SHA562: Control of Hotel Real Estate

This course includes

- Two self-check quizzes
- Multiple discussions; you must participate in two
- One tool to download and use on the job
- One scored project
- One final action plan assignment
- One video transcript file

Completing all of the coursework should take about five to seven hours.

What you'll learn

- List factors that influence decisions about who controls the daily operations of hotels and explain why these factors are influential
- Describe the key attributes of contemporary hotel leases and their applicability in different international settings
- Evaluate a proposed franchise agreement
- Assemble term sheets for new management contracts
- Analyze management contracts from the perspectives of owners and operators

Course Description

This course, produced in partnership with the Cornell School of Hotel Administration, explores the ways hotel investors separate ownership from control of the hotel. It examines the two major decisions owners face. First, what are the benefits and costs of franchise affiliation? Second, under what conditions should an owner hire a professional operator?

In the course, you examine contemporary hotel leases prevalent around the world. You financially evaluate a potential franchise affiliation. Finally, you explore how to negotiate management contracts and learn to prepare term sheets considering the perspectives of both owners and operators.

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Professor Jan A. deRoos, on the faculty of the Hotel School since 1988, has devoted his career to hospitality real estate, with a focus on the valuation, financing, development, and operation of lodging, timeshare, and restaurant assets. He holds B.S., M.S., and Ph.D. degrees from Cornell University, all with majors in Hotel Administration. Areas of teaching expertise span the entire range of hospitality real estate topics: real estate finance; real estate principles; hotel asset management; real estate portfolio management; hotel and restaurant valuation; lodging market and feasibility analysis; hotel/resort planning and design; hotel/resort development and construction, and the analysis of timeshare/vacation ownership projects. He teaches courses in the Hotel School's undergraduate and graduate degree programs, teaches extensively in the Hotel School's executive education programs, and has developed an on-line professional Certificate in Hotel Real Estate Investments and Asset Management.

Start Your Course

Module Introduction: The Hotel Owner-Operator-Lender Partnerships

The question of control-how control is apportioned between the owner and the operator of a hotel-has a powerful influence on the outcome of a hotel investment. Control influences the hotel's financial performance and the returns each partner earns. Control is also a key means of shifting risk between partners. This module introduces the major control questions and examines one of the control options: hotel leases.

When you have completed this module, you will be able to:

- Describe owners' major options for control of the hotel
- Connect the interests of owners and operators with the available branding and operating options
- Describe the key attributes of contemporary hotel leases and their applicability in different international settings

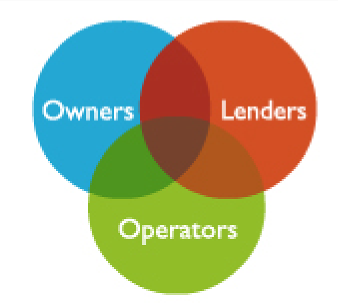
Listen: Who Controls the Operation of the Property?

The question of who controls the operations of a hotel, who operates or manages the hotel, is important, and has a range of answers. One of the first questions owners face concerns control: who will operate the hotel? Click the link below to hear Prof. deRoos describe the options owners must consider and explain what is at stake in the decision.

The operator or manager faces a different set of options. Click the link below to hear Prof. deRoos describe the control options facing a hotel operator.

Watch: Income Statement

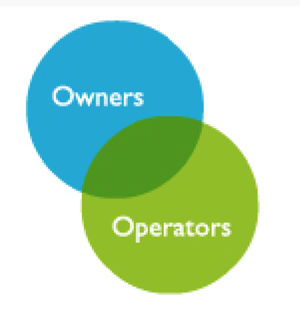
An illustrated presentation appears below. Use this resource to enhance your understanding of how the operator and the owner get paid through an analysis of the standard hotel income statement.



Read: The Partnership: Owner, Operator, and Lender

Most hotel real estate projects involve a three-way partnership among owners, operators, and lenders. Each of these partners seeks to structure a hotel investment to achieve their goals or further their interests. In general, owners seek a sufficient return on their investment. Operators seek revenues sufficient to fund their fees. Lenders seek a healthy yield on their loan. A successful investment brings together each of the partners in an agreement that is mutually advantageous.

In this course, we are concerned with two questions: who controls the real estate asset? How is control apportioned among the relevant partners?



In this analysis, the lenders play the role of an interested observer. They do not generally have a significant role in the decision. Once an operator is selected, the lender requires an agreement with the operator specifying the lender's obligations to the operator in the case of an owner default. Otherwise, lenders have little to do with control questions.

The key questions to be considered:

- Who has control and how is it specified?
- How does the control relationship shift risk between the two partners?

Both questions need to be borne in mind throughout the course.

Watch: Operator and Brand

Owners face a series of control decisions. Will the owners operate the property? If yes, under what terms? If no, how will they hire an operator?

An illustrated presentation appears below. Use this resource to enhance your understanding of the range of control options available to hotel owners and operators.

Read: If the Owner Operates

Let's look more closely at the different control options. Recall that owners face a decision: do they want to manage the property themselves or do they want to hire a manager to operate? Here we consider the first scenario, in which the owners operate or manage the property. In this situation, there are essentially three options.

Independent Hotel

With an independent hotel, the owners manage without any outside relationship to other hotels. The owners have complete control. They are not beholden to a franchisor or a branded manager. They don't have to conform to any franchise or brand standards. That is the good news. The bad news is that they must operate without the support a brand provides. They must create their own national or international marketing programs, and they must create relationships that allow guests to book the hotel without the leverage of a brand reservation system. This entails a substantial amount of work. But good owners can make this work for them, especially for a unique property or a property with a local, loyal clientele.

Referral

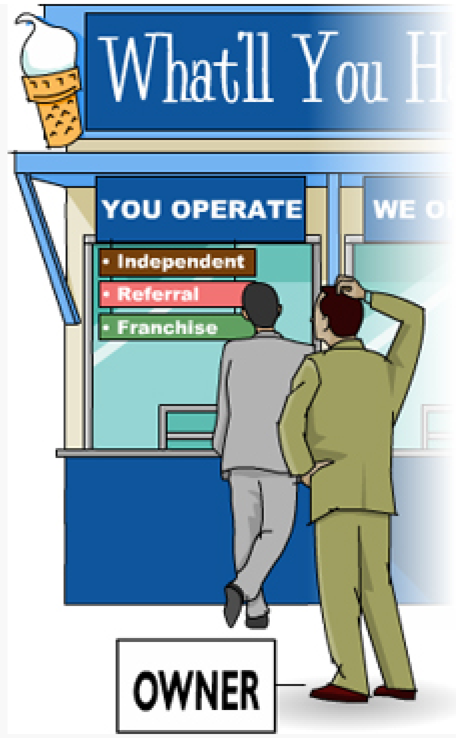
A referral provides a middle ground between independence and a franchise. The hotel belongs to an association such as Preferred Hotels, Relais Chateau, or Leading Hotels of the World. The referral organizations provide marketing and a significant distribution system for the owners. The member hotels do not pay a royalty, but do pay for the association's international marketing and distribution systems. There may be some performance standards, some minimum signage standards, and expectations for the use of the loyal preferred customers program. The cost per reservation through the preferred customer program is not trivial. For example, the cost per reservation in the Leading Hotels system is between $30 and $40 per reservation. Although these costs may seem significant, they are not seen as inappropriate, given the benefits.

Franchise

The most extensive relationship an owner can enter while still operating the hotel is becoming a franchisee. The franchisor creates brand standards and imposes them on the franchisee. This brings a great deal of standardization to the property, which is both good and bad. Franchised hotels lose the individuality of independent hotels, but many customers look for precisely the standardization that franchises provide.

On the benefit side, the franchise brings the owner a large and efficient international marketing and sales organization. The owner receives the infrastructure-the 1-800 number, the dot-com address-created by the brand. Additionally, in many secondary and tertiary markets, lenders will only lend to branded hotels. If you want to be Ye Olde Independent Inne in Concord, New Hampshire, it may be very difficult to obtain financing. If you want to be the next Hampton Inn in Concord, it will be much easier with the brand.

With these benefits come significant costs. These include a royalty fee of between 4% and 6% of total revenues. The royalty is a fee for the ability to use the brand's name, trademarks, and standards. Additionally, marketing fees, reservation fees, system charges, and cost-of-compliance charges all get factored into the costs of affiliation. The total costs of a franchise are between 6% and 12% of total revenues.



Read: Referral

Key Points

Third party management offers benefits to owners

Management contract or lease are the options

Suppose the owner does not want the responsibility of operating the hotel. The owner can decide to hire a third party to operate the hotel and to deliver the financial benefits that come from operating the property. In this case, what are the choices? There are two fundamental options, the management contract and the lease.

