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HOTEL CONTRACTS

TO LEASE OR NOT TO LEASE?

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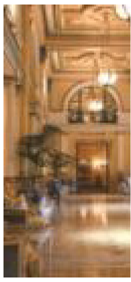

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Summary

Hotel managing companies date back to the early 1900s. Back then, the normal method to supply management services was through total property leases by which the operator leased the hotel from the owner. It was only between 1950 and 1960, following the global hotel expansion, that management agreements were created to provide a buffer against the operating risks associated with unknown uncertainties in foreign countries. In this article, we set out the pros and cons of leases and hotel management agreements, give an example of how they impact on hotel value and discuss the best option for different investors.

Hotel Leases

A lease is an interest in the land and the tenant takes over the property for a certain term. As such, under a lease structure, the hotel company holds the entire financial burden. The hotel company in this case is a tenant and assumes all operating responsibilities together with all the financial obligations; therefore, it enjoys the benefits if the property is successful but suffers all of the losses if the property does not perform adequately. The hotel company receives all of the profits, after rents have been paid. Rental structures can vary depending on the amount of risk that the investor is ready to take. Some of the possible options are:

- **Fixed fee**: this is a fixed rent with indexed growth. This form of lease structure has a guaranteed return, which bears the least risks for the property owner;

- **Share of Revenue**: in this variable lease scenario, the rent is calculated on the amount of sales generated. In this case, the property owner shares some of the risks linked to the level of performance of the hotel. They do, however, have the opportunity to assess the performance of the hotel against market data;

- **Share of Net Operating Income** (NOI): in this variable lease scenario, the rent is linked to the NOI after all the operating expenses have been deducted. This scenario carries the highest risk to the owner, as it also include the operating risk of running the hotel and offers little transparency as to likely income.

Both the revenue-based and NOI-based rents can include a base rent, which is a guaranteed return to the owner (hybrid lease). A hybrid lease might also include some clauses that can be found in management agreements, such as an obligation to maintain brand standards.

The following figure shows the advantages and disadvantages of leases for both owner and operator.

FIGURE 1: ADAVANTAGES AND DISADVANTAGES OF LEASES

Owner		Operator	
Advantages	Disadvantages	Advantages	Disadvantages
The owner retains the title to the property and the residual value created at the end of the lease	The operator has little interest in maintaining the property as the lease comes to expiration and might divert the business to other hotels it manages	The operator retains total control over operations	When the lease term expires the operator loses its rights on the property
The owner incurs minimal financial risk, especially if the hotel company is reliable	The owner is passive and has no control over the hotel's operations	The leasehold value created by the hotel can be realised through a sale (if the lease contract allows it)	The leashold loses/decreases its value as the term come to an end
The owner has no operational responsibilities	The owner does not benefit if/when the property is more profitable than expected	The operational upside is retained solely by the operator	The operator incurs all the operating financial risk
	Leases are more difficult to terminate than management contracts because they create a vested interest in the property for the operator		Leashold interests are a liability on the balance sheet that could negatively afffect value

SOURCE: HVS

Hotel Management Agreements

Hotel Management Agreements (HMAs) can be considered as an agent contract by which the property owner also owns the hotel business and the operator is hired to manage the hotel on behalf of the owner. This contract structure means that the owner carries all the risks but also reaps the greatest part of the rewards. Some of the main HMA structures are:

- **Standard**: a base management fee of 3% of total revenue and an incentive management fee of 10% of gross operating profit (GOP) after base fees;
- **On Layers**: a base management fee of say 2.5% and an incentive management fee based on a threshold of GOP levels or scaled to be lower in the first operating year and reach a higher level in the stabilised year;
- **Hybrid**: base and incentive management fees are associated to a guaranteed return to the owner or subordinated to debt coverage.

We note, however, that HMAs are fully negotiable and can be tailored on specific deals. Since HMAs have become very detailed and sophisticated, it is very important during the negotiation stage to rely on expert advisors.

Figure 2 shows the advantages and disadvantages of HMAs for both owner and operator.

