

How to get the right hotel operator: Part 1 - By Jim Butler, author of www.HotelLawBlog.com 2008-04-22

Hotel Lawyer on hotel management agreements. Long-term, no-cut hotel management agreements: How to get the right brand and operator for your hotel project . . . and a deal you can live with.

The successful matching of a hotel brand and operator with an asset and its owner is an important determinant of the financial and operational success of a hotel project. Aside from the right "marriage" partners, the terms of the management contract tying them together is critical, because it will likely govern the relationship for decades and is hard to change once cast.

Question: What's more important for your hotel project than getting the "right" brand and operator?

Answer: Not much! Finding the right operator or brand for your project -- and achieving reasonable terms -- can make a significant and positive impact in key areas: value, financing, and operational success.

So how do you do that?

Hotel management agreement & hotel operator fundamentals

We have covered a lot of ground about hotel operators here at www.HotelLawBlog.com. We even have an entire section of the website devoted to the topic of Hotel Management Agreements.

In representing clients in many hundreds of hotel management agreements over the years -- possibly more than a 1,000 -- we find that there is no single one "best" or "right" operator or brand. What's "best" in each situation depends upon each individual client's goals and circumstances, many project-specific facts and circumstances, and the economic environment. It also depends upon the capabilities, vision and strategic needs of a particular hotel brand and operator at a given moment.

Finding the right brand and operator "partner" for your hotel is one of the most critical factors controlling the financial and operating success of your hotel and related project components. It will affect everything from financing, design, programming, operations, market plan and target market, and ability to accomplish or exceed reasonable expectations. The selection of a hotel brand and operator, and the management contract terms, will generally have a determinative impact on the value, marketability and financeability of the property. And if you make a bad choice in brand, operator or contract terms -- or a good situation turns sour -- it will be difficult or impossible to fix. Why?

Consider these facts in the typical branded management contract:

Contracts tend to be very long-term agreements. (30-50 years is not uncommon and some run to 100 years!)

The operator will have almost exclusive control over all aspects of your hotel property and operation -- hiring and firing, setting rates and policies, marketing, renovations, capital expenditures.

The owner's ability to control runaway costs and require appropriate efforts to drive the top line, when necessary, largely depend upon "approval rights" over critical matters like annual operating budgets, marketing plans, capital expenditures, entering into union or other major contracts, personnel hiring and benefit plans, and operator self-dealing.

Many developers and investors worry about "locking in" operators to keep them from walking away. In fact, meaningful performance standards and termination rights may be the most important value-preserving terms to have.

The successful matching of the brand and operator with an asset and its owner is an important determinant of the financial and operational success of a hotel project. And it is widely recognized that the business and legal terms of the hotel management agreement -- wholly apart from the operator's abilities -- can add or subtract 25% of the nominal value of the hotel, or more. That is huge! Take a hotel nominally worth \$100 million. By this industry rule of thumb, the hotel's value could easily swing from \$75 million to \$125 million depending on the operator and the management contract terms.

Famous last words - the 5 biggest mistakes owners continue to make

Hotel owners that get into bad situations with their operators often follow the same pattern at the outset. The following are "famous last words" that illustrate the 5 biggest mistakes owners make when seeking an operator or brand for their hotel:

1. "I just have to have Brand X for my hotel. They are perfect for my project."

Even if Brand X is perfect for your project, the best way to get a great operator and a fair deal is to have a little competition, compare the results, and be sure each operator knows there is at least one other brand they have to "meet or beat." This process should not feel like an auction, but rather like a controlled, selective, competition. A proper investigation will probably reveal more than one great brand or operator for you.

2. "We met some operators at the recent hotel conference, and they are really interested in our project. I think we can do a deal with them. Or ... maybe you can just give me a couple of phone numbers to call."

Executives in the hotel industry are generally friendly and fun people. That's why they went into hospitality. But a casual or accidental process is not the best way to identify, recruit, and selectively draw out the best business and legal terms for your hotel management agreement. You will have already given up more than you know over cocktails or a round of golf in an undisciplined process. Hotel executives make their living by negotiating hundreds of deals with guys like you. Without identifying all your project's strong points at the outset and drawing the blueprint for your RFP process, your deal will get shop worn and tired before it can be properly positioned. And if you let the hotel companies guide the process, you may find yourself with a Letter of Intent (LOI) or term sheet BEFORE you have guided and shaped the hotel company's expectations. As a result, owners often lose big, important "deal points" that could have been accomplished if they had engaged in a disciplined process.

3. "Let me get the LOI signed first. It's 'non-binding' anyway. Then we will bring in the management agreement experts."

It is a false economy -- usually a near disaster -- to negotiate the LOI terms first, and THEN bring in your hotel management agreement advisors. By the time the LOI has been discussed, much less signed, it is too late to protect your interests. Although most LOIs say they are non-binding (except on exclusive dealings with only the one operator and on confidentiality), the custom of the industry is that you are "retrading" the deal if you try to change those "non-binding" terms when your experts try to un-ring the bells that you have set off. Yes, you could probably walk from the deal (after waiting out the exclusivity period), but you have now lost the ability to do a reasonable deal with the operator you thought would be best, and you have lost time and momentum. The operators are well aware of this and they usually will not retrade.

