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Hotels and leisure

Key terms for hotel management agreements
Issue 6 – Key money

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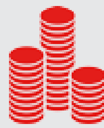
This is the sixth in a series of short briefing notes identifying key issues for discussion when agreeing the terms of a hotel management agreement (the HMA). In this briefing, we look at ‘key money’; how it is typically structured; and the relevant considerations beyond the purely commercial incentives that such provisions can provide.

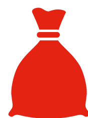


What is key money?

Key money is an up-front payment by a hotel operator or franchisor to a hotel owner to secure the entering into of a HMA or franchise agreement. Key money is more likely to be a consideration in respect of high-end projects (where there is competition between operators for access to particular critical markets/ trophy buildings) or where franchisors are looking to expand a flag.

In essence, key money is a financial contribution by the operator to the owner. Structures vary, but often it can viewed as a hybrid between a loan and an equity contribution. Key money can involve significant sums, and on high-end projects may be several million pounds. But as a rule of thumb, key money is generally five per cent or less of the total costs of the management or franchise deal.

In some circumstances, key money is repaid by owners via ‘burn off’ provisions by which the owner’s obligation to repay key money is waived on a pro rata basis; often over all or a substantial part (generally the first 10-15 years) of the initial term of the HMA/franchise agreement. Where the HMA is terminated for any reason prior to the expiry of any ‘burn off’ period, it is therefore usual for the balance of the key money to be immediately repayable to the operator. Nonetheless, the offer of key money remains attractive to owners looking to hedge some of the risk involved in the project, and is attractive to banks when underwriting a loan.



Structure

The structuring of key money payments and burn off provisions should be considered carefully in the context of the applicable jurisdictions of the owner and operator and the location of the hotel property from a tax perspective to maximise the benefit of such arrangements.

Alternatives

Given that in effect the payment of key money is an investment by the operator into the owner's hotel project, there are myriad alternatives which can give a similar commercial outcome including (but not limited to) the following

- A waiver of technical services fees (these are typically paid prior to the opening of a hotel).
- A minority equity investment by the operator into the SPV owner of the hotel company (with buyout rights and other appropriate protections).
- An acquisition (or underwriting the purchase) of off-plan condominium units in the owner's real estate component of the project.
- Mezzanine finance (by which the operator lends the owner part of the funds required to undertake the development).

Such financial incentives will assist the owner in funding the hotel's development.

If funding (or the cost of fundraising) is not a key consideration, then an arrangement by which base and incentive fees are adjusted to more closely align the parties will have the same financial impact over the term of the relationship.

The main benefit of such key money provisions and the alternatives discussed above (as opposed to a simple adjustment in base/incentive fees) is that they soften the financial burden by allowing funds to the hotel owner during the period that the hotel is being developed (and will not be cash generative).

Whether that burden is hardened in the later years of hotel operation via a more aggressive fee regime will depend on the relevant negotiating position at the time of agreeing the HMA.

Facilitating development

One of the critical issues in getting a hotel project 'off the ground' is securing funding. Lenders will look carefully at financial models and assumptions in considering appropriate lending levels. Incentives given by the operator have the potential to enhance the position of the operator in the eyes of lenders, opening up the project to a wider pool of potential lenders, and resulting more competitive interest rates. Incentives that have the potential to improve the owner's position could include

- An income guarantee underwritten by the operator to the owner for the initial post opening period for the project.
- A priority payment to the owner of certain levels of income before any management fees are paid.
- Subordination of incentive fees to the lender.

Risks

The balancing of the financial burden between hotel operation and development via key money /other incentives changes the risk profile of a transaction from the operator's perspective. An insolvent owner of an undeveloped hotel project is not an attractive proposition. Such risks can be overcome via guarantees and other comfort (which could for example include the timing of payment of incentives by the operator, and the taking of security).

Conclusions

Key money is a valuable negotiation tool for an operator who is looking to secure a high-profile project for its brand. It is also likely to appeal to owners looking for innovative ways to fund the development stage of their scheme, and it can materially change the risk profile of a transaction for the operator and any prospective lenders. However the parties should consider, at heads of terms stage, other alternatives that may give a similar commercial outcome, especially in light of the potential tax implications associated with the payment of key money.

For more information

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

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