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NORTON ROSE FULBRIGHT

Hotels and leisure

Key terms for hotel management agreements
Issue 4 – Fees

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Chambers Global 2015

This is the fourth in a series of short briefing notes identifying key issues for discussion when agreeing commercial terms for a hotel management agreement. We briefly identify the typical position adopted by each interested party and further issues for consideration when negotiating from such a position.

Fees

Fees will be one of the most important areas of consideration for both owners and operators when negotiating the heads of terms of a hotel management agreement. Hotel management agreements typically reserve two main fees for operators; a gross revenue related fee (often referred to as a basic fee/base fee); and a profit related fee (often referred to as an incentive fee). It is not uncommon, however, for other additional fees to be reserved by the management agreement which might include sales and marketing fees/booking fees/centralised services fees.

The operator’s position

From the operator’s perspective, the base fee is the minimum compensation expected for managing and generating revenue for the hotel, and does not take into account the expenses associated with the operation of the hotel. This fee provides operators with some comfort that a certain level of return may be achieved when agreeing to manage a hotel. The incentive fee, on the other hand, is based on operating profit, meaning that this fee will take into account certain above the line expenses, such as operating expenses, which means that an operator who manages costs efficiently will be rewarded with a greater incentive fee. Operators will be wary of including any below the line costs, over which the operator has no control (such as FF&E reserve and property taxes) in the calculation of fees paid to the operator.

The owner's position

Owners need to ensure that the level of fees charged by the operator will permit the owner to have a sufficient return on investment, and should focus on ensuring that the main remuneration of the operator is calculated on the basis of gross operating profit, which will incentivise the operator to manage the hotel efficiently and generate profit. Accordingly owners may try to push down base fees (based on revenue) and focus on incentive fees based on operating profit. Owners can require that the incentive fees be paid on a sliding scale basis (i.e. the higher the profit the higher the fee paid to the operator to push the operator to increase profit) and may also consider requiring the payment of an owner's return (or priority payment), that is a minimum level of return, prior to payment of incentive fees to the operator. Owners should ensure that any tender or proposal invited from operators requires the operator to identify all of the fees that it intends to charge in relation to the hotel (both at pre-opening and post opening) and the basis of their calculation (including the relevant accounting standards intended to be used) to ensure that no later "hidden" fees appear in the hotel management agreement which could reduce the owner's return on investment.

The lender's position

Fees payable to operators will be a key concern to lenders as these will impact the owner's ability to service its debt payment. While owners may look to procure financing after signing the hotel management agreement, owners need to consider how the level of fees payable to the operator will impact their ability to pay their debt and accordingly may impact the favourability of the terms of any financing. In particular the payment of an owner's return which can be used to pay off a debt will be viewed positively by lenders. Regardless of whether the hotel management agreement reserves an owner's return payment, lenders will often attempt to subordinate certain fees to the payment of debt, particularly on an event of enforcement under the financing. Typically operators will resist this but may agree to subordinate incentive fees. See our earlier note on hotel financing for further commentary.

Negotiation consideration

Ensuring clarity over all fees at term sheet level will ensure that a fair comparison is made against any competing operators. Operators ought not to have an issue with providing transparency over the provision of their fee proposal, however we have seen instances of fees being hidden in the long-grass of the operating agreement but not identified at term sheet level. This can lead to delays or break down in negotiation of the hotel management agreement.

Both parties need to understand the basis on which the fees are being calculated, for example, how is revenue calculated and how is operating profit calculated? Should any below the line costs be taken into account when calculating gross operating profit, such as the FF&E reserve?

Negotiating fees is a give and take process – an owner who intends to hold a prime hotel asset in the long term and agrees that any incoming owner is bound by the hotel management agreement may be in a position to push for lower fees. Alternatively, an owner who only wishes to hold the hotel in the short term (such as a hedge fund) and requires flexibility on the continuation of the hotel management agreement on sale, may agree to payment of higher fees in return for such flexibility.

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For more information

Our global legal practice is highly experienced in all aspects of the hotel and leisure industry and we have advised hotel owners, developers, lenders and many of the world's top hotel and leisure operators on all aspects of their operations. Through our extensive global platform of lawyers we are able to provide a co-ordinated legal service catering to all aspects of our clients' legal needs – from a single project boutique hotel development, to a multi-jurisdictional hotel portfolio acquisition. Our previous track record in the hotel and leisure sector has not only given us insight into the often complex legal requirements of the industry, but has also enabled us to build an in-depth understanding of the commercial and practical aspects of our clients' business. Our global offices can offer you the skills and experience required in this growing and diversified sector.

If you would like further information please contact Nick Clayson or Louisa Lynch or your local Norton Rose Fulbright contact.

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