Management Contract

In signing a management contract with an operator, the owner receives professional management but gives up a great deal of influence on the property. Owners are often well versed in the discipline of hotel asset management. But the management contract has a non-disturbance clause, which limits the owner's ability to influence day-to-day operations.

The financial risk in a management contract is fundamentally borne by the owner. The operator runs a property on the owner's behalf, generally as the owner's agent. The operator is paid a fee for providing those services, and the owner gets the cash flow from the property. The operator shares some financial risks through the incentive fee mechanism, but when bad things happen the financial losses are borne by the owner.

If you hire a branded operator, that operator will provide the brand standards and the international and regional marketing systems. The operator provides group purchasing benefits by aggregating the value of the goods they purchase and having preferred vendor relationships. Lastly, the operator may be willing to co-invest in the property through the provision of key money, a loan, or in rare instances, some equity capital.

What are the costs? The costs come in three categories. First there is a basic fee, usually between 2% and 3% of gross revenues. Second, there is an incentive management fee, which is some function of cash flow from the property. Third, there are system-reimbursable expenses that "make the operator whole" for running their systems. These expenses include marketing, sales, reservations, purchasing, accounting, training, and other systems that are provided corporation-wide for the benefit of the individually managed properties. We take a detailed look into management contract terms later in the course.

Lease

A second option for hiring an operator is to sign a lease. A hotel lease works like any landlord-tenant relationship. The property owner is a landlord, and the operator is a tenant. What does the owner get in this relationship? As with a management contract, the owner receives professional management of the property. However, there are important differences. Under a lease, the tenant has "quiet enjoyment of the property," meaning no owner involvement. In exchange for money, the owner generally is prohibited from intervening in any way. In exchange for the lease and no owner involvement, the operator takes all the financial risk. This means that if bad things happen, if the cash flow falls precipitously, the operator still has to pay rent to the owner.

Rents come in a variety of forms. Rent can be fixed, meaning that there is a base rent indexed to inflation. Rent can be variable, meaning that rent is some negotiated function of property revenues. Rent can also be a hybrid of the two, in which the tenant pays a base rent or a percentage rent, whichever is higher. We look more closely at lease terms later in the course.

Listen: Introduction to Leases

Hotel leases are a form of control relationship common in many parts of the world. Leases are one means by which owners and operators work out the question of control. Although leases are not as prevalent as franchise agreements or management contracts in the United States, they are an important form of control in other parts of the world. Click the diagram to hear Prof. deRoos describe the benefits owners and operators might see in a lease.

Why lease a hotel?

We first consider the question from the perspective of the owner and then from the perspective of the operator or manager. From the owner's standpoint, the choice is between a management contract or a lease. They see the lease as a risk management or financial engineering device; either term would be synonymous here. What a lease does is turn risky cash flows from operations into much less risky rents. Properly structured, lease revenues (or rents) are much less volatile than cash flows from operations, because the tenant has to pay the rent regardless of economic conditions.

Let's contrast this with the operator's perspective. While owners use leases to lower their risk, operators often use leases to take on more risk in return for larger fees. Operators need to decide whether, in the long run, they want to operate the property under a management contract or under a lease.

Often, operators begin by owning a property. They then sell the property to a new owner conditional on the right to continue to operate the property. If they operate under a management contract, this is called a sale-manageback. If they operate under a lease, it is called a sale-leaseback. Sale-leaseback is seen as an attractive alternative to a sale-manageback. It is a way to earn higher-than-market fees for operating the property, using a lease to take on greater financial risk. The operator agrees to pay contract rents to the owner in exchange for the right to operate the property and to collect all of the operating revenues. If the operating revenues under the sale-leaseback are significantly greater than the contract rents, the operator has the opportunity to earn significant profits-in some cases, the profits are larger than the fees from managing the property. The lease structure requires the operator to take on the risk of paying minimum rents, in exchange for earning significant profits by operating efficiently.

Watch: Hotel Leases Around the World

An illustrated presentation appears below. Use this resource to enhance your understanding of how hotel leases work and how they are commonly structured in different parts of the world.

Read: Lease Terms and Issues

Key Points

The provisions of a lease are structured to apportion responsibilities

Responsibilities are apportioned between the owner (lessor) and the operator (the lessee)

The goal of apportioning responsibilities between the owner and the operator is to avoid a series of "moral hazards," in which one party has an incentive to underinvest or underperform. Keep this in mind as you review the major issues in lease terms.

Hotel Lease Issues

Term of the lease: Leases are generally long-term documents: 20 years is an absolute minimum, and 30 to 40 years is much more common. There are even some 84-year leases, structured as seven distinct 12-year rolling terms, with the lease terminable every 12 years.

Renewal: Leases are generally renewed at the option of the tenant, not at the option of the owner.

FF&E: Who owns the FF&E? There are two general ways this is handled. In the first, the owners rent their walls, and tenants bring their FF&E with them. The tenants own FF&E and are responsible for its replacement. In the second, the tenants get the FF&E that was in the hotel when they took over the lease, they are responsible for the FF&E until the end of the lease, and at the end of the lease they must give the owner back an equivalent amount of FF&E value adjusted for inflation. Invariably, due to moral hazard considerations, the tenant is responsible for FF&E replacement. If the owner is responsible for FF&E replacement, operators always want more and better FF&E. The long-term annual cost of FF&E replacement is usually between 3% and 4% of revenues.

Capital expenditures: Who is responsible for keeping the bones of the building-the boiler structure, the pumping systems, the exterior closure, the roof, the elevators-in shape over the long term? In most cases owners are responsible for capital expenditures to replace any of these items. They set aside the money from rent for facilities maintenance. In some cases, the operator accepts this responsibility in exchange for lower rent. Long-term annual capital expenditures are roughly 2% of revenues.

Maintenance: In general, the operators are completely responsible for maintenance, which refers to the regular maintenance of the building's "bones". The operators pay the rent, and in addition they pay for maintaining the building. The owner may hire an inspection team to insure that proper maintenance is being performed.

Security deposit: In general, the industry has a one-year-rent requirement for security deposits. In some cases, it could be two years of rent and an additional security deposit. Given the large sums of money involved, owners may accept letters of credit in lieu of the security deposit.

Insurance: In general, the operator carries the liability insurance on the building, with the minimums established by the owner. In some cases, if the owner is an insurance company, the owner may offer the operator insurance at a lower fee.

Assignment: Does the tenant have the right to sublease the building to a third party? The answer is usually no. The tenant is leasing the building for a specific purpose, contracting with a specific operator for their management and their brand. In general it's in the operator's best interest to be allowed to sublease and it is in the owner's best interest not to allow sublease. Owners rarely grant this right.

Standards: The maintenance of brand or franchise affiliation is very important to the operator and the owner, because the brand is often a key element in the owner's ability to pay rent. So owners are very concerned about the tenant's ability to maintain the brand affiliations and standards. Owners may want some measure of reporting from the operator. Given that the owner has no role in operations, however, operators see reporting requirements as onerous. Reports to owner are generally monthly, sometimes quarterly or even yearly, but certainly not the weekly or daily reporting typical in a managing contract environment.

Audits: Owners have the right to audit from time to time. If the audit finds nothing, the owner pays. If the audit finds the operator has been misreporting or violating general audit standards, the operator pays for that audit, in addition to compensating the owner for any fee shortfalls.

End of term: There are two separate issues here. First, does the operator have the option to purchase the hotel at the end of the lease term? This is generally negotiable. It serves the operator to have the right to purchase the building, keep control of it, and then sell it to another owner. Owners are understandably reluctant to provide advance purchase options, but many of them will negotiate this point.

Second, what happens in the last, say, two to three years of the lease, especially in an environment where the operator knows that the lease won't be renewed? At that point, the operators have a big incentive to underinvest, undermaintain, or even shift business to another hotel they operate in the market. It is vitally important for the owner to engage the operator in early conversation to prevent these problems in the last years of the lease.

Module Introduction: Negotiating Contemporary Hotel Franchise Agreements

Franchise agreements are one method an owner can use to operate a hotel while benefiting from the recognition, distribution, and reach of a brand. Making a wise franchise affiliation decision requires a thorough understanding of the costs and benefits of affiliation. In this module, use quantitative and qualitative means to evaluate the franchise affiliation decision.

