HOSPITALITYLAWYER.COM PRESENTS
THE 2011 HOSPITALITY LAW CONFERENCE
FOCUSING ON LEGAL, SAFETY & SECURITY SOLUTIONS
FEBRUARY 9-11, 2011 • HOUSTON, TEXAS

Key Business Terms In Major Hotel Agreements

Brian Tress, Executive Director
Ernst & Young

Michelle Russo, President
Hotel Asset Value Enhancement

Presenters

- Brian Tress, Executive Director – Ernst & Young
- Ernst & Young is the world's leading provider of advisory, audit, assurance and tax services to the hospitality industry.
- Two decades of experience in the hospitality sector advising developers, operators, lenders and investors/owners.
- Leads hospitality practice for the Northeast and Mid-Atlantic regions.

- Michelle Russo, President and Founder – Hotel Asset Value Enhancement
- Hotel Asset Value Enhancement, Inc. (hotelAVE) is one of the nation's leading owner-focused provider of advisory and asset management services to the hotel investment community with over $2B and 6,000 rooms under management.
- Over 20 year's hospitality industry experience
- Certified Hotel Administrator (CHA) and Appraisal Institute Designated Member (MAI)

Roadmap

- What is a hotel management agreement?
- Terms frequently subject to negotiation
- Financial implication of terms
- Non-disturbance agreements
- How do you value a management contract?
- What are management companies doing to secure management agreements?
- Who are management companies targeting?
- Receiverships
- Branded vs. independent operators
- Franchise agreements

What is a Hotel Management Agreement?

A hotel management agreement is a contract between a hotel owner and a hotel operator where the operator agrees to operate a hotel as an agent or independent contractor of the owner in exchange for management fees and other considerations.

- Hotel management agreements allow hotel owners with limited or no experience in the lodging industry to benefit from the expertise and reputation of independent or branded operators.
- Through hotel management agreements, operators have the opportunity to expand their market presence and increase their revenue streams.
- Ensure agreement defines Operator’s duties as well as rights.

Terms Frequently Subject to Negotiation

- Length of Term
- Fees
  - Base
  - Incentive
  - Technical and Pre-opening Services
- Termination on Sale & Post-Termination Responsibilities
- Performance Tests
- Reserve for Replacement
- Restricted Area

Terms Frequently Subject to Negotiation

- Key Owner Approvals
  - Budget
  - Employees and Relocation Costs
- Relationship (Agency vs Independent)
- ROFO
- Assignment & Indemnification
- Working Capital Balance

Terms Frequently Subject to Negotiation: Length of Term

- Initial term
  - Third-party operators: typically shorter
  - Branded operators: typically longer
    - Can be as high as 50 years for certain brands
  - Operators aim to maximize initial contract term – steady, predictable stream of fee income
  - Owners prefer shorter term
    - Most Lenders are procuring 30-day termination at-will

Terms Frequently Subject to Negotiation: Length of Term

- Renewal terms
  - Longer initial terms can result in longer renewal terms
  - Operators typically want sole discretion; however, owners would like an option to approve
  - **<u>Typical negotiation: mutual consent or performance-based automatic renewal</u>**

Terms Frequently Subject to Negotiation: Fees

- Base fee
  - % of gross revenue (define)
  - Higher percentage for limited service hotels due to lower revenue levels
  - **Typical negotiation: ramp-up during initial years of operation**

Terms Frequently Subject to Negotiation: Fees *(continued)*

- Incentive fee
  - % of GOP (or adjusted GOP that looks like NOI), subordinated to preferred investor returns
    - Return to increase with invested capital
    - Return to increase in line with CPI (tougher to get)
    - Watch out for “cash flow” definition
    - Strive to subordinate to a +/- return on owner’s “total invested capital” which includes ALL forward capital expenditures above reserve for replacement

Terms Frequently Subject to Negotiation: Fees *(continued)*

- CENTRALIZED Reimbursable fees
  - Such as centralized accounting, revenue mgt, HR, and IT
  - Fees are meant to substitute for an on-site responsibility NOT for regional oversight
  - More common in select-service hotels
- Optional Reimbursable fees
  - These fees are disclosed as optional and typically opted in during the budget approval process
  - Fees could include e-commerce and purchasing
  - Fees should be at cost

