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HOTEL CONTRACTS

TO LEASE OR NOT TO LEASE?

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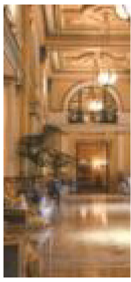

Summary

Hotel managing companies date back to the early 1900s. Back then, the normal method to supply management services was through total property leases by which the operator leased the hotel from the owner. It was only between 1950 and 1960, following the global hotel expansion, that management agreements were created to provide a buffer against the operating risks associated with unknown uncertainties in foreign countries. In this article, we set out the pros and cons of leases and hotel management agreements, give an example of how they impact on hotel value and discuss the best option for different investors.

Hotel Leases

A lease is an interest in the land and the tenant takes over the property for a certain term. As such, under a lease structure, the hotel company holds the entire financial burden. The hotel company in this case is a tenant and assumes all operating responsibilities together with all the financial obligations; therefore, it enjoys the benefits if the property is successful but suffers all of the losses if the property does not perform adequately. The hotel company receives all of the profits, after rents have been paid. Rental structures can vary depending on the amount of risk that the investor is ready to take. Some of the possible options are:

- **Fixed rent**: this is a fixed rent with indexed growth. This form of lease structure has a guaranteed return, which bears the least risks for the property owner;

- **Share of Revenue**: in this variable lease scenario, the rent is calculated on the amount of sales generated. In this case, the property owner shares some of the risks linked to the level of performance of the hotel. They do, however, have the opportunity to assess the performance of the hotel against market data;

- **Share of Net Operating Income** (NOI): in this variable lease scenario, the rent is linked to the NOI after all the operating expenses have been deducted. This scenario carries the highest risk to the owner, as it also include the operating risk of running the hotel and offers little transparency as to likely income.

Both the revenue-based and NOI-based rents can include a base rent, which is a guaranteed return to the owner (hybrid lease). A hybrid lease might also include some clauses that can be found in management agreements, such as an obligation to maintain brand standards.

The following figure shows the advantages and disadvantages of leases for both owner and operator.

FIGURE 1: ADVANTAGES AND DISADVANTAGES OF LEASES

Owner		Operator	
Advantages	Disadvantages	Advantages	Disadvantages
The owner retains the title to the property and the residual value created at the end of the lease	The operator has little interest in maintaining the property as the lease comes to expiration and might divert the business to other hotels it manages	The operator retains total control over operations	When the lease term expires the operator loses its rights on the property
The owner incurs minimal financial risk, especially if the hotel company is reliable	The owner is passive and has no control over the hotel's operations	The leasehold value created by the hotel can be realised through a sale (if the lease contract allows it)	The leashold loses/decreases its value as the term come to an end
The owner has no operational responsibilities	The owner does not benefit if/when the property is more profitable than expected	The operational upside is retained solely by the operator	The operator incurs all the operating financial risk
	Leases are more difficult to terminate than management contracts because they create a vested interest in the property for the operator		Leashold interests are a liability on the balance sheet that could negatively afffect value

SOURCE: HVS

Hotel Management Agreements

Hotel Management Agreements (HMAs) can be considered as an agent contract by which the property owner also owns the hotel business and the operator is hired to manage the hotel on behalf of the owner. This contract structure means that the owner carries all the risks but also reaps the greatest part of the rewards. Some of the main HMA structures are:

- **Standard**: a base management fee of 3% of total revenue and an incentive management fee of 10% of gross operating profit (GOP) after base fees;
- **On Layers**: a base management fee of say 2.5% and an incentive management fee based on a threshold of GOP levels or scaled to be lower in the first operating year and reach a higher level in the stabilised year;
- **Hybrid**: base and incentive management fees are associated to a guaranteed return to the owner or subordinated to debt coverage.

We note, however, that HMAs are fully negotiable and can be tailored on specific deals. Since HMAs have become very detailed and sophisticated, it is very important during the negotiation stage to rely on expert advisors.

Figure 2 shows the advantages and disadvantages of HMAs for both owner and operator.

