Horwath HTL
Hotel, Tourism and Leisure

Realignment of hotel contracts: Change from lease to management contracts?

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In the German hotel industry, the predominant model has long been the classic lease agreement. According to the German Hotel Association (IHA), domestic investors still dominate the German transaction market with a share of 63%. Developments over the last ten years have seen the brand hotel industry in particular benefit from an increase in new hotels. Branded hotels have expanded the portfolio of available brands and thus the spectrum of categorization.

Previously traditional markets of the "private hotel industry" (especially in B and C cities) have thus become suitable for investment. The contractual model of lease/rental agreements was expanded to include franchise and hybrid models. However, international investors with an awareness of value appreciation through participation in operations prefer management and/or hybrid models. In addition, the pandemic and associated crisis situation strengthened the trend towards more flexible contract models.

Since then, clauses limiting rental payments (so-called CAP clauses) in times of weak sales or variable rents that are adjusted to sales or operating results have become a fixed part of contracts. Is this increasing risk-sharing at the burden of the property the logical consequence of replacing the "traditional fixed lease" with variable models?

What is a lease contract?

With a lease contract, the leaseholder usually receives a ready-to-use property from the investor that is already equipped with all the necessary FF&E (fixtures, furniture and equipment). The "equipment" factor is a key difference between a lease and a rental agreement, as the last usually involves renting premises that are not equipped. In addition, unlike a rental agreement, a lease not only allows the leasee to use the property, but also to receive the resulting income. Due to tax advantages, in many cases the FF&E is now rented out in a separate rental agreement in addition to a lease. While rents for commercial properties such as offices, warehouses and retail are linked to the floor space, this is rather unusual in the hotel industry. Hoteliers operate their business not only in a property, but with this property. Therefore, their earning power must be determined, an appropriate profit contribution deducted and thus the ability to pay the lease of the respective hotel determined. During the lease term, the lessee can take full advantage of the building and the FF&E. In return, he pays a fixed rent to the investor. The term of a lease is typically between 15 and 30 years. This lease is often staggered (so-called graduated leases), as hotels usually only reach their sales and earnings plateau after a term of three to five years.
The lease agreement offers the owner - the property - a controllable risk. This means that the real estate does not share in the hotel's operating success. From a real estate perspective, there is a positive correlation between the "risk" and "earning power" of a hotel. The higher the fixed lease share, the lower the possibility for the owner to participate in future earnings (value protection through index clauses excluded). With a lease agreement, the owner has no say in the management of the hotel per se. Management decisions are the responsibility of the lessee. Conversely, the lessee has an increased risk, as he is obliged to make the rental payments to the property owner - regardless of the economic and therefore financial situation of his company. This often leads to an unequal distribution of opportunities and risks between the parties involved (Linder, 2013).

Advantages of lease agreements from the owner's perspective	**Disadvantages of lease agreements from the owner's perspective**
Low financial risk	Lower profit potential for the owner with successful operational management
No operational risk	Owner has no say in the management of the company
The land and property remain in the owner's possession and ideally increase in value	Towards the end of the lease, the operator has little interest in maintaining the FF&E of the hotel.

Figure 1: Advantages and disadvantages of lease agreements from the owners' perspective, own visualization

What is a management contract?

In legal terms, the management contract is an agency agreement in which the owner of the property usually asks an operator to run the property at the owner's risk. The management contract separates the hotel property from the hotel management (operator). Investors are not in a position or do not have the interest to manage a hotel, which is why an operator (manager) takes on this task. The investor “commissions” an operator (e.g. a hotel chain) to manage the property or hotel, which in this case provides the chain's own system including the hotel brand. The hotel is operated under the brand name of the chain, while the invoices are permanently run under the name of the investor. For operating the hotel, the operating hotel company receives compensation in the form of an agency fee, which is commonly understood as a management fee. The operator, in particular the international hotel chains, differentiate between compensation for the brand name (royalty fee), the basic management fee (basic management fee) and a performance-related fee (incentive fee). The basis for calculating the brand and basic fee is based on the hotel's turnover. The performance-based fees are calculated as a percentage of the calculated gross operating profit (GOP).
In this model, the investor assumes the risk for success and failure, which is why additional profits or losses are attributed to him. However, the investor is also responsible for maintenance reserves, property tax and building insurance. Consequently, the investor is dependent on the operator's actions.
Risk minimization for the investor, the property, is achieved through hybrid management structures. The operator (manager) is held financially liable. Models for this include achieving a minimum turnover or setting a minimum result in gross operating profit (GOP) before an incentive is paid out. However, as the management fee is also dependent on the success of the hotel, the operating hotel company will strive to achieve the best possible result by generating as much revenue as possible while simultaneously incurring as few costs as possible, as both factors are essential for the final management fee (Henschel, Gruner and von Freyberg, 2018).