When you have completed this module, you will be able to:

- Examine the quantitative and qualitative methods used to evaluate franchise affiliation
- Analyze the financial costs and benefits of franchise affiliation for owners
- Assess the qualitative impact of a franchise affiliation
- Explain how franchising is changing and what factors will probably drive this change in the future

Read: Franchising Around the World

Key Points

Franchising offers certain benefits for owners

Franchising mitigates certain risks, lowers some costs

Franchising offers opportunities and benefits to owners, and there are certain factors to be aware of in terms of costs, efficiency, and control. There is a range of franchise affiliation options.

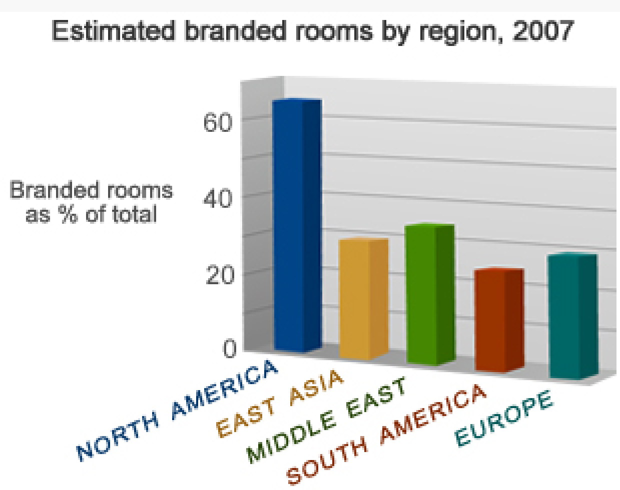
Moral Hazard

As a brand owner, you have the choice of owning your hotels and operating them yourself or hiring franchisees to operate them for you. If the brand chooses to own and operate hotels, the moral hazard comes from the fact that the manager does not have an economic stake in the hotel. Problems include managers shirking duties or taking excessive risk. Because managers do not receive the funds left over from running the operation, they have little financial incentive to work hard. At the same time, they don't bear the costs of their decisions, so they are less concerned about risk. By franchising the brand, the franchisor creates an environment in which the franchisee receives the residual benefits of the operation, thus removing the moral hazard.

Search Costs

Franchisees can search much more efficiently than the franchisor, or brand, can. Consider the bustling market of Boise, Idaho. A franchisor based in Atlanta, Georgia, has very little incentive to incur the costs of sending talent to Boise to search for the best sites. On the other hand, the local hotelier, who has lived in the Boise market, knows where the area is growing and where the best corner is located. Franchising leverages the search efforts of the franchisees, who can search at much lower cost to the franchisor, or brand owner. The lower search costs remove barriers to growth for the franchisor by creating opportunities for franchisees.

Distribution



Does the brand distribute its products themselves or do they distribute their products through an intermediary? Franchising exists because people who own the brands feel that there is more money to be made through the distribution as a brand than through distribution via the intermediaries. Distribution through intermediaries such as tour operators and wholesalers is common in Europe. In the United States, on the other hand, the brands have decided they can make money by distributing through franchises .

Financing

Because the franchisors are cash-constrained, they can use the borrowing capacity and equity of the franchisees to expand their domains very quickly. But there is not much empirical evidence to support this theory, and when you consider companies such as Intercontinental, Marriott, Starwood, or Accor, you can see why. All are multibillion-dollar firms, with cost of capital significantly lower than the cost of capital for their franchisees.

This is part of the explanation for the extremely large disparity in branding levels in North America versus the rest of the world. North America is almost 70% branded, and brands continue to increase their market share. Europe is about 25% to 30% branded, with huge variants between countries. For example, France is about 50% to 60% branded, whereas markets such as Switzerland and Italy have fewer than 10% branded hotels. The Asia-Pacific region is about 25% branded, but the brands are growing extremely rapidly and the conventional wisdom in the industry is that Asia will look very much like the North American market over the long-term. Finally, South America, the Middle East, and Africa are all very small hotel markets with low levels of hotel branding. The most highly branded market in South America is Chile, and in Africa the highly branded markets are Egypt and South Africa. The big middle of Africa remains the domain of the independent hotels.

Read: Operator's and Owner's Perspective

Here we consider the steps to take in analyzing franchise affiliation alternatives. To begin, we need to chart the field of affiliation options. There are five ways to affiliate with a chain.

- In the dominant form, an owner-operator enters into a standard franchise agreement with a brand. The vast majority of affiliations happen this way.

- A second way to affiliate with a brand is to enter into a management contract with a branded operator. A few of the branded operators will sign a "manchise," a combination of a management contract and a franchise agreement, with the intent that the management agreement will be terminable but the franchise agreement would survive.

- A third model would be an independent manager. An owner hires a manager, and in an addition, the owner signs a franchise agreement with the brand. This is not an owner-operator model, it is an owner-operator-brand model. The owner signs two distinct contracts: one for management expertise and one for the brand's services.

- A fourth model is a "master franchise." Large branded operators may sign a master franchise agreement for an entire country, such as China or India. This is a way for the franchise to expand into a market very quickly. The master franchisee has the right to operate hotels within the market and to sell franchises to others in the market. The franchisor is prohibited from competing with the master franchisee, so long as the master franchisee meets agreed goals over a time horizon.

- A final model is a strategic marketing alliance in which the brand is lent to a third party for use in other ancillary areas. Brands may license their name for use in marketing various hotel-related goods such as beds or lifestyle goods. This option is almost exclusively used in the five-star domain.

Those are the relevant options. How does an owner go about deciding on a brand affiliation? The process can be summarized through a series of steps:

1. Analyze the business mix of the property, searching for a brand that matches the owner's needs.
2. Assess the potential benefits of the affiliation.
3. Determine the costs of affiliation.
4. Compare the cost to the benefits. This includes performing the relevant net present value calculations or estimating the internal rate of return and making a decision.

Collectively, these four steps allow us to quantitatively evaluate whether a brand is a good affiliation.

5. Make a qualitative evaluation of the benefits and cost of affiliation. In this step, you evaluate potential conflicts of interest and what is called the "softer" side of the business. These are very difficult to quantify in dollars and cents, yet remain an important consideration.

We will consider each of these steps in greater detail.

Read: Analyze the Business Mix

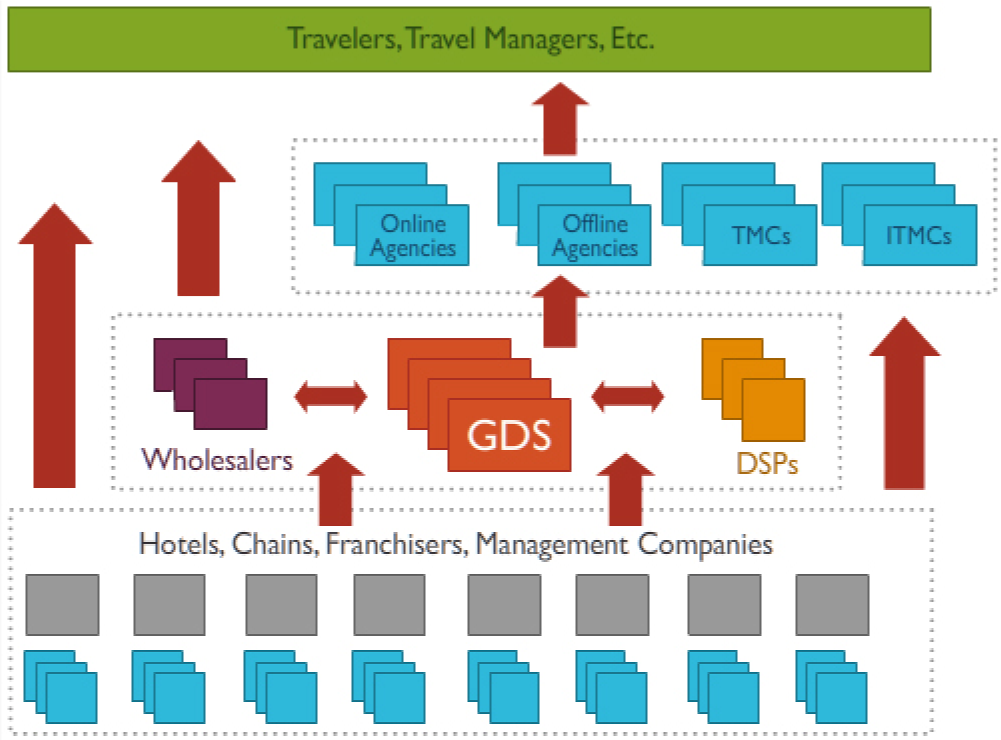
Each hotel has a different mix of attributes that make up the formula for success. Understanding the business mix for a hotel helps determine the answer to two key questions. First, is this hotel well suited for a brand, or is it better off operating independently? Second, if it is suited for a brand, which brands best match the needs of the hotel?

