits and other non-operating licenses, permits

Variations on the Standard Formula

- Non- Recoverable Stand Aside to Owner's Priority
- Recoverable Stand Aside to Owner's Priority
- Percentage of Net Cash Flow After Income Taxes, Depreciation, Interest and Amortization.

Deficiency

- “Forgiven” – that is the Incentive Fee for the year in question is the higher of 10% of GOP or cash available after all Operating Expenses and Owner’s Priority are paid;
- Accumulates as deferred incentive fee and is aggregated with all previously deferred incentive fee payments; the aggregate deferred amount may or may not bear interest – this too is negotiable.

ILLUSTRATIONS OF THE DEFERRED/ CATCH-UP INCENTIVE FEE MODEL

Years 1 through 4

Year 1: GOP $10 Million

Owner's Priority =$6,000,000

Debt Service = $6,500,000

Current Incentive Fee = the lesser of the following (but not less than zero):

10% x GOP = $1,000,000

or

the amount by which GOP exceeds the greater of Owner’s Priority or Debt Service

$10,000,000 – $6,500,000 = $3,500,000

Therefore, the Current Incentive Fee is $1,000,000 in Year 1.

Catch-Up Incentive Fee = the <u>lesser</u> of the following (but not less than zero):

the amount by which the Cumulative Catch-Up Amount exceeds all Catch-Up and Alternate Catch-Up Incentive Fees Already Paid

0 - 0 = $0

or

the amount by which GOP exceeds the sum of (a) the greater of OP or Debt Service, plus (b) 10% of GOP

= $10,000,000 – ($6,500,000 + $1,000,000)

= $2,500,000 = the Catch-Up Incentive Fee is zero in Year 1.

Yearly Catch-Up Amount = the least of the following (but not less than zero):

(10% x GOP) minus the Current Incentive Fee

= $1,000,000 - $1,000,000 = 0

or

GOP minus OP

= $10,000,000 - $6,000,000 = $4,000,000

or

Debt Service minus OP

= $6,500,000 - $6,000,000 = $500,000

Therefore, the Yearly Catch-Up Amount is zero in Year 1.

Under the “waterfall” provisions of the MA, the $10 Million GOP for Year 1 would be paid as follows (assuming no amounts are retained as Operating Funds):

1. Owner’s Priority $6,000,000
2. Additional amount to cover Debt Service 500,000
3. Current Incentive Fee 1,000,000
4. Catch-Up Incentive Fee 0
5. 25% of remainder to Senior Debt Reserve Acct 625,000
6. Balance to Owner 1,875,000

Year 2: GOP $5 Million

Owner's Priority =$6,000,000

Debt Service = $6,500,000

Current Incentive Fee = the <u>lesser</u> of the following (but not less than zero):

10% x GOP = $500,000

or

the amount by which GOP exceeds the greater of OP or Debt Service

= $5,000,000 – $6,500,000

= - $1,500,000

Therefore, the Current Incentive Fee is zero in Year 2.

Catch-Up Incentive Fee = the <u>lesser</u> of the following (but not less than zero):

the amount by which the Cumulative Catch-Up Amount exceeds all Catch-Up and Alternate Catch-Up Incentive Royalties Already Paid

0 - 0 = $0

or

the amount by which GOP exceeds the sum of (a) the greater of OP or Debt Service, plus (b) 10% of GOP

= $5,000,000 – ($6,500,000 + $500,000)

= - $2,000,000

Therefore, the Catch-Up Incentive Fee is zero in Year 2.

Yearly Catch-Up Amount = the least of the following (but not less than zero):

(10% x GOP) minus the Current Incentive Fee

= $500,000 – 0 = $500,000

or

GOP minus OP

= $5,000,000 - $6,000,000 = - $1,000,000

or

Debt Service minus OP

= $6,500,000 - $6,000,000 = $500,000

Therefore, the Yearly Catch-Up Amount is zero in Year 2.

Under the "waterfall" provisions of the MA, the $5Million GOP for Year 2 would be paid as follows (assuming no amounts are retained as Operating Funds):

1. Owner's Priority	$5,000,000
2. Additional amount to cover Debt Service	0
3. Current Incentive Fee	0
4. Catch-Up Incentive Fee	0
5. 25% of remainder to Sr. Debt Reserve Acct	0
6. Remainder to Owner	0

Year 3: GOP $8.5 Million

Owner’s Priority =	$6,000,000
Debt Service =	$8,000,000

Current Incentive Fee = the <u>lesser</u> of the following (but not less than zero):

10% x GOP = $850,000

or

the amount by which GOP exceeds the greater of Owner's Priority or Debt Service

= $8,500,000 – $8,000,000 = $500,000

Therefore, the Current Incentive Fee is $500,000 in Year 3.

