



Operator Performance Tests in International Hotel Management Agreements

20 June 2013

Disclaimer

This document (“Publication”) is based on the law applicable in Australia at the time of its preparation and:

- is intended to provide a summary and general overview of its subject matter only;
- is not comprehensive and should not be relied upon on that account; and
- is not legal advice and is not intended to be relied upon as such.

Accordingly this Publication may not reflect most recent developments and is subject to change without notice.

Persons using this Publication should not rely or act on this Publication and should obtain their own legal advice specific to their situation and only rely and act on that advice.

Use of this Publication does not create any solicitor-client relationship.

Aequus Counsel is not responsible for any loss suffered in connection with the use of this Publication or any of its content and does not give any warranty or representation about this Publication or any of its content. To the maximum extent permitted by law, all liability which may arise as a result of the use of this Publication or its content is expressly excluded.

Aequus Counsel Pty Ltd ACN 007 936 183 as trustee for The Aequus Counsel Trust
Level 10, 75 Elizabeth Street, Sydney, NSW 2000, Australia **T** +61 2 9043 4009 **F** +61 2 9231 5660 **W** www.aequus.net.au

Liability limited by a scheme approved under Professional Standards Legislation. Employed lawyers are members of the scheme.



Index

Executive Summary 1

1. Introduction 2

2. Purpose of Performance Tests 2

3. Performance Test Structure 3

4. Budget Test 6

5. RevPAR Test 7

6. Operator Cure Rights 10

7. Operator Term Renewals 10

8. What Can Owners Do? 11

9. Negotiation Issues 13

10. Conclusion 14



Executive Summary

Operator performance tests rarely provide an Owner with the comfort against agency costs and the moral hazard faced by an Owner under a hotel management agreement and this paper examines some of the reasons for disappointment.

Operator promoted performance tests are not about risk transfer or risk sharing but rather are concerned with Operator performance accountability. Under typical Operator promoted tests this will occur in only very limited circumstances, that is, in a “disaster” scenario where the hotel’s operating performance has seriously failed.

The performance tests usually proposed by Operators are conjunctive not alternate and so the Operator does not fail the performance test for any given fiscal year unless both a budget test and a RevPAR test are failed in the same year. Also not only must the Operator fail the conjunctive test but such failure must occur in two consecutive fiscal years or two of three consecutive fiscal years in order to enliven the Owner’s right of termination.

In order to exercise a termination right for performance test failure the Owner must not have been in breach of its material obligations under the hotel management agreement during the performance test period, for example, if the Owner has failed to meet its capital expenditure contribution obligations. Furthermore the performance of the hotel during the performance test period must not have been adversely affected by an intervening event which disrupts the business of the hotel either specific to the hotel or relative to the market in which the hotel operates, for example, a force majeure event or works to the hotel.

The Owners’ right to terminate for non performance is also impaired where the Operator has “cure” rights, that is, rights to cure a test breach by compensating the Owner for the test breach. Cure rights can take many different forms.

Usually the Operator is exempt from compliance with the performance test for a new hotel during the period accepted as necessary to “stabilise” the performance of the hotel which is to be negotiated although, three fiscal years from opening is generally a reasonable starting point.

The Owner’s right to approve the hotel Annual Plan provides the Owner with the opportunity to materially influence the final Annual Plan and the budget for the hotel and therefore the budget test. Where the Owner does not effectively use its Annual Plan approval and other rights in a constructive manner, so that there is an effective and robust Annual Plan process, then there is a high risk that the Owner will be disappointed in the Annual Plan outcome and in turn the efficacy of the budget test to protect the interests of the Owner.

The RevPAR test is a top line test which measures the revenue of the hotel against occupancy relative to other competitive hotels in the same market and will typically require the RevPAR Index (based on RevPAR of competitive hotels) for the hotel not to be less than an agreed upon percentage of 100 index points. The importance of selecting the right “competitive set” and periodic review of the “competitive set” cannot be overstated because, amongst other things, if this does not occur the competitive set RevPAR will be distorted and this will, in turn, distort the RevPAR Index for the hotel and undermine the test.

Where a hotel management agreement contains options for renewal, at the election of the Operator, making the exercise of the option to renew conditional upon the performance of the Operator under the performance test during the current term of the hotel management agreement should be considered.

An Operator performance test can provide an Owner with the ability to terminate a hotel management agreement in the event of poor Operator performance. How effective the protection afforded by such provisions may be for an Owner depends on a number of variables to be negotiated in agreeing the terms of the test and each of these variables require careful consideration in the context of the hotel and the market in which it will operate in order to effectively achieve the intended purpose.



1. Introduction

From the perspective of an international hotel owner (“**Owner**”) the operator performance test clause in a Hotel Management Agreement (“**HMA**”) often receives considerable attention in management agreement negotiations.

Usually this is because of the Owner’s perception that, in the absence of termination at will provisions, the operator performance clause may represent the only means by which an Owner can contractually hold the hotel operator (“**Operator**”) accountable for its performance. This becomes more important as the length of the HMA term increases.

In my experience operator performance clauses rarely provide an Owner with the comfort or satisfaction sought with respect to the agency costs and moral hazard faced by an Owner under a HMA and the purpose of this paper is to examine some of the reasons why.

2. Purpose of Performance Tests

As a starting point it is important to keep in mind the essential character of an HMA and the role of an operator performance clause within an HMA.

Under a typical HMA, the Owner:

- Owns the hotel and all associated plant, fixtures, fittings, furnishings and equipment;
- Owns the hotel business although the business is generally conducted in the Operator’s name; and
- Employs all of the hotel staff.

The key issue is that the “business risk” of hotel operation is the Owner’s.

If the hotel business makes substantial profits they belong to the Owner and if the hotel business makes substantial losses they are the Owner’s losses.