Analyzing the business mix begins by understanding the target customers for the hotel. Are they travelers making the journey along an adjacent interstate highway? If yes, the brand can add a great deal of value, especially a brand with good distribution along the relevant travel corridors. Are they loyal business travelers looking for a "brand promise" in many different cities? If yes, a brand can deliver on the promise, especially a brand well known for maintaining consistent brand standards. Are they pleasure travelers looking for a distinctive hotel experience? If yes, a brand with the flexibility to adapt to a distinctive or unique physical space may be required, or it may be necessary to forgo affiliation and operate the hotel independently.

A second, related factor has to do with why guests stay at the hotel. There are many reasons to book a room in a hotel-its location, the hotel's amenities, the hotel's service. The owner needs to determine the mix of reasons in the prospective client base, and answer this question: can a specific affiliation influence the customer's decision to stay in the hotel?

Third, where is the hotel's business coming from? What are the specific demand generators? If the demand is fundamentally local, affiliation may not be necessary or advantageous. On the other hand, highway properties have a strong need for affiliation to "capture" customers from the road via signage, billboards, and the recognition a brand provides.

The fourth factor concerns how the hotel rooms are booked. Does the central reservation system (CRS) of the brand, including the Web site and 1-800 number, add important value? If the business can be booked by in-house staff, there may be little need for a brand. But brands are able to manage customer flows from multiple sources, and can save a great deal of the time and effort that must be put into booking. This is a simplified diagram from distribution expert Dr. William Carroll, of Cornell's School of Hotel Administration, showing the myriad of channels used by hotels to allow customers to book rooms. The diagram is very complicated, but the point is that there is no need for a hotel owner to work at this level of complexity if the brand can handle distribution and booking for the owner.



Finally, a less important consideration. Is the hotel's business seasonal? If so, can affiliation boost occupancy during slow and shoulder seasons? If so, the affiliation may add important value.

Once hotel owners have considered each of these factors, they are in a much stronger position to pursue a beneficial affiliation.

Read: Assess the Benefits of Affiliation

Once you've analyzed the business mix and determined that a franchise affiliation is worth pursuing, you need to carefully assess the benefits and the costs of the franchise affiliation. The goal is to estimate the expected benefits and costs over a series of years. Let's begin with the benefits.

Increase in occupancy. The franchisors' basic story is that they "put heads in beds". This occurs when a recognized brand is coupled with a well-developed distribution engine.

Increase in the average daily rate. A great deal of evidence shows that the rates that come over the central reservation system are higher than the rates the hotel itself is able to achieve through its own selling efforts. It is clear that the brands have the ability to sell hotel rooms at very attractive rates.

The reduction of on-site marketing expenses. With the brand's reservation system and group selling efforts, you don't need as large a marketing staff to run your hotel. You also don't need investments in Web technology, which comes from the brand. It is difficult to model these savings. For an existing hotel, you can investigate what other franchisees accomplished by moving from independent to managed status. For a new development, you can investigate what the standard marketing staff at a franchise hotel would look like.

The brand's preferred purchasing system. Purchasing goods and supplies for the hotel at very attractive rates provides quite a significant benefit. The brands have well-developed supply chain management technology both for operating supplies and for goods needed in renovations.

What about estimating the costs of affiliation? Let's look at the specific costs involved. The first two are upfront costs:

The initial fee. This is either a lump sum or a cost-per-room fee. If you are a very good franchisee with a long and successful relationship with the franchisor, the initial fee may be negotiable (it is one of the only fees that is negotiable).

Product Improvement Plan (PIP). The PIP is the cost of the initial conversion to the brand. The cost of conversion ranges anywhere from $2000 to $10,000 per key and in some cases can exceed $10,000 per key.

The remaining fees are ongoing.

Royalty fees. This is the fee for the use of the brand's name. No additional services flow from this fee. The royalty fee in general is anywhere from 1% to 7% of room revenues. For most of the very-high-quality brands, the range is 5% to 7% of revenue. Some brands are willing to negotiate a reduced royalty during the initial years of a property, generally for the first two or three years.

Marketing fees. Including Internet, print, and other media, these fees cover the actual cost of creating brand identity. The brand can leverage franchisee contributions to establish and maintain a regional and international identity. Marketing fees are usually around 2% of room revenues.

Reservation fees. These include the cost of purchasing the reservation system, training staff to use the system, and operating the system. Reservation fees are also typically around 2% of room revenues.

Frequent-traveler fees. The brand receives a fee for every guest who checks in using the brand's royalty card. Generally the charge for running the frequent traveler royalty program is about 2% to 3% of room revenues.

Other fees. These may include sales representation fees, technology fees, and fees for changing brand standards (for instance, a change in bedding, or Internet access).

These are the costs of operating the franchise over a number of years. If the contract is terminated before the end of term, the franchisee may have to pay a termination fee or a liquidated damages fee. In general the fees paid in these circumstances are quite large. It is usually the cash value of all the fees that the franchisor expected over the remaining term of the contract.

Tool: Calculating Franchise Fees

Download the Tool

U.S. Hotel Franchise Fee Guide

The ability to accurately calculate the costs of hotel franchise fees is crucial in making informed franchise affiliation decisions. HVS, a global consulting and services organization focused on the hospitality industry, publishes a guide that provides a comparative review of the franchise fees associated with various hotel brands. The U.S. Hotel Franchise Fee Guide will help you to:

- Benchmark the fees charged by different hotel franchise companies, broken down into economy, mid-rate, and first-class categories
- Analyze how the different fees (including royalty reservation, marketing, frequent traveler, and miscellaneous) influence the overall fee structure

Watch: Evaluating the Benefits and Costs of Affiliation

An illustrated presentation appears below. Use this resource to learn how to use a decision support spreadsheet to evaluate the costs and benefits of franchise affiliation.

Watch: Completing the Franchise Affiliation Analysis

Download the Tool

Using Excel's "Goal Seek" Feature

An illustrated presentation appears below. Use this resource to complete the analysis of affiliation and determine the necessary rate, occupancy, and flowthrough.

This presentation uses the "Goal Seek" function in Excel to determine what specific value will yield a desired result. If you are not familiar with Excel's Goal Seek function, please download the brief tutorial by clicking the link above.

Read: Possible Issues and Concerns

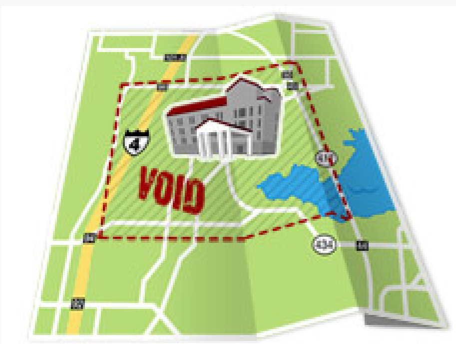
Key Points

Consider areas of potential friction between franchisor and franchisee

Negotiation may be necessary

We have considered the quantitative analysis of franchise affiliation, but we also need to consider the less quantitative aspects of the decision. The relationship between the franchisor and the franchisee contains many areas for negotiation and possible contention. Let's consider some of the major issues. We begin with topics in which both the franchisee and the franchisor have concerns.

Impact, or Territorial Protection



Consider a Holiday Inn franchise in a particular market. Another franchisee is proposing another Holiday Inn in the same market, maybe five miles away. What is the impact of this new hotel? Both the franchisee and the franchisor see this as a hot-button issue.

Why do franchisees view impact as an important issue? The original franchisee objects, claiming the new Holiday Inn will have a negative impact on the property. First, the new Holiday Inn will reduce occupancy, reduce profits, reduce returns, and reduce the value of the original property. Second, the impact is cumulative. Each new competitor in the market hurts the original until demand grows. Third, the threat of impact impairs the relationship between the partners. The mere fact that the franchisor allows new hotels to be built in an area, that the franchisor will not give territorial protection, can damage the relationship between the two.

Additionally, the franchisors know that if their brand does not meet growing demand, another brand will. If a new Holiday Inn is not built, someone will probably build a Hilton Garden Inn, or a Marriott Courtyard. If new hotels are going to come into the market, the franchisor can demonstrate that there are some advantages to the franchisee if the new hotel is the same brand. For example, another Holiday Inn offers co-marketing advantages and cross-selling opportunities.

