CARLTON FIELDS

Hotels 101: Legal and Business Issues in Hotel Development and Ownership, a Beginner's Guide

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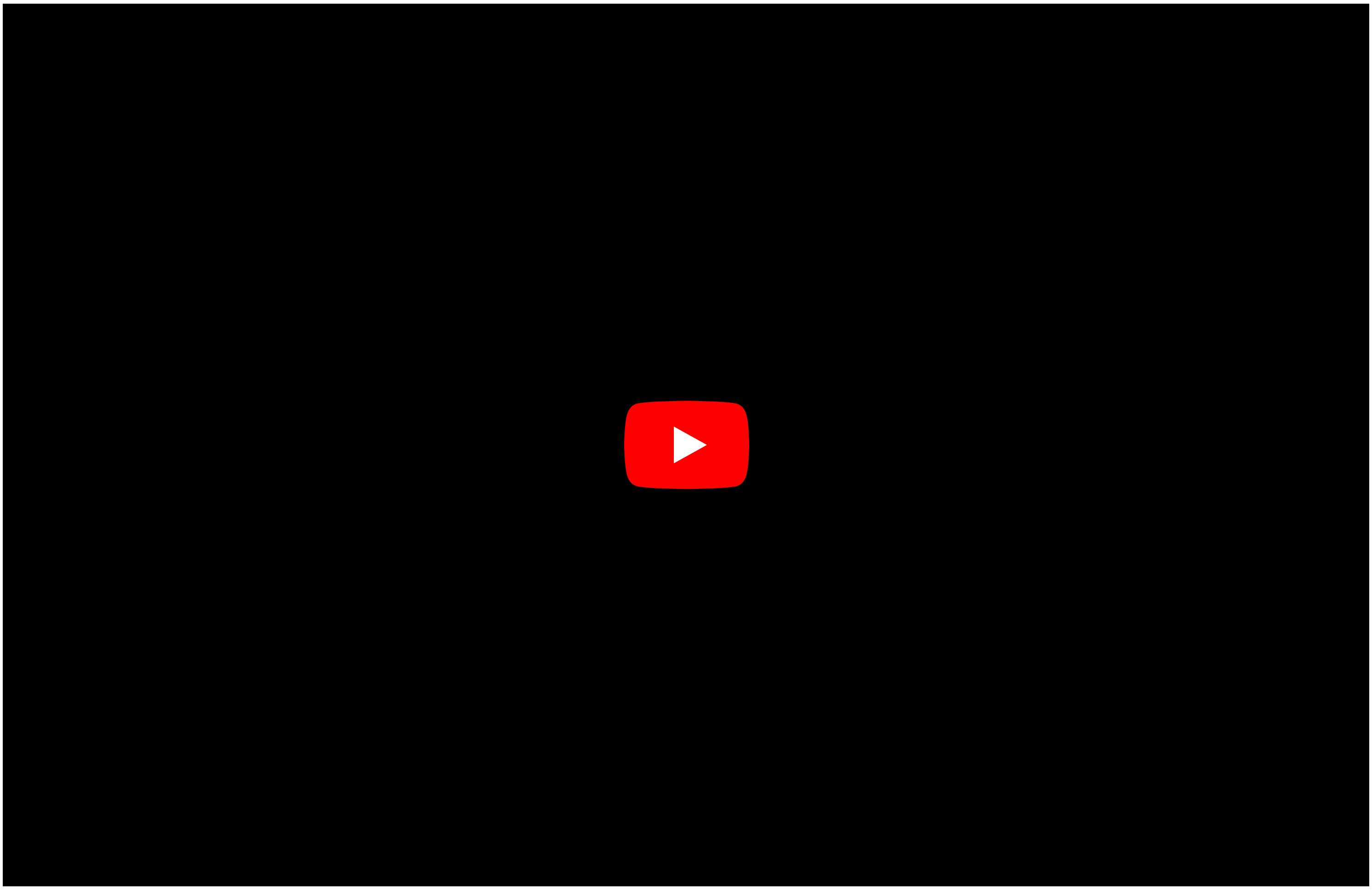