In its most basic form an Operator under a HMA is a fee for service provider. Of course there is a “bundle” of services typically provided by Operators under a HMA which include branding, marketing, reservations and management of the hotel (“**Services**”). It is also true that the nature and scope of those Services have a material and direct impact on the profitability of the hotel enterprise. However, this does not change the essential character of the nature of the relationship between the Owner and the Operator or the business risk allocation to the Owner.

An HMA is fundamentally different from a lease under which:

- The Owner owns the building and sometimes the FF&E and collects rent, which, with the exception of any turnover or profit related element, is unaffected by the performance of the hotel business; and
- The Operator owns the hotel business, employs all of the hotel staff and after payment of rent enjoys all of the profits and suffers all of the losses arising from the conduct of the hotel business.

Conceptually the purpose of a HMA performance clause is to measure the quality and effectiveness of the services provided by the Operator under the HMA in specific and limited circumstances.

Some Owners are inclined to confuse service quality accountability with business risk transfer or risk sharing when they are in fact quite different matters giving rise to different commercial considerations on both sides. In the ordinary course it makes no commercial sense for an Operator under a traditional HMA fee structure to assume business risk. Sometimes it happens for strategic reasons but this is the exception rather than the rule.



Often this confusion is the source of disappointment amongst Owners with such performance clauses.

One reason for this confusion and disappointment is that the actual operating results of a hotel are the result of a confluence of many factors affecting hotel operating performance some of which are within the control of management and some of which are not.

Matters within the control of management are properly within the scope of an Operator performance review. Matters which are outside of the control of management, unless reasonably foreseeable, are really part of the hotel operating business risk assumed by the Owner.

The second important factor which needs to be borne in mind arises from the different perspectives and approaches to these provisions by the parties. Owners commonly see such provisions as providing the ability to terminate the HMA if the Operator is not “performing” – which translates to the hotel is not performing as expected or as the Owner needs the hotel to perform in order to satisfy the Owners economic return requirements. Conversely the Operator’s approach to performance clauses is to provide the Owner with very limited assurance that in an operating “disaster” scenario the Operator will be accountable and the Owner will have a right to terminate, as a right of “last resort”. The Owner thinks he is negotiating a “sword” when in fact all the Operator is offering is a “shield”.

Performance clauses are not about risk transfer or risk sharing. They are concerned with Operator performance accountability in very limited circumstances. They do not provide Owners with rights to hold management accountable in the conduct of the hotel business in the ordinary course but rather only provide limited and specific rights in a “disaster” scenario where the hotel’s operating performance has seriously failed.

If Owners wish to transfer or share business risk or to make Operators continuously accountable for their management then they will need to employ other provisions and asset management strategies because traditional performance clauses do not do so. Fee subordination, income guarantees and management audits are some of the mechanisms employed to address these issues. It should also be remembered that hotels operate in long term business cycles affected by a range of extraneous factors including the local economy and imbalances in the hotel supply/demand. In this context short term oriented performance tests may operate unfairly.

3. Performance Test Structure

The standard form agreements proposed by Operator’s do not necessarily include a performance test, but typically, when required, the performance test which Operators commonly propose have two key elements namely:

- The extent to which actual hotel operating results (Income Before Fixed Charges or Gross Operating Profit¹ (“**Gross Operating Profit**”) compare with the budgeted operating results (“**Budget Test**”); and
- The extent to which the actual Revenue Per Available Room (“**RevPAR2**”) of the hotel compares with RevVPAR of a defined group of comparable hotels (“**Competitive Set3**”) (“**RevPAR Test**”);

¹Eyster J & deRoos A “*The Negotiation and Administration of Hotel Management Contracts*” 4th Edition, 2009, Pearson, New York, p.7. Income Before Fixed Charges (Gross Operating Profit) : Profit after deducting from gross revenue all operational expenses, including the basic management fee, but excluding the following: depreciation, interest; property taxes; property insurance; amortization of pre-opening expenses; capital expenditures, including replacement of furniture, fixtures and equipment; and the incentive management fee. As defined in the Uniform System of Accounts for the Lodging Industry.

² RevPAR is acronym for “Revenue Per Available Room.” calculated by dividing the hotel’s Gross Revenues for a specific period of time by the total number of available room nights over that period to indicate the revenue generated from each hotel room for the period. It reflects the average daily rate (“**ADR**”) which is included in revenue and Occupancy which is reflected in the available room nights.

³ The Competitive Set is a group of hotels that are similar to the subject hotel which are in the same city and competitive with the subject hotel. So for example a competitive set for a Four Seasons hotel would only include hotels in the same city positioned in the same class and market segment as Four Seasons hotels, that is, luxury hotels. Competitive set data is provided by independent data purveyors, like Smith Travel Research, and usually require a minimum of five different hotels in the set (in addition to the subject hotel) although this is not always practically possible.



(“Performance Test”).

Sometimes the metric in the Budget Test is Cash Flow after Debt Service or Cash Flow after debt service and return on equity but typically Gross Operating Profit or Income before Fixed Charges is the basis of assessment.

Typically these tests when proposed by Operators are conjunctive not alternate. So the Operator does not fail the Performance Test for any given fiscal year unless **both** the Budget Test and the REVPAR Test are failed in the same year. Having conjunctive test criteria obviously makes it more difficult for the Performance Test to be failed because failure requires that:

- The hotel Gross Operating Profit fails to meet the Annual Plan budget forecast by more than the permitted tolerance; **and**
- The hotel’s actual RevPAR compared with the average Competitive Set RevPAR is not within the permitted tolerance.

An Operator will fail the Budget Test in respect of a fiscal year if the actual Gross Operating Profit or Cash Flow of the hotel for that fiscal year is less than a defined negotiated percentage (85% - 95%) of the Gross Operating Profit or Cash Flow forecast in the Annual Plan for the hotel in respect of that fiscal year. An Operator will fail the REVPAR Test in respect of a fiscal year if the actual REVPAR for the hotel for that fiscal year relative to the average REVPAR for the Competitive Set is less than a defined agreed percentage.

