Hotel Management Contract Trends in the Gulf

2016
Introduction

This article, based on findings from an analysis of over 85 management contracts negotiated and/or collected by TRI, as well as executive level interviews with hospitality professionals, provides an overview of recent trends across the Gulf. The Gulf region includes Bahrain, Kuwait, Qatar, Oman, Saudi Arabia and the United Arab Emirates. The survey is an update of our 2006 article on management contract trends covering the same region. Of particular importance to our clients is the relative bargaining strength highlighted in this article.

Management Fee

A management fee is the compensation a hotel operator receives for providing branding and management services as defined in the management agreement. A typical management fee structure will comprise two main components:

- A base fee and/or license fee charged as a percentage of a hotel’s gross revenue; and
- An incentive fee charged as a percentage of a hotel’s gross operating profit or ‘adjusted’ gross operating profit.

Base and License Fee

Base and license fees are generally charged as a fixed percentage of the hotel’s gross revenue. However, a number of contracts exclude revenues that are not under the management of the operator from the gross revenue (such as retail rental, leased F&B and parking revenues).

In the recent years, a number of international hotel operators have introduced license/royalty fees in addition to or instead of base fees. While the license fee is typically channelled to a different entity, most of the operators are considered to take this route for tax advantages. We note that the allocation of the between base and license fees usually does not have an impact on the total fee paid by the owner.

Based on our survey, luxury brands command the highest base and license fees in the region with an average of 2.3 percent of total revenue. International operators are generally more selective when it comes to signing luxury properties and appear to show less flexibility in negotiating these fees, arguably given the constraints on the number of luxury properties they may sign in a given market.

Although the fee may be significantly above or below the average based on the individual property, we note that the traditional base fee scales of 3.0 percent (or even higher) have become less common in recent years.

The average base and license fees for upscale brands stands at 1.9 percent. Based on our research, owners have been able to secure lower base and license fees on the back of increased competition among upscale brands, particularly in strong performing markets such as Dubai and Doha.

Historically, the GCC hotel markets have been dominated by luxury and upscale segments. However, the region is witnessing a surge in branded midmarket and economy hotels which aim to address the lack of quality branded hotels for price conscious customers. Consequently, major international operators are reporting increased demand for their midmarket and economy brands, and many of them have been quick to respond to the market by launching their midmarket brands in the region. Nevertheless, the relatively limited number of quality midmarket brands historically available in the region appears to have given the operators some advantage to be able to charge higher fees for these brands, with base and license fees averaging around 2.1 percent.

As operators are invariably faced with owners demanding lower fees, the introduction of lower base/license fees in the initial years of operations are becoming more common, with fees ramping up to desirable levels by the third to fifth year.
Incentive Fee

While base and license fees are paid to operator on the top-line, incentive fees reward the operator for achieving the bottom-line which is usually the Gross Operating Profit (GOP). Compared to base/license fees, incentive fees can be more complex and varied in their structures.

Based on our experience, owners are showing a growing preference for scaled incentive fees, placing more emphasis on incentivising the operators for their performance and aligning their interests. Some operators are even proactively incorporating a sliding incentive fee scheme in their initial term sheet, rather than waiting for negotiations to advance to the next level. However, we note that some luxury operators show limited flexibility to negotiate management fees and insist on a flat incentive fee.

In addition to scaled incentive fees, a number of operators are now willing to waive their incentive fees below certain GOP threshold, usually up to a 20-30% GOP level. For the owner, this will obviously reduce the burden of fees and help enhance the hotel’s ability to pay its debt and equity holders in the initial years of operation, when the performance levels are ramping up, and during years of poor performance.

In addition, the basis of calculating incentive fee appears to be shifting from GOP to Adjusted GOP (AGOP). Roughly 45 percent of the contracts surveyed use AGOP as the basis of calculating incentive fees, however the ratio is much higher amongst the more recent contracts. In most cases, AGOP is defined as GOP less base/license fees, while a handful of contracts allowed for additional deduction from GOP such as FF&E reserve and insurance.