Termination

When a franchise contract is terminated, the amount of liquidated damages can be contentious. The contract is written so that the franchisor is owed the cash value of all expected future flows over the term of the license. If the franchise has, for example, over ten years remaining, this can be a very large sum. In the case of an under-performing brand or a brand that has allowed significant new competition, the franchisees may legitimately believe they are being penalized for keeping the contract. Hence, there are some negotiations around performance termination, especially in a situation where a number of new, same-brand, competing hotels have been brought into the market. Although each additional hotel may have had little impact, the cumulative effect can be significant.

Additional means of termination are "bilateral reaffirmation" provisions that provide both sides with a window to continue or discontinue the affiliation. These provide one means by which potential conflicts can be managed, giving the franchisee the ability to exit under certain circumstances at specific points during the franchise term.

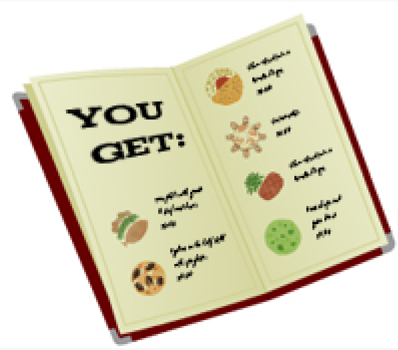
Data

A smaller issue, but one that is increasingly contentious, is the question of data ownership and data mining. Does the franchisor have the right to sell customer data? Does the franchisee have the right to sell customer data? Can the franchisor sell large account data to a competitor? Can the franchisor provide a list of all the guests in one market to a hotel in another market, especially if the franchisee is in a resort market? All of these situations are known to have occurred. Contemporary contracts generally specify that the franchisor owns the data, but the franchisee has the right to use the data for guests at his property.

Read: More Issues and Concerns

Having considered areas of concern to both parties to a franchise agreement-the franchisor and the franchisee-we can now consider issues that are particular to each side. We begin by looking at two issues that concern franchisees.

Programs



The franchisor offers a number of programs that must be paid for by the franchisee. These include required programs, such as marketing and loyalty programs, and optional programs such as "participating hotel" programs. In some cases, franchisees see these programs as benefiting the franchisor or certain franchisees more than others. Franchisees have two specific issues. First, there is no incentive for the franchisor to make the program cost-effective if the costs are borne by the franchisees. As a result, the franchisees are increasingly asking for the ability to opt out of these programs. Second, the franchisees want some input into the design of programs that have a real impact on the franchisees' bottom lines. They want programs that do more than boost revenues, but do little to boost cash flows.

A brief look at specific programs illustrates these concerns. Consider marketing programs. Franchisees want to have input via the franchisee committee on the direction and content of national, regional, and local marketing programs. For the loyalty programs, on the other hand, the concern is different. Everybody knows these programs work. The questions here are the cost versus the benefits of the program and the manner it is implemented, especially franchisee control over the number of rooms that need to be allocated to the program on any given night.

Brand Standards and Capital Investment

Franchisees agree the franchisor has the right to change the brand standards from time to time. The issue of contention centers on these questions: how much can the standards change? How often can they change? Who benefits from the changes? How quickly must the changes occur? And a related question: are the changing standards being implemented uniformly? This last concern can generate considerable debate and rancor at annual franchisee meetings. Consider a brand that has 1000 hotels, 200 of them owned by the company. If the company-owned hotels are seen to be dragging their feet on implementing new brand standards while the company is pressuring the franchisees to meet the standards, this is cause for significant concern. Franchisees frequently bristle at perceived double standards. Franchisees look for clear and flexible guidelines. Is the new standard optional? Can implementation be spread out over a couple of years to stay in line with the franchisees' capital budgeting process?

Now let's look at an issue of franchisor concern.

Free Riders on the Brand

Franchisors today are much less tolerant of franchisees who don't meet brand standards, who fail inspections, or who underperform. Franchisees have a set of tactics that they use to prevent "free riding" on the brand. First, franchisors are offering shorter license terms. Several brands have reduced 20-year licenses to 10-year terms renewable at the option of the franchisor and subject to a product improvement plan, or PIP. If the franchisee runs a good hotel, meets the brand standards, and is a good team player, the renewal is a formality. But if the franchisee is problematic, the shorter term provides an easy exit. At the renewal, the franchisor can hit the franchisee with substantial PIP charges, or institute stringent inspections.

Potential parties to franchise agreements need to be aware of each of the areas of potential concern before they enter into an agreement.

Listen: Why Be An Independent Hotel?

Owners might choose to operate their hotel independently for a number of reasons.

First, independence makes sense for one-of-a-kind hotels that are large enough to carry the marketing effort internally. Examples include many classic hotels: the Broadmoor, a mountain resort in the Rocky Mountains; the Greenbriar, an eastern mountain resort in West Virginia; the Del Coronado, an icon on the beach. All of these hotels are large, with more than 500 rooms. They also have rates that can support a significant independent marketing effort. A smaller example is the Woodlands, in Summerville, South Carolina. This 19-room property, with Mobil five-diamond status on both the hotel and the restaurant, uses word of mouth and exclusivity to support its status as an independent hotel.

Second, independence might make sense if the business mix doesn't lend itself to affiliation. We can illustrate this with a number of examples.

Click each of the doors below to hear Prof. deRoos discuss three different business mixes that suggest the benefits of independence.

A third reason to remain independent is if you have other means of distribution. Instead of relying on the brand's distribution system, you embrace tour operators, or wholesalers, or the Internet, as your distribution mechanism. Traditionally, other distribution channels were limited-hoteliers would sell their inventory to tour operators and wholesalers, who in turn could sell it to their customers. This is a very European model. The more recent model is to embrace the Internet as a way to reach customers directly and easily.

A final reason to remain independent is to attract customers who want a different experience. Independent hotels often sell themselves as different and attract clients who come because they are different. This model works for one-of-a-kind hotels that attract a very exclusive clientele, such as the Morgans Hotel Group or Kimpton Hotels, operators of boutique hotels in many cities.

In sum, there are situations in which franchise affiliation is the right decision, and other situations in which a franchise is not necessary or cannot provide the distinct virtues that independence provides.

Read: Outlook for the Future

Let's take a look into the future and examine what we think the future will hold. Franchise agreements are likely to change in order to better serve both franchisors and franchisees.

Fee Structures

New fee structures are likely to spread through the industry, especially more pay-for-performance clauses. What might this look like? The franchisee will pay a small royalty on all guestroom revenues. Franchisees will have the option to opt in or out of specific programs that have the potential to deliver additional heads in beds; these programs will have financial incentives for the franchisor to perform. Instead of being forced to take all franchise programs, franchisees will choose from a menu of services offered by the franchisor.

Another change that is finding some interest in the industry: we may see higher royalties for short-term contracts, and lower royalties on longer-term contracts that allow the franchisor to terminate early.

Flexible Contracts

We are likely to see more flexibility in contracts, especially with respect to conflicts of interest in shorter terms. A notable example is impact. The franchisors are in the business of compensating their franchisees for impact. The franchisors won't stop building competing hotels, but they will compensate the existing franchisees in the market for their decreasing occupancy.

Standardizing Performance

Brands are starting to standardize around the way they measure brand performance. The ultimate performance measurement is known generically as Central Reservation System (CRS) contribution. How many of the heads in beds come from the brand's central reservation system, from the 1-800 number, and from the Internet? How is this measured? The metrics used are occupancy and rate (ADR). It is widely established that CRS gets higher average daily rates than the local selling efforts.

What franchisees want to know is how their franchise benchmarks with other franchisees of the brand and how it compares across brands? Franchisees want data on booking pace, numbers of rooms sold to different market segments, and average daily rate by market segment.

Online Choices

The brands have been out in front in embracing the expanding role of the Internet, with things such as best-price guarantees. Their goal has been to not give either the online travel agents or their franchisees a chance to disintermediate their inventory. As franchisees become increasingly Internet savvy, the brands need to continue to answer the following question from their franchisees: why do I need the affiliation when I can market my rooms myself? The brands have been answering this question by creating sophisticated revenue management engines and by training their franchisees to use their systems. These systems require massive investments, which cannot be matched by individual franchisees.

New Programs

New program offerings are a way for the brand to bring more value to the table. Some possible examples:

Yield management: the franchisor can help the franchisee sell their hotel more efficiently.

Operational support via the brand's face-to-face and online training materials: the franchisor can help the franchisee operate more efficiently once revenues flow in.

Better training programs: the hotel academies run by the brands are likely to expand, and online training holds great promise for lowering their training costs and increasing their efficiency of operation.