FIGURE 2: ADVANTAGES AND DISADVANTAGES OF HMAs

Owner		Operator	
Advantages	Disadvantages	Advantages	Disadvantages
Quality management and recognition	The owner has limited operational control (although this can be addressed in HMAs)	Opportunity for an inexpensive and rapid expansion which would guarantee a critical mass for optimising performance	The operator does not enjoy the residual benefit of ownership and does not capitalise on the value created
The owner retains ownership benefits (such as, cash flows, depreciation deductions, tax benefits and so forth)	The owner is liable for all expenses (operational, fixed and fees to the operator)	Low downside risk	Minimal control over owner's decisions
	Premature termination of HMAs might result in very high expenses	The operator maintains all operational control	Dependence on owner's financing
	More difficult disposition of the property if it's encumbered with a HMA (although this can be addressed in the HMA)		The agreement can be terminated at any time by the owner (albeit at very high costs)
	The owner suffers higher downside risks (which are shifted to the operator in the case of a lease) – this can be limited by guaranteed return/subject to debt service		

SOURCE: HVS RESEARCH

On account of the current difficult financial environment, we note that HMAs are undergoing a restructuring to reflect a greater alignment of risk by eliminating or reducing some of the disadvantages to the owner. For example, they are granting the owner more operational control while including the possibility for the owner to terminate the HMA upon a sale of the property. Also, HMAs can include some sort of guaranteed return to the owner, sometimes in the form of subordination of operator’s fee to the debt coverage.

The following figure graphically summarises the level of risk/reward to the property owner of the four main different types of lease agreements and HMAs.

FIGURE 3: RISK/REWARD TO THE PROPERTY OWNER

SOURCE: HVS RESEARCH

As illustrated, leases (fixed or variable) are low risk/low reward investments. HMAs offer the opportunity for higher returns but are accompanied by a higher level of risk. We note that hybrid HMAs, developed as a response to the global economic downturn, which has affected hotel performance, offer a higher return than leases but a lower level of risk compared with traditional HMAs.

Impact on Hotel Value – HMAs vs Leases

To illustrate the likely rewards to both parties we have prepared a fictional operations statement. The projected profit and loss account is identical save for the costs of management (HMA Figure 4 and lease Figure 5). We considered an imaginary 160-room proposed hotel. The hotel is due to open in 2013 and is expected to stabilise operations in 2016. We have assumed a ten-year holding period, although we only show the hotel's performance up to the stabilised year. For the purpose of this exercise, we have also assumed a ten-year term for both the HMA and the lease agreement. We note that the following is a theoretical exercise and if any of the assumptions made for the two scenarios were to change then the outcomes would also change. In practice, different agreements might be the optimal choice for specific investors on specific properties.

HMA Scenario

For the purpose of our exercise, we have assumed a base management fee of 2.5% of total revenue and a scaled incentive fee based on achieved levels of GOP as outlined below.

GOP Level over Total Revenue	Incentive Fee as a % of NOI
GOP <30%	3%
30%<GOP<40%	5%
GOP>40%	10%

We note that in this case there is more risk to the operator with the incentive fee being calculated on NOI after all fixed expenses have been deducted.

FIGURE 4: HOTEL PERFORMANCE WITH HMA (£ 000s)