Accordingly if:

- An Operator does not achieve a satisfactory level of Gross Operating Profit under the Budget Test but the actual RevPAR achieved is satisfactory compared with the Competitive Set RevPAR under the RevPAR Test; or
- The actual RevPAR achieved is less than the tolerance allowed against the Competitive Set RevPAR under the RevPAR Test but nonetheless the Operator achieves a satisfactory level of Gross Operating Profit under the Budget Test;

the Operator will not fail the Performance Test.

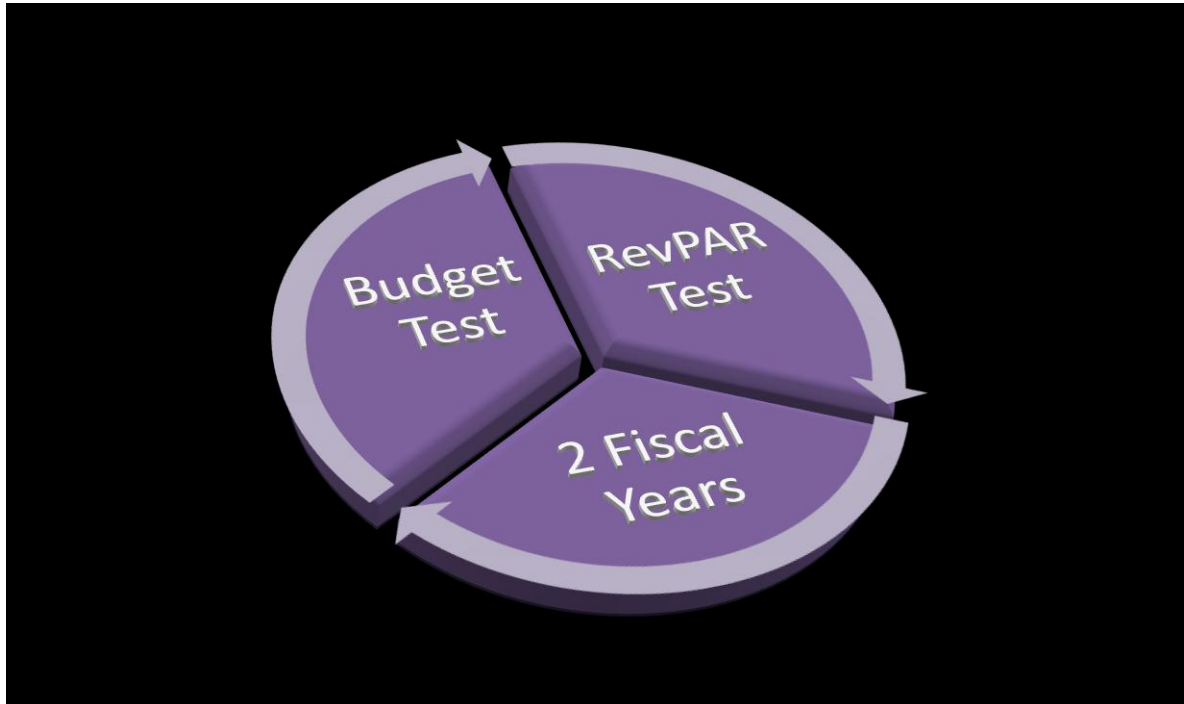
The rationale underlying the dual test is that the Budget Test alone is not a fair test.

An Operator will not wish to be exposed to termination if the hotel does not achieve its forecast profits, but operates at least as well as its competitors and conversely, an Operator will not want to be subject to termination if it achieves forecast profitability, even if other competitive hotels operate more profitably.

If the Budget Test is failed due, for example, to poor economic conditions but the hotel’s RevPAR penetration is maintained, that is, the Operator maintains the hotel’s market share of revenues then as a matter of principle the Owner should not be able to terminate the HMA. The point is that, as already observed, there are a variety of factors outside of the control of management which can cause the revenues of the hotel to be less than budgeted and where those same factors apply across the competitive market in which the hotel operates and the Operator ensures that the revenue share of the hotel, albeit reduced, is maintained relative to its competitors then the Operator has still “performed” and should not be penalised by being exposed to termination in those circumstances.

If the RevPAR Test is failed but the Operator satisfies the Budget Test then the Operator has failed to achieve satisfactory RevPar penetration, that is, its fair share of revenues in the relevant competitive market, but has still achieved budget. This indicates, inter alia, poor budgeting by the Operator and the Owner.





Typically the performance clauses proposed by Operators require that the Performance Test is breached in any two consecutive years before the Owner's right to terminate the HMA arises. This is intended to protect the Operator from being terminated if it suffers a single bad year in a series of good years and to allow the Operator time to adjust to an economic or market shift that may occur quickly.

The time frame for assessing the Performance Test can range from a single fiscal year to:

- Two consecutive fiscal years;
- Two of any three consecutive fiscal years;
- Two of any four consecutive fiscal years; or
- Three consecutive fiscal years.

One of the concerns which Owners have regarding the Budget Test is that as it takes two years of failure to trigger the Owner's right to terminate, in consequence the Operator can, in the second year revise its projections to reduce the probability of failure and also facilitate management of the hotel's financial performance thereby to avoid termination.

So not only is the Performance Test conjunctive (Budget Test **and** RevPAR Test) but failure must occur in two consecutive fiscal years or two of three consecutive fiscal years. To satisfy these conditions the management of the hotel must be grossly inept for the foregoing reasons.

Usually the Operator is exempted from compliance with the Performance Test for a new hotel during the period which it is accepted as necessary to "stabilise" the performance of the hotel that is, in order to develop and regularise the hotel business from start up. This period is negotiated and depends on the circumstances. However, three fiscal years from opening of a new hotel is generally a reasonable starting point.

