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Strategies for Hotel Management and Operations

Sudhansu Patnaik

Abstract--- *The history of management contracts in the hotel industry has been well documented, but the changing trends and alternative options have been less well covered. There is an evolution going on which is slowly but surely changing the balance of risk in favor of the owner of a hotel, and putting a greater onus on operators to 'perform' as custodians and managers of the investment. This paper examines contract options and structures with hotel management companies and highlights some of the trends and issues that have to be taken into consideration when choosing an operating partner. Following the turmoil in the hospitality industry in the last two years, the activities have been renewed, and developers in most sectors in both the United Kingdom and many other international and resort markets are now showing renewed optimism and interest. At the same time, there are some new companies that are prepared to make flexible and innovative agreements and to tailor the contracts directly to the needs of owners, but who has not the same "muscle" as the main hotel groups until they have brand presence.*

Keywords--- *Agreements, Hospitality, Industry, Management and Operators*

I. INTRODUCTION

The history of hotel management contracts has been well documented, but changing trends and alternatives have not been well covered. There is a development that gradually but surely changes the risk balance in favor of a hotel owner and places greater emphasis on operators as custodians and investment managers. Traditionally, anyone who wanted to secure the services of one of the best management companies had to accept the standard contracts offered; however, this is changing because of a number of factors. The fact that some major companies have not been immune against global economic circumstances (see Le Meridien) and that an increasing number of smaller, growth-driven hotel companies are looking for and are prepared to make their own brands more flexibles are among the factors which have caused this sea change.

I.I. For a management company the issues are normally as follows:

- How much do we in this place want / need a "flag"
- Is it going to add long-term value and share price to the group
- Who owns the project and have they the financial resources to help and execute it
- Do we have the channels of distribution and customer base for the hotel supply
- What is the downside risk
- Can businesses be diluted as a result of this contract with other group hotels
- What is the risk (geographical, political, economic) associated with the location

I.II. For the owner the issues can be far wider:

- Can I work with and trust these people?

Department of Management, Siksha 'O' Anusandhan (Deemed to be University), Bhubaneswar, sudhansu@soa.ac.in

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- Can the customers deliver?
- Were they long-term stars (as far as it can be assessed)?
- Where are the activities going to support them and what will it cost me?
- Do hidden fees or costs exist?
- How well do you know the market, or do you need to learn at my cost?
- If they do not, or if I want to sell the hotel, can I get rid of them?
- Will they pay me a minimum amount for my debt service every year?
- Are they going to share in the pain?

Therefore, the key question when negotiating any management arrangement is the risk distribution, which the owner must understand. Every project has no' correct' or' best' solution and the owners will consider other areas as targets where they take risks and others where they do not take a different role and each owner will be willing to do so.

II. LITERATURE SURVEY

II.I. The traditional management contract:

The owners develop and finance the hotel, the working capital and pre-opening costs and the financing of any losses in the traditional management contract. The developer or management company offers "intellectual" capital; they supply and operate the hotel on behalf of the owner, help it with sales and marketing and reservation and marketing control systems, fidelity services and so forth, etc. the brand name and organizational management.

In general, the operator is paid a percentage of the highest level (3%), and GOP (typically 10%) is the gross profit before the property charges, insurance of buildings, and the reserve set aside for replacing the furniture and fittings, and equipment (FF&E). Typically the operator is paid a share of the high-line revenue. It should be remembered that 100% of the risk rests with the owner and usually any employee — except perhaps the manager is the owner's employee. Management agreements usually last for 20 years but many of the established hotel brands seek much more time (35-50 years and renewals). The initial term of ten years is generally agreed by smaller and emerging groups. An owner must note that the property is subject to such a management agreement which, if offered for sale, would be limited to his appeal. It may decrease the open market value by up to 20%, but management companies argue that they will offset additional revenue and profit against a hotel managed by an independent operator. Management fees based on hotel profit and no turnover related base fees are regarded by some operators alone. Typically, the GOP / adjusted gross operating benefit (AGOP) would amount to 16-20 percent.

Many industries do not consider this suitable except in certain exceptional circumstances, because the operator ' sweats' the company and may reduce maintenance etc to increase short-term profits and in turn their costs. The operating risk is totally transferred to the operator in the "lease." After paying the rent, you manage the business as your own. This provides the owner with a' guaranteed' revenue, but if the hotel does it well, it is not upside-down– the owner has everything left with him. This gives the operator an' guaranteed' income. Leases are typically between 15 and 20 years old. In advance, operators try to fix the rent or index it to 70% of the retail price indice change. Yields will be consistent with market norm and the negotiating hand's strength. The standards require a rent of between 18 and 21% of stabilized annual revenues, and operators will consider covering a rent of between 120-140% for projected profit. Some recent sales and leases show a rent of around 28% of the sales, but generally when the operator runs the company for many years and knows the property and the market well.

Capital cost yields may be between 6 and 9%, with variables being the operator's covenant strength and any guarantees that may be given. Recent uncertainty on the markets has caused leases to lose their appeal to operators—the loss of Dorint as a good example of an over-exposed enterprise to leases on its portfolio. Furthermore, US corporations must consolidate full contingent liability of the rental balance sheet under US general accounting principles, and therefore few US hotel companies conclude such an agreement.