Catch-Up Incentive Fee = the <u>lesser</u> of the following (but not less than zero):

(A) the amount by which the Cumulative Catch-Up Amount exceeds all Catch-Up and Alternate Catch-Up Incentive Royalties Already Paid

0 – 0 =$0

or

(B) the amount by which GOP exceeds the sum of:

(x) the greater of OP or Debt Service , plus (y) 10% of GOP

= GOP $8,500,000 – ((x) $8,000,000 + (y) $850,000)

= - $350,000

Therefore, the Catch-Up Incentive Fee is zero in Year 3.

Yearly Catch-Up Amount = the <u>least</u> of the following (but not less than zero):

(10% x GOP) minus the Current Incentive Fee

= $850,000 - $500,000 = $350,000

or

GOP minus OP

= $8,500,000 - $6,000,000 = $2,500,000

or

Debt Service minus OP

= $8,000,000 - $6,000,000 = $2,000,000

Therefore, the Yearly Catch-Up Amount is $350,000 in Year 3.

Under the “waterfall” provisions of the MA, the $8.5 Million GOP for Year 3 would be paid as follows (assuming no amounts are retained as Operating Funds):

1. Owner’s Priority	$6,000,000
2. Additional amount to cover Debt Service	2,000,000
3. Current Incentive Fee	500,000
4. Catch-Up Incentive Fee	0
5. 25% of remainder to Sr. Debt Reserve Acct	0
6. Remainder to Owner	0

Year 4: GOP $12 Million

Owner's Priority (OP) =	$ 6,000,000
Debt Service =	$ 8,000,000

Current Incentive Fee = the <u>lesser</u> of the following (but not less than zero):

10% x GOP = $1,200,000

or

the amount by which AHP exceeds the greater of OP or Debt Service

= $12,000,000 – $8,000,000

= $4,000,000

Therefore, the Current Incentive Royalty is $1,200,000 in Year 4.

Catch-Up Incentive Royalty = the <u>lesser</u> of the following (but not less than zero):

the amount by which the Cumulative Catch-Up Amount exceeds all Catch-Up and Alternate Catch-Up Incentive Fees Already Paid

= $350,000 – 0

= $350,000

or

the amount by which GOP exceeds the sum of (a) the greater of OP or Debt Service, plus (b) 10% of GOP.

= $12,000,000 – ($8,000,000 + $1,200,000)

= $2,800,000

Therefore, the Catch-Up Incentive Fee is $350,000 in Year 4.

Yearly Catch-Up Amount = the least of the following (but not less than zero):

(10% x GOP) minus the Current Incentive Fee

= $1,200,000 - $1,200,000 = 0

or

GOP minus OP

= $12,000,000 - $6,000,000 = $6,000,000

or

Debt Service minus OP

= $8,000,000 - $6,000,000 = $2,000,000

Therefore, the Yearly Catch-Up Amount is zero in Year 4.

Under the “waterfall” provisions of the MA, the $12 Million GOP for Year 4 would be paid as follows (assuming no amounts are retained as Operating Funds):

1. Owner’s Priority	$6,000,000
2. Additional amount to cover Debt Service	2,000,000
3. Current Incentive Fee	1,200,000
4. Catch-Up Incentive Fee	350,000
5. 25% of remainder to Sr. Debt Reserve Acct	612,500
6. Remainder to Owner	1,837,500

RENTAL PROGRAM REVENUE

ASSUME:

Condo-Hotel Unit A is rented for $1,000

Typical Split:

4% Rental Commission to Management Company = $40

6% FF&E Reserve = $60

Balance is split 55/45 Hotel/Unit Owner

= 55%X $900 = $495

= 45%X $900 = $405

RENTAL PROGRAM (continued)

- $40 Commission – since the Management Company took this from th Unit Owner, it should not be included in Hotel Gross revenue for purposes fo determining the Base Fee. Arguably, it is reinstated in the P&L for the purpose of determining GOP and therefore increases the Incentive Fee

RENTAL PROGRAM (continued)

- $60 FF&E Reserve should not be included at all in the Hotel revenue stream and therefore is not included as Gross revenue for purposes of calculating the Base Fee nor as GOP for purposes of calculating the Incentive Fee.

RENTAL PROGRAM (continued)

- $495 Hotel Share and $405 Owner Share.

The former logically should be included in Gross revenue and therefore will increase both the Base Fee and the Incentive Fee

The latter – negotiable. Owner argues that is is not retained by the Hotel but is merely collected by the Hotel on behalf of the Unit Owner and therefore should not enter the Hotel P&L at all.

RENTAL PROGRAM (continued)

- The Management Company sees the split with the Unit Owner – i.e., the $405 – as a substitute for bank financing the the Hotel owner did not have to obtain because the unit owner financed the construction of the rental unit; therefore the $405 should also be included as Hotel Gross revenue and will be used to calculate both the Base Fee and the Incentive Fee.

RENTAL PROGRAM (continued)

- It’s All Negotiable!

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