Finally there are two other important qualifications imposed by Operators on the ability of an Owner to invoke termination rights for what would otherwise constitute Performance Test failure namely:



- The Owner must not be in breach of its material obligations under the HMA during the Performance Test period, for example, if the Owner has failed to meet its capital expenditure contribution obligations; and
- The performance of the hotel during the Performance Test period must not have been adversely affected by an intervening event which disrupts the business of the hotel either specific to the hotel or relative to the market in which the hotel operates, for example, a force majeure event or works to the hotel.

The Owners' right to terminate for non performance is also impaired where the Operator has "cure" rights, that is, rights to cure a test breach by compensating the Owner for the test breach. These are discussed in more detail later in this paper.

4. Budget Test

The Budget Test measures the extent to which actual hotel operating results (Income Before Fixed Charges or Gross Operating Profit⁴) ("**Gross Operating Profit**") compare with the budgeted operating results ("**Budget Test**") of the hotel.

Prior to the commencement of each fiscal year the Operator will be required to produce an Annual Plan for the operation of the hotel under a process provided for in the HMA.

In summary that process involves the Operator preparing an Annual Plan including a budget for the operation of the hotel for the forthcoming fiscal year. It is this budget and the forecast Gross Operating Profit, as finally determined, which is used as the basis for the Budget Test.

Historically HMA Annual Plans were not required to be approved by the Owner but today most HMA's give the Owner Annual Plan approval rights.



Typically HMA Annual Plan provisions contemplate an iterative process between the Operator and Owner culminating in an agreed and Owner approved Annual Plan as the ideal outcome. Where agreement is not reached it is usual to provide for independent expert determination of matters in issue, although clearly this is not ideal. Independent expert determination involves a third party expert, mutually agreed between Owner and Operator or if they cannot agree by an independent institution, to determine the matter in issue between the parties using his expert skill and judgement and having regard to the terms of the HMA.

It is important to note that it is the Operator who is the initiator and author of the Annual Plan and it is the Owner and its advisers who respond to the Annual Plan.

The Operator's role as initiator of the Annual Plan gives the Operator considerable power with respect to the Annual Plan in terms of the levels of income (including rates and occupancy) and expenditure forecast to project Gross Operating Profit. This is properly the case because the Owner has hired the Operator for its expertise in these matters. Moreover the Operator, by virtue of

⁴ Ibid



its management of the hotel, is in a position to “manage” the operations of the hotel to achieve the necessary level of performance, for example, by deferring expenditure.

The Operator is also thereby empowered to raise or lower the threshold for the Budget Test, by being more aggressive or conservative, which can be a useful tool in the context of the Performance Test being required to be failed in two successive years.

However, Owners are not powerless.

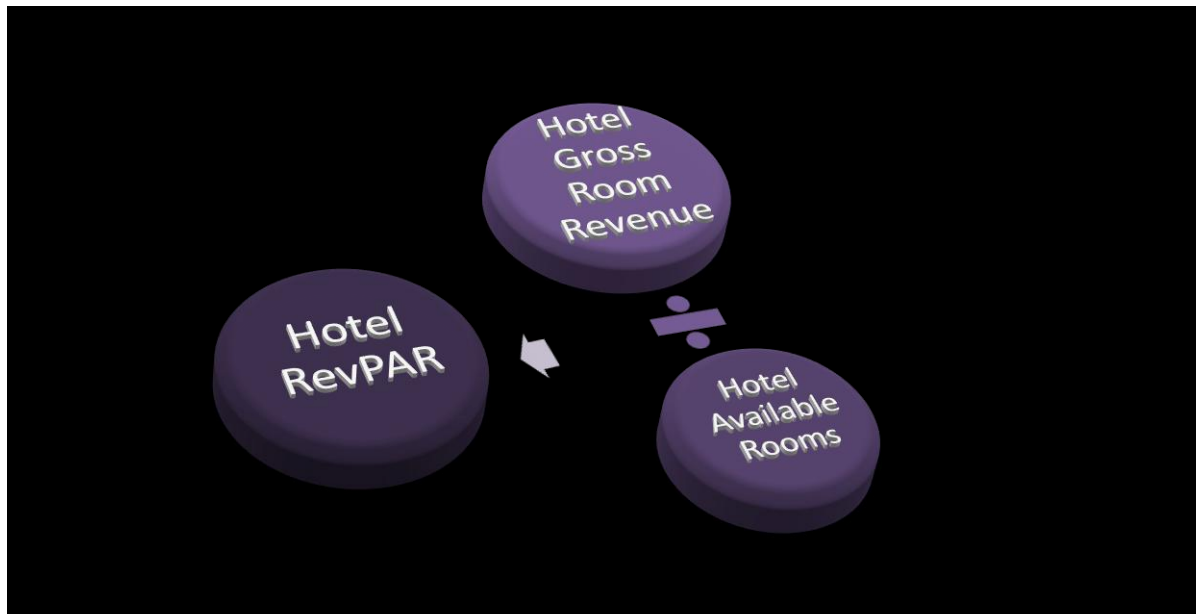
The Owner’s right to approve the Annual Plan provides the Owner with the opportunity to materially influence the final Annual Plan and the Budget.

Some Owners are better placed than others to take advantage of the process. Generally, Owners are better informed than they have been in the past and typically have (or should have) the benefit of experienced professional hotel asset managers, either internally or as consultants, to assist them in reviewing and responding to the Annual Plan to achieve an appropriate end result.

The Annual Plan negotiation should not be an adversarial process but rather one with the common objective of agreeing the right plan for the hotel given its condition, circumstances, market, market - positioning and other material considerations, Where the Owner does not effectively use its Annual Plan rights in a constructive manner, so that there is an effective and robust Annual Plan process, then there is a high risk that the Owner will be disappointed in the Annual Plan outcome and in turn the efficacy of the Budget Test to protect the interests of the Owner.