FIGURE 2: ADVANTAGES AND DISADVANTAGES OF HMAs

Owner		Operator	
Advantages	Disadvantages	Advantages	Disadvantages
Quality management and recognition	The owner has limited operational control (although this can be addressed in HMAs)	Opportunity for an inexpensive and rapid expansion which would guarantee a critical mass for optimising performance	The operator does not enjoy the residual benefit of ownership and does not capitalise on the value created
The owner retains ownership benefits (such as, cash flows, depreciation deductions, tax benefits and so forth)	The owner is liable for all expenses (operational, fixed and fees to the operator)	Low downside risk	Minimal control over owner's decisions
	Premature termination of HMAs might result in very high expenses	The operator maintains all operational control	Dependence on owner's financing
	More difficult disposition of the property if it's encumbered with a HMA (although this can be addressed in the HMA)		The agreement can be terminated at any time by the owner (albeit at very high costs)
	The owner suffers higher downside risks (which are shifted to the operator in the case of a lease) – this can be limited by guaranteed return/subject to debt service		

SOURCE: HVS RESEARCH

On account of the current difficult financial environment, we note that HMAs are undergoing a restructuring to reflect a greater alignment of risk by eliminating or reducing some of the disadvantages to the owner. For example, they are granting the owner more operational control while including the possibility for the owner to terminate the HMA upon a sale of the property. Also, HMAs can include some sort of guaranteed return to the owner, sometimes in the form of subordination of operator's fee to the debt coverage.

The following figure graphically summarises the level of risk/reward to the property owner of the four main different types of lease agreements and HMAs.

FIGURE 3: RISK/REWARD TO THE PROPERTY OWNER

SOURCE: HVS RESEARCH

As illustrated, leases (fixed or variable) are low risk/low reward investments. HMAs offer the opportunity for higher returns but are accompanied by a higher level of risk. We note that hybrid HMAs, developed as a response to the global economic downturn, which has affected hotel performance, offer a higher return than leases but a lower level of risk compared with traditional HMAs.

Impact on Hotel Value – HMAs vs Leases

To illustrate the likely rewards to both parties we have prepared a fictional operations statement. The projected profit and loss account is identical save for the costs of management (HMA Figure 4 and lease Figure 5). We considered an imaginary 160-room proposed hotel. The hotel is due to open in 2013 and is expected to stabilise operations in 2016. We note that the following is a theoretical exercise and if any of the assumptions made for the two scenarios were to change then the outcomes would also change. In practice, different agreements might be the optimal choice for specific investors on specific properties.

HMA Scenario

For the purpose of our exercise, we have assumed a base management fee of 3% of total revenue and a scaled incentive fee based on achieved levels of GOP as outlined below.

GOP Level over Total Revenue	Incentive Fee as a % of NOI
GOP <30%	5%
30%<GOP<40%	10%
GOP>40%	15%

We note that in this case there is more risk to the operator with the incentive fee being calculated on NOI after all fixed expenses have been deducted.

FIGURE 4: HOTEL PERFORMANCE WITH HMA (£ 000s)