	2013				2014				2015				Stabilised			
Number of Rooms:	160				160				160				160			
Days Open:	365				365				365				365			
Occupied Rooms:	26,280				29,784				30,952				33,872			
Occupancy:	45%				51%				53%				58%			
Average Rate:	480.00				515.00				555.00				570.00			
RevPAR:	216.00	% Gross	PAR	POR	262.65	% Gross	PAR	POR	294.15	% Gross	PAR	POR	330.60	% Gross	PAR	POR
REVENUE																
Rooms	12,614	66.6 %	78,838	479.98	15,339	68.5 %	95,869	515.01	17,178	68.3 %	107,363	554.99	19,307	69.2 %	120,669	570.00
Food and Beverage	4,455	23.5	27,844	169.52	5,009	22.4	31,306	168.18	5,700	22.7	35,625	184.16	6,190	22.2	38,688	182.75
Spa/Health Club	1,535	8.1	9,594	58.41	1,695	7.6	10,594	56.91	1,901	7.6	11,881	61.42	2,017	7.2	12,606	59.55
Other Income	329	1.7	2,054	12.51	346	1.5	2,165	11.63	357	1.4	2,232	11.54	374	1.3	2,337	11.04
Total Revenues	18,933	100.0	118,329	720.42	22,389	100.0	139,934	751.73	25,136	100.0	157,101	812.10	27,888	100.0	174,300	823.33
DEPARTMENTAL EXPENSES *																
Rooms	3,208	25.4	20,051	122.07	3,421	22.3	21,381	114.86	3,540	20.6	22,125	114.37	3,740	19.4	23,373	110.41
Food and Beverage	4,383	98.4	27,393	166.78	4,471	89.3	27,941	150.10	4,560	80.0	28,500	147.32	4,787	77.3	29,916	141.31
Spa/Health Club	1,425	92.9	8,909	54.24	1,454	85.8	9,088	48.82	1,483	78.0	9,269	47.92	1,513	75.0	9,455	44.66
Other Expenses	207	63.0	1,295	7.88	213	61.6	1,333	7.16	218	61.1	1,364	7.05	224	60.0	1,402	6.62
Total	9,224	48.7	57,648	350.98	9,559	42.7	59,743	320.94	9,801	39.0	61,258	316.66	10,263	36.8	64,146	303.01
DEPARTMENTAL INCOME	9,709	51.3	60,681	369.44	12,831	57.3	80,191	430.79	15,335	61.0	95,843	495.44	17,625	63.2	110,153	520.33
UNDISTRIBUTED OPERATING EXPENSES																
Administrative & General	2,070	10.9	12,935	78.75	1,944	8.7	12,152	65.28	2,004	8.0	12,522	64.73	1,573	5.6	9,829	46.43
Marketing	1,099	5.8	6,867	41.81	1,151	5.1	7,194	38.65	1,192	4.7	7,453	38.53	741	2.7	4,630	21.87
Prop. Operations & Maint.	903	4.8	5,641	34.34	1,046	4.7	6,535	35.10	1,130	4.5	7,060	36.49	1,019	3.7	6,370	30.09
Utilities	1,020	5.4	6,377	38.82	1,069	4.8	6,680	35.89	1,107	4.4	6,921	35.78	1,152	4.1	7,201	34.02
Total	5,091	26.9	31,819	193.72	5,210	23.3	32,562	174.92	5,433	21.6	33,956	175.53	4,485	16.1	28,030	132.40
GROSS OPERATING PROFIT (GOP)	4,618	24.4	28,862	175.72	7,621	34.0	47,629	255.86	9,902	39.4	61,887	319.91	13,140	47.1	82,124	387.92
Management Fee	473	2.5	2,958	18.01	560	2.5	3,498	18.79	628	2.5	3,928	20.30	697	2.5	4,357	20.58
GOP AFTER MANAGEMENT FEES	4,145	21.9	25,904	157.71	7,061	31.5	44,131	237.07	9,273	36.9	57,959	299.61	12,443	44.6	77,766	367.34
FIXED EXPENSES																
Property Taxes	311	1.6	1,944	11.84	317	1.4	1,983	10.65	324	1.3	2,023	10.46	330	1.2	2,063	9.75
Insurance	259	1.4	1,620	9.86	264	1.2	1,653	8.88	270	1.1	1,686	8.71	275	1.0	1,720	8.12
Incentive Management Fee	96	0.5	599	3.65	290	1.3	1,815	9.75	384	1.5	2,398	12.40	1,072	3.8	6,701	31.65
Reserve for Replacement	379	2.0	2,367	14.41	672	3.0	4,198	22.55	1,005	4.0	6,284	32.48	1,116	4.0	6,972	32.93
Total	1,045	5.5	6,530	39.76	1,544	6.9	9,649	51.83	1,983	7.9	12,391	64.05	2,793	10.0	17,456	82.46
Net Operating Income	3,100	16.4 %	19,373	117.95	5,517	24.6 %	34,482	185.24	7,291	29.0 %	45,568	235.56	9,650	34.6 %	60,310	284.88

* Departmental expenses are expressed as a percentage of departmental revenues.

SOURCE: HVS'S PROJECTIONS

Lease Agreement Scenario

We have assumed a fixed base lease of £300,000 in the first year of operation, £500,000 in the second year, £800,000 in the third year and £1 million in the fourth year indexed, thereafter to the Consumer Price Inflation (CPI). Furthermore, from the second year of operation we have assumed a turnover rent as follows.

