Horwath HTL

Health & Wellness

INDUSTRY REPORT

MOUs Explained

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MOUs Explained: What Hotel Owners and Operators Need to Know

The arrangement between a hotel owner and a hotel operating company has been a well-accepted business model in the hospitality industry for several decades, originally developed to allow hotel operators to expand their portfolios globally with minimal risk associated with real estate ownership. Approximately 21% of all hotels in Europe and 13% of all hotels in North America were operated under management agreements as of 2015 (HVS), and although each management agreement is unique, the same principal issues are typically identified and negotiated between the parties. The negotiation of a hotel management agreement (or HMA) is a complex process and typically preceded by the negotiation of a memorandum of understanding or a letter of intent. According to the Cambridge Dictionary (2018), a memorandum of understanding (or MOU).

"records the details of an agreement between two companies or organizations, which has not yet been legally approved".

The MOU sets out the prime commercial terms presented by the operator on which the hotel management agreement package will later be drafted.

Despite its non-binding nature, once the MOU has been signed, re-negotiation of the main commercial terms becomes difficult. Missing out on negotiating and resolving issues at this preparatory phase may lead to either party finding itself in an unfavorable position when the management agreement package arrives. To achieve an optimum balance between a hotel owner's and operator's interests (Figure 1) and ensure that both parties' goals are aligned, it is important to understand the rationale behind key terms and common issues that arise during the negotiation process.

Figure 1: Preferred Terms

	OPERATOR	OWNER
Term	Long term	Short term
Termination On Sale	No termination on sale	Termination upon sale
Management Fees	High, above-market fees	Low, below-market fees
Performance Clause	Weak clause; not easy termination if the hotel does not perform well	Strong clause; easy termination if the hotel does not perform well
Property Investment	Not interested in investing in the property	Significant contribution of the operator to the investment

Source: Horwath HTL Health and Wellness, 2018

Operating Term

Operator:

One of the main commercial terms noted in the MOU is the duration a hotel management agreement is to remain in effect, typically from the opening date or the date of execution of the management agreement until the expiration of a specified number of years (HVS, 2017). Ranging between 10 and 30 years, the operating term depends largely on the brand of the management company, its status, as well as the right to extend the term (usually for 5 to 10 years). A more luxurious property would usually have a longer operating term than a more economy property.

For an operator, it is important to have the term long enough to allow the hotel to establish itself in the market and reap the benefits of the goodwill generated through the operator's brand. Moreover, a longer term would also allow the operator to rationalize investment of its time, effort and professional expertise put into running the property, and make attractive returns. For these reasons, and assuming a hotel's successful performance, an operator would prefer the renewal terms to be set in its favor, and would typically resist early termination by the hotel owner as well as attempts to include early termination rights.

Owner:

As the operating term locks a hotel owner to a particular operator for a long time, the owner would be advised to negotiate into the MOU the following clauses:

- A shorter term if the operator's term is excessively long for the brand in question and its standard in the market place.
- An option for either party not to renew the term at the end of the first operating term.
- An ability to terminate if certain performance criteria are not met.
- If possible, a guarantee of performance where the operator is obliged to make up for any shortfall in budgeted gross operating profit (GOP).
- An ability to terminate the management agreement if the operator fails to cure a material breach of its obligations under the hotel management agreement.
- If possible, the ability of the owner to terminate upon sale of the hotel; however, it may be difficult to obtain, and typically compensation would have to be paid out to the operator if agreed to.

Brand Name

Operator:

The memorandum of understanding will state the operator's brand name and the proposed name of the hotel. In the case of a multi-brand operator, the operator will choose which one of its brands is the most appropriate for a hotel's location and market positioning. The operator would also have the right to later on approve the name under which the property will operate, which will dictate brand standards and level of management fees.

Owner:

For the owner, it is important to ensure that the brand and the hotel name proposed by the operator in the MOU are right for the intended target market.

Brand Standards and Capital Reserves

Operator:

To protect the goodwill and reputation associated with its brand, the operator will require the hotel to be built and operated in compliance with the operator's brand standards, policies, and specifications. In this case, the owner will be obligated to ensure that such brand standards are complied with, the hotel is adequately staffed, and the property's interior and exterior are properly maintained at all times at the owner's expense.