Sales & Marketing Fee

Operators charge a Sales and Marketing (S&M) fee in return for a host of sales and marketing services offered on a global, regional and local level, including brand development and marketing, promotions and campaigns, cost of running regional sales offices etc. S&M fees are generally charged as a percentage of the hotel’s gross revenue or room revenue.

Most of the large international operators refuse to negotiate S&M fees, maintaining that S&M is not a profit centre and often claim that these fees are standardised for each brand and are applied to all owners in the region. However, given the lack of transparency of the utilisation of these funds, a growing number of owners are seeking an allocation of a part of the fees locally for hotel-specific marketing to ensure that the properties benefit directly from this payment.

It should be noted that most operators levy additional fees for reservations (made through GDS, phone/email, brand website etc.) over and above the S&M fees, which can typically range between US$3 and US$12 per reservation.

In our opinion, the sales, marketing and reservation charges is an area where many operators need to show better transparency at the contract negotiation stage, both in terms of the fees and charges as well as the utilisation of these funds.
Technical Service and Pre-Opening Fee

To make sure that the hotel complies with the operator’s brand standards, operators provide certain technical consultancy services to owners during the development and pre-opening phase, in exchange for a fee (Technical Service Fee). Technical service fees are typically paid in instalments, spread across the period from the signing of the contract to the hotel opening.

In the majority of the cases, technical service fees are an agreed lump sum fee, while in a few cases the fee can be an amount per key. It is worth noting that many operators are now willing to cap the out of pocket expenses or include it within the agreed fees. However, in our experience, very few operators in the region charge a pre-opening fee or commitment fee, while others consider this as part of the technical service fees.

Contract Term & Extension

The contract term corresponds to the duration of validity of the hotel management agreement. This duration is usually specified as an ‘initial term’ with the provision for a number of ‘renewals’ or extensions.

In the GCC, most international hotel operators are reluctant to negotiate initial terms of less than 15 years for their midmarket and upmarket brands and 20 years for luxury brands. On the contrary, “white label” operators are known to regularly sign terms of less than 10 years, notably for rebranding and conversion projects. We note, however, that contract terms in the region tend to be much shorter than what is observed in more matured Western markets where contracts can be negotiated for a 40-50 year term.

Based on our experience, owners and operators are faced with diverging interests in regards to the duration of the contract. While owners would prefer a shorter contract to limit the risks of underperformance by the management company, operators would argue for a longer initial term as it has a direct impact on their assured future cash flows and company value.

Most hotel management agreements provide for one or more renewals which extend the contract beyond the initial term. Our survey indicates that two renewal terms of five years each, based upon mutual consent, is the most frequently agreed provision of contract renewal in the region.

Termination

Performance Termination

The recent economic crisis has made owner’s more risk averse, most of whom are now insisting on including Performance Termination and other protection clauses linked to exit provisions. Most of the contracts in the region allow the owner to terminate the agreement if the operator does not achieve:

- a pre-determined percentage (generally 80 or 85 percent) of the budgeted GOP; and/or
- a pre-determined percentage (generally 80 or 85 percent) of the RevPAR reported by the property’s competitive set.

Based on our survey, over half of all contracts include a performance test of which 82 percent have a two-pronged test. In a two-pronged test, the contract can be terminated only if the operator fails both GOP and RevPAR tests during the test period (typically 2-3 consecutive years) and the test typically starts only after the stabilisation period (usually after Year 3-5). Invariably, operators tend to include a “Cure Right”, allowing them to pay the owner the GOP short-fall between the actual GOP and the GOP that would have been achieved if the property had achieved the test thresholds.
With a two-pronged test, cure rights and Force Majeure protection in the operator’s favour, the performance termination clauses are not considered to offer owners sufficient protection against poor performance of the hotel operator. The possibility of enforcing this clause is questionable as it is either difficult to prove the failure of the operator in the case of non-performance or may require onerous arbitration process which could be detrimental to the relationship anyway.

**Arbitrary Termination**

Arbitrary termination rights for owners are generally disliked by operators. However, operators are showing some flexibility these days to include an arbitrary termination provision for a compensation which can either be discussed at the time of the termination or based on a formula agreed in the contract. Based on the formula, the compensation can range between 3-5 times the average management fees (base, license and incentive) earned in the previous 2-3 years, but can go up to the entire management fees for the full remaining term of the agreement.