Prototypes

Prototypes are designed to expand new product offerings. In an effort to enhance service and lower operating costs, the brands are in the business of developing well-targeted, efficient prototype hotels. Interestingly, some of the innovations in prototype and product have come out of the franchisee community. Rather than punish departures from brand standards, franchisors are more willing to see if these departures might sensibly be folded into developing brand standards.

Module Introduction: Negotiating Contemporary Management Contracts

When owners hire an operator, they commonly sign a management contract. These contracts are the product of negotiations that determine the control relationship between the owner and the operator. The contracts also act as risk-shifting devices. In this module you examine contemporary management contracts from the perspective of both owners and operators.

When you have completed this module, you will be able to:

- Explain how the relative power of owners and operators influences management contract negotiations
- Describe the key control goals that each party hopes to see codified in the management contract
- Explain the key provisions of management contracts and how owners and operators negotiate term sheets that protect their interests
- Analyze management contract term sheets from the perspectives of different owners and operators

Read: The "Rules of Engagement"

A management contract is the end result of a process of negotiation between a hotel owner and a hotel operator. In these negotiations, each party seeks a contract that will help them achieve their own goals. The finished contract is a measure of negotiating skill, but it is also a result of the relative bargaining strength of each party. The relative power of owner and operator plays a crucial role in determining the overall shape of the contract.

Power lies on a continuum. One pole of the continuum is defined by the operator having most of the power. The other end of the continuum is defined by the owner having most of the power. Imagine two scenarios with the same very desirable hotel on Central Park South in New York City. First, consider an operator who is thinking about the sale of his property subject to a management contract, a situation known as a sale-manageback. Who would have power in this case? Obviously, it is the operator. The sale of the hotel is contingent on the management contract; you don't get to own the asset unless you agree to the management contract terms. In this case, the operator essentially drives a deal by their crafting of the management contract terms that the hotel will be subject to.

Now consider the same site, same hotel, owned by a life insurance company whose vision is to redevelop the hotel into one of New York's premier properties. They are seeking an operator to manage the hotel under a long-term contract. Who has power in this case? --The owners. The owners have an extremely desirable site in New York City. They are looking to sign an operator to a long-term contract. In this case, the owners are confident that they can issue a request for proposals and there would be many operators bidding for this contract. The owners would be in a position to drive the terms of the deal.

These are the extreme poles of the continuum-obviously, most situations are much less clear-cut. However, the power levers are generally clear to the two parties to the contract. Where each party lies on this continuum plays an important role in the negotiation of the key management contract provisions.

Read: Bargaining Strength

What factors influence the relative bargaining strength of an owner and operator? We begin by examining the factors that enhance the operator's bargaining position. Affirmative answers to the following questions mean greater leverage for the operator.

Factors that improve the operator's bargaining position:

- Reputation: do the public, other owners, and lending institutions regard the operator as excellent?
- Size: does the operator have enough properties to support a centralized staff and to indicate sufficient experience?
- Growth: does the operator have a stable and continuous history of growth?
- Services: does the operator offer complete and competent marketing, sales, reservations, operational controls, financial reporting, and pre-opening management and technical services?
- Contribution: is the operator willing to make a significant investment contribution?
- Supervision: does the operator have experienced and thorough national and regional staff supervision?
- Flexibility: will the operator be flexible in contract negotiations?
- Owner's perception: does the owner perceive the operator as responsive to the owner's goals?

Now let's consider the owner's bargaining position. Affirmative answers to the following questions mean greater leverage for the owner.

Factors that improve the owner's bargaining position:

- Holding period: does the owner intend to maintain ownership for an extended period of time?
- Experience and capability: does the owner have a record of sound experience and capable management?
- Financial commitment: can the owner make an adequate financial commitment to the project, and does the owner have a stable financial background?
- Institutional owner: is the owner a stable institutional owner rather than a riskier entrepreneurial owner?
- Potential: does the owner have the potential to achieve the operator's financial and return goals?
- Opportunity: does the owner's property provide an excellent opportunity for an operator to enhance its market posture, visibility, and competitive position in the industry?
- Competition: is there likely to be substantial competition among operators for the property?

The answers to these questions have a strong influence on any management contract negotiation. The negotiating skill of the participants also influences the outcome.

Watch: The Continuum of Power

An illustrated presentation appears below. Use this resource to enhance your understanding of the relationship between power and provisions in management contract negotiations.

Read: Preliminary Objectives

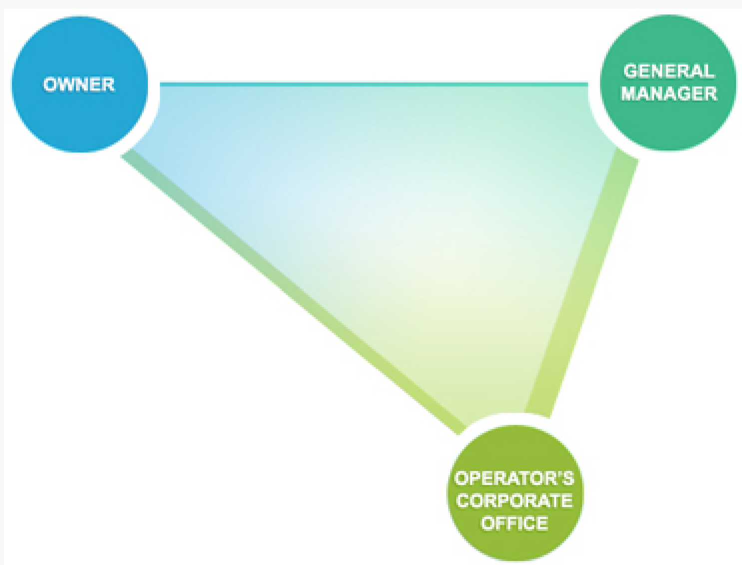
The operator and the owner enter the contract process with certain objectives and with preconceived notions about the desired relationship among owner, operator, and on-site manager. Let's look at each in turn.

The Operator's Preliminary Objectives

The operator begins contract negotiations seeking the following traditional objectives. The operator wants:

- The sole and exclusive right to manage the hotel without ownership interference. In the contract, this is known as a nondisturbance clause.
- The owner to assume all, or most, of the financial risk
- To be indemnified except for gross negligence, fraud, or willful misconduct
- The right to manage the property consistently with the approved annual budget
- The right to cash for the approved capital expenditures budget and for any budgeted annual operating shortfalls
- The right to operate the property according to brand standards
- The right to earn fair, basic, and incentive management fees
- The right to make all personnel decisions at the property, subject to owner input on the general manager
- The right to consistent strategic direction from the owner

Graphically, the operator's vision of the working relationship looks like this:



Note that the operator sees most of the exchange of information going from the owner to their corporate or regional office, who in turn communicate with the on-site manager. Operators seek to minimize the owner's involvement in the property.

The Owner's Preliminary Objectives

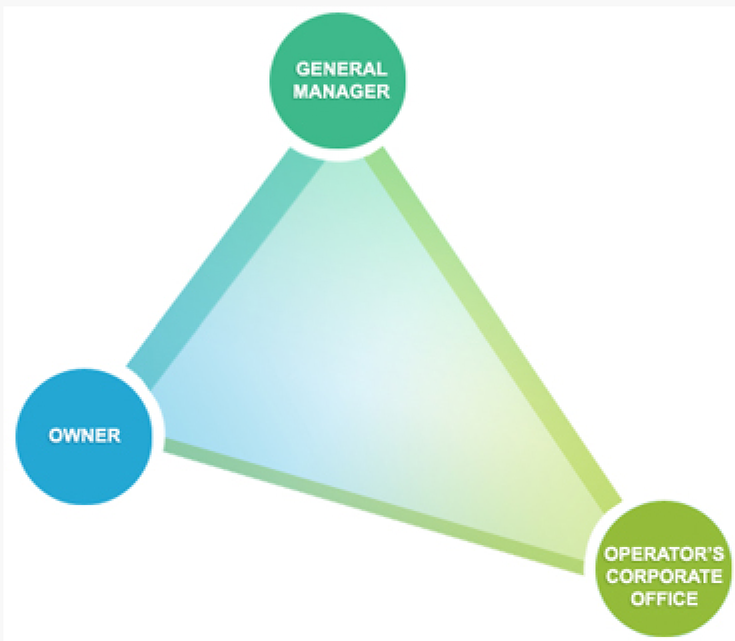
The owner negotiates the contract to achieve the following traditional objectives. The owner wants:

- Some financial risk to be borne by the operator, generally through the contract's incentive management fee
- Some operational influence and control over the asset, generally through aggressive asset management
- The operator to demonstrate appropriate and reasonable flexibility in tough times, especially as it relates to

brand standards. Both operator and owner know that this flexibility does not pertain to the fee; the fees get paid.