Year	Turnover Rent
2	3% of rooms revenue and 0% of food and beverage revenue
3	5% of rooms revenue and 3% of food and beverage revenue
4	10% of rooms revenue and 5% of food and beverage revenue

FIGURE 5: HOTEL PERFORMANCE WITH LEASE (£ 000s)

	2013				2014				2015				Stabilised			
Number of Rooms:	**160**				**160**				**160**				**160**			
Days Open:	**365**				**365**				**365**				**365**			
Occupied Rooms:	**26,280**				**29,784**				**30,952**				**33,872**			
Occupancy:	**45%**				**51%**				**53%**				**58%**			
Average Rate:	**480.00**				**515.00**				**555.00**				**570.00**			
RevPAR:	**216.00**	**% Gross**	**PAR**	**POR**	**262.65**	**% Gross**	**PAR**	**POR**	**294.15**	**% Gross**	**PAR**	**POR**	**330.60**	**% Gross**	**PAR**	**POR**
REVENUE																
Rooms	12,614	66.6 %	78,838	479.98	15,339	68.5 %	95,869	515.01	17,178	68.3 %	107,363	554.99	19,307	69.2 %	120,669	570.00
Food and Beverage	4,455	23.5	27,844	169.52	5,009	22.4	31,306	168.18	5,700	22.7	35,625	184.16	6,190	22.2	38,688	182.75
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Total	9,224	48.7	57,648	350.98	9,559	42.7	59,743	320.94	9,801	39.0	61,258	316.66	10,263	36.8	64,146	303.01
DEPARTMENTAL INCOME	9,709	51.3	60,681	369.44	12,831	57.3	80,191	430.79	15,335	61.0	95,843	495.44	17,625	63.2	110,153	520.33
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Marketing	1,099	5.8	6,867	41.81	1,151	5.1	7,194	38.65	1,192	4.7	7,453	38.53	741	2.7	4,630	21.87
Prop. Operations & Maint.	903	4.8	5,641	34.34	1,046	4.7	6,535	35.10	1,130	4.5	7,060	36.49	1,019	3.7	6,370	30.09
Utilities	1,020	5.4	6,377	38.82	1,069	4.8	6,680	35.89	1,107	4.4	6,921	35.78	1,152	4.1	7,201	34.02
Total	5,091	26.9	31,819	193.72	5,210	23.3	32,562	174.92	5,433	21.6	33,956	175.53	4,485	16.1	28,030	132.40
GROSS OPERATING PROFIT (GOP)	4,618	24.4	28,862	175.72	7,621	34.0	47,629	255.86	9,902	39.4	61,887	319.91	13,140	47.1	82,124	387.92
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Property Taxes	311	1.6	1,944	11.84	317	1.4	1,983	10.65	324	1.3	2,023	10.46	330	1.2	2,063	9.75
Insurance	259	1.4	1,620	9.86	264	1.2	1,653	8.88	270	1.1	1,686	8.71	275	1.0	1,720	8.12
Turnover Lease	0	0.0	0	0.00	460	2.1	2,876	15.45	1,030	4.1	6,437	33.27	2,240	8.0	14,001	66.14
Base Lease	300	1.6	1,875	11.42	500	2.2	3,125	16.79	800	3.2	5,003	25.86	1,000	3.6	6,251	29.53
Reserve for Replacement	379	2.0	2,367	14.41	672	3.0	4,198	22.55	1,005	4.0	6,284	32.48	1,116	4.0	6,972	32.93
Total	1,249	6.6	7,806	47.53	2,214	9.9	13,835	74.32	3,429	13.7	21,432	110.79	4,961	17.8	31,007	146.47
Net Operating Income	3,369	17.8 %	21,056	128.19	5,407	24.1 %	33,794	181.54	6,473	25.7 %	40,455	209.12	8,179	29.3 %	51,116	241.46

* Departmental expenses are expressed as a percentage of departmental revenues.

SOURCE: HVS'S PROJECTIONS

To illustrate the returns to each party, the table below shows the significant difference in rewards for each party when they take a different position on risk.

Stabilised-Year Income	HMA Scenario	Lease Scenario
To the Owner	£9,650	£3,240
To The Operator	£1,769	£8,179

From a pure reward basis, it is clear which option would be favoured by each party.