With many institutional investors and investment funds getting into the regional hotel development space, who typically have shorter holding periods, we believe that the termination clause is likely to become an important discussion point between owners and operators in the near future.

**Right of First Offer / Refusal**

The Right of First Offer or Refusal is a related topic which relates to the sale of the property. The Right of First Offer will give the operator the right to make an offer for the purchase of the hotel before the owner can approach a third party while under the Right of First Refusal, once the owner has negotiated the terms of a sale with a third party, he is obliged to approach the operator who will have the right to take the hotel on the same terms.

The latter is considered more problematic for the owners as the time taken by the operator to decide on the offer received may squeeze the time the owner has to conclude the deal with the third party. However, less than 10 percent of contracts in our database included a “right of first refusal”.

In nearly all the contracts, operators required the buyer to be ‘qualified’ (of strong financial standing, not sanctioned, not a competitor etc.). However, in some cases, operators may also retain the right to continue the operations under the new owner on the same terms until the contract expires, which may also be disadvantageous to owners.

**Area of Protection**

In our experience, owners are increasingly demanding an Area of Protection (AOP), or territorial exclusivity, preventing the operator from owning, operating or franchising another property of the same brand within a specified geographical area (usually some kilometre radius) around the hotel and over a specific period of time.

Based on our survey, the inclusion of exclusivity clauses in hotel management agreements is more prominent for luxury brands which had a wider AOP radius in comparison to upscale and midmarket brands. Midmarket and economy hotels typically have a larger target audience and limited catchment area, which enable these brands to operate a larger number of hotels in a given city without the risk of cannibalisation compared to their upscale and luxury counterparts.

However, despite the growing number of contracts including AOPs, our study indicates that the average radius has been declining and exclusivity zones shrinking over the years. We note that operator are reluctant to restrict their growth opportunities in fast growing markets by offering large AOPs. Additionally, the recent development of micro-markets in primary cities such as Dubai, Riyadh, Abu Dhabi and Doha with their own demand generators appear to be prompting owners and operators to focus on competition within these micro-markets rather than a wider kilometre radius.

The AOP clauses are typically limited to a number of years, most frequently 8-10 years, and may frequently come with a “burn off” period whereby the area is reduced or AOP lifted after a specified number of years or if the operator achieves certain performance thresholds (typically occupancy) during the period.
Owner’s Priority & Guarantee

Owner’s Priority is a provision where the operator will receive an incentive fee only once the property has breached a minimum return threshold (typically an agreed lump sum) in terms of the GOP/NOP, while an operator guarantee (or minimum guarantee) is where the operator guarantees a minimum return to the owner regardless of the actual returns achieved. These provisions generally intend to protect the owner against low returns, particularly when there is debt involved in the project. In our experience, operators invariably apply a “claw-back” provision to recoup any foregone fees when the profitability levels exceed the minimum return thresholds.

Owner’s priority and guarantee clauses appear to be relatively rare in the GCC, arguably due to the high liquidity levels enjoyed by the owners and developers in the region. On the other hand, operators in the region are also very reluctant to offer such guarantees and assume the risk. However, the decline in hotel performance levels in many regional markets and its impact on the owners’ returns are likely to bring this issue to the fore in the coming years.

Owner Approvals

A typical management contract would require the owner virtually hand over total control of the property to the operator, with limited scope for interference. However, owners are often given approval rights on certain key decisions in terms of both operations and capital improvements, such as approval rights on budgets and appointment of key personnel.

Budget Approvals

The large majority of hotel management agreements surveyed included provisions for budget approvals, which require the operator to present its annual operating and capital budgets to the owners for approval. Although operators may have certain ‘carve-outs’ and limitations on the extent and scope of such approvals, with the exception of a handful, all operators are known to offer owners the right to approve annual budgets.

Appointment of Key Personnel

More than three quarters of the contracts gave the owner the right to approve the hotel’s key executives, which include GM and, in most cases, the Director of Finance. Although this clause is increasingly becoming common in hotel contracts, operators often limit the number of candidates the owner can reject, usually up to three candidates, per position. A small number of contracts included approval rights for other key positions too, such as Executive Assistant Manager, Director of Sales and Marketing and Director of Food and Beverage.