5. RevPAR Test

The RevPAR test seeks to measure the extent to which the actual Revenue Per Available Room (“**RevPAR**”) of the hotel compares with average RevPAR of a defined group of comparable hotels (“**Competitive Set**”) (“**RevPAR Test**”).



This test is a top line test which measures the revenue of the hotel against occupancy relative to other competitive hotels in the same market. RevPAR is the standard key metric used to measure an individual hotel’s room revenue performance and is calculated by dividing the hotel’s room revenue by the hotel’s available rooms.



Most commonly the RevPAR Test is based on the RevPAR Index score of the hotel which is one of the most widely utilized benchmarks in the hotel industry.

RevPAR Index measures an individual hotel's performance compared to market/market segment RevPAR and is calculated by dividing an individual hotel's RevPAR by the market/ market segment RevPAR ("RevPAR Index") as follows:

$$\text{RevPAR Index} = \text{Market/Market Segment Hotel RevPAR} \div \text{RevPARs} \times 100$$

The RevPAR Index of a hotel reflects a measurement of the property's ability to obtain its fair share of RevPAR for its specific market. For example, if the hotel's RevPAR is \$100 and the RevPAR of its Competitive Set is \$100, then the hotel's index would be 100. If the hotel's RevPAR is \$110, its index would be 110, which indicates that the hotel has captured more than its fair share. If the hotel's RevPAR is \$90, its index would be 90, which indicates that the subject hotel has captured less than its fair share.

In summary if a hotel is capturing:

- its fair market share, the hotel's index will be 100;
- more than its fair market share, the hotel's index will be greater than 100; and
- less than its fair market share, the hotel's index will be less than 100.

In each case, other than the last, that is, if the Index is 100 or greater, the hotel is performing satisfactorily.

The RevPAR Test will typically require the RevPAR Index for the hotel not to be less than an agreed upon percentage of 100 index points. So an agreed upon percentage of less than 100 means that it is accepted that the hotel's revenue penetration will be less than its fair market share and an agreed upon percentage greater than 100 would require the hotel to achieve more than its fair market share. If the RevPAR Index is less than the agreed percentage then the Operator fails the test on the basis that it has achieved less than its fair share of the market segment revenue relative to its competitors. A RevPAR test which is based on less than 100% of the RevPar Index accepts that the Operator's performance is "satisfactory" when the hotel achieves less than its fair market share.

Properties included in a Competitive Set should represent direct competitors of a specific property whose performance serves as a standard of comparison for the subject hotel.

Generally, hotels having similar physical attributes, proximity to the same demand generators and serving a similar mix of market segments will make up the Competitive Set. Factors to be considered in determining the selection of directly competitive properties include physical characteristics (age, condition and size), location and proximity to demand generators, prior operating history, market segmentation, owner/operator management, amenities and available meeting space.

The importance of selecting the right Competitive Set cannot be overstated because, amongst other things, if this does not occur the Competitive Set RevPAR will be distorted and this in turn will distort the RevPAR Index for the hotel.

It is critical that the Competitive Set does not include hotels that are not truly comparable and direct competitors with the subject hotel. Generally the Competitive Set needs to include at least 3 comparable and directly competitive hotels otherwise there will be insufficient breadth in the sample to define and compare the RevPAR performance of the relevant market segment and therefore no proper basis for benchmarking performance against other comparable hotels. In circumstances where there are insufficient hotels to constitute a Competitive Set, which happens frequently in new destinations/markets, then the RevPAR Test cannot be used and the Performance Test will default to a Budget Test only until a Competitive Set can be identified.



Fundamentally, a Competitive Set with the most accurate depiction of the property's competitiveness can drive and impact actual results. A properly selected Competitive Set, will allow management to focus and improve performance against the hotel's direct competitors. Hotel management performance is typically determined and judged by its ability to maximize a Competitive Set's RevPAR index. Management's goals and objectives are often based on improving these statistics.

Provision should be made in the HMA for Competitive Set selections to be reviewed continuously to ensure their continuing relevance. Most hotel markets are dynamic and subject to continuous change whether as a result of new hotels coming into the market, supply reductions as existing hotels are redeveloped or converted to other use, changes in demand generators and other events. Normally review of the Competitive Set will be a matter for agreement between the parties but if they are unable to agree then the selection should be reviewed by expert determination and this will require relevant selection criteria to be set out.

The source of the data for calculating the RevPar of the Competitive Set and the RevPar Index is typically the STR Global Star Report⁵. As you will see Star Reports rely on data from chosen members of the Competitive Set being provided to Smith Travel Research and such data being reliable. These requirements are not always met even though Smith Travel Research generally provides good coverage in mature markets. In circumstances where there is no reliable data coverage for the Competitive Set then the RevPAR Test cannot be used and the Performance Test will default to a single Budget Test only until reliable data coverage for a Competitive Set is available.

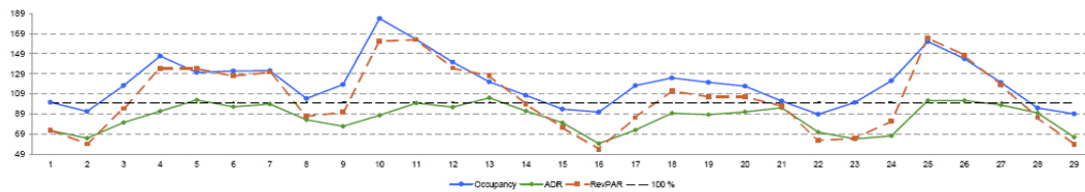
Tab 9 - Daily Data for the Month - Industry

Sample Hotel Address City, Postal Code, Country Phone:
 STR # 123456 ChainID: MgtCo: Owner:
 For the Month of: February 2008 Date Created: March 28, 2008

