

Hotel operator selection process: Some guidance for developers

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When a developer decides to increase its property portfolio with a hotel project, a number of factors should be taken into account, and a number of preparatory phases should be considered as essential elements for the future project.

Regardless of the rationale behind the developer's plans, extensive homework should precede the hotel operator selection process.

One of the greatest and most widespread mistakes made by hotel developers is the appointment of the operator only by reference to the operator's market profile and perceived reputation. However the operator's success in any particular project and in any particular market should not be viewed as a guaranteed prerequisite of high performance in other upcoming hotel projects. This article is designed to outline the steps to be taken by a developer prior to and in the course of the hotel operator selection process, in order to achieve the optimum balance between the operator's (and the chosen brand's) reputation, and the economic feasibility of the hotel project.

STAGE 1: FEASIBILITY STUDY

A lot of developers underestimate the importance of a proper feasibility study relying too much on their own knowledge of the market and extensive experience in real estate development. Although a developer may indeed be successful in the development of commercial real estate, the hospitality industry has its own particular operational specifics, neglect of which may result in under-performance of the hotel and, consequently, the developer's return on investment.

A feasibility study performed by an independent professional hotel consultant should precede any operator selection process, even where the developer may already have existing relationships with hotel operators. This is because what may be working well for one hotel may not be suitable for another, taking into consideration the hotel location, positioning, construction costs, existing competitions and likely guest profile.

The feasibility study will include a market study of existing and future demand and supply on the market among existing and upcoming accommodation facilities. Based on this, the consultant may recommend a particular hotel segment which suffers undersupply, and then convert the results of its market research into estimated performance of the project, taking into account the existing competition of lodging facilities with interchangeable accommodation services. Thereafter, based on the projected performance, and taking into account projected development costs and operating expenses, the hotel consultant can estimate the owner's return as the annual net operating profit. Based on such measures the hotel consultant may recommend an increase or decrease of the number of guest rooms, adjustment of the optimum room rate, a focus on additional services to be provided in the hotel (such as conference, spa/leisure, or F&B facilities etc.), which may substantially contribute to the increased profitability of the project.

As soon as the hotel segment, room count, economics and concept of the project have been identified based on the feasibility study, the developer can move on to the next stage.

STAGE 2: PREPARATION OF REQUEST FOR PROPOSAL

At this stage it is crucial to determine the developer's areas of leverage/advantage and major points of concern as the benchmark for further negotiations with candidates for the operator's position. Particularly, the following issues may in whole or in part represent the developer's key areas of concern:

- Subordination of incentive management fee (or portion thereof) in favor of a lending bank or third party-investor contributing to the development finance, or owner's priority return (usually arising due to the necessity to cover debt service). In case income from the hotel operation before fixed charges is not enough to maintain debt service or to ensure the owner's priority return, the incentive fee may be deferred or sometimes waived, if specifically negotiated with the candidate operator at the outset. Furthermore, it is important to clarify whether any deferred fee bears interest or not, and to clarify the mechanism for implementing the subordination/priority return.
- Variation of base for calculation of incentive fee (i.e. percentage of the gross operating profit, or percentage of GOP (gross operating profit) after property taxes, insurances, reserve for replacement of FF&E and/or debt service). As the basis for calculation of incentive fee is decreased, the percentage of incentive fee will be increased in order to compensate the operator's additional risk and smaller calculation base.
- Performance test to measure the operator's performance and ensure an Owner's right to terminate the management contract in the event of under-performance of the hotel. Unless a clear and robust performance test is in place, it will be almost impossible for the owner to terminate the contract with the operator. However the mere fact of existence of a performance test is not a guarantee of protection – it is important to ensure that the test itself is effective and based on realistic projections. Thus the performance test may be based on benchmarking of actual GOP against targeted GOP as an absolute financial measure, or alternatively, against budgeted GOP together with measuring the hotel actual RevPAR (revenue per available room) against the RevPAR of a competitive set of hotels, or benchmarking the hotel actual GOP against the targeted percentage of hotel gross revenue.

Alternatively, but less common, a developer may consider benchmarking of the hotel's occupancy rate against targeted occupancy or comparison of the hotel's performance with the performance of other similar hotels in the region managed by the operator. Even with such tests in place, a hotel developer should be aware that such tests may be subject to a certain amount of manipulation on the operator's side. In order to find the best solution for the performance test base, and to eliminate possible deficiencies and reduce the risk of manipulation, the hotel developer should take advice and closely cooperate with its hotel consultant and legal advisor. Otherwise the performance test may remain only on paper and may not be enforceable in practice.