Advantages of management contracts from the owner's perspective	**Disadvantages of management contracts from the owner's perspective**
High profit potential with successful operational management	High financial risk
Owner has a say in operational management	Owner bears full operational risk
Management contracts are more flexible than leases	Shorter contract terms can lead to uncertainty in long-term planning

Figure 2: Advantages and disadvantages of management agreements from the owners' perspective, own visualization

Background and development of contract structures in the German hotel market

Lease agreements dominate the German hotel market. However, international investors are more risk-averse than has previously been the case with real estate in Germany. As mentioned in the introduction, around two thirds of hotel properties are owned in Germany.

The financing of real estate in Germany is traditionally a bank-financed model. In contrast, in the Anglo-Saxon world, it is customary to include equity in an investment model such as a hotel. The increasing demand from international investors is therefore leading to a shift towards management contracts. These investors have a differentiated understanding of risk sharing. If, as is usual in Germany, the property is “paid for” in full by the owner, they either want the lessee to share the risk or to participate in the success of the lease. The management contract in hybrid form therefore comes closer to this understanding of risk. Industry expert Michael Schnürle can confirm this international shift towards risk-sharing models.

“From my personal experience as a consultant in Brazil and as a manager at B&B Hotels, I can say that in addition to franchise agreements, management agreements are predominantly concluded worldwide. The large, international hotel chains such as Accor and Hilton in particular rely exclusively on management contracts,” explains Michael Schnürle, Senior Consultant at Horwath HTL Germany. “In Germany, on the other hand, lease agreements are largely used, although a clear change is noticeable here.”

But where does this considerable asymmetry between lease and management contracts in the German hotel industry come from?

Culturally, Germans prefer stability and predictability in business relationships. These cultural values also reflect the preference for lease contracts in Germany. Lease agreements are more predictable due to the fact that the term is defined in the contract. In addition, lease agreements generally offer more stability in a constant cooperation, as they do not contain any special termination rights, for example, if agreed economic targets are not achieved, as is often the case with management contracts. In contrast, management contracts, which entail a higher sales potential from the owners' perspective, are perceived as more volatile and risky. Furthermore, a lack of experience in dealing with management contracts in Germany also contributes to an increased risk.

In addition, the legal structure in Germany restricts innovative contractual arrangements. This is particularly evident in the fact that important institutional investors in the hotel sector, including insurance companies and open-ended real estate funds, are only allowed to assume limited economic risks in accordance with the regulations of the German Federal Financial Supervisory Authority (BaFin).

This in turn contrasts with the structure of the management contracts, which include a large number of variable components on the one hand and transfer the full risk of operating losses to the owner on the other. In addition to these aspects, gray areas and not clearly defined responsibilities can arise in the management contract due to the numerous contractual contents to be regulated. Large international hotel chains in particular prefer the management contract to the lease agreement. An important reason for this is the lower capital commitment in the management contract and the resulting possibility of rapid expansion. In addition, no lease amounts appear as liabilities on the balance sheet with a management contract and therefore reduce the operating result. But how are investors in the German hotel market reacting to this development, which is being driven by hotel chains?

“It is to be expected that lease agreements will continue to dominate the German hotel market. However, there is an increasing dialogue about hybrid contract models that combine features of the traditional lease model with inherent aspects of management contracts,” explains Prof. Dr. Christian Buer, Managing Partner at Horwath HTL Germany and professor in the Hotel Management class at Heilbronn University.

