

# Addressing the balance

In a weakening market, ensuring the interests of the hotel owner and operator are aligned is essential for the successful financial performance, say **Richard Bursby** and **Paul Smith**

## COLUMNIST

There has been a trend in recent years for hotels to be operated on behalf of the owner by a third party operator under a management agreement. One of the vital requirements for a successful relationship between a hotel owner and operator is the alignment of interests between the parties and the main tool the parties have used to realise this is through linking the income each party receives to the revenue and profits generated by the hotel.

The traditional fee structure in a management agreement is for the owner to take the benefit of the profits of the hotel (but to also incur the losses of the business) and the operator to receive a basic fee (usually in the region of 2% - 3% of the hotel's revenue) and an incentive fee (usually in the region of 8% - 12% of the hotel's gross or adjusted gross operating profit). By structuring the fees and income in such a way, the operator is incentivised to maximise the revenue and profitability of the hotel and therefore both its fees and the return to the owner.

However, and particularly in times of a downturn when hotel occupancy rates and REVPAR are falling, this simplistic fee structure does not truly align the interests of the owner and operator. For example, a fall in a hotel's REVPAR would lead to a decrease in the operator's fees, but to a much larger, disproportionate decrease in the income received by the owner. In the same way, the operator is much less impacted in the decline in its incentive fee by an increase in costs and reduced profitability than the owner. Furthermore, whilst the operator will be concerned about any reduction in its fees, it is also concerned about maintaining brand standards (elements of which may



The balance between the owners and operators interests must be aligned

**“PROPERLY EXECUTED SECURITISATION REMAINS A PROMISING SOLUTION TO CAPITAL DEMANDS FOR THE HOSPITALITY SECTOR”**

not produce an appropriate return for the owner) and keeping hotels flagged with its brand and so can take a broader view. The owner is concerned with making a return on its investment and making interest payments.

So what can be done to better align the interests of an owner and operator and provide protection for owners in difficult times?

**Owner's Priority:** The operator should agree to subordinate part or all of its incentive management fee to an agreed amount of debt service on the hotel or to pre-agreed levels of EBITDA (earnings before interest, tax, depreciation and amortisation). The operator will insist on a right to claw back the deferred incentive fee out of subsequent years profits.

**Operator Guarantees:** The operator may guarantee to the owner that a minimum level of gross operating profit will be achieved each year by the hotel. If this is not achieved, the operator will fund the shortfall but with the right to claw this payment back out of subsequent years profits.

**Performance Targets:** The operator's incentive fees may be performance related and depend on certain performance levels being reached (such as having an incentive fee ratchet up as the level of gross operating profits increase). In addition, if the hotel fails to meet certain financial targets or underperforms its competitor set, the owner should have the right to terminate the management agreement.

**Reductions in FF&E Reserve:** Various mechanisms may be agreed to provide for monies allocated to the FF&E Reserve to be either used for working capital purposes (rather than just held as cash in a segregated account) or to be reduced to support an owner's return (ie. the contribution to the FF&E Reserve is reduced from say 4% to 3% and the balance paid to the owner).

**Sliver Equity:** Minority holdings by the operator of equity in the owner are a good way of ensuring the operator shares some of the pain and also focuses on ROCI (return on capital invested) as well as its fees.

By addressing these issues, owners and operators can establish a relationship which is far more likely to succeed regardless of market conditions. ■

Richard Bursby is partner and Paul Smith associate at Taylor Wessing (Hotels Group). Taylor Wessing LLP is a leading law firm providing support for commercial organisations doing business in Europe, the Middle East and China. For more information visit [www.taylorwessing.com](http://www.taylorwessing.com). The authors can be reached on [r.bursby@taylorwessing.com](mailto:r.bursby@taylorwessing.com) and [p.smith@taylorwessing.com](mailto:p.smith@taylorwessing.com)