Terms Frequently Subject to Negotiation: Fees *(continued)*

- **<u>Typical negotiation:</u>**
  - **Return hurdle**
  - **Basis for fee**
  - **Increase in investor return**
  - **Mandatory vs optional reimbursable fees**
  - **Total management fee cap**

Terms Frequently Subject to Negotiation: Fees *(continued)*

- Technical and pre-opening services fees
  - Fees for operator's participation in pre-construction and construction periods to ensure facility will meet brand standards, including, but not limited to:
    - Design and construction
    - Marketing the property and booking business prior to opening
    - Hiring and training hotel associates
    - IT support
  - Typically payable as an initial payment plus monthly installments
- Pre-Opening termination fee
  - Not typical

Financial Implication of Specific Provisions: Base Fee Ramp-Up

Operator Wants

- 3.5% throughout term

Resulting NOI

- Year 1: $4,825,000
- Year 2: $5,790,000
- Year 3: $6,755,000

NPV: $16,814,000

Owner Wants

- 1.0% in year 1
- 2.0% in year 2
- 2.5% in year 3 onward

Resulting NOI

- Year 1: $4,950,000
- Year 2: $5,880,000
- Year 3: $6,825,000

NPV: $17,092,000

Assumptions

NOI Before Base Fee:

- Year 1: $5,000,000
- Year 2: $6,000,000
- Year 3: $7,000,000

Financial Implication of Specific Provisions: Incentive Fee

Operator Wants

- Priority Return: 7.0%
- Incentive Fee: 20.0%

Results

- Owner's Return: $1,750,000
- Incentive Fee: $250,000

Owner Wants

- Priority Return: 11.0%
- Incentive Fee: 10.0%

Results

- Owner's Return: $2,750,000
- Incentive Fee: $25,000

Assumptions

- Owner's Equity Investment: $25,000,000
- Debt Service: $3,000,000
- NOI: $6,000,000

Terms Frequently Subject to Negotiation: Termination on Sale

- Typical Parameters
  - Operators typically do not allow for termination during ramp-up period
  - Owners favor termination-on-sale clauses as it provides more flexibility for the owner to find qualified buyers
  - Branded operators with long term agreements typically require approval rights over the assignment of the agreement to a buyer
  - **Typical negotiation: Length of non-terminable period**

Terms Frequently Subject to Negotiation: Performance Tests *(continued)*

- Typical Parameters (continued)
  - Right to cure – Operator's right to make up difference between budgeted GOP hurdle and actual GOP to avoid termination (typically limited to up to two times during initial term and any subsequent renewal terms)
  - **<u>Typical negotiation: Operating and market test hurdles</u>**

Terms Frequently Subject to Negotiation:
Reserve for Replacement

- Typical Parameters
  - Higher percentages for resorts and higher-end hotels
  - For new and just-renovated properties, a step-up approach is customary
  - Amounts spent in excess of the balance of the fund typically require Owner's approval
  - Review Loan Document requirements. Operator requirements should not exceed.
  - **Typical negotiation: ramp-up**

Terms Frequently Subject to Negotiation:
Reserve for Replacement *(continued)*

- Contract defines how Reserve for Replacement Funds can be used
  - Brand standards only
  - All capital expenditures (including building and structural)

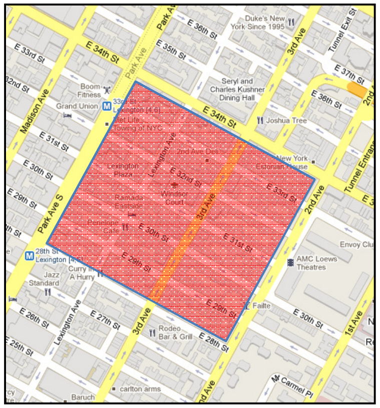
Terms Frequently Subject to Negotiation:

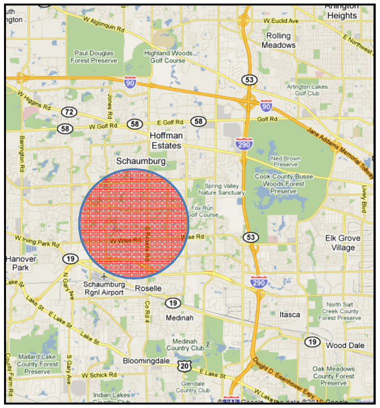
Restricted Area

- Typical Parameters
  - Indicate the radius in which a management company cannot manage additional hotels
  - Restrictive covenant can be limited to a specific brand or service level or owned properties
  - Duration of restriction is typically for a portion of the initial term.
  - Can range from blocks to miles (see examples below):