- Clear monitoring and evaluation mechanisms, including the right to meet regularly with the operator to review performance
- The right to asset-manage the property
- The operator to put the owner's interests ahead of the operator's interests when it comes to the operation of the hotel
- The right to approve the annual operating and capital expenditure budgets
- The right to inspect and audit the financial records of the hotel
- The right to have input into system-wide initiatives and to understand the costs associated with system-reimbursable charges
- The right to all cash in excess of working capital requirements

Graphically, the owner's vision of the working relationship looks like this:



The owner sees a far more robust relationship between the owner and the hotel's on-site management, especially as it relates to the owner's right to actively asset-manage the hotel.

The exact nature of the relationship between the owner, the operator, and the on-site manager lies somewhere between these two polar positions. The specific relationship is a product of the negotiations between owner and operator.

Listen: Negotiating the Term Sheet

Before signing a management contract, owners and operators negotiate a term sheet that contains the major provisions of the contract. The process of negotiating a management contract between owners and operators consists of three distinct steps.

Click to hear Professor deRoos describe the term sheet negotiation process.

1. The owners and operators come to terms over the numbers, agreeing on projections of revenue and cash flow. This is usually an owner-driven process. The owners have a hotel, they have a vision, they have engaged consultants to do a market study and produce projections of future revenues and future cash flows. The owners ask the operators to develop their projections using the owners' market study and their understanding of the owners' vision. The owners and operators then share financial projections. If the numbers agree, they proceed to the second step. If they can't agree on the numbers, the owners approach different operators. There is no reason to proceed to the term sheet unless the owners and operators have a clear understanding of each other's financial objectives.
2. The owners and operators negotiate a term sheet, which includes the major provisions of the contract. This is a three- to seven-page document, written in plain language, describing the major agreements between the parties. This is where the key negotiations between owners and operators take place.
3. The legal teams for both parties convert the term sheet into a management contract, typically a 50- to 100-page document.

Because the term sheet is the crux of the negotiation between owners and operators, we will devote a great deal of time to understanding the process by which it is negotiated, and its major provisions.

Read: Investment Contributions

The first specific provision to be negotiated is the investment contribution the owners ask the operators to make in the form of "key money," a loan, or equity. Until the operators know how much money they would be asked to invest, they are unwilling to commit to the contract's term or fees. In general, if the operators invest in the property, they expect a long-term contract with very reasonable management fees.

Overall, the use of investment contributions is decreasing. Years ago, investment contributions were a fairly common component of management contracts. Today, operators are reluctant to invest in the contract and owners are reluctant to allow operators any equity stake in the hotel. If required to make a contribution, both operators and owners generally prefer "key money," which is literally a contribution to the owner in exchange for obtaining the contract.

Owners asking for key money signal that they lack some of the capital necessary to complete the project; this causes the owners to be perceived as less powerful and puts them in a poor negotiating position relative to the operators. Operators consider key money either for a location that the operators are extraordinarily interested in securing or to induce owners to sign a contract with these particular operators instead of a competitor.

If key money is not forthcoming, the owners' second choice would be to structure the contribution as a loan from the operators. The third option, an equity contribution, has essentially gone out of the industry. Any significant equity contribution from the operators makes them partners with the owners. This has the legal effect of making the contract extremely difficult to terminate, because one cannot terminate a partner. Owners are extraordinarily reluctant to sign a non-terminable contract.

The more common key money contributions, or the rarer equity or debt contributions, are usually small relative to the total capital that's needed for a project. They generally make up less than 10% of the total capital, with the more typical range between 0% and 5%.

Despite the diminishing prevalence of investment contributions, they remain the first step in negotiating a term sheet. If there is to be an investment contribution, the details need to be arranged before the negotiations turn to the term of the contract.

Read: Term and Termination

Now that we've negotiated the investment contribution, the negotiations move to a discussion of the term of the contract. Two questions are crucial, and are generally treated together:

1. How long does the contract last?
2. Under what circumstances can it be terminated?

The issues that influence the length of the term are the relative power of the parties and how much the owners want to be in the project long-term or short-term. Generally, term is seen as something you negotiate extraordinarily hard over, unless it's very obvious that you're not going to get good termination rights. Any short-term owners who will attempt to sell the hotel in the future would negotiate very hard about termination-on-sale rights in conjunction with term. If they don't have good termination rights, then they will negotiate a very short term. If they do have termination-on-sale rights, the initial term and renewals are somewhat less important.

The initial terms have historically been a 20-year contract, with two 5-year or two 10-year renewals. The overall term is 30 to 40 years. For the high-quality branded operators, the initial terms have gotten shorter across the industry. Today a good contract might be a 15-year initial term, with one 10-year renewal or two 5-year renewals. Independent operators might obtain a 5- to 10-year initial term, with two 5-year renewals. The best operators are able to negotiate very long terms. One branded operator can obtain a 30-year initial term with four 10-year renewals on a regular basis. This illustrates that term is highly dependent on the perceived quality of the operator.

Categories of Termination Clauses

There are three broad categories of termination clauses:

- Termination without cause.
  This is usually restricted to independent operators. The quality branded operators will generally not allow an owner to terminate the contract without cause. Independent operators may agree to a termination without cause as a means to secure the contract. Certain owners, however, require a termination-without-cause contract. Unless they must have the ability to terminate, at any time, they will not sign the contract.
- Termination upon sale.
  Termination upon sale has essentially two flavors. In the first, the owner has the right to terminate upon sale without offering the operator the right to purchase. In the second, the owner must offer the operator the "right of first offer" (called ROFO rights). In general, when you negotiate termination upon sale, giving the operator the right of first offer is not seen as an undue burden for the owner. Generally, the operator is given 20 to 60 days to make an offer. If the sides do not reach agreement, the owner can put it on the market.
- Performance termination.
  These are extremely complicated clauses, which essentially give the owner the right to terminate the contract if the operator fails to meet agreed-upon performance thresholds. In a typical clause, if the operators do not achieve 90% of the budgeted gross operating profit (GOP) for two consecutive years, they are subject to termination. The owner wants to be able to distinguish between a good operator and a bad operator. The owner wants to be able to terminate a poor operator who has not benchmarked well-that is, one who has not provided

expected cash flows. If, on the other hand, a good operator is working in a poor market, the operator wants protection against termination. For this reason, protections are built into this clause. The contract usually contains a force majeure clause revoking termination if "bad" things happen in the market that have harmed the performance of every hotel. This is typically in the contract as a RevPAR comparison. If the operator benchmarks well relative to competitors, indicating that the entire market has sunk, the termination clause is not operative.

Read: Fees

After agreeing on contribution, terms, and termination provisions, the owner and operator are ready to discuss fees. There are three kinds of fees in every management contract-the base fee, the incentive fee, and the system-reimbursable charges. For negotiation purposes, only the base fee and the incentive fee are relevant. The system-reimbursable charges are fundamentally nonnegotiable. The parties negotiate the fee structure backward. The owner and the operator negotiate the incentive fee first, and once they negotiate the incentive fee, then they agree on the base fee.

Types of Incentive Fees

- Traditionally, incentive fees have been some percentage of the gross operating profit (or "income before fixed charges"). A typical incentive fee might be 8% of gross operating profit, plus a standard base fee of approximately 2.0% to 2.5% of total revenues. In this case, the operator is not looking to take on much financial risk. The operator receives a base fee, operates efficiently, and receives an incentive fee, and whatever is left over goes to the owner. In this case, the operator's incentive is to deliver a healthy GOP, which will produce a healthy incentive fee. The operator has little incentive to meet the owner's return objectives.
- Increasingly, owners have asked for a priority return, shifting some of the financial risk to the operator. In these cases, the operator receives the incentive fee after a priority return to the owner. Let's assume the owner invests $50 million, and there is $6 million of cash flow. Say the owner wants an 8% priority return. In this case it is 8% of the $50 million investment, or $4 million. After the owner receives that $4 million, the incentive fee is a significant share of whatever is left over, usually 20% to 30%. If the operators are willing to take that kind of financial risk by essentially guaranteeing a return to the owner prior to taking the incentive fee, they would expect a healthy base fee in return.

Once the parties have negotiated the incentive fee, they negotiate the base fee. The base fee is in general 2% to 3% of total revenues. The specific size of the base fee is related to the negotiated agreement on incentive fees.

Once the parties have negotiated the fees, the major provisions of the term sheet have all been agreed to. Now it is time to negotiate the remaining provisions.

