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Debating fairness of management contracts

November 9 2011

Miguel Rivera, senior VP at HVS Asset Management & Advisory, said incentive-based, rather than base-fee contracts, would leave operators to be judged and compensated more accurately.

Highlights

- Miguel Rivera of HVS Asset Management & Advisory suggests incentive fees for managers should be based on revenue per available room and GOP margin performance.
- Attorney Jim Butler believes management should assume a greater level of risk.
- Not everyone is onboard with Rivera's proposed audible.

By Chuck Green
HNN contributor

GLOBAL REPORT—Today, a hotel's performance primarily is driven by two factors: market and management performance. Miguel Rivera, senior VP at HVS Asset Management & Advisory in San Francisco, is proposing that subtracting the market effect from overall hotel performance would leave managers to be judged more accurately on the result of their work and assure management companies are assuming greater operating risk.

“That's what an operator's compensation should be based on," Rivera said. This implies good managers that beat the market will earn incentive fees during both rising and declining markets, he said.

To implement this new management-fee structure, incentive fees for managers should be based on revenue per available room and gross operating profit margin performance—the two most important factors under management's purview that drive property value, Rivera said.

"It sounds like Rivera's been reading our (hotel management agreements) handbook," said Jim Butler, attorney with Jeffer Mangels Butler & Mitchell.

Clearly, from the owner's perspective, a better alignment of interests is required, he said. "For years, we've been pushing operators to subordinate a significant portion of their base fee and all of their incentive fees.”

Further, like Rivera, Butler believes management should assume a greater level of risk. "The typical branded hotel-management agreement provides the operator with all the benefits of ownership, which has meant virtually complete control of the hotel for decades, and with none of the financial risk borne by the owner," Butler said.

Opposition
However, not everyone is onboard with Rivera's proposed audible.

Kevin Mahoney, who has experience with both ownership and management, believes Rivera is overlooking the depth of services that management companies are expected to provide today, such as expertise in technology, human resources and risk, project and construction management, e-commerce, revenue management, training, accounting and financial compliance, as well as related costs. He called those expenses "significant," compared even to just a few years ago.

"When evaluating a management-fee structure between base and incentive fees, I think it's more important to understand the true scope of services that are being provided and how those costs are allocated and priced," said Mahoney, COO of Stonebridge Companies.

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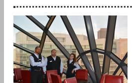
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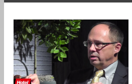
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But Rivera contends a base management fee shouldn't be a source of profit for management companies. "Why should they make fat profits based on just showing up to work, regardless of the performance they generate?"

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The fact is, most management companies have generated "scant" incentive fees during the past two years; yet, they continue to be profitable off base fees alone—just not as much as in previous years when they also had earned incentive fees, he contended.

Meantime, Mahoney also emphasized management fees are negotiated with much effort.

"Owners don't just hand out a generic incentive fee," he said. “In today's world, those fees are heavily negotiated and earned." Further, typically with a new deal, incentive management fees don't even kick in until probably the third or fourth year, Mahoney added.

"I never suggested there's only one generic incentive management fee," Rivera said. "We have hundreds of management agreements in our database that show common patterns and ranges in line with what I presented. Of course, incentive management fees are negotiated in every individual case. I never suggested that they aren't or shouldn't be."

In any event, now that he's more active on the management side, Mahoney doesn't think management companies and managers are compensated enough for the risks and services required of "true" institutional owners and asset managers.

"The requirements and time are significant, particularly in a down market. Often, the way management fees are priced, when you have a hotel that might be generating, say, less than (US)$5 million to (US)$7 million per year, a basic management fee doesn't cover the associated costs or risks."

For his part, Rivera said he's not suggesting managers be paid less than they are today.

"I am suggesting that they be paid based on different benchmarks that more accurately reflect their level of effectiveness." In fact, under his proposal, strong managers would be paid substantially more, particularly during a down market —provided they perform better than the competition, he added.

Other factors
Tinkering with incentives could de-motivate some managers, said Neal Jackson, VP of Jackson Hospitality Services.

"(He or she might say) they could work hard, but the markets are so bad, they'll never make any more money," Jackson said.

His firm regularly evaluates bonus incentive programs that are aggressive yet attainable. That way, managers "have that carrot" and know, if they work hard and control expenses—and if the hotel makes money—there’s a strong possibility they'll be rewarded.

Ultimately, though, Jackson's relatively open-minded. "I'd love to see some results (of Rivera's work). I don't think managers would feel his plan would be fair, but if it works, then I'm wrong. I'm always glad to look at different ideas."

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This is always an interesing debate and one that I believe has to move away from what is often a adversarial approach to one that is much more of a partnership that will truly leverage the owner's asset and the hotel manageemnt company expertise. Rivera's concept of putting more emphasis on the incentive is one that is happening more often - but of course it is more likely to happen when the hotel in question is a trophy asset and management companies are competing fiercely for the agreement. Incentives are fine, but in today's dynamic environment the base against which they are set should be reset every quarter to ensure that they are still relevant and tuned to the market situation and property's needs. It would be interesting to look at performance below the GOP and provide rewards on lift on asset value - the ultimate measure of value delivered. I was interested to see that Mr Mahoney does not think management companies are rewarded for the

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ESA: Renovated hotels continue to drive gains that Mr Mahoney does not think management companies are rewarded for the risks they take. Most management agreements are risk free for the management company (they do not share in the losses) and all the other services they provide are charged for in addition to the fees - of course this is cost recovery and they don't make any money out of it! I look forward to seeing what others think.

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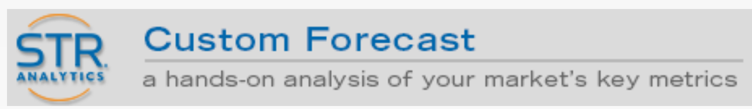

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