One example of the flexibilization of lease agreements is the introduction of a variable profit or turnover lease combined with a minimum lease. Only in conjunction with a minimum rent are variable turnover lease models usable for institutional investors in Germany due to the limited risk. In the case of a profit rent, the lessee pays a fixed share of the GOP if this is higher than the minimum rent. In return, however, the lessee must present its cost structure to the lessor and justify it to the lessor. In the case of the turnover lease, the lessee pays a certain percentage, usually between 20-30 percent of the total net turnover from the areas of lodging and food and beverage (F&B), provided this is higher than the minimum lease.

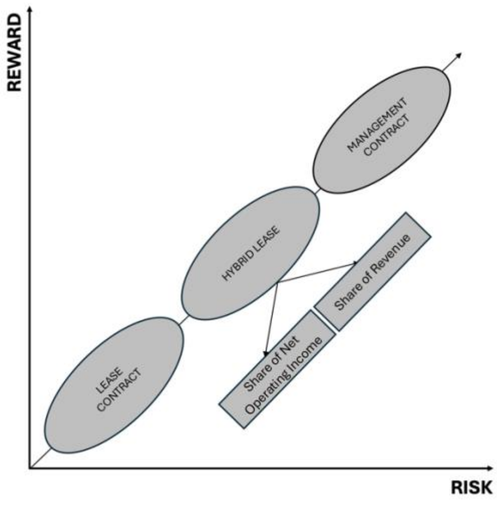

Figure 3: Risk/reward distribution of contract types, own visualization

Each of these forms of contract can be combined with a franchise agreement. In return for a fee, the franchisee, the operator of the hotel, benefits from the concept, the distribution system and the operational standards of the franchisor's brand. In practice, the constellation of owner - operator/lessee - franchisor, the so-called “sandwich lease”, is often found. This is the case when an investor is unable to find an operator despite an attractive location because international hotel chains do not want to enter into lease agreements. An independent operating company is therefore interposed, which procures the brand and the distribution system for the hotel operation as part of a franchise agreement.

Protection in times of crisis

The new, more flexible modifications to lease agreements serve to integrate the advantages of management agreements into lease agreements and minimize the risk for both lessee and lessor. One way of making lease agreements more flexible and thus minimizing the lessee's risk is to integrate a CAP clause. This clause allows the lessee to amend, terminate or continue the contract if a cumulative loss (usually based on net profit) previously defined in the contract occurs.
For the investor who rents out his property, it is crucial to ensure that his claims under the lease are well secured. Especially in times of crisis, as in recent years, the importance of effective financial security has increased. In order to take inflation into account and thus ensure a fair distribution of risks between landlord and lessee, indexation clauses are integrated into the contract models, which link the lease amounts to be paid to the consumer price index (CPI).

In times of high inflation, such as since the coronavirus pandemic, this often leads to considerable financial challenges for lessees. Rental collateral such as rent guarantees, which are provided either by banks, insurance companies or parent companies, have also become increasingly important. Letters of comfort, which fulfill a similar security function, are also increasingly being used. However, practice has already shown that even guarantees have not been sufficient in some cases, as these can be contested in court. In order to ensure comprehensive protection, it is therefore recommended to use various forms of security at the same time.

For example, the FF&E reserve account, which the leaseholder is obliged to maintain, serves as additional security for the landlord. The landlord has access to the account if the lessee fails to meet its obligations. Another aspect is the operating obligation, which ensures that the lessee operates the hotel to the contractually agreed extent. Particularly if the rent includes a variable component, the operating obligation prevents the lessee from deliberately reducing turnover by restricting operations.

During the coronavirus pandemic, hotel operators have partially ceased operations due to low bookings, which reduced costs in the short term but increased the risk for the landlord in the long term. A legal obligation to operate does not exist automatically and must therefore be explicitly agreed in the contract. In addition, most hotel rental agreements contain extensive information obligations for the lessee. This is particularly important for turnover-based rents so that the landlord can understand and check the rent calculation.

In summary, the choice of contract type - be it a lease, management contract or hybrid model - is significantly influenced by the legal framework of a country, the subjective preferences and the risk aversion of the contracting parties. In the German market, a clear change is emerging in which innovative and flexible contractual arrangements are becoming increasingly important, drawing on proven principles of hotel contracts. These new approaches not only offer better protection and adaptability in times of crisis, but also make the German market more attractive for international hotel chains. While legally sophisticated clauses can create a framework for this, the real key to functioning contracts lies in both parties implementing these agreements in practice.

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