Watch: Negotiating the Key Provisions

An illustrated presentation appears below. Use this resource to enhance your understanding of how owners and operators seek to pursue their interests through the major provisions of the term sheet.

Read: Final Provisions

Key Points

Remaining provisions must be agreed upon

Final deliverable: a "term sheet"

Term sheet will become the management contract

After you've completed negotiation over the big three items-investor contribution, term and termination, and the management fees-you can move on to the remaining provisions of the management contract. These can be negotiated in no particular order.

Personnel

Almost universally, employees are employed by the owner, not the operator. Sometimes the operator employs hotel personnel in the United States, but this is generally not lawful outside the U.S. The owner usually wants the right to input on selecting the general manager, and possibly other managers such as the controller or the director of marketing. This input can entail approval of the operator's choice or, more commonly, an active role in the selection process. The operator is responsible for negotiating union contracts. The owner then has the right to approve or disapprove these contracts negotiated on behalf of the operators.

Budgeting and Spending Limitations

Owners are increasingly involved in the budgeting process. Owners want to secure and negotiate the right to approve the annual operating budget, not just to review the budget. In addition, the owner wants the right to negotiate over and approve the reserve replacement budget and the projected capital additions budget. The reserve replacement budget would be 3% to 4% of total revenues, and the capital expenditure budget would be 1% to 2% of total revenues, so total reserves are 4% to 6% of revenues for most hotels.

Financial Reporting

The owner wants annual, certified (or audited) reports from the operator. The standard three reports are the balance sheet, the income statement, and a statement of changes in financial position. Additionally, there should be a reconciliation of the base and incentive management fees, and a reconciliation of the system-reimbursable expenses. They would also negotiate a number of monthly, noncertified reports.

The other financial reporting issue negotiated today is the owner's ability to look inside of, and pull information out of, the operator's systems. In general, operators have taken a very proactive approach to allowing owners to have at least a limited look inside their financial information systems.

Territorial Restriction Provisions

Does the operator have the right to put additional, same-brand properties in the same market as the existing hotel? Operators do not want to be precluded from bringing new hotels into the market, especially if someone else is going to build them anyway. Owners don't want to face unreasonable levels of competition. Together, they must negotiate the size of a protected area, the term of the restriction, and any conditions placed upon new properties inside the restriction zone. Operators are often allowed to open new properties if, through an impact study, they can show no incremental harm to an owner's hotel.

System Reimbursables

There is very little negotiation here. System reimbursables were extraordinarily contentious during the 1980s and 1990s. Since then, operators have worked hard to make these expenses transparent. Owners now know what they are paying for. Though they may not like it, it is clear that the owners need to pay their fair share of the operator's systems.

System reimbursables include payments for marketing and sales officers, the reservation system, group purchasing of operating supplies, replacements of capital expenditures, a centralized accounting function, a centralized training function, and then the reimbursement for corporate personal, travel, and room and board while they are at the owner's property. In general, system-reimbursable expenses are in the range of 1% to 3% for the branded operators and from 0% to 1% for the independent operators.

At this point, all the key provisions have been negotiated, and they can be formalized in a completed term sheet. Both sides may go back and forth on the specific provisions of the term sheet. Once agreement has been reached, the term sheet is ready to go to the lawyers and be turned into a management contract.

Activity: Craft an Advantageous Agreement

You now have some experience crafting provisions of the term sheet that meet your control needs while also addressing the concerns of the other side. In the real world, term sheet provisions are the result of a back-and-forth negotiation between the owners and the operators. For this exercise, you will engage in some of this negotiation.

How to complete this exercise:

1. Your instructor has assigned you to a Group (see instructions below) with one other person. One of you should now create a new Discussion in your group space to decide the following

    - Who will represent the *Owners* and who will represent the *Operators*
    - How you will work together to complete this assignment (discuss how often you intend to participate in the negotiation etc.)

2. Create a second Discussion in your group space to conduct the negotiation based on the Term A agreement using the ideas you generated in the Changing the Term Sheet Provisions assignment. Together, you will negotiate the new terms of the agreement. As you negotiate, consider:

    - What is attractive about the other party's offer?
    - What would you like to see changed, and how?

This agreement will be shared with the other members of the course for the Final Discussion: Crafting an Advantageous Agreement.

Working in Groups

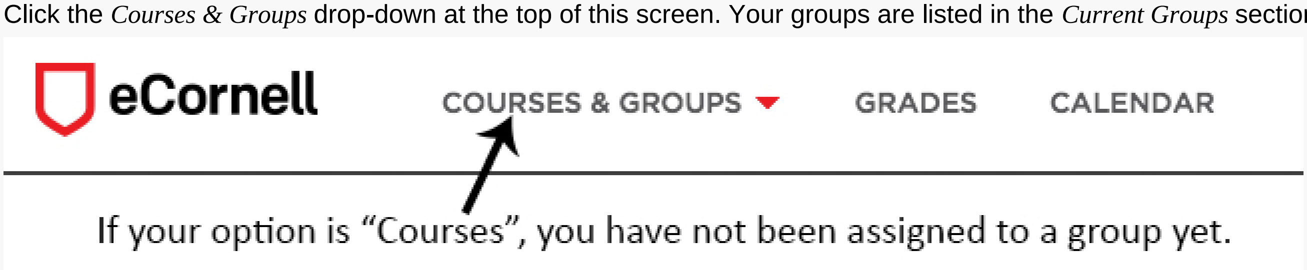
For this assignment, you have been assigned to a Group.

What does that mean?

You and your group members have your own separate space to work apart from the rest of the class. You can hold discussions, create collaborative documents and submit assignments as a group.

How do I find my Group space?

Click the *Courses & Groups* drop-down at the top of this screen. Your groups are listed in the *Current Groups* section.



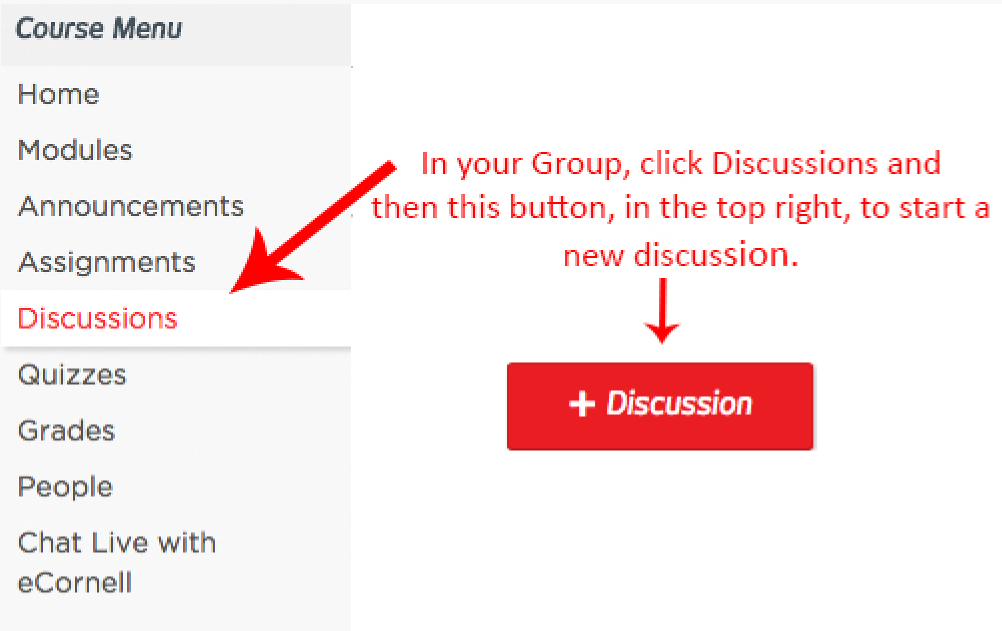
How do I see who else is in my Group?

In the Group space, click the People link to see the other members of the Group.

Who can access the Group space?

Only members of the Group and the course instructor have access to the Group space.

How do I create a new discussion in my Group Space?



Click Play to Listen

Jan deRoos
HVS Professor of Hotel Finance and Real Estate
School of Hotel Administration, Cornell University

Listen: Thank You and Farewell

Hi, this is Jan deRoos again. Obviously, hotel investments may take many forms. All hotel investments involve risk. By now, you should be able to fruitfully analyze the different control relationships best suited to a particular investment. You should also be able to identify and describe how risk is apportioned between the owner and the operator through these control mechanisms.

I hope you found this to be a stimulating and informative introduction to hospitality real estate and will continue with the next course in the certificate program.

Stay Connected

Additional Resources

The Center for Hospitality Research provides focused whitepapers and reports based on cutting-edge research.