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Lodging Outlook

HVS

SMITH TRAVEL RESEARCH

Finding A Way Out

Reprint: August 2009 Article By Steve Rushmore, MAI, CHA, CRE, President and Fonder of HVS

With the drastic downturn in the economy and the resulting cutback of all types of travel, hotels are suffering from significantly lower demand and rate cutting. Smith Travel Research has predicted an unprecedented RevPAR decline of more than 17 percent this year. Those properties financed in the last five years are likely struggling to pay their debt service, which means owners must use their own capital to make mortgage payments.

Most operators have altered their normal mode of operations by cutting staff, deferring maintenance and renovations and implemented innovative ways to capture demand and lower operating expenses. However, a few operators have not been successful in adjusting and continue to conduct "business as usual" as their properties hemorrhage.

Unfortunately, in many cases, owners cannot terminate these incompetent operators because their management contracts either do not have a performance termination provision or the provision is ineffective. It is during these downturns that owners realize how important these provisions are. While it is probably too late to assist those with poorly structured contracts, let's look at some typical hotel management contract performance termination provisions and see which are the most effective in enabling owners to terminate ineffective operators.

Over the past 30 years, HVS has collected thousands of hotel management contracts during the course of its consulting activities. These have all been filed in a database allowing searches by specific contract provision. A review of "Performance Termination" found a number of tests, but the three most common were: a RevPAR Test, a Budget vs. Actual Test and a Net Income Test.

Essentially, a performance termination provision is one or more financial tests that if failed, allow the owner to terminate the operator. Let's look at each:

RevPAR Test

This starts by calculating the percentage resulting by dividing the RevPAR for the subject property by the average RevPAR for the hotels in the subject's competitive set. If this percentage is below a certain specified level, the test is failed. The two critical components of the test are the types of hotels comprising the competitive set and the minimum percentage threshold. Care must be taken when identifying the competitive set to select truly comparable properties reflecting the RevPAR performance that would be an acceptable measure for the subject property. The minimum percentage threshold should be at least 100 percent, which represents the mathematical average performance. Your operator should always do better than the average. The downside of the RevPAR test is it only measures rooms revenue (occupancy and average room rate). It does not incorporate other critical financial components such as other sources of revenue, operating expenses and profit. In today's difficult environment, the RevPAR test fails to consider the operator's ability to competently manage operating expenses - a major flaw.

Budget vs. Actual Test

This compares the actual financial performance of the hotel to the annual budget prepared by the operator. If the actual house profit (or another profit line) is less than the budgeted house profit by a minimum percentage threshold, then the test is failed. The minimum threshold typically ranges from 80 percent to 90 percent. This is obviously not a true financial performance test, but rather a test of the operator's ability to develop a budget - and more likely - a low budget. The only way the budget vs. actual test provides any protection for the owner is if the budget approval process can be controlled by the owner or a neutral third party.

Net Income Test

This compares the actual net income (or another profit line) to some predetermined minimum net income. If the actual net income is below the minimum, then the test is failed. The predetermined minimum net income is usually an amount that