To further emphasis the different risk/reward profiles, the following figure shows the different valuation parameters applied to lease and HMA structures as well as the hotel values under the two scenarios. Figures 6A and 6B show the return to the owner and operator under the HMA and Figures 6C and 6D, under the lease agreement.

FIGURES 6A AND 6C: HOTEL VALUES UNDER THE HMA AND THE LEASE (£)

6A HMA – Hotel Value to the Owner		
Stabilised Year:	2016	
Inflation:	2	%
Loan to Value:	60	%
Amortisation:	20	years
Term:	10	years
Interest Rate:	6.25	%
Terminal Capitalisation Rate:	9	%
Equity Yield:	18	%
Income Value:	**75,900,000**	

6C Leasehold Interest – Hotel Value to the Operator		
Stabilised Year:	2016	
Inflation:	2	%
Loan to Value:	50	%
Amortisation:	20	years
Term:	10	years
Interest Rate:	6.25	%
Terminal Capitalisation Rate:	16	%
Equity Yield:	21	%
Income Value:	**45,700,000**	

SOURCE: HVS

FIGURE 6B: FEE-STREAM VALUATION AND RETURN TO THE OPERATOR (£ 000S)

Terminal Capitalisation Rate	7.0%
Discount Rate	5.30%

Calendar Years	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Base Management Fee	473	560	628	697	702	716	730	745	759	775	790
Incentive Management Fee	96	290	384	1,072	1,002	1,022	1,042	1,063	1,085	1,106	1,128
Total Received Rent	569	850	1,012	1,769	1,704	1,738	1,772	1,808	1,844	1,881	1,918
Reversion Value										26,996	
Total Net Rent	569	850	1,012	1,769	1,704	1,738	1,772	1,808	1,844	28,876	1,918
Discount Factor	0.9497	0.9019	0.8565	0.8134	0.7724	0.7336	0.6966	0.6616	0.6283	0.5966	
Discounted Rent Cash Flow	541	767	867	1,439	1,316	1,275	1,235	1,196	1,159	17,229	

Present Value of Total Received Fees	**27,022**
(Say)	**27,000**

Reversion Analysis

11th Year's Net Operating Income	1,918
Total Sales Proceeds	27,407
Less: Transaction Costs @ 1.5%	411
Net Sales Proceeds	26,996

SOURCE: HVS

FIGURE 6D: LEASE RENT VALUATION AND RETURN TO THE OWNER (£ 000S)

Terminal Capitalisation Rate	6.0%
Discount Rate	5.0%

Calendar Years	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Turnover Rent	0	460	1,030	2,240	2,266	2,311	2,357	2,405	2,453	2,502	2,552
Fixed Rent	300	500	800	1,000	1,020	1,041	1,061	1,083	1,104	1,126	1,160
Total Received Rent	300	960	1,830	3,240	3,286	3,352	3,419	3,487	3,557	3,628	3,712
Reversion Value										60,937	
Total Net Rent	300	960	1,830	3,240	3,286	3,352	3,419	3,487	3,557	64,565	3,712
Discount Factor	0.9524	0.9070	0.8638	0.8227	0.7835	0.7462	0.7107	0.6768	0.6446	0.6139	
Discounted Rent Cash Flow	286	871	1,581	2,666	2,575	2,501	2,430	2,360	2,293	39,637	

Present Value of Total Received Rent	**57,200**
(Say)	**57,200**

Reversion Analysis

11th Year's Net Operating Income	3,712
Total Sales Proceeds	61,865
Less: Transaction Costs @ 1.5%	928
Net Sales Proceeds	60,937

SOURCE: HVS

In both scenarios, the total value of the asset (both parties' interests combined) is approximately £103 million, but how that value is divided depends on the risk/reward profile.

HMA Scenario: Figures 6A and 6B

Owner's perspective

Value to the owner is the operational income stream once the management fees have been deducted (Figure 6A). For accepting the operational risk, the owner receives a 30% increase in return compared with the operating value resulting under a lease agreement. Property owners must then consider whether that risk/reward profile is acceptable. Having illustrated the different values to the owner, we can now turn to the capitalisation of income to the operator.

Operator's perspective

Value to the operator is the income stream generated from the fees payable (Figure 6B). The higher terminal capitalisation rate assumed in the valuation of management fees (compared to the valuation of the rent payable in Figure 6D) accounts for the higher risk of a fully turnover-based fee payable.