Owner:

The owner should ensure that the MOU contains provisions to keep maintenance and staffing expenditure within reasonable limits and within a predetermined percentage of the current fiscal year's approved annual plan or annual operating budget, save for the case of having to meet new legislation requirements or emergencies.

Group Charges, System Fees, Marketing Contribution and Reservation Fees

Operator:

The MOU will briefly spell these out. The operator will want the hotel to contribute to system programs, group marketing, participate in loyalty programs, and pay a reservation fee for each room booked through the operator's central reservation system.

Owner:

The operator will not normally accept any revisions or deduction from these fees and charges but the MOU should specify that all these fees and charges are system wide and should be allocated amongst all operator-branded hotels on a fair and equitable basis.

General Manager and Other Key Senior Positions

Operator:

As a general rule, all hotel personnel would be employees of the owner. All employees will report to the hotel's general manager, who in turn will report directly to the operator. The success of the hotel will depend a great deal on the general manager's performance and his/her ability to run the property. Therefore, to ensure the agreed performance criteria are met, the operator would have the right to directly employ the general manager and other members of the senior executive staff. For the operator, it is also important that the general manager and other personnel are employed and provided with appropriate brand standard training prior to hotel opening.

Owner:

The general manager would be a key contact between the operator and the owner. Accordingly, the owner would have a vested interest in the selection of the general manager and other senior personnel and should have the right to review and reject such candidates proposed by the operator up to two or three times.

Termination of the general manager's employment for any reason by the operator should be done in consultation with the owner in advance and before any communication to the general manager. Likewise, the owner should be able to raise the possibility of terminating the general manager's employment in case his/her performance is deemed unsatisfactory for any legitimate reason.

The general manager's salary is a significant expense for the owner; therefore, it should be noted in the MOU that the commencement of employment and remuneration packages of the general manager and other hotel staff prior to hotel opening (prior to any revenue being generated by the property) should be agreed upon between the parties.

Hotel Rates, Staff Salaries and Staffing Numbers

Operator:

Some MOUs may state that an operator will have total discretion to set hotel room rates and other charges, salaries for the staff and the total manning numbers. It is important for the operator to ensure that (i) the hotel charges rates that are appropriate for the operator's brand, (ii) the staff receive an attractive compensation package, and (iii) the hotel is staffed in sufficient numbers to provide a level of service commensurate with the operator's brand standards.

Owner:

As hotel rates, salaries, and staffing numbers would directly affect the hotel's profitability, and therefore the owner's returns, the owner should ensure the MOU states that the owner needs to be consulted on these matters, and that payroll expenses should be kept within the limits agreed in the annual plan and annual operating budget.

Operator's Fees and Taxes

Operator:

The MOU will include the operator's desired level of fees and charges, typically net of any taxes and other deductions. The operator may also charge a technical services fee to advise on the construction of the hotel in accordance with the brand specifications as well as reimbursement of any travel expenses associated with site inspections. From the opening, a base management fee is calculated as a percentage of gross operating revenue (GOR) and an incentive fee is calculated as a percentage of gross operating profit (GOP), encouraging the operator to maximize the financial performance of the hotel. Often, the operator will include a license fee (as a percentage of GOR) for using the brand name and logos.

Owner:

The owner should carefully review the fees in the MOU because any change to the fee structure will be resisted by the operator when the management agreement is drafted. Hospitality lawyers suggest that when an operator is challenged on the fees at the MOU stage, it is possible to negotiate a reduction as well as an adjustment to the criteria of what comprises GOR and GOP. The MOU should state that the operator's reimbursable expenses should be reasonable and either be subject to the owner's prior approval or be included in a pre-approved budget.
While the operator would prefer to have all professional fees grossed up, payment of withholding taxes on top of the operator's fees may result in increasing the total cost for the owner by 10-15%, depending on the withholding tax rate in the country concerned. Thus, the owner may insist on these additional costs being borne by the operator.