	2013				2014				2015				Stabilised			
Number of Rooms:	**160**				**160**				**160**				**160**			
Days Open:	**365**				**365**				**365**				**365**			
Occupied Rooms:	**26,280**				**29,784**				**30,952**				**33,872**			
Occupancy:	**45%**				**51%**				**53%**				**58%**			
Average Rate:	**480.00**				**515.00**				**555.00**				**570.00**			
RevPAR:	**216.00**	**% Gross**	**PAR**	**POR**	**262.65**	**% Gross**	**PAR**	**POR**	**294.15**	**% Gross**	**PAR**	**POR**	**330.60**	**% Gross**	**PAR**	**POR**
REVENUE																
Rooms	12,614	66.6 %	78,838	479.98	15,339	68.5 %	95,869	515.01	17,178	68.3 %	107,363	554.99	19,307	69.2 %	120,669	570.00
Food and Beverage	4,455	23.5	27,844	169.52	5,009	22.4	31,306	168.18	5,700	22.7	35,625	184.16	6,190	22.2	38,688	182.75
Spa/Health Club	1,535	8.1	9,594	58.41	1,695	7.6	10,594	56.91	1,901	7.6	11,881	61.42	2,017	7.2	12,606	59.55
Other Income	329	1.7	2,054	12.51	346	1.5	2,165	11.63	357	1.4	2,232	11.54	374	1.3	2,337	11.04
Total Revenues	18,933	100.0	118,329	720.42	22,389	100.0	139,934	751.73	25,136	100.0	157,101	812.10	27,888	100.0	174,300	823.33
DEPARTMENTAL EXPENSES *																
Rooms	3,208	25.4	20,051	122.07	3,421	22.3	21,381	114.86	3,540	20.6	22,125	114.37	3,740	19.4	23,373	110.41
Food and Beverage	4,383	98.4	27,393	166.78	4,599	91.8	28,744	154.41	4,691	82.3	29,319	151.56	4,785	77.3	29,905	141.26
Spa/Health Club	1,425	92.9	8,909	54.24	1,454	85.8	9,088	48.82	1,483	78.0	9,269	47.92	1,513	75.0	9,455	44.66
Other Expenses	207	63.0	1,295	7.88	213	61.6	1,333	7.16	218	61.1	1,364	7.05	224	60.0	1,402	6.62
Total	9,224	48.7	57,648	350.98	9,687	43.3	60,546	325.26	9,932	39.5	62,078	320.90	10,262	36.8	64,136	302.96
DEPARTMENTAL INCOME	9,709	51.3	60,682	369.45	12,702	56.7	79,388	426.47	15,204	60.5	95,023	491.20	17,626	63.2	110,164	520.38
UNDISTRIBUTED OPERATING EXPENSES																
Administrative & General	1,570	8.3	9,810	59.73	1,644	7.3	10,277	55.21	1,704	6.8	10,647	55.04	1,767	6.3	11,041	52.15
Marketing	1,099	5.8	6,867	41.81	1,151	5.1	7,194	38.65	1,192	4.7	7,453	38.53	1,237	4.4	7,729	36.51
Prop. Operations & Maint.	903	4.8	5,641	34.34	946	4.2	5,910	31.75	980	3.9	6,122	31.65	1,016	3.6	6,348	29.99
Utilities	1,020	5.4	6,377	38.82	1,069	4.8	6,680	35.89	1,107	4.4	6,921	35.78	1,148	4.1	7,177	33.90
Total	4,591	24.3	28,694	174.70	4,810	21.4	30,062	161.49	4,983	19.8	31,143	160.99	5,167	18.4	32,294	152.55
GROSS OPERATING PROFIT (GOP)	5,118	27.0	31,987	194.75	7,892	35.3	49,326	264.98	10,221	40.7	63,880	330.22	12,459	44.8	77,870	367.83
Management Fee	568	3.0	3,550	21.61	672	3.0	4,198	22.55	754	3.0	4,713	24.36	837	3.0	5,229	24.70
GOP AFTER MANAGEMENT FEES	4,550	24.0	28,437	173.13	7,220	32.3	45,128	242.43	9,467	37.7	59,167	305.85	11,622	41.8	72,641	343.13
FIXED EXPENSES																
Property Taxes	315	1.7	1,971	12.00	322	1.4	2,010	10.80	328	1.3	2,051	10.60	335	1.2	2,092	9.88
Insurance	263	1.4	1,642	10.00	268	1.2	1,675	9.00	273	1.1	1,709	8.83	279	1.0	1,743	8.23
Incentive Management Fee	180	0.9	1,123	6.84	596	2.7	3,724	20.01	786	3.1	4,912	25.39	1,484	5.3	9,275	43.81
Reserve for Replacement	379	2.0	2,367	14.41	672	3.0	4,198	22.55	1,005	4.0	6,284	32.48	1,116	4.0	6,972	32.93
Total	1,136	6.0	7,103	43.24	1,857	8.3	11,608	62.36	2,393	9.5	14,956	77.31	3,213	11.5	20,082	94.86
Net Operating Income	3,414	18.0 %	21,334	129.89	5,363	24.0 %	33,520	180.07	7,074	28.2 %	44,211	228.54	8,409	30.3 %	52,559	248.27

* Departmental expenses are expressed as a percentage of departmental revenues.