Lease Agreement Scenario: Figures 6C and 6D

Owner's perspective

Value to the owner is the income stream generated from the rent payable (Figure 6D). The terminal capitalisation rate is reduced in the lease scenario as the income stream is certain and there is little risk fluctuation to the property owner's income. However, if this was not a hybrid lease the difference would be more pronounced.

Operator's perspective

Value to the operator consists of the value of the operational income stream once the rent has been deducted (Figure 6C). Valuing the hotel operation under the lease agreement scenario (Figure 6C), we have assumed a higher terminal capitalisation rate and equity yield paired with a lower gearing to account for the long term higher risk of the rent payable's fixed component.

We note that although a lease agreement provides a safer, less risky, return to the owner, it also determines a reduced value of the hotel operational income stream. As shown in figure 6A and 6C, the hotel's value to the operator under the lease agreement is reduced by approximately 40% compared to the hotel's value to the owner under the HMA. This is due to the fact that the lease rent is payable on the top line before any expenses are deducted; thus, it has a larger impact on NOI compared to management fees, which are paid as a percentage of GOP or, in some cases, NOI. Also, the rent's fixed component increases the risk to hotel operation during a downturn.

Based on the two scenarios and the valuation parameters outlined above, the value of the interests of either party is as follows.

Hotel Value	HMA Scenario	Lease Scenario
To the Owner	£75,900,000	£57,200,000
To The Operator	£27,000,000	£45,700,000

Finally, to fully reconcile the risk/reward profile a total return should be calculated. That is, the property interest valued and income stream are directly correlated. A higher operating performance generally corresponds to a higher value. An exception to this is the fixed rent, which eliminates any variable gain/loss related to the hotel's performance.

Conclusion: To Lease or Not to Lease?

It depends! Different investors have different appetite. A high-risk, high-return oriented investor such as private investors and equity funds will be more attracted by the opportunities set forth by the HMA. We note, however, that it is advisable that either the investor is knowledgeable of the hotel sector or that he seeks the support of expert advisors in order to draft the optimal HMA.

A low-risk oriented investor such as insurance companies and family trusts will be more attracted towards the lease agreements which, even though they have a lower return, represent a less risky, safer income stream.

Moreover, we note that operators are not keen on signing lease agreements as they are service providers and their expertise lies in the management of the hotel business. From the owner perspective, it makes sense to lease properties that are more liquid, such as budget and mid-market hotels. Upscale and luxury hotels and resort properties are rarely subject to leases and almost always to HMAs, as they are more illiquid and it is harder to dispose of them.

It is worth noting that a lease would bring a vested interest in the property to the operator. This would be beneficial to the operator as it would protect it from a possible abrupt termination of the HMA by the owner, as this always preserves the power (if not the right) to terminate the agreement at any time (as was the case in the recent dispute of Turnberry v Fairmont Hotel and Resorts).

We further note that, in the current troubled economic environment, limited debt available forces investors to make mainly equity investments. This triggers higher required returns on investment. Insurance companies for example will consider investing in hotels, instead of office or retail, only if they foresee a yield premium.

To conclude, whatever the agreement between the owner and the operator, both parties must be incentivised to continuously and sustainably increase the property's profitability. Should the hotel underperform, the owner would bear the consequences not only in the case of a HMA but also with a lease if the operator is not able to guarantee a level of profits that supports the rent payable. Hybrid and variable leases allow more flexibility and reduce the risk of unsustainable rental levels. However, doesn't a variable lease resemble more and more to a hotel management agreement, especially when HMAs start including forms of guaranteed return to the owner? It seems that hotel contracts are reaching a level of optimal balance between operators' and owners' return, while preserving the value of the asset which is ultimately what sustains both returns.

About HVS

HVS is the world's leading consulting and services organisation focused on the hotel, restaurant, shared ownership, gaming, and leisure industries. Established in 1980, the company performs more than 2,000 assignments per year for virtually every major industry participant. HVS principals are regarded as the leading professionals in their respective regions of the globe. Through a worldwide network of 30 offices staffed by 400 seasoned industry professionals, HVS provides an unparalleled range of complementary services for the hospitality industry. For further information regarding our expertise and specifics about our services, please visit **www.hvs.com**.

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