II.II. Operator equity:

Many companies will take part in or otherwise provide' soft' loans to an owning company's share capital to enable venture funding. For example, in certain cases, operators may finance the operating capital and pre-opening costs (in C=2–2.5 m) or even fund FF&E. The' equity' provided by hotel companies is generally' cost' by being less flexible in the terms of the management agreement and reflecting the investment hurdles needed in the fee structure. In general, companies will provide 10-20 percent and perhaps up to 25 percent in certain strategic cities / locations. Thus, while the developer may claim to be part of the risk of the enterprise, few will take any risk related to construction costs and make a shareholding contribution at the end of every construction / development programme. In the eyes of the owner, this is not ideal because equity is usually spent on any new hotel build project before debt.

The documentation then needs an additional layer due to the need for a shareholder agreement, and consideration of exit mechanisms must be taken care of because the operator will wish to remain in the control of the hotel. Lastly, the industry is seeing many fewer stand-alone hotels and more mixed-use hotels now constructed, in which the quality of the hotel depends in part on the success of the rest of the construction. This will often be reflected in the agreement that has taken place with operators seeking the protection of quality in neighboring commercial and residential areas and pursuing more assurances that vacancy rates without some sort of penalty do not reach a predefined amount.

II.III. Turnover lease:

Some managing firms seek to remedy the balance of normal leases and compensate for some "risks" by offering either a sales lease or a lease with a low fixed / warranty element and a variable profit. The level of risk obviously depends on the extent to which the rentals are set and variable. In times when a hotel is doing well, owners can benefit significantly but take risk in a downturn in the market. Care needs to be taken to closely identify rents to maintain a stable and non-excessively optimistic project projection.

II.IV. Operator stand-aside or subordination of fees:

In attempting to conclude an agreement and reach a common position on "risk," the majority of operators are prepared, for the preferred return of a proprietor, to stand or defer the entire or part of their incentive fee (and, in some cases, the incentive fee). Usually, this will be done at a cash level equivalent to the cash required for servicing the debt on the property, with operators requiring the contract to set the maximum gear quantity, limit interest rate and borrowing level, so as to effectively ring-fenced factors outside their control.

If an operator is excluded from a tax, he sometimes does so on the grounds that the unpaid payments are converted into an interest-bearing subordinate loan to be reimbursed as a reward after future profit or in some situations the prospect of converting into preference shares. In the experience of the author, while it benefits financiers and offers some protection, the risk remains substantial. The owner remains.

II.V. Operator guarantees:

The increasingly popular scenario is where an operator offers a warranty, which provides a guarantee and compensates for the loss if the accepted standards of performance are not met. This is usually again for debt service rates and operators typically provide only' money' after the reward fee has been withdrawn as it was in the previous section (as opposed to the equity return). In the riskier early years of the hotel, certain operators will guarantee the establishment; others will see this as the risk of the hotel owner and typically provide a stability guarantee from three to five years depending on the market.

Operators also attempt to limit the guarantee each year to a certain amount and to a capped total amount. This is a much greater proportion of the risk to the owner, but a guarantee provider is much less flexible to offset the risk.

III. CONCLUSIONS

No two projects are the same and no requirements of two owners are the same. In view of this fact, the owners should use their market knowledge to consider which hotel operators are most interested in this opportunity and in general evaluate the broad terms offered by those operators. The' owner' should then identify the important issues for them.

- How long do we want to take risk?
- How important is the operator's brand or name?
- Will the name of the operator add value to the sale of any residential item, for example?
- Is this intended as a long-term investment, where a long-term agreement or a short-or medium-term investment is necessary, or a five to seven-year exit??
- What is the guarantee or flexibility of the contract most important?
- What are the performance and termination provisions reasonable?
- Is the potential for future buying or selling to the investment market best suited for the operator?

The approach adopted by the author's company is to draw up a term sheet describing the key questions the owner requires (of course there is no certainty that the company will get these), which is clearly laid down by disbursing into the agreed "list." The company believes that the conditions should be fair to both sides, and an operator that does well should be properly remunerated and have the opportunity to make a difference, whereas one who does not only has to "sign up" the achievement in any way, but is in danger of termination of the contract.

The company deals with the control of the owner and discusses with the owner how much they really want or if it feels it is appropriate for an asset manager to monitor and interface regularly. To order to obtain better terms, the business also tries to encourage competition between operators and this needs a good approach to the industry and to companies running hotels. The company considers that the owner must have adequate contractual checks and authority, rights and penalties. These depend on the circumstances.

So what are some of the other problems finally? In some ways, a management contract is like any other relation. It must be worked on, transparent, trust-based and communication between both sides on a regular basis. Colliers RH recommends that the following be advised in contracts.

Request a clause granting the owner the right to terminate if the operating company is changing ownership (perhaps after a time to assess the change) or if the managing staff or area management staff is changing frequently. The owner clearly does not have to end, but operators must realize that if management changes frequently this can disturb the company and consequently, the company's performance could be reduced. Set reasonable performance targets in line with either the agreed budgets, the capacity to provide debt or competition in the market if the performance criteria have not been met. Consider the ultimate sanction for termination of repeated failure. Operators should develop realistic performance criteria and include these in contracts as standard clauses. Usually, no operator needs the termination indignation to endure. Nonetheless, the owner should be free to terminate except when the operator starts operations of a competing hotel in a given region (and, thus, there are apparent conflicts of interest) or when the asset is sold. In addition to the execution termination (lack of). In the latter case, for the contract termination, it is customary for the operator to seek compensation and that should again be "reasonable.'

In the contract, it must be clearly stated that the provider may not accept payments other than as accepted in the contract or as part of the annual budget process or offer any recharges to the company. Sometimes it is really hard to determine whether some party projects are better off than others in some hotels. Find a clause by which the operator will not be charged if the hotel is losing. Share the costs and the rewards. It has always seemed unfair to the owner to bear all of the downside risk and to pay the operator for the loss of money.

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