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September 2009	Number of Rooms	Occupancy Rate (%) 2009	Occupancy Rate (%) 2008	Average Room Rates (in $CAD) 2009	Average Room Rates (in $CAD) 2008	RevPAR (in $CAD) 2009	RevPAR (in $CAD) 2008	Room Supply % chg	Room Demand % chg
Nova Scotia Area	1,378	61.7%	62.4%	$103.44	$100.24	$63.82	$62.55	0.9%	-0.1%
Halifax, NS	4,184	77.5%	81.7%	$133.51	$146.31	$103.47	$119.54	1.3%	-4.0%
Montreal Downtown	10,315	72.1%	77.9%	$146.17	$166.56	$105.39	$129.75	1.7%	-5.8%
Montreal Area	2,361	60.1%	65.4%	$104.29	$105.85	$62.68	$69.23	0.0%	-8.1%
Quebec City, QC	3,928	73.4%	82.2%	$153.61	$177.78	$112.75	$146.14	0.0%	-10.8%
Quebec Area	4,466	64.9%	61.8%	$132.19	$135.44	$85.79	$83.70	0.0%	5.1%
Toronto Downtown	14,496	84.3%	84.8%	$167.26	$199.04	$141.00	$168.79	1.1%	0.6%
Toronto North/East	6,748	67.7%	68.8%	$108.86	$120.38	$73.70	$82.82	1.4%	-0.3%
Toronto Airport/West	8,644	61.8%	69.3%	$105.53	$117.54	$65.22	$81.46	5.0%	-6.4%
Ottawa, ON	7,516	77.2%	79.9%	$136.66	$141.15	$105.50	$112.78	0.9%	-2.5%
Ontario East	4,958	65.4%	67.4%	$106.59	$108.00	$69.71	$72.79	1.7%	-1.4%
Windsor/ Ontario SW	1,951	40.3%	52.8%	$97.63	$115.35	$39.34	$60.90	-2.0%	-25.2%
London/ Kitchener	2,965	59.4%	60.6%	$101.51	$103.12	$60.30	$62.49	0.0%	-1.9%
Ontario North/ Thunder Bay	2,288	73.7%	79.0%	$98.18	$94.64	$72.36	$74.77	1.0%	-5.9%
Ontario NC/ Sudbury	4,914	69.8%	69.3%	$117.58	$114.51	$82.07	$79.36	3.6%	4.4%
Niagara Falls, ON	9,389	69.2%	68.5%	$134.54	$130.00	$93.10	$89.05	0.2%	1.2%
Ontario Central	3,870	59.8%	62.6%	$108.67	$112.73	$64.98	$70.57	2.0%	-2.4%
Mississauga, ON	4,595	63.2%	68.8%	$104.44	$111.97	$66.01	$77.04	-1.5%	-9.5%
Winnipeg, MB	3,621	68.1%	75.3%	$110.43	$116.78	$75.20	$87.94	0.5%	-9.1%
Regina/Saskatoon, SK	2,454	73.0%	75.5%	$115.79	$111.86	$84.53	$84.45	3.2%	-0.3%
Calgary, AB	8,526	77.4%	79.8%	$152.90	$155.59	$118.34	$124.16	2.0%	-1.2%
Edmonton, AB	8,804	66.4%	78.3%	$121.92	$127.28	$80.95	$99.66	2.3%	-13.2%
Alberta North Area	3,868	52.2%	73.1%	$153.80	$167.58	$80.28	$122.50	5.1%	-25.0%
Alberta South Area	8,030	57.5%	66.4%	$132.65	$136.17	$76.27	$90.42	2.6%	-11.1%
Vancouver Downtown	8,303	83.1%	84.8%	$170.10	$185.27	$141.35	$157.11	1.6%	-0.5%
Vancouver/ Burnaby Area	2,063	70.9%	73.4%	$124.42	$129.22	$88.21	$94.85	4.9%	1.5%
Richmond-Surrey/ East Area	3,993	71.7%	73.4%	$120.55	$129.40	$86.43	$94.98	0.0%	-2.2%
British Columbia Area	6,152	56.1%	58.2%	$127.00	$132.98	$71.25	$77.39	0.3%	-3.3%
Kamloops/ Kelowna Area	4,995	59.6%	66.0%	$117.18	$117.13	$69.84	$77.31	0.7%	-9.0%
Vancouver Island	4,914	70.9%	73.9%	$136.59	$145.28	$96.84	$107.36	1.4%	-2.8%
Provinces									
Alberta	31,650	63.0%	73.4%	$135.86	$139.50	$85.59	$102.39	2.8%	-11.8%
British Columbia	31,872	65.3%	68.5%	$126.42	$131.30	$82.55	$89.94	1.0%	-3.6%
Manitoba	4,511	63.1%	67.1%	$100.89	$97.67	$63.66	$65.54	0.4%	-5.5%
New Brunswick	4,735	61.4%	60.8%	$110.65	$112.05	$67.94	$68.13	0.0%	1.0%
Newfoundland	1,833	89.5%	82.8%	$130.31	$127.19	$116.63	$105.31	0.0%	8.0%
Nova Scotia	5,562	69.7%	71.8%	$120.39	$128.78	$83.91	$92.46	1.0%	-1.8%
Northwest Territories	325	63.4%	67.4%	$143.11	$143.43	$90.73	$96.67	0.0%	-5.9%
Ontario	79,490	66.2%	69.3%	$119.38	$125.73	$79.03	$87.13	1.5%	-3.1%
Prince Edward Island	793	59.7%	62.6%	$106.74	$110.72	$63.72	$69.31	0.0%	-4.8%
Quebec	26,403	66.2%	72.3%	$125.21	$138.07	$82.89	$99.82	1.1%	-7.4%
Saskatchewan	6,888	69.4%	73.2%	$108.31	$100.61	$75.17	$73.65	2.2%	-3.0%
Yukon Territory	769	39.6%	44.3%	$111.60	$111.54	$44.19	$49.41	0.0%	-10.6%
Canada	194,831	65.3%	69.3%	$121.42	$126.32	$79.29	$87.54	1.4%	-4.3%

*INS - Insufficient Data

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Montreal Area	2,361	52.5%	56.5%	$104.59	$105.52	$54.91	$59.62	0.3%	-6.8%
Quebec City, QC	3,928	63.4%	71.9%	$141.01	$162.33	$89.40	$116.72	0.0%	-11.8%
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considers factors such as the property's debt service, cost to develop or acquire and a return on invested equity. This is the only test that truly aligns the financial interest of the owner with a performance measure reflecting the overall competency of the operator.

It appears the simple solution to a fair and effective performance test is to utilize only the net income test and enable termination upon the first failure. Unfortunately, most operators incorporate other provisions into the contract that significantly reduce the owner's protection. Here are some examples of the these mitigating provisions:

- The various tests do not start for several years after the operator is hired. The tests must be failed for two or three consecutive years before the owner can terminate.
- Sometimes the tests are paired: the net income test and the budget vs. actual test both have to be failed for two or three consecutive years before the owner can terminate.
- The net income test might have a provision where the operator can lend the owner an amount equal to the amount by which the net income test failed, which is ultimately returned to the operator during better times.
- These tests are sometimes suspended because of an incident of force majeure.

While it is probably too late to modify the performance termination provisions for your current management contract, this economic downturn clearly demonstrates the need to focus on these provisions when you negotiate future agreements with your operator.

DEFINITIONS

Occupancy:	Rooms sold divided by rooms available.
Room Revenue:	Total room revenue generated from the sale or rental of rooms.
Average Daily Rate (ADR):	Room revenue divided by rooms sold.
Room Revenue Per Available Room (RevPAR):	Room revenue divided by rooms available (occupancy times average room rate will closely approximate RevPAR).

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The Hotel Association of Canada is a federation of provincial and territorial associations, hotel chains and suppliers with a mandate to represent members nationally and internationally and to provide cost-effective services that stimulate and encourage a free market accommodation industry.

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