Currency: European Euro

Market Class: Upper Upscale Class

Daily Indexes for the Month of February



Occupancy (%)	February																												
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29
My Property	53.4	61.5	61.5	97.3	95.9	103.0	100.0	67.6	68.9	86.5	97.3	94.6	87.8	82.4	64.9	58.8	70.3	58.6	103.0	96.6	77.0	54.1	58.8	58.8	98.0	100.0	92.6	68.2	52.0
Market Class	53.0	67.2	52.4	96.3	73.5	75.4	75.7	64.7	58.3	46.9	59.8	67.3	72.6	76.7	69.1	62.5	59.9	77.3	83.1	84.5	75.6	61.0	56.5	48.2	63.8	96.5	77.0	72.0	58.4
Index	100.7	91.5	117.2	146.7	130.5	133.9	132.1	104.4	118.2	184.3	163.2	140.5	122.9	107.5	93.9	90.8	117.3	124.9	123.4	116.7	121.9	88.6	100.4	122.0	161.1	143.9	126.3	94.8	89.0
% Chg																													
My Property			213.8	22.0	14.5	18.4	62.6			324.1	23.1	14.8	3.2	35.6			173.7	23.9	6.6	25.7	20.0			314.3	52.6	91.0	65.1	63.6	
Market Class	-13.1	25.2	10.6	9.3	8.5	12.3	13.2	29.8	11.4	4.7	-11.8	-5.3	0.8	20.5	31.4	15.5	27.0	24.7	16.6	14.9	6.3	2.2	15.4	9.1	17.4	25.3	23.5	6.7	
Index			155.3	11.7	5.6	5.4	43.7			352.8	29.8	21.2	2.4	12.5			115.5	-1.1	-5.7	4.3	4.4			247.0	45.0	28.8	31.8	54.3	
ADR	February																												
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29
My Property	136.52	115.58	149.69	175.58	159.78	187.73	186.42	155.30	137.69	191.02	194.90	189.29	203.05	182.40	155.47	110.71	136.38	182.84	188.22	187.72	152.16	73.13	72.88	72.65	187.69	191.01	178.34	124.39	83.91
Market Class	136.78	178.94	186.63	191.56	191.18	195.19	191.57	180.85	179.69	193.80	194.71	197.54	193.28	196.50	197.41	186.65	186.86	203.87	213.33	206.16	207.75	190.63	193.16	184.35	187.05	187.42	196.55	202.91	245.32
Index	72.3	64.7	80.5	91.6	102.9	96.2	98.9	83.1	76.6	87.6	89.9	95.8	105.1	91.9	83.3	59.3	72.9	89.7	88.2	91.0	95.1	70.9	64.0	67.1	102.4	102.4	97.9	89.8	65.7
% Chg																													
My Property			-15.8	-5.2	5.4	-11.2	-8.8			10.7	5.9	-0.8	3.4	-5.2			-11.3	0.0	4.8	14.3	23.7			-20.1	15.9	16.9	19.3	15.5	
Market Class	5.2	0.2	4.0	4.3	4.9	6.2	4.3	6.7	2.9	4.7	9.4	6.8	1.0	1.9	2.7	-0.5	2.5	4.7	6.1	1.7	5.6	2.8	6.1	2.4	6.1	1.7	1.3	-2.8	16.1
Index			-18.8	-9.1	0.4	-16.3	-10.8			5.7	-0.5	-7.1	2.4	-7.0			-13.5	-4.4	-1.4	12.4	17.1			-21.9	9.3	14.9	17.8	18.8	
RevPAR	February																												
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29
My Property	72.87	71.07	92.04	170.84	168.78	187.73	186.42	154.93	95.06	139.28	189.24	179.05	178.35	150.96	102.79	82.84	97.24	178.78	188.22	187.72	152.16	73.13	72.88	72.65	187.69	191.01	178.34	124.39	83.91
Market Class	100.06	119.99	97.56	127.06	143.58	148.02	145.05	120.98	104.91	86.27	116.08	132.69	140.39	152.19	139.42	116.64	113.76	157.65	177.21	176.80	156.86	116.49	113.05	88.89	113.72	130.22	151.25	146.05	143.36
Index	72.8	59.2	94.3	134.5	134.3	128.8	130.6	86.7	80.6	161.4	163.0	134.7	127.0	98.6	79.3	70.9	85.5	112.1	105.2	106.2	98.9	62.6	64.3	61.8	165.0	147.4	117.7	85.2	58.5
% Chg																													
My Property			164.9	15.7	20.6	5.2	51.6			424.9	30.3	13.9	6.7	25.5			142.7	23.3	14.7	41.4	48.4			231.1	76.9	76.6	96.9	120.1	
Market Class	-8.5	25.5	14.4	14.9	13.8	19.2	16.1	32.2	14.6	9.6	-8.2	1.1	1.8	22.9	34.9	14.9	30.2	33.5	23.4	20.6	21.4	9.2	8.4	22.2	15.7	19.4	28.9	20.1	28.0
Index			133.6	1.5	6.0	-11.6	28.4			378.8	38.8	12.6	4.6	4.8			86.5	-5.5	-7.1	17.2	22.3			170.8	52.9	47.9	55.2	83.3	
Exchange Rate	0.6729 0.6758 0.6758 0.675 0.678 0.6823 0.6856 0.6893 0.6896 0.6896 0.6892 0.6879 0.6892 0.6892 0.6893 0.6893 0.6893 0.6893 0.6892 0.6892 0.6892 0.6892 0.6892 0.6892 0.6892 0.6892 0.6892 0.6892 0.6892 0.6892 0.6892																												

* See "Help" tab for explanation.

⁵ <http://www.strglobal.com/Details/NNA/STRG%20STAR%20Sales%20Sheet.pdf>



6. Operator Cure Rights

The Owner's right to terminate for non performance is impaired where the Operator has "cure" rights, that is, rights to cure a Performance Test failure by compensating the Owner for the test failure. Where the Operator cures then the Owner is not entitled to terminate.

Cure rights can take many different forms.