Metropolitan

18 square blocks





Suburban

Three miles

Terms Frequently Subject to Negotiation: Approvals

- Budget
  - Operator prepares annual budget and submits to Owner for review
  - Operator is to make good-faith effort to address Owner's concerns (but ultimately retains final say in budget)

  OR

  - Owner has right to approve or dispute any items
    - Budget dispute resolution: arbitration vs mediation
  - Operating Capital: new brand costs

Terms Frequently Subject to Negotiation: Approvals *(continued)*

- Employees
  - All hotel employees employed by the Manager
  - Manager wants ability to hire solely at their discretion, while Owner wants approval rights over certain key personnel
  - **Typical negotiation: Owner retains right to approve hiring of General Manager, Director of Sales and/or Controller**

Terms Frequently Subject to Negotiation: Relationship

- Agency vs Independent Contractor
  - Operators prefer to act as Independent Contractors
    - Marriott
  - Operator only wants contractual vs. fiduciary duties
  - Owners require Operators to be Agents
    - To put Owner interest above Operator Interest
    - Negative is Owner is directly liable for Operator's actions

Subordination & Non-Disturbance Agreements

- What is an SNDA?
  - Determines status of a management contract upon foreclosure
    - Can lender terminate the management agreement upon foreclosure or will the hotel will remain encumbered by the management agreement?
  - Determines lenders rights to obtain data and speak to Operator
  - Confirm Operator compliance with agreement, particularly with respect to default notices
- Most brand operators require non-disturbance agreements

What are Management Companies Doing to Secure Management Agreements?

- Key money
- Fund the Property Improvement Plan (PIP)
  - Burns off over the course of the management agreement
- More relaxed terms
  - Longer ramp-up for base fee
  - Greater flexibility with initial term length
  - Reduced technical services fees
- Flexibility on brand standards
  - Stretch renovation dollars further

What are Management Companies Doing to Secure Management Agreements?

- Supplemental Financing (sliver/mezz)
- Short-term fixes to maintain existing agreements
  - Subordinate base fees below debt service
  - Discounted fees (to 0% if necessary) to keep management agreement

Receiverships *(continued)*

- What is a receiver?
  - An entity placed in a role to act as an intermediate hotel operator following a foreclosure while the lender determines their course of action
- Why use a receiver?
  - Best interest of all parties to maintain ongoing operations following a foreclosure
    - Maintain franchise
    - Ongoing cash flows
    - Keep liquor license

Receiverships *(continued)*

- Why do management companies act as receivers?
  - Additional revenue stream
  - New contracts without new development
  - Protection from down cycle
  - Potential to extend short-term contracts to long-term

Branded vs. Independent Operators

Brand

- Experts in how to operate their brands
- No royalty fees
- More infrastructure
- Less flexibility on contract provisions
- Longer terms
- Ability to add real estate premium
- Ability to create market awareness
- Better fit with larger properties
- Clustering/critical mass

Independent Operator

- Potential for more one-on-one attention
- Shorter terms
- More favorable management fee structure
- Franchise fees
- Greater design flexibility
- Easier to terminate upon sale creating greater exit value

Franchise Agreements *(continued)*

- What is a franchise agreement?
  - A contract that outlines the terms between the franchisee (Owner) and franchisor (hotel brand) that both parties must abide by during the life of the agreement for the property to maintain its franchise flag
- UFOC (Uniform Franchise Offering Circular)
  - Call FDD now (Franchise Disclosure Document)
- DSC guaranty renovation requirements

Franchise Agreements *(continued)*

- Terms are uniform: non negotiable
  - Term and renewals
  - Franchise fees, including:
    - Initial fee
    - Royalty fee
    - Reservation fees
    - Marketing fees
    - Loyalty program fees
  - Restricted area (negotiable)

Franchise Agreements *(continued)*

- Additional Resources
  - *The Negotiation and Administration of Hotel Management Contracts* by James Eyster and Jan de Roos
- Comfort Letters
  - Determines the status of the franchise agreement upon lender foreclosure
  - Determines the transition process, which is typically less cumbersome than a change of ownership

Questions?