Comenius

HOTEL MANAGEMENT CONTRACT

WHAT TO EXPECT BY THE HOTEL OWNER?

MANAGEMENT AGREEMENT

The management contract started many years ago in the United States and today in Europe is also a widely accepted form of cooperation between hotel owner/investor and operating companies. The picture behind a hotel management agreement is that the hotel owner pays a fee to the hotel operator for his management services and in return the hotel owner transfers the full responsibility for the daily operations of his property to the management company. A management company like Comenius has a strong Sales and Marketing team with experts in corporate sales, pricing and distribution, e-commerce and MICE. Comenius also has experts supporting each hotel with branding, and successfully carries out cost control measures leading to an increased bottom-line. Hence, a company like Comenius is better equipped to operate hotels more effectively than most owners/investors are.

The fee paid to the management company is based on an agreed-upon percentage of revenue and of gross operating profit. This is to ensure that the management company will protect both interests of the owner; revenue and GOP. Owners' benefit from such a structure, as this strives to ensure that it will drive higher returns.

The proper execution of a management contract between the hotel owner and the management company is a vital step in the development of a successful hotel venture. The management contract spells out the basic relationship between the owner and the operator. For example, it might specify who is responsible for the provision of operating capital, the payment of property taxes, or employment of the general manager and other key executives. Great care should be taken in putting together the management contract, since an agreement that is overly favourable to one party can result in a contentious relationship between the owner and the operator, with potential disastrous results for the hotel.

CONTRACT TERM

The term of a management contract is the length of time for which the agreement is to remain in effect. Both a commencement date and a termination date are usually specified in this provision. The commencement date may be either a specific date or it may be as of a certain occurrence, such as the date the hotel officially opens for business. The contract term may comprise an initial term and one or more additional renewal terms that extend the total length of the agreement.

A hotel operator generally incurs high start-up costs when taking over new contracts, so the company needs a term long enough to recoup the initial one-time expenses. In addition, most management fees are structured so that they reward profitable operating results, and as a result, it may take an operator several years to achieve the level of profits needed to earn a reasonable amount of compensation. The length of the contract term has also additional importance because of their public name recognition. Therefore, contracts usually run for an initial term of 10 or 15 years. Renewal terms extend the contract for a stated period beyond the initial term. The renewal term is typically structured as a contract extension option that may be exercised by either the operator or the owner acting alone or in agreement for a period from 5 till 10 years. In special occasions Comenius accept a 5 years contract term.

MANAGEMENT FEE

A management fee is the compensation a hotel company receives for providing the various services called for in a management contract. The management fee covers the management services. The calculation of the management fee is usually tied to one or more financial indicators, such as revenue or profit. From the hotel owner's point of view, the management fee represents an operating expense, something that should be controlled and minimized. However, management fees can be treated as an incentive and thus become an ownership tool for fostering profitable operations. One of the primary goals of hotel owners is to receive net income from the hotel operations. The ability and efforts of the management company have a direct impact on whether the hotel is able to realize this goal.

BASIC FEE

Under the agreement known as the basic fee, the management fee is determined by a percentage of gross revenue, creating an incentive for the operator to increase marketing efforts and other activities that increase sales volume. The drawback to this arrangement is that the basic fee provides no incentive to minimize operating expenses. If the entire management fee is in the form of a basic fee, the operator can theoretically increase market and sales efforts to the point at which the highest possible revenues are reached, but any margin of profits is eliminated. A balance of risk is thus required with operations aligning their interest to those of the owners. This is done with the Incentive fees.

INCENTIVE FEE

In another type of management fee, known as the incentive fee, the fee paid to the management company is based on a specified percentage of a defined income, usually determined by sales volume and expense control. Therefore, incentive fee rewards the operator for efficient, profitable management. For example, consider an 80 room hotel that currently operating at a 65.2% stabilized occupancy with an average room rate of 105.20 Euros. Both parties agree that 3% of the total annual revenue of 108,000 Euros as the basic management fee is a fair compensation for the services of the management company. The second part of the total fee will be paid on an incentive basis and calculated as a percentage of a defined profit and is in general 10%.

This fee will be calculated below GOP on the income statement. From the operator's point of view, the management fee represents compensation for services rendered. The fee must be enough to both cover the management company's operating expenses and provide an adequate profit. The ROI (return on investment) for the owner is the know-how, the power of the brand, and the systems provided by the operator.

Operators understand the need of owners to receive the maximum net income possible from hotel operations, but they also realize that in some instances they have little control over operating results. In overbuilt markets or depressed economies, even the best management companies find it difficult to generate suitable profits. In such situations a management company might be unfairly penalized if the entire fee is calculated as a percentage of a defined profit. The same is true for new hotels, for which a period of occupancy build-up and initial operating losses are expected.