Exclusivity Period

Operator:

The MOU will include an exclusivity period, from signing the MOU up to signing the HMA, or at least for a minimum of three to six months. It ensures a certain level of protection for the operator, preventing the owner from having any discussions with a competing operator during the negotiation period so as to be able to compare terms or to obtain a better deal or leverage.

Owner:

As the exclusivity clause in the MOU is always binding, it has important implications and the owner should be looking to add that either party may terminate the MOU on written notice to another at any time, or at least be able to do so when it is clear that negotiations have ceased entirely. It is also advised that exclusivity in the MOU is reciprocated by the operator.

Additional Provisions

Operator:

- Capital Reserve: The MOU will state that, soon after the hotel opening, the owner must contribute to a capital reserve fund to ensure there are funds available to pay for capital replacements and improvements; this is based on a scale of percentages of gross revenue, which increases as the property ages. The operator would prefer total control over this fund and the ability to dip into it to pay for capital expenses, as and when the operator considers necessary, to maintain the hotel up to brand standards.

Owner:

- Area of Protection: To protect the hotel from undue competition by the operator, the MOU should state there will be an area of protection clause in the management agreement, preventing the operator from managing a competing brand/hotel within an agreed radius of the hotel for an agreed period.

- Sale/Mortgage of Hotel: The MOU should include provisions that allow the owner to sell the property or mortgage it without the consent of the operator, subject, however, to certain criteria and conditions to protect the operator.

- Annual Budget: The MOU should state that the annual budget should be provided to the owner for its review and approval (and not just for the owner's comments), and allow an appropriate length of time for the owner to respond that is not unduly short, with any dispute being referred to an "expert", and not an arbitrator.

- Signing Authority of the General Manager: The owner should include in the MOU appropriate parameters within which the general manager of the hotel can sign without participation of anyone from the owner's side; however, beyond those parameters, a joint signature with the owner's representative would be required.

- Assignment: The MOU will often allow the operator to assign the benefit of the MOU as it desires. Ideally, any assignment should take place with the consent of the owner and whatever is agreed should be reciprocated in favor of the owner.

- Governing Law and Dispute Resolution of MOU and HMA: The owner is advised to seek professional legal advice when considering the implications of the governing law and the location of dispute resolution of both the MOU and HMA. Depending on the governing law chosen, the cost of litigation and hidden principles of law may adversely affect the HMA package with respect to the operator.