- Key money, loan or equity contribution to be made by the operator, forming a joint venture with the developer. In certain trophy projects, or projects for development of a hotel portfolio, the developer may require the operator to contribute financially and this may be a stumbling block for certain chain operators, particularly those that are public companies having a policy of management only.
- In any case, the developer should beware an operator's financial participation, as the investment injected by the operator may be eventually the most expensive funding the developer could get for the project (as compared to banks or other third party investors). It does not necessarily mean that the rate of interest, or other form of return on investment (i.e. dividends in a joint venture or the like), required by the operator in return for its financial investment will be more onerous than those available on the open market, but still the operator will have the ability to use the investment as leverage over the developer to encourage a trade away of other key commercial terms in the deal, which may otherwise not be agreeable to the developer.
- Termination of management agreement on sale. If the developer contemplates the hotel project as a short-term investment, with an intention of subsequent sale as soon as the hotel generates

sustainable profit, the developer should strengthen its ability to sell the hotel by introducing into the management agreement a right to terminate if the new purchaser, for any reason whatsoever, would like to acquire the hotel with vacant possession. At this point, the question of compensation (or liquidated damages) that would fall due to the operator in such circumstances, will be a major item for discussion between the parties. The compensation/liquidated damages may be calculated in a variety of ways, but typically will be identified as an amount representing the monthly average incentive fee due to the operator over the duration of the previous 2 or 3 years of operation, multiplied by 24-36, or alternatively, multiplied by an amount which represents the number of months that remain in the term of the agreement at the date of termination. Alternatively, the exact amount of compensation/liquidated damages may be set out in a form of a sliding scale and linked to the average occupancy rate or the hotel's performance, over an agreed number of years preceding the termination. Further, the compensation/liquidated damages may be set in a descending scale, and the level of compensation/liquidated damages due would depend on which operating year of the management agreement the sale occurs.

- Restriction of competition by the operator. Although restriction of competition by the operator (i.e. its operation of another hotel under the same brand/position) within the vicinity of the hotel is rather common in practice, the major issue of concern to a developer often lies in the restriction of competition not only in respect of the same brand, but also in respect of so called "sister" brands of the operator. The sister brands may provide similar interchangeable accommodation services in the same or contiguous hotel segment, which in practice may create competition for the hotel. Operators are usually reluctant to include sister brands in the restriction of competition clause, so this issue will heavily depend on the developer's bargaining strength.

STAGE 3: DEFINING THE SET OF COMPETING OPERATOR CANDIDATES AND HOLDING THE BIDDING PROCESS

Even where a developer knows for sure that a certain operator and certain brand is perfect for its hotel project, it may be fatal to focus on just one operator, letting them know that this brand is a "must have". The best way to get the best deal is to create a competition between 3-5 operators and have them bid for the project in several bidding stages, screening candidates for elimination along the way, bearing in mind the developer's key areas of concern and ensuring a transparent discussion of these areas as part of the process.

As soon as the operator is selected, the achieved arrangements should be documented in the form of Letter of Intent or Memorandum of Understanding (LOI/MOU), and subsequently further reflected in the hotel management agreement and concomitant contracts.

The better the LOI/MOU is drafted on major commercial and financial issues, the smoother will be the drafting of the main hotel management contracts, and the quicker (and cheaper) the process of finalizing same.

CONCLUSION

The above issues are merely examples of some key issues that may be subject to negotiation at the early stage of discussions with an operator, and which should always be considered as part of the operator selection process. These issues will of course vary, depending on the developer's and operator's concerns, market conditions, location of the project, the projected profitability of the hotel, the existing competition in the market and other factors.

Regardless of what particular issues are the key points of concern for a certain developer, all issues should be, by all means, thoroughly considered at the stage of preparation of the Request for Proposal, together with the developer's negotiation position and benchmarks for further negotiations with operator candidates.

In this process one should not underestimate the importance of active engagement of hotel experts and legal advisors. A widespread mistake is inadequate attention to such considerations at this stage, and signature by a developer of a Letter of Intent/Memorandum of Understanding in haste, without having taken commercial and legal advice.

Although developers may consider the LOI/MOU to be a non-binding document, in practice re-negotiation of express commercial terms already agreed and set out in an LOI/MOU is very difficult and will be strongly resisted by an operator. The risk is that, by re-opening negotiation of a particular term in the LOI/MOU, the developer will introduce bad faith and bad feeling, and may ultimately lose the operator, which might have been the perfect operator for its hotel project. This is why undertaking extensive homework and obtaining the right advice before and during the operator selection process is so important for a developer. It will often be too late to look for such advice after the operator has been selected and an LOI/MOU signed.