SOURCE: HVS'S PROJECTIONS

Lease Agreement Scenario

We have assumed 15-year term lease with a fixed base lease of £500,000 in the first year of operation, £750,000 in the second year, £1 million in the third year and £1.5 million in the fourth year indexed, thereafter to the Consumer Price Inflation (CPI). Furthermore, from the second year of operation we have assumed a turnover rent as follows.

Year	Turnover Rent
2	5% of rooms revenue and 3% of food and beverage revenue
3	10% of rooms revenue and 6% of food and beverage revenue
4-15	20% of rooms revenue and 18% of food and beverage revenue

FIGURE 5: HOTEL PERFORMANCE WITH LEASE (£ 000s)

	2013				2014				2015				Stabilised			
Number of Rooms:	160				160				160				160			
Days Open:	365				365				365				365			
Occupied Rooms:	26,280				29,784				30,952				33,872			
Occupancy:	45%				51%				53%				58%			
Average Rate:	480.00				515.00				555.00				570.00			
RevPAR:	216.00	% Gross	PAR	POR	262.65	% Gross	PAR	POR	294.15	% Gross	PAR	POR	330.60	% Gross	PAR	POR
REVENUE																
Rooms	12,614	66.6 %	78,838	479.98	15,339	68.5 %	95,869	515.01	17,178	68.3 %	107,363	554.99	19,307	69.2 %	120,669	570.00
Food and Beverage	4,455	23.5	27,844	169.52	5,009	22.4	31,306	168.18	5,700	22.7	35,625	184.16	6,190	22.2	38,688	182.75
Spa/Health Club	1,535	8.1	9,594	58.41	1,695	7.6	10,594	56.91	1,901	7.6	11,881	61.42	2,017	7.2	12,606	59.55
Other Income	329	1.7	2,054	12.51	346	1.5	2,165	11.63	357	1.4	2,232	11.54	374	1.3	2,337	11.04
Total Revenues	18,933	100.0	118,329	720.42	22,389	100.0	139,934	751.73	25,136	100.0	157,101	812.10	27,888	100.0	174,300	823.33
DEPARTMENTAL EXPENSES *																
Rooms	3,208	25.4	20,051	122.07	3,421	22.3	21,381	114.86	3,540	20.6	22,125	114.37	3,740	19.4	23,373	110.41
Food and Beverage	4,383	98.4	27,393	166.78	4,599	91.8	28,743	154.41	4,691	82.3	29,319	151.56	4,785	77.3	29,907	141.27
Spa/Health Club	1,425	92.9	8,909	54.24	1,454	85.8	9,088	48.82	1,483	78.0	9,269	47.92	1,513	75.0	9,455	44.66
Other Expenses	207	63.0	1,295	7.88	213	61.6	1,333	7.16	218	61.1	1,364	7.05	224	60.0	1,402	6.62
Total	9,224	48.7	57,648	350.98	9,687	43.3	60,545	325.25	9,932	39.5	62,077	320.90	10,262	36.8	64,137	302.96
DEPARTMENTAL INCOME	9,709	51.3	60,681	369.44	12,702	56.7	79,389	426.48	15,204	60.5	95,024	491.21	17,626	63.2	110,163	520.37
UNDISTRIBUTED OPERATING EXPENSES																
Administrative & General	1,570	8.3	9,810	59.73	1,644	7.3	10,277	55.21	1,704	6.8	10,647	55.04	1,767	6.3	11,041	52.15
Marketing	1,099	5.8	6,867	41.81	1,151	5.1	7,194	38.65	1,192	4.7	7,453	38.53	1,237	4.4	7,729	36.51
Prop. Operations & Maint.	903	4.8	5,641	34.34	946	4.2	5,910	31.75	980	3.9	6,122	31.65	1,016	3.6	6,348	29.99
Utilities	1,020	5.4	6,377	38.82	1,069	4.8	6,680	35.89	1,107	4.4	6,921	35.78	1,148	4.1	7,174	33.89
Total	4,591	24.3	28,694	174.70	4,810	21.4	30,062	161.49	4,983	19.8	31,143	160.99	5,167	18.4	32,292	152.54
GROSS OPERATING PROFIT (GOP)	5,118	27.0	31,987	194.75	7,892	35.3	49,327	264.99	10,221	40.7	63,881	330.22	12,459	44.8	77,871	367.83
FIXED EXPENSES																
Property Taxes	315	1.7	1,969	11.99	322	1.4	2,015	10.82	328	1.3	2,048	10.59	335	1.2	2,092	9.88
Insurance	263	1.4	1,645	10.02	268	1.2	1,678	9.01	273	1.1	1,705	8.81	279	1.0	1,741	8.23
Turnover Lease	0	0.0	0	0.00	917	4.1	5,733	30.80	2,060	8.2	12,874	66.55	4,976	17.8	31,098	146.89
Base Lease	500	2.6	3,125	19.03	750	3.3	4,688	25.18	1,000	4.0	6,248	32.30	1,500	5.4	9,374	44.28
Reserve for Replacement	379	2.0	2,367	14.41	672	3.0	4,198	22.55	1,005	4.0	6,284	32.48	1,116	4.0	6,972	32.93
Total	1,457	7.7	9,106	55.44	2,930	13.0	18,310	98.36	4,665	18.6	29,158	150.73	8,204	29.4	51,276	242.21
Net Operating Income	3,661	19.3 %	22,881	139.30	4,963	22.3 %	31,017	166.62	5,556	22.1 %	34,723	179.49	4,255	15.4 %	26,594	125.62