David: My name is David Adams. Welcome back to our podcast series on the national commercial real estate market. Today we're talking with Dan Weede, a guy who needs no introduction in the regional hospitality industry and more importantly, the guy who was willing to start this podcast series with me. He is the co-founder and President of the Atlanta Hospitality Alliance, an approximately 300 member Atlanta-based professional development and networking group that meets quarterly to socialize and discuss hospitality industry trends and developments. I thought it very fitting to ask him about the hospitality industry. It's the goal of this podcast to give those who have never participated in the hospitality industry an introduction to the business and detail. This is the first podcast in a three-part series on the hospitality industry, and Dan has dubbed this first installment *Hotels 101: Legal and Business Issues in Hotel Development and Ownership, a Beginner's Guide.* The second and third podcasts in this series will be called *Hotels 201: Legal and Business Issues in the Purchase and Sale of Hotels, What You Don't Know Can Hurt You* and *Hotels 301: Legal and Business Issues in Hotel Management Agreements, an Owner's Guide.* Dan,we're thrilled to welcome you back. **What should new developers and potential investors should pay attention to if they are involved in their first hotel deal and why are more people becoming involved in their first hotel deal? Dan:** Wow, that's a lot to cover. As mixed-use developments become increasingly more common in both urban and suburban markets, we are seeing more experienced retail, office and even residential developers becoming "first time" hotel developers . . . this podcast is aimed primarily at those first- time hotel developers and other professionals who may be new to the hospitality industry. So, let's start with the basics. One of the most important differences with hotels when compared to all other commercial real estate asset classes – with the possible exception of retail – is the critical importance of the *brand* as it relates to creating value in a hotel asset. I'll go into more detail on this in future podcasts, but by way of example, brands such as Courtyard by Marriott and Hampton Inn, which are widely considered to be "category killers" within their respective segments, can increase the value of a hotel asset by upwards of 30 to 50 percent when compared to other brand options that might be placed on such hotel assets. Therefore, in addition to the brand (a/k/a the franchisor), almost every hotel deal has at least three other stakeholders with a critical interest and role in the hotel. These parties are the *owner*, the *manager* and the *lender*. Each of these parties has unique perspectives based on their respective interests and each party has certain contractual rights and obligations to the other parties, but the main documents that govern the operation of the hotel are the Franchise Agreement and the Management Agreement. For larger hotels, the Management Agreement and Franchise Agreement are combined into a single document that we sometimes call a "Branded" Management Agreement. These are critical documents and negotiations over fees, incentives, operating authority, operating standards, budget approvals, early termination rights and liquidated damages are all highly negotiated. If you take nothing else away from this podcast, please remember this: *you need to hire an experienced hotel attorney to advise you in negotiating these documents.* The final introductory point that I think new investors need to focus on is the evaluation of the market and understanding the metric terminology that the industry uses to evaluate the financial performance of a hotel. Savvy investors carefully consider all of the factors in the given trade area from which the hotel draws from. As I'll touch on more later, a hotel does not come with in-place, long-term cash flow represented by leases. Therefore, it is of critical importance to understand both the demand side of the equation (as represented by the demand drivers in the market that feed the hotel) as well as the supply side of the equation (as represented by the current set of hotels that are deemed to be competitive to the subject hotel, and anticipated changes to this competitive set, as represented by new hotels being added to this set through new development or conversions of existing building or hotels being removed from this set due to the loss of competitive brands to the subject hotel due to physical obsolescence). To really understand the health of the hotel market in the given trade area, investors need to look at the historic performance of the competitive set of hotels as measured by their Average Daily Rate (ADR), Occupancy and RevPAR (or Revenue Per Available Room, which is the all-important metric used in the hotel industry and represents the occupancy of the hotel for a given period of time multiplied by the hotel's average daily rate for that same time period). Fortunately for hotel investors, there is a very powerful tool that provides this information on the subject market and the subject set of competitive hotels, known as the STAR Report from STR Global. An entire podcast could be devoted to the importance of the STAR Report but I just don't have the time to go into it now, except to say that all potential developers and investors should obtain and carefully analyze the STAR Report to understand the health of a given hotel market. **Hotels are both a real estate asset as well as an operating business and, of course, that makes them fundamentally different than other real estate classes. Can you tell us how and what this means? Dan:** Well, of course, in a traditional real estate investment the owner buys the real property and then creates a long-term in place income stream via long-term leases. These owners will frequently hire a management company to primarily collect rent, track and pay expenses, prepare budgets, and schedule maintenance, etc. These management responsibilities can usually be handled with minimal on-site staff. Hotel deals are different. When we say that they are an "operating business" we mean that in order to function, a hotel must employ dozens of employees to do everything from cleaning the rooms, serving meals, maintaining the hotel, checking in guests, marketing the hotel, and performing all the HR duties related to employing so many people. Since a hotel "leases up nightly" as we like to say, a hotel really obtains its revenue from operations as opposed to its real estate. Properly managing a retail/office or multi-family property and properly managing a hotel are both challenging endeavors, but they very different and