The cure right may be mandatory or an option for the Operator. Sometimes the cure right is mandatory but Owners often prefer the cure right to be optional as this gives the Owner a genuine opportunity to terminate if the Operator elects not to cure.

The Operator's right to cure may be limited or unlimited. Where cure rights are unlimited the Operator essentially has an option to keep the HMA alive by payment of compensation to the Owner. From the Owner's perspective this is unsatisfactory in that such compensation is unlikely to compensate the Owner for continuing management failure given its impact on the cash flow and value of the hotel. Some Owners argue that in order for the Performance Test to be meaningful there should not be any cure rights. Generally a limitation on cure rights is negotiated, Limiting cure rights to 2 times in a period of six fiscal years is not unreasonable.

The form of compensation may vary and could include any of the following methods:

- An outright cash payment to the Owner;
- Contribution of current basic and incentive management fees;
- Contribution of deferred incentive management fees;
- An interest bearing loan to the Owner;
- A non interest bearing loan to the Owner.

The extent of compensation payable to the Owner is also negotiable and depends on the circumstances:

- If the Performance Test is for two consecutive fiscal years can the cure be exercised in respect of the first fiscal year where failure occurs so as to "reset the clock" on the Performance Test?
- Is it sufficient to compensate the Owner for the "profit deficiency", that is, the difference between the actual Gross Operating Profit in the relevant budget forecast and the agreed upon threshold for the Budget Test or 100% of the Gross Operating Profit budgeted and if not what should the compensation be?;
- If the Performance Test is for two consecutive fiscal years should the compensation be referable to both fiscal years rather than just the latter?;

Operators will often seek "claw back" provisions where they are able to "claw back" compensation paid to the Owner under cure rights from subsequent surplus profits of the hotel realised within a specified period. The argument in support of such provisions is that the hotel business cycle is a long cycle and that Operators who, when faced with a rapid economic or market shift that may occur, exercise their cure rights to preserve their HMA should fairly be entitled to recoup their contribution when the hotel business cycle improves. The loan method of compensation is based on this concept.

7. Operator Term Renewals

Where the HMA contains options for renewal at the election of the Operator, making the exercise of the option to renew conditional upon the performance of the Operator under the Performance Clause during the current term of the HMA should be considered.



Factors relevant to whether the Operator should be entitled to renew would include the number of times during the current term, the Operator has failed the Performance Test, the Budget Test or the RevPAR Test and exercised its cure rights. This would lead to specifying a failure threshold below which the Operator will not be entitled to exercise its renewal option.

8. What Can Owners Do?

A comprehensive analysis of all of the matters that could or should be considered by Owners in relation to Performance Tests is beyond the scope of this paper. However, the following discussion seeks to highlight a number of key issues which should be considered by Owners with a view to achieving Performance Tests that provide them with more effective protection.

From an Owner's perspective the problem with a conjunctive Performance Test is that it attributes as much significance to the RevPar Test as it does to the Budget Test. Obviously the relevance of RevPar to the top line is inescapable but the Owner is properly focussed on the bottom line. Whilst market penetration relative to competitors, as measured by the RevPar Test, is commercially important, from an Owners perspective it is the Budget Test which is commercially critical.

The Budget Test is focussed on the bottom line and requires the Operator to manage both hotel revenue and expenses. This requires as much attention to revenue generation through sales and marketing as it does to service delivery and managing labor productivity and efficiency. So for Owners a Performance Test which focussed on the Budget Test is preferable to the typical conjunctive test proposed by Operators.

As to the structure of the Budget Test it is possible to structure the test in a number of different ways to achieve the desired objective for an Owner. Different levels of precision may be appropriate in forecasting and managing hotel income and expenses. One way of managing this would be to include a requirement that hotel Gross Operating Profit not be less than a specified percentage of Revenue. In this scenario the Performance Test would be structured to require that the test will be failed if either:

- The hotel's Gross Operating Profit fails to meet the Annual Plan budget forecast by more than the permitted tolerance; or
- The percentage which hotel's actual Gross Operating Profit bears to Revenue is less than a threshold percentage.

Under a test structured in this way the Operator will fail the test even if the Operator achieves the Budget if it does not achieve the minimum specified Gross Operating Profit margin. It will be appreciated that such more complex multiple criteria tests measure the performance of hotel management at a materially higher level.

As mentioned earlier a problem with the Budget Test as the sole criterion in the Performance Test is that it can operate unfairly against the Operator where the performance of the hotel is adversely affected by events outside of the Operator's control. In a balanced negotiation this problem should be recognised and addressed in a constructive manner. Budgeting is not an exact science and so whilst it is important that the Operator is accountable there should be checks and balances to ensure that the test does not operate unfairly.

There are a wide range of potential events outside of the control of the Operator which could adversely affect the performance of a hotel. At one extreme are force majeure events such as fire, flood, storm, Acts of God, war, civil unrest or commotion, terrorist attacks, labor disputes, strikes and lockouts. At the other end of the spectrum are events like material changes in market conditions, for example a dramatic change in room supply, or a reduction in demand as a result of recession or depression of the economy of a country or state in which the hotel is located. With reference to the application of a performance test, events in the nature of force majeure fall into an entirely different category from changes in market conditions and must be treated differently.



One of the major advantages an Owner should realise in employing an experienced Operator is to have the benefit of the Operator's experience in operations. Competent Operators, based on their experience, should, where possible, anticipate and make provision for events outside of their control. Accordingly, not all events of the kind mentioned above should excuse the Operator from failing to pass the Budget Test in any given fiscal year particularly certain changes in market conditions.

The following considerations are relevant as to whether an event should potentially excuse Operator Budget Test failure:

(a) Material Adverse Effect

Only events which have a direct and material adverse effect on the performance of the hotel business should qualify. An event will have a direct effect if it can be clearly demonstrated that it decreases hotel revenue or increases hotel expenses which is the "adverse effect". So the first issue is whether there is the required nexus between the event and the asserted adverse consequences in terms of revenue reduction or increase in expenses. The effect will be material if it is material in an accounting sense consistent with International Accounting Standards. If there is not the required direct nexus between the event and hotel performance or there is but the demonstrable impact is not material then the event and its consequences should be ignored.

