Management agreements – blocking the road to value growth for hotel property owners

By Anders Nissen, CEO Pandox AB

The traditional fee structure of management agreements can be a large stumbling block for value growth in a hotel property and should be phased out to be replaced by incentive based agreements. The nature of the management agreements has led to hotel operators prioritising gross revenues and brand issues, while neglecting operations and productivity issues. Hotel operators on lease agreements, on the other hand, rely on effective operations and high productivity to create their profits. The point here is that there is a risk that the most important factors for value growth in a hotel property; high productivity and efficient operations, will be neglected by the companies that prefer management agreements, as opposed to rent based agreements. Are passive financial investors and property owners really aware of this?

THE VARIOUS AGREEMENT MODELS

For optimal performance, modern, rent based agreements are structured so that the operator pays a fee based on the operating company's turnover. An active property owner and an operator will enter into agreements where investments and product development costs are split in such a way that they create common goals. This type of agreement will give the operator an incentive to improve profitability through increasing revenues, cutting costs and making investments that improve the product in the longer term. The result is that both sides have a fair share of the upside, as well as the potential downside of the operations, taking into account invested capital, future potential and risk.

Traditional management agreements can be compared to agent agreements. What distinguishes them is that the hotel property owner also owns the operations and will shoulder all investments. The deal for the operator is to run the hotel on behalf of the property owner. The owner pays a 'management fee' to the operator, usually a share of the turnover, with the underlying idea that this is an effective way to drive revenues. Sometimes, the property owner also pays an incentive fee on top of that, often based on the profitability of the operations, but normally this makes up a much smaller part of the total.
This type of agreement leaves the operator in full control over the business while the property owner is reduced to being a passive investor with limited possibility to influence decisions that drive value growth in the individual hotel property. The agreements often span several decades during which the operator agrees to operate the hotel in line with set brand strategies. Thus, the property owner finds himself in a situation where he is fully responsible for operations, as well as all investments, while the operator – who is in complete control of the value chain – profits from any upside, without having to shoulder either risk or investment costs.

The hotel market is broadly divided into hotel companies that enter into rent based agreements and those that prefer management agreements. North America is dominated by management agreements while rent agreements based on turnover is the most common business model in Scandinavia. This turnover based rent agreement is also well established in the retail sector. Management agreements became popular in the 1950-ties and 60-ties when it proved an effective and relatively risk free way for the large, often American based, hotel chains to quickly expand across new and unknown territories. For them, the model has proven very successful and, apart from a few isolated places, the hotel chains have more or less conquered the earth.

PRODUCTIVITY AND PROFITABILITY ARE NOT PRIORITISED IN MANAGEMENT AGREEMENTS!

Productivity and profitability are the two most important factors for value growth in a hotel property. The difference when compared to other changes, such as increased demand or higher room prices, is that improved productivity is 100% reflected as profit on the bottom line and that improved profitability, in turn, increases the value of the property.

And this is the problem with management agreements. The fee structure in a management agreement is based on the operating company receiving a management fee from the hotel property company based on total revenues. As a result, focus will be on increasing sales and less on managing costs. The end result is that the most important factors for value growth, productivity and profitability, rarely make the agenda in those companies that prefer management agreements. Productivity is not prioritised, as the operator has no responsibility to manage cost or to make investments under this type of agreement. The full responsibility for those aspects falls on the property owner even though he or she has little insight into the running of the business.

THERE IS STILL A GREAT LACK OF KNOWLEDGE SURROUNDING RENT BASED AGREEMENTS

Over time, lenders in international markets have grown accustomed to evaluate hotel companies' accounts based on management agreements, while ignorance is widespread when it comes to evaluating rent agreements based on turnover. The fact that management agreements are the most common in the large international markets has resulted in accounting principles being adjusted to accommodate them. With the owners remaining passive, the accounting principles have been designed in a way that often favours the operator. One of the examples is the prominent line,"FF&E reserves" (furniture, fixtures and equipment) where the hotel owner, under the agreement structure, is expected to set aside funds to be invested by the operating company, but without any insight into how and why.

For an owner that has elected a management agreement, the full P&L statement is incorporated into the hotel company's accounts. This creates the illusion for the lender that the hotel property company is in overall control as, on paper, he owns the operations. This is completely opposite to a rent based agreement where the lender needs to make a separate risk assessment of both owner and operator *without* having full insight into the business of the operator.

To assume that this is a great risk seems incorrect; yet, on the contrary, a more real risk seems to be the lenders' great belief in the large hotel brands' ability to run efficient hotel operations. What is not properly taken into account is that hotel operators, due to the structure of the agreement, do not put enough effort into profitability issues. As a result, the hotel companies' goals – to drive revenue and thereby management fees – are different from the ones the lender and the hotel property owner have, or should have, i.e. to create value growth.

WHY AREN'T THE LARGE HOTEL COMPANIES ABLE TO RUN SUCCESSFUL OPERATIONS UNDER RENT AGREEMENTS?

Over the years, the large hotel companies have had problems achieving adequate results using turnover based rent agreements which has led to the model acquiring an undeservedly bad reputation in large sectors of the industry. However, we shouldn't blame the model; what it actually reveals is the lack of knowledge in running efficient hotel operations among the large hotel companies. This is also a reasonable explanation as to why the large brands have problems breaking into the Nordic market where the turnover based rent model is the most common.

Please note that the turnover based rent agreement is completely different from fixed lease agreements. Fixed, long term agreements, which are common in Europe, do not create the important common incentives that turnover based agreements do. Passive investors often view long term fixed agreements with an established hotel operator as a low risk investment, creating a situation similar to the one under management agreements i.e., owners and operators do not share the same goals and incentives.

MANAGEMENT AGREEMENTS SHOULD BE PHASED OUT IN FAVOUR OF INCENTIVE BASED RENT AGREEMENTS

It is about time for the industry to wake up to the fact that hotel companies that choose the rent model develop invaluable competence in both profitable and efficient operations, and as a result create significant value growth compared to the companies that elect the management agreements.

To create similar joint incentives under a management agreement, the structure of the agreement must be altered. The first change could be that the full management fee is based on an incentive structure which requires the operator to focus more on productivity issues. Another change should be the addition of exit clauses in the management agreements, where the property owner has the right to cancel the operator's contract if not happy with the running of the hotel or its efficiency levels.

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