It must be recognized that a sizable portion of the total operating costs for a management company are incurred during the initial part of the contract term. During the start-up phase for a newly opened hotel or the takeover phase for an existing property, the operator must devote a significant amount of supervisory time to institute new systems, procedures, and controls. This phase also entails greater efforts in recruiting, training, marketing, purchasing, and accounting. In order for a contract to be attractive to an operator, there should be some reasonable expectation that these initial costs can be recovered over the contractual term.

FINANCIAL REPORTING

The complete, accurate, and timely reporting of financial operating results is one of the most important services provided by a hotel management company, because it is the only real measure available to a hotel owner to evaluate the performance and effectiveness of the management company.

Management contracts should detail the types of financial reports that the operator must prepare, the manner in which they should be prepared and when they should be submitted.

Financial reports must be:

- organized in a uniform manner and in sufficient detail so that results can be quickly evaluated and any deficiencies immediately spotted
- accurately compiled by knowledgeable accountants and audited periodically
- issued in a timely manner.

The first requirement of a financial reporting system is a uniform accounting procedure that allows for easy comparison between financial reports within the same property, along with the operating results of other, similar hotels.

Comenius has adopted the Uniform System of Accounts for Hotels and is able to fulfill all above mentioned requirements.

The financial reports provided by the management company could include daily, monthly, annual, and miscellaneous reports.

REPORTS

- Daily reports
  These reports should provide information regarding revenues and occupancy and should include details of all authorized complimentary rooms.
- Monthly reports
  These reports should include an income and expense statement with full supporting schedules calculated on an accrual method and statistical data that details revenues by outlet, occupied rooms by market segment, food and beverage covers by outlet, and labor utilization by department. These reports should provide data for the current month, current month's budget, current year-to-date budget, last year's month, and last year's to date budget, and in addition should provide a balance sheet, identification of sources and uses of funds, details of capital expenditures, and a Manager's summary and overview of operations.
- Annual reports
  These reports must contain an income and expense statement, but not audit and statutory accounting reports or consolidation (so-called owners accounting), a balance sheet, and documentation of the sources and uses of funds, all of which should be audited.
- Optional reports
  These reports, to be issues at the request of the owner, include information regarding the aging of accounts receivable, schedules of payables, and schedules of supplies and inventory, as well as reports on occupancy, labor utilization, and insurance claims.

All financial reports should be prepared by the operator either locally on the property or centrally at the hotel company's HQ. The operator should maintain a strong control system in order to prevent theft and embezzlement and ensure that all transactions are properly accounted for and reported. The entire system, along with the financial reports, should be audited at least annually, and more often of accounting problems are expected. Financial reports must be prepared on a timely basis to be the greatest value to the owner and operator. Hotel owners should be aware that significant costs are involved in preparing financial reports and should refrain from needlessly burdening an operator with unnecessary requests for information.

ANNUAL PLANS

All well-run businesses prepare budgets, usually annually agreed between the owner and the operator, plans for future operations, and evaluations of past performance in order to facilitate financial planning and control costs. Such planning and analysis is especially important for lodging facilities operated by hotel management companies. Under normal circumstances, a management company submits an annual plan to the owner that comprises a number of budgets, reports, and plans detailing the expectations of the management company for the subject property over the following twelve months. Annul plans include a forecast of income and expenses, a capital expenditure budget, a repair and maintenance budget, a marketing plan, and reports on engineering systems, leasing plans for commercial space, staffing, and salaries.

FORECAST OF INCOME AND EXPENSES

Perhaps the most important element of an annual plan is a month-by-month forecast of income and expense. This forecast should include full supporting schedule of each revenue and expense category. All standard budget items, including reserves for replacement, property tax, equipment leases, and debt service, should be projected.

BUDGET FOR CAPITAL EXPENDITURE AND REPAIR AND MAINTENANCE

This budget contains four categories:

1. Budgeted CAPEX (owners funded)
2. Unbudgeted CAPEX (emergency related and owners funded)
3. FF&E Reserve (controlled by operator)
4. Repair & Maintenance (day to day and budgeted in P&L)

The capital expenditure budget should contain a detailed listing of all necessary expenditures. Each entry in the listening should provide a full description of the expenditure, a concise explanation of why it is necessary, and an identification of the aspect of the property it will improve. In addition, the listing should include the manner in which the cost will be funded and a time frame for its occurrence.

The repair and maintenance budget should contain the same sort of information as the capital expenditure budget, except that the items listed in it will relate to expenses contained in the repair and maintenance category of the income and expense statement.

MARKETING PLAN

The marketing plan should be a comprehensive description of the operating company's marketing efforts on behalf of the subject property.