Governing Law

Hotel management contracts are usually governed by the laws of a specific country, which may or may not be the country where the property is located. As the legal systems in the region develop and more hotel operators expand and set up bases here, more hotel operators appear to be amenable to accepting local laws to govern the contracts. Nearly 70 percent of the management contracts sampled in our survey were governed by the local laws.

Arbitration and dispute resolution are treated separately from the contract’s governing law. In the majority of management contracts in the region, arbitration procedures are done under the jurisdiction of the London Court of International Arbitration (LCIA) in London or Dubai International Arbitration Centre (DIAC) in DIFC. However, in the recent years, more and more operators are including Expert Opinion provisions for the resolution of minor disputes between the parties, which can be a much quicker and more cost effective alternative.

Relative Bargaining Strength

Our survey re-confirms our earlier findings that, in the context of hotel management contracts in the Gulf, the relative bargaining power appears to be shifting in favour of the owners. While operators are considered to have the upper hand in many aspects of the contract negotiations, owners continue to be more sophisticated with access to professional advisors.

Based on our survey, we present below a continuum of “Relative Bargaining Strength”, divided into five zones with varying degrees of bargaining strength, illustrating the interaction between the operator and owner:
## Hotel Management Contract Trends in the Gulf

### Relative Bargaining Strength

<table>
<thead>
<tr>
<th>Terms</th>
<th>Heavily Favours Operator</th>
<th>Slightly Favours Operator</th>
<th>Neutral</th>
<th>Slightly Favours Owner</th>
<th>Heavily Favours Owner</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base &amp; License Fee:</td>
<td>+3%</td>
<td>2 - 3%</td>
<td>1.5 - 2%</td>
<td>1 - 1.5%</td>
<td>0 - 1%</td>
</tr>
<tr>
<td>Incentive Fee:</td>
<td>+10%</td>
<td>9 - 10%</td>
<td>7 - 9%</td>
<td>6 - 7%</td>
<td>&lt;6%</td>
</tr>
<tr>
<td>Sales &amp; Marketing Fee:</td>
<td>+2% of Total Revenue</td>
<td>1 - 2% of Room Revenue</td>
<td>0 - 1%</td>
<td>Minimal lump sum</td>
<td></td>
</tr>
<tr>
<td>Tenure (Initial Term):</td>
<td>25+ years</td>
<td>20 - 25 years</td>
<td>15 - 20 years</td>
<td>10 - 15 years</td>
<td>&lt;10 years</td>
</tr>
<tr>
<td>Termination:</td>
<td>Breach of contract only</td>
<td>Termination on performance test failure for three consecutive years on GOP and RevPAR</td>
<td>Termination on performance test failure for two consecutive years on GOP or RevPAR (80-85%), Force Majeure protection but no cure rights</td>
<td>Performance Test failure for two consecutive years on GOP (85-90%), No cure rights</td>
<td>Performance Test failure for two consecutive years on GOP, with no cure rights</td>
</tr>
<tr>
<td></td>
<td>No performance termination</td>
<td></td>
<td></td>
<td>Arbitrary termination rights with compensation for the full remaining term</td>
<td>Arbitrary termination rights within minimal agreed compensation</td>
</tr>
<tr>
<td>Governing Law:</td>
<td>Operator's country of origin/ incorporation</td>
<td>UK, France, Geneva</td>
<td>Local law (location of the hotel)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Owner Approval:</td>
<td>Limited approval rights on budgets &amp; contracts/leases; GM only</td>
<td>Approval rights on: budgets &amp; contracts/leases; GM and Finance Dir. Only (can reject up to three) bank account operations (subject to limits)</td>
<td>Approval rights on: budgets &amp; contracts/leases; GM (can reject as many) nomination of Finance Dir. bank account operations (subject to limits)</td>
<td>Approval rights on: budgets &amp; contracts/leases; nomination of key staff bank account operations</td>
<td></td>
</tr>
<tr>
<td>Area of Protection:</td>
<td>None</td>
<td>Specific market area, with burn-out in 5-8 years from signing</td>
<td>Specific market area, with burn-out in 8-10 years from opening</td>
<td>Large radius area, with burn-out in 10-15 years from opening only upon achieving performance thresholds</td>
<td>Entire city or very large area, for the entire term of the contract</td>
</tr>
<tr>
<td>Technical Service Fee:</td>
<td>US$1,500+ per key</td>
<td>US$750-1,500 per key</td>
<td>US$500-750 per key</td>
<td>US$350-500 per key</td>
<td>US$200-350 per key</td>
</tr>
<tr>
<td>Guarantees:</td>
<td>None</td>
<td>None</td>
<td>No incentive fee if GOP below agreed GOP%</td>
<td>No incentive fee if GOP/NOP below agreed amount, with claw-back provision</td>
<td>No incentive fee if GOP/NOP below agreed amount, without claw-back provision</td>
</tr>
</tbody>
</table>
TRI Consulting