* Departmental expenses are expressed as a percentage of departmental revenues.

SOURCE: HVS'S PROJECTIONS

To illustrate the returns to each party, the table below shows the significant difference in rewards for each party when they take a different position on risk.

From a pure reward basis, it is clear which option would be favoured by each party.

To further emphasis the different risk/reward profiles, the following figure shows the different valuation parameters applied to lease and HMA structures as well as the hotel values under the two scenarios. Figures 6A and 6B show the return to the owner and operator under the HMA and Figures 6C and 6D, under the lease agreement.

Stabilised-Year Income	HMA Scenario	Lease Scenario
To the Owner	£8,409	£6,475
To The Operator	£2,321	£4,255

FIGURES 6A AND 6C: HOTEL VALUES UNDER THE HMA AND THE LEASE (£)

6A HMA – Hotel Value to the Owner

Year	Net Operating Income	Discount Factor @ 12.3%	Discounted Cash Flow
2013	3,414,000	0.89051	3,040,186
2014	5,363,000	0.79300	4,252,860
2015	7,074,000	0.70617	4,995,453
2016	8,409,000	0.62885	5,287,993
2017	8,578,000	0.55999	4,803,626
2018	8,749,000	0.49868	4,362,929
2019	8,924,000	0.44408	3,962,926
2020	9,103,000	0.39545	3,599,793
2021	9,285,000	0.35215	3,269,727
2022	168,056,000 *	0.31359	52,701,168
		Estimate of Likely Future Value	**90,276,660**
		(SAY)	**90,300,000**

Reversion Analysis

11th Year's Net Operating Income	9,660,000
Capitalisation Rate (%)	6.0
	$0
Total Sales Proceeds	161,000,000
Less: Transaction Costs @ 1.5%	2,415,000
	0
Net Sales Proceeds	158,585,000
	0

*10th year net operating income of €9,471,000 plus sales proceeds of €158,585,000