OTHER REPORTS

Among the other reports that the hotel management company must prepare and update annually for the owner are the following: (1) an engineering status report; (2) a leasing plan for commercial space; and (3) a staffing and salary report.

HOTEL PERSONEL

Hotel staff will be employed by the Owner. All employees and related expenses will be at the Owner´s expense and risk. Owner will have reasonable rights of approval over the selection of the Hotel´s General Manager.

BUDGET APPROVAL PROCESS

The budget approval process is the procedure by which hotel budget are prepared, submitted to the owner, reviewed, modified, and put into effect. It is also the means by which the owner exerts influence over the expenditures of, and thus the operation of, the hotel. This process is generally clearly defined in the management agreement.

The budget approval process generally begins about four months before the start of a new operational year, and, much like an annual plan is put together by the hotel department heads and is supervised by the general manager. Most operators have a multi-step approval process that takes the proposed plan up their corporate ladder. The property owner generally has no input in the process during this initial preparation phase.

Once the annual plan has made it through the internal approval process of the management company, it is submitted to the property owner, usually within sixty to ninety days of the start of a new operating year. The property owner should require ample time to review the plan, develop a critique, and resolve any differences before the time at which the budget become effective. The procedure, orientated to the owner's interest allows the owner an opportunity to review the annual plan, make comments, and approve either certain specific aspects of the plan or the entire plan.

Once the annual budget plan has been approved, the management company must operate within its budgetary limits. However, unforeseen events and emergencies may cause the operator to exceed such limits.

TERMINATION OF AGREEMENT

When two parties enter into an agreement such as a hotel management contract, the implicit belief is that the relationship will continue for the full term. Often it does, but occasionally one of the participants fails to meet its contractual obligations and the agreement must be terminated.

To protect both parties from such situation, hotel management contracts often incorporate specific provisions that allow one or both parties to terminate the agreement. Circumstances that can trigger termination by the owner include:

- bankruptcy of the operator
- failure to achieve specific level of performance (e. g. "Performance Test"; Revpar should be three years in a row above index 100 in comparison with competition)
- operator buy-out
- operator's material breach of the contract
- operators misconduct or fraud
- operators revocation of license
- cessation of operator activity in the hotel business
- condemnation or casualty
- bankruptcy of the owner
- owners material breach of the contract
- owners revocation of license
- owners failure to provide adequate funds
- mortgage or lease default
- condemnation or casualty foreclosure.

The key to any termination clause is that it should allow for the rapid and conclusive removal of the party at fault. A drawn-out termination by either the owner or the operator is to be avoided, because it can have a devastating effect on the current and future operating results of the property.

RESERVE FOR REPLACEMENT (FF&E reserve)

A reserve for replacement is a fund set up to accumulate capital for the periodic replacement of FF&E. Hotel FF&E should generally be replaced on an average of once every eight to ten years, so the reserve for replacement must be of adequate size to meet these requirements. Hotel owners that are also operators usually do not actually establish a fund for this purpose, but rather contribute capital at the time that FF&E replacements are required. Depending on the owner's financial situation at the time FF&E funds are needed, they may come from the hotel's cash flow, additional borrowings, or new equity contribution. Occasionally, these sources of funds of funds are not available and the FF&E replacements must be postponed.

A hotel management company has a vested interest in maintaining the hotel in top physical condition, so it does not want to be in a position where adequate funds are not available to make necessary replacements. A worn-out facility negatively effects profitability as well as the image and reputation of the operator.

To provide protection against such an occurrence, hotel management companies generally require that an actual reserve for replacement fund be established, coupled with contractual obligations for regularly depositing capital.

The management company typically opens a separate reserve for replacement bank account and administers its activity. Deposits are made by the operator directly from cash flow. Withdrawals from the fund are to be used only for the replacement of FF&E and generally only with the approval from the operator and/or owner.

PRE-OPENING MANAGEMENT SERVICES

Since most hotel management agreements are structured primarily for operating lodging facilities, hotel companies that are taking over a newly-constructed hotel generally draw up an additional contract to cover pre-opening management services. The period known as the pre-opening phase of a hotel's development generally begins with the employment of a sales staff or the general manager and extends to the actual opening day.

Depending on the type of hotel and the pre-opening sales activities, the pre-opening service can start between 3 and 6 months prior to the opening. Some of the services the hotel operator typically provides during the pre-opening period include: pre-opening budget, personnel services, advertising and promotion, leases and agreements, licenses and permits, purchasing, installation, sales and marketing, financial statements and controls, and coordination. Compensation for the pre-opening services can be structured via an amount per room or a flat amount.

IN CLOSURE

In case you are interested in a COMENIUS MANAGEMENT CONTRACT for your property and want to discuss options and possibilities, please contact:

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