TRI Consulting is one of the region’s leading management consultancy firms, specialising in hotels, leisure and real estate. With over 20 years of experience in the region, TRI is regularly called upon to advise government entities, publicly listed companies, regional developers, hotel operators and high net worth individuals through their extensive range of services. A selection of recent operator selection and hotel management contract negotiations undertaken by TRI include:

<table>
<thead>
<tr>
<th>Assignment</th>
<th>Location</th>
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</thead>
<tbody>
<tr>
<td>Operator selection for a luxury and midmarket hotel</td>
<td>Kuwait</td>
</tr>
<tr>
<td>Operator selection for a midmarket hotel and serviced apartments</td>
<td>Dubai</td>
</tr>
<tr>
<td>Operator selection for a five star family resort project</td>
<td>Abu Dhabi</td>
</tr>
<tr>
<td>Review of Commercial Terms for a luxury resort project</td>
<td>Ras Al Khaimah</td>
</tr>
<tr>
<td>Operator selection for a midmarket hotel</td>
<td>Jeddah</td>
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<tr>
<td>Contract negotiation and finalisation for a luxury resort project</td>
<td>Bahrain</td>
</tr>
<tr>
<td>Operator selection for a midmarket hotel and serviced apartments</td>
<td>Jubail, Saudi Arabia</td>
</tr>
<tr>
<td>Operator selection for three hotels and two serviced apartments</td>
<td>Dubai</td>
</tr>
<tr>
<td>Operator selection for three luxury, upscale and midmarket resorts</td>
<td>Salalah, Oman</td>
</tr>
<tr>
<td>Operator selection for a lifestyle hotel</td>
<td>Doha, Qatar</td>
</tr>
<tr>
<td>Review of Commercial Terms for a Mega-Resort Project</td>
<td>Doha, Qatar</td>
</tr>
<tr>
<td>Operator selection for a landmark luxury hotel</td>
<td>Riyadh</td>
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<tr>
<td>Operator search for a liquor free luxury hotel</td>
<td>Cairo</td>
</tr>
<tr>
<td>Operator selection for an upmarket hotel</td>
<td>Muscat</td>
</tr>
<tr>
<td>Operator selection for a lifestyle hotel</td>
<td>Beirut</td>
</tr>
</tbody>
</table>

About the authors:

**Rashid Aboobacker | Associate Director**

Rashid has over eight years’ experience in tourism, hospitality and real estate consulting at TRI Consulting. Over these years, he has advised private and institutional investors, developers and government agencies on close to 150 hospitality and mixed-use real estate projects across the MENA and Indian Ocean Region.

Apart from development planning, Rashid has recently been involved in several market opportunity studies, market entry and expansion strategy studies for developers and operators, and completed operator selection for many prestigious projects across the region.

**Julien Laloye | Analyst**

Julien joined TRI after graduating from Glion Institute of Higher Education and Les Roches Gruyere U.A.S where he obtained two bachelor degrees: a BBA and a Bsc in Hospitality Management, specializing in International Finance. As part of his industry training, he gained practical experience in luxury properties in Switzerland, Thailand and China.

Julien brings to TRI his international work experience and knowledge of hospitality operations in new and expanding markets. Since joining TRI, he has worked on various assignments such as feasibility studies, financial reports and operator selection in the UAE and Saudi Arabia.