6C Leasehold Interest – Hotel Value to the Operator

Year	Net Operating Income	Discount Factor @ 22.0%	Discounted Cash Flow
2013	3,661,000	0.819672	3,000,820
2014	4,963,000	0.671862	3,334,453
2015	5,556,000	0.550707	3,059,727
2016	4,255,000	0.451399	1,920,703
2017	4,340,000	0.369999	1,605,797
2018	4,426,000	0.303278	1,342,309
2019	4,514,520	0.248589	1,122,258
2020	4,604,810	0.203761	938,281
2021	4,696,907	0.167017	784,465
2022	4,790,845	0.136899	655,864
2023	4,886,662	0.112213	548,345
2024	4,984,395	0.091978	458,453
2025	5,084,083	0.075391	383,296
2026	5,185,764	0.061796	320,461
2027	5,289,480	0.050653	267,926
		Estimate of Likely Future Value	**19,743,159**
		(SAY)	**19,700,000**

SOURCE: HVS

FIGURE 6B: FEE-STREAM VALUATION AND RETURN TO THE OPERATOR (£ 000S)

Discount Rate	15.0%

Calendar Years	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Base Management Fee	568	672	754	837	853	870	888	906	924	942	961	980	1,000	1,020	1,040
Incentive Management Fee	180	596	786	1,484	1,514	1,544	1,575	1,606	1,639	1,671	1,705	1,739	1,774	1,809	1,845
Total Received Fees	748	1,268	1,540	2,321	2,367	2,414	2,463	2,512	2,562	2,613	2,666	2,719	2,773	2,829	2,885
Discount Factor	0.8696	0.7561	0.6575	0.5718	0.4972	0.4323	0.3759	0.3269	0.2843	0.2472	0.2149	0.1869	0.1625	0.1413	0.1229
Discounted Rent Cash Flow	650	958	1,013	1,327	1,177	1,044	926	821	728	646	573	508	451	400	355
Present Value of Total Received Fees	**11,576**														
(Say)	**11,600**														

SOURCE: HVS

FIGURE 6D: LEASE RENT VALUATION AND RETURN TO THE OWNER (£ 000S)

Terminal Capitalisation Rate	6.0%
Discount Rate	9.0%

Calendar Years	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Turnover Rent	0	917	2,060	4,976	5,075	5,177	5,280	5,386	5,493	5,603	5,715
Fixed Rent	500	750	1,000	1,500	1,530	1,560	1,592	1,623	1,656	1,689	1,740
Total Received Rent	500	1,667	3,059	6,475	6,605	6,737	6,872	7,009	7,149	7,292	7,455
Reversion Value										122,388	
Total Net Rent	500	1,667	3,059	6,475	6,605	6,737	6,872	7,009	7,149	129,680	7,455
Discount Factor	0.9174	0.8417	0.7722	0.7084	0.6499	0.5963	0.5470	0.5019	0.4604	0.4224	
Discounted Rent Cash Flow	459	1,403	2,362	4,587	4,293	4,017	3,759	3,518	3,292	54,778	
Present Value of Total Received Rent	**82,468**										
(Say)	**82,500**										

Reversion Analysis

11th Year's Net Operating Income	7,455
Total Sales Proceeds	124,252
Less: Transaction Costs @ 1.5%	1,864
Net Sales Proceeds	122,388

SOURCE: HVS

HMA Scenario: Figures 6A and 6B

Owner's perspective

Value to the owner is the operational income stream once the management fees have been deducted (Figure 6A). For accepting the operational risk, the owner receives a 10% increase in return compared with the value resulting under a lease agreement. Property owners must then consider whether that risk/reward profile is acceptable. Having illustrated the different values to the owner, we can now turn to the capitalisation of income to the operator.

Operator's perspective

Value to the operator is the income stream generated from the fees payable (Figure 6B). The higher discount rate assumed in the valuation of management fees (compared to the valuation of the rent payable in Figure 6D) accounts for the higher risk of a fully turnover-based fee payable.