(b) Foreseeability

An event which is reasonably foreseeable should not excuse or exculpate an Operator from failure to satisfy a Budget Test. An event will be reasonably foreseeable if a prudent international hotel Operator in the circumstances would have foreseen and reasonably provided for the impact of the event on the business of the hotel at the time of preparation of the relevant Annual Plan. An Operator may not have provided at all for the consequences of the event and in circumstances where it was reasonable to expect that it should have then the occurrence and impact of the event should be ignored. An Operator may have anticipated the event but provided inadequately for its impact on the hotel business in which case the actual impact over and above the inadequate provision should be ignored.

(c) Operator Failure

An event which arises because of the failure of the Operator to exercise due care and diligence in the management of the hotel, at the standard that one could expect from a competent hotel Operator in the circumstances, should not excuse the Operator from a Budget Test failure. So, for example, a labor dispute which is caused by the Operator should not excuse Budget Test failure. Generally, the legal liability of Operators under an HMA is limited to circumstances where the Operator has been guilty of gross negligence or wilful misconduct and there is no suggestion here that this should be changed. However, making an Operator accountable under a Budget Test for not having exercised an appropriate standard of care in management is not to impose legal liability on the Operator for the loss which the Owner incurs.

Even if an event occurs which qualifies as one which could excuse or exculpate the Operator from failure to meet a Budget Test the Operator should only be excused to the extent that the Operator has taken all steps reasonably necessary in order to mitigate the consequences of the event on the operation of the hotel. So if a qualifying event occurs and

- The Operator fails to take the steps reasonably necessary to mitigate the impact of the event on the business; and
- The operating performance of the business is adversely effected more than it would have been had the Operator taken the appropriate steps to mitigate or reduce the impact;



then the Operator should not be entitled to be excused to an extent greater than it would have had it taken the appropriate action. What is reasonable is what a competent operator in those circumstances would have done.

Provision for expert determination by a hotel management expert of disputes as to:

- Whether an event qualifies to exculpate the Operator from satisfying the Budget Test; and
- If the event so qualifies to exculpate the extent to which the Operator should be excused, if at all;

should be made to ensure that these issues can be dealt with expeditiously and objectively. The point is that simply because a relevant event occurs should not result in the Performance Test being abandoned for that fiscal year. Expert determination of issues arising in the application of a Budget Test is extremely important in order to ensure fair application of the test in the interests of both parties.

A Performance Test focussed solely on a Budget Test has the potential to introduce a degree of conservatism on the part of the Operator in developing a hotel Annual Plan. Clearly this is not in the Owners' interests. The Owner wants Operator to be "pushing the envelope" in budgeting to achieve the best possible outcome for the Owner.

Of course under a typical HMA fee structure incentive fees payable to the Operator are intended to incentivise the Operator to maximise Gross Operating Profit. If the Performance Test is the "stick" the incentive fee is the "carrot". So having an appropriately structured incentive fee that provides a genuine incentive to the Operator to perform to balance the Budget Test "stick" is extremely important.

In the context of the Budget Test Owners should be prepared to allow Operators some latitude. Where Operators "over perform" that is, they exceed budget then they ought to be able to offset a "recent" budget surpluses against "recent" budget shortfalls rather than having cure rights as a difference to termination.

So, for example, if the Performance Test is that the Operator fails in two out of any three consecutive fiscal years to meet the Budget Test if aggregate or cumulative actual Gross Operating Profit in those three fiscal years exceeds aggregate or cumulative budgeted Gross Operating Profit then the Performance Test failure could be excused. This approach recognises the cyclical nature of the hotel business and rewards the Operator for prior superior performance in the context of a long a term relationship.

The approach advocated in this section will only be effective if there is a robust Annual Plan process and the Owner has effective and expert asset managers engaged in that process.

9. Negotiation Issues

Whilst an Operator performance test may look simple, it should be appreciated from the foregoing that such provisions give rise to a number of complex issues which need to be considered and dealt with carefully.

In summary some of the key issues for negotiation in an operator performance clause include:

- Determining the performance criteria base, typically Gross Operating Profit or the Budget Test;
- The extent of the deviation from the performance criteria base below which the test will be failed;
- The nature of the test for unfavourable economic conditions typically a RevPAR Test unless there is no Competitive Set or reliable data;



- The extent of the agreed upon deviation from the test for unfavourable economic conditions below which the test will be failed;
- The make up of the Competitive Set for unfavourable economic conditions and how the Competitive Set will be reviewed;
- If no test for unfavourable economic conditions is possible the relevant provisions which will excuse failure of the performance criteria test;
- The number of fiscal years and the period over which the performance test must be breached to enliven the Owner's right of termination;
- The extent of the start up or stabilisation period during which the performance test will not operate;
- Where a performance test failure occurs whether the Operator shall have cure rights and if so the number and nature of those cure rights; and
- The relationship between future Operator term renewal rights and Operator performance during the current term.

10. Conclusion

An Operator performance test can provide an Owner with the ability to terminate an HMA in the event of poor Operator performance.

How effective the protection afforded by such a provision may be for an Owner depends on a number of variables to be negotiated in structuring and agreeing the terms of test at the outset. Each of these variables require careful consideration in the context of the hotel and the market in which it will operate in order to achieve their intended purpose. Hopefully this paper has provided some insight as to how these issues ought be approached.

For further information please contact Danny Farrugia on +61 2 9043 4009 or dlf@aequus.net.au

Aequus Counsel Pty Lt is a legal and corporate adviser based in Sydney Australia with significant expertise and experience in cross border transactions in the hospitality industry.