We have approximately 36 "first tier" and "second tier" owner-oriented deal point issues that we believe have to be raised BEFORE the LOI is signed. If you do not fight to get these deal points into the LOI up front, you are unlikely to accomplish those terms ever. If you don't know what those issues are, don't even think about letting the LOI process start without us or other experienced advisors with both legal and hotel business savvy.

4. "We have the operator's interests aligned with ours. They are making an investment in the deal, along with us."

At first it is exciting. The operator thinks so highly of your project that this major institutional, experienced operator, that sees hundreds of projects is actually willing to co-invest with you in your project. What an endorsement that is for you and your project. It also seems that having the operator invest some equity in your hotel deal or providing a credit enhancement of some kind might be an easy way to raise some capital, and also the best way to align the economic interests of operator and owner. Each investor will make, or lose, money together on the same basis.

Be forewarned: the operator's money will be the "most expensive" capital an owner can get -- not in terms of the return paid on the capital, but in the terms you will have to "give up" in the management agreement. You will get virtually none of the meaningful concessions you need for a balanced agreement. But the operator will still get its real money "off the top," before any return is paid to equity.

5. "I don't care about the hotel management agreement terms. I just need someone to take over the hotel aspects of the deal so I can do my retail/office/golf/condos. I'm not a hotel guy."

Our typical client is very successful in business, perhaps even in real estate or development. But many of our clients are novices when it comes to hotel development, management agreements and operational issues. Fortunately, it is pretty easy to "rent" this expertise on a short-term or as-needed basis. It is usually much better to temporarily hire the team of experts, rather than to build that kind of infrastructure, or to turn the hotel issues over to someone else who does not have the same interest and concerns that you do. This is particularly important in hotel mixed-use projects where integration of the hotel with other project components must go smoothly.

How do you get a great operator -- one that shares your vision and will give you reasonable terms?

The hotel owner's best friend - the Hotel RFP

Hotel owners and operators need each other. Although there is always some tension in the push-pull of owner-operator relations, there are many situations where owners and operators seem to share the same vision of what a hotel should be, how it should operate and how to make it a smashing success. The hotel management agreement is like a Constitution in setting many of the critical ground rules for the owner-operator relationship, and in setting the expectations of the parties.

Some miserable hotel owners have great operators "locked in" on terrible 50-year, no-cut, operator-takes-all management agreements. Other unhappy owners have great management agreements with operators who cannot execute the business plan or deliver on financial or guest expectations. How do you get the "Goldilocks" balance (not too hot, not too cold, but just right) of a great operator, a shared vision for the property, and fair management contract terms?

In the course of handling more than \$50 billion of hotel transactions, JMBM's Global Hospitality Group(R) has developed and refined an approach that seems to improve the outcome on a consistent basis. It is our version of the Hotel Brand and Operator RFP Process. This RFP Process is an organized, disciplined and highly interactive process. It's not about "putting your project out to bid." It's about strategically positioning your property to attract the right operator for you and your project. Here's how it works:

Based upon the owner's goals, the specifics of a project and its market fundamentals, we first identify an exhaustive list of possible brand and operator candidates. Working with the client and other team members, we review and prioritize choices, and compare alternative operator contacts and approaches, tailoring them to the individual project and operator candidates.

Unlike RFPs for many other purposes, we generally recommend that the owner plan to actively "sell" the merits of the project to the brand and operator candidates: Tell them why this is a great project that they want to have in their family of hotels. Clarify your vision of what distinguishes the project, how it will be successful, and why it may be strategically or financially important to their particular hotel company.

Careful planning and execution of the RFP Process is one of the most important keys to finding a good hotel operator and brand and getting a fair agreement. The strategy and process is complicated enough that it is best to have a separate discussion, in which we can explore the important considerations in more detail.

Look for "How to get the right hotel operator, Part 2" soon, for a discussion on using the RFP process for strategically positioning your project to attract the right operator.

About the Author



Jim Butler is recognized as one of the top hotel lawyers in the world. He devotes 100% of his practice to hospitality, representing hotel owners, developers and lenders. Jim leads JMBM's Global Hospitality Group(R) -- a team of 50 seasoned professionals with more than \$40 billion of hotel transactional experience, involving more than 1,000 properties located around the globe. In the last 5 years alone, they have brought their practical advice to more than 80 "hotel-enhanced mixed-use" projects, a term Jim coined to fill a void in industry lexicon. This term describes one of the hottest developments in real estate-where hotels work together with shopping center, residential, office, retail, spa and sports facility components to mutually enhance the entire project's excitement and success.

Jim and his team are more than "just" great hotel lawyers. They are also hospitality consultants and business advisors. They are deal makers. They can help find the right operator or capital provider. They know who to call and how to reach them. They are a major gateway of hotel finance, facilitating the flow of capital with their legal skill, hospitality industry knowledge and ability to find the right "fit" for all parts of the capital stack. Because they are part of the very fabric of the hotel industry, they are able to help clients identify key business goals, assemble the right team, strategize the approach to optimize value and then get the deal done.

Jim is the author of the www.HotelLawBlog.com. He can be reached at +1 310.201.3526 or jbutler@jmbm.com .

This article comes from Hotel News Resource

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