Lease Agreement Scenario: Figures 6C and 6D

Owner's perspective

Value to the owner is the income stream generated from the rent payable (Figure 6D). The discount rate is lower in the rent valuation compared to the leasehold interest valuation (Figure 6C), as the income stream is more certain and there is reduced risk fluctuation to the property owner's income. We note that if this was not a hybrid lease the difference would be more pronounced.

Operator's perspective

Value to the operator consists of the value of the operational income stream once the rent has been deducted (Figure 6C). Valuing the hotel operation under the lease agreement scenario (Figure 6C), we have assumed a higher equity yield paired with a zero rated gearing to account for the long-term higher risk of the rent payable's fixed component and the absence of a collateral (the operator only has a limited 15-year real interest in the property which will then be reverted to the freeholder at the end of the HMA).

We note that although a lease agreement provides a safer, less risky, return to the owner, it also determines a reduced value of the hotel operational income stream. As shown in figure 6A and 6C, the hotel's value to the operator under the lease agreement (£19,700,000) is reduced by approximately 80% compared to the hotel's value to the owner under the HMA (£90,300,000). This is due to the fact that the lease rent is payable on the top line before any expenses are deducted; thus, it has a larger impact on NOI compared to management fees, which are paid as a percentage of GOP or, in some cases, NOI. Also, the rent's fixed component increases the risk to hotel operation during a downturn.

Based on the two scenarios and the valuation parameters outlined above, the value of the interests of either party is as follows.

Hotel Value	HMA Scenario	Lease Scenario
To the Owner	£90,300,000	£82,500,000
To The Operator	£11,600,000	£19,700,000

In both scenarios, the total value of the asset (both parties' interest combined) is approximately £102 million, but how that value is divided depends on the risk/reward profile.

Finally, to fully reconcile the risk/reward profile a total return should be calculated. That is, the property interest valued and income stream are directly correlated. A higher operating performance generally corresponds to a higher value. An exception to this is the fixed rent, which eliminates any variable gain/loss related to the hotel's performance.

Conclusion: To Lease or Not to Lease?

It depends! Different investors have different appetite. A high-risk, high-return oriented investor such as private investors and equity funds will be more attracted by the opportunities set forth by the HMA. We note, however, that it is advisable that either the investor is knowledgeable of the hotel sector or that he seeks the support of expert advisors in order to draft the optimal HMA.

A low-risk oriented investor such as insurance companies and family trusts will be more attracted towards the lease agreements which, even though they have a lower return, represent a less risky, safer income stream.

Moreover, we note that operators are not keen on signing lease agreements as they are service providers and their expertise lies in the management of the hotel business. From the owner perspective, it makes sense to lease properties that are more liquid, such as budget and mid-market hotels. Upscale and luxury hotels and resort properties are rarely subject to leases and almost always to HMAs, as they are more illiquid and it is harder to dispose of them.

It is worth noting that a lease would bring a vested interest in the property to the operator. This would be beneficial to the operator as it would protect it from a possible abrupt termination of the HMA by the owner, as this always preserves the power (if not the right) to terminate the agreement at any time (as was the case in the recent dispute of Turnberry v Fairmont Hotel and Resorts).

We further note that, in the current troubled economic environment, limited debt available forces investors to make mainly equity investments. This triggers higher required returns on investment. Insurance companies for example will consider investing in hotels, instead of office or retail, only if they foresee a yield premium.

To conclude, whatever the agreement between the owner and the operator, both parties must be incentivised to continuously and sustainably increase the property's profitability. Should the hotel underperform, the owner would bear the consequences not only in the case of a HMA but also with a lease if the operator is not able to guarantee a level of profits that supports the rent payable. Hybrid and variable leases allow more flexibility and reduce the risk of unsustainable rental levels. However, doesn't a variable lease resemble more and more to a hotel management agreement, especially when HMAs start including forms of guaranteed return to the owner? It seems that hotel contracts are reaching a level of optimal balance between operators' and owners' return, while preserving the value of the asset which is ultimately what sustains both returns.

About HVS

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