In case of a Dispute

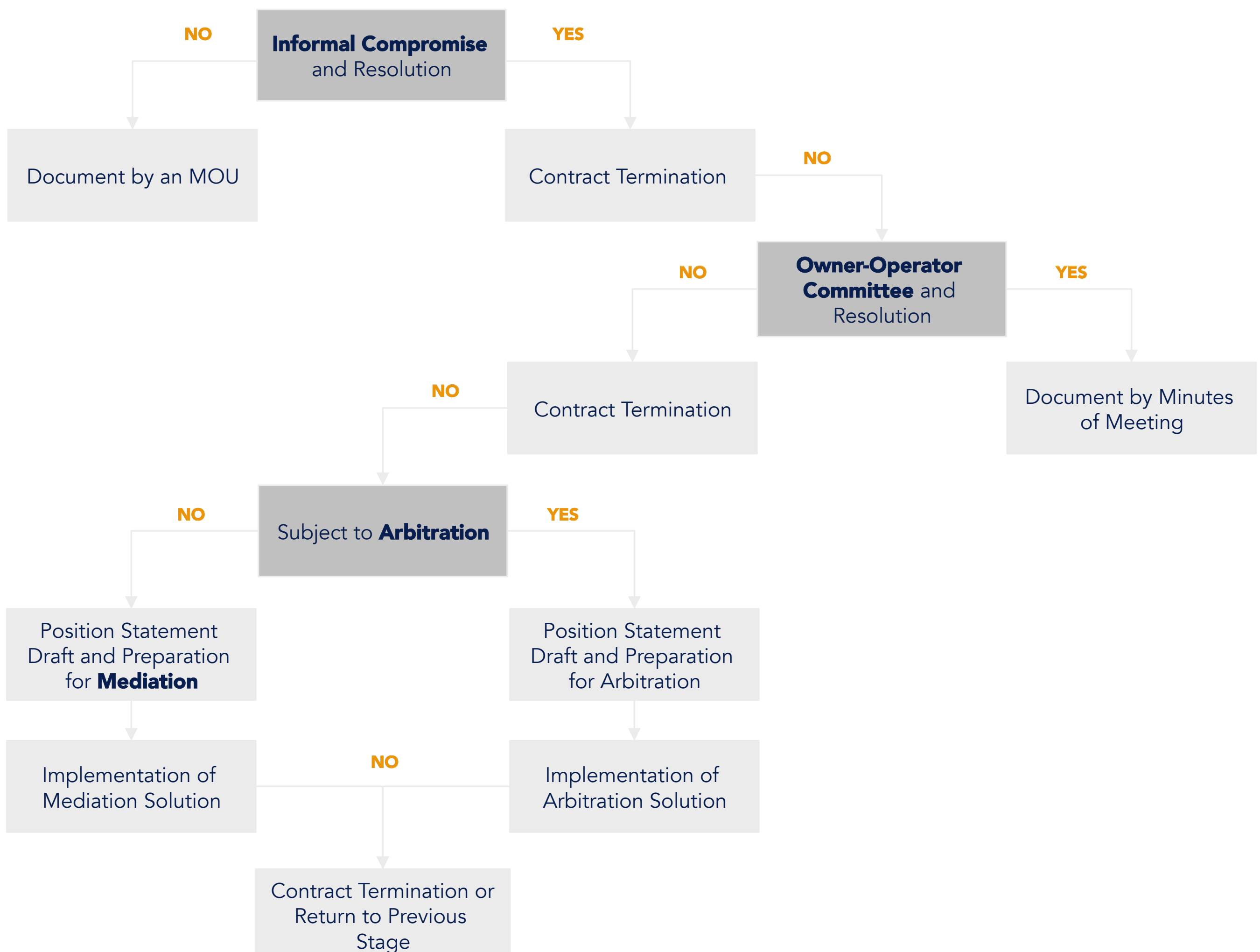
The difference between the owner's and the operator's interests often leads to disputes between the parties, which, if not resolved, may eventually lead to contract termination. For this reason, the means of conflict resolution should be agreed upon and included in the agreement during the negotiation period.

According to Cornell University, the first and the easiest step in dispute resolution between the owner and the operator is an informal compromise. If parties reach a consensus at this stage, it is documented by an MOU, eliminating the need for a formal contract amendment. The majority of disputes are resolved this way.

If the parties cannot come to an agreement, the conflict moves to the next stage – owner-operator committee. Made up of three representatives from each side, the committee works in a quasi-mediation form, attempting to find common ground and come to an agreement. Similar to the informal compromise, the outcome is documented by formal minutes of meeting.

If the owner-operator committee fails to resolve a dispute, mediation or arbitration are employed. In either case, the asset manager will draft a position statement, prepare for the mediation/arbitration process, and execute the solution. Figure 2 illustrates the typical conflict resolution process and the potential outcomes of each stage.

Figure 2: Dispute Resolution Process



Source: Cornell University; Horwath HTL Health and Wellness, 2018

Wellness Developments: How Are They Different?

Wellness resort management agreements are in general terms similar to hotel management agreements. They employ the same business model where the operator receives a percentage of the gross operating revenue and the gross operating profit for managing the property's day-to-day operations and are rarely signed for under 20 years. The key distinction, however, is that the base management fees of wellness operators are higher (often considerably) than the industry average of 2.5% to 3.5%. Due to a smaller room inventory of wellness resorts (usually between 50 and 100 keys), the base management fees average 4% to 8% of gross operating revenue. Higher incentives are based on the greater amount of technical know-how and practical experience that wellness operators need to put in to ensure appropriate design, clear strategy, pre-opening setup, and success of the overall wellness development.

Generally, gross operating revenue (GOR), which serves as a base for the base management fee calculation, includes all income derived directly or indirectly from the operation of the wellness resort.

This includes:

- rooms revenue;
- branded real estate rental program revenue;
- food and beverage revenue;
- service charges;
- laundry charges;
- telecommunication revenue;
- spa, wellness, and fitness facility revenue;
- banquet and catering revenue;
- parking revenue;
- and commissions on foreign exchange conversions.

However, in the case of medical wellness resorts, further specifications are often necessary.

Medical therapies require highly specialized expertise that neither holistic wellness operators nor hotel operators typically possess. Therefore, medical services (e.g. dentistry, plastic surgery, stem cell therapy) are often outsourced to a third-party medical service provider, experienced in healthcare and hospital management. Under this scenario, the wellness operator would manage the rooms, food and beverage outlets, and integrative wellness components, and the medical operator would oversee the medical center (providing semi-invasive and invasive treatments). In the management agreement context, it is crucial that the allocation of medical service revenue is clearly specified.

In addition, the owner may decide to sell any residential real estate that forms part of the wellness resort (or a wellness development where the resort is located). In this case, it is common for the operator to charge an additional branding fee (of approximately 5%) on the total sales price, which corresponds with the substantial premiums achieved by wellness branded real estate properties.

Another sector of the health and wellness industry that has to be looked at separately is spa consulting. Spa consulting services are often provided by small private companies, experienced in spa operations but lacking in-depth know-how of all-encompassing health and wellness developments. Given that a spa is only one pillar in a wellness resort's service platform, spa operations are relatively less complex. Thus, hotel and resort spas often partner with a product house, and therefore focus less on spa performance and more on product sales.

As management agreements come further into focus, the importance of understanding key terms and potential pitfalls is on the rise. While this article highlights some key issues for hotel owners and operators alike, the list is not exhaustive. It is therefore recommended to seek expert advice at the very beginning of the negotiation process to align the interests of the owner and the operator and achieve a successful contractual relationship for the long run.

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Injecting fresh ideas and professional management into the rapidly expanding wellness hospitality sector, Ingo Schweder brings together more than 30 years of experience in the spa and hospitality industries. He leads the multidisciplinary teams at GOCO Hospitality and Horwath HTL Health and Wellness to strategize, conceptualize, design and manage the latest wellness developments for the world's top hospitality and real estate brands. From individual hotel spas to dedicated wellness resorts and master planned mixed-use developments, Ingo's experience and insights have taken over 400 projects worth more than $1.4 billion across upwards of 42 countries from initial idea to profitable realization and on-going management.

The company manages GOCO-branded spas in Italy, Greece and the UAE, and owns the Glen Ivy Hot Springs in Southern California, the United States' oldest and highest grossing spa. GOCO Hospitality is currently developing several GOCO Retreats in strategic spots around the world. Ingo was formerly a board member of Mandarin Oriental and earlier Corporate Director of Operations for Oberoi Hotels & Resorts. Under his guidance, Ananda in the Himalayas, the globally recognized destination spa, was established.

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Practicing law for over 35 years based in London, Hong Kong, and Bangkok, Tim worked with major international law firms, such as Linklaters, Deacons, Allen & Overy and DLA Piper. Specializing in hospitality, real estate, construction, and banking and finance, Tim advised multi-internationals and local clients on a wide range of transactions from large complex cross-border deals to small investments.

As part of his hospitality practice, Tim worked with hotel owners and operators, covering both sides in drafting and negotiation of hotel management documentation, including letters of intent, memorandums of understanding, pre-opening and technical services agreements, management agreements, licenses and permits among others. Tim and his firm acted as lead counsel for such hospitality industry players as Ascott, Centara, Citadines, Holiday Inn, Hyatt, Mandarin Oriental, Marriott, and Oberoi.

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As a Consultant of Horwath HTL Health and Wellness, Krystyna is primarily responsible for the development of market research and feasibility studies, business plans, and client presentations for wellness-centric hospitality projects and mixed-use real estate developments. Before joining Horwath HTL in Bangkok, Krystyna worked in international hotels and resorts in Europe and the Middle East. Krystyna holds a BA in Hospitality Management with Real Estate Finance and Revenue Management from Glion Institute of Higher Education, Switzerland, and a Certificate in Hotel Industry Analytics from American Hotel and Lodging Association. Krystyna is a member of Eta Sigma Delta International Hospitality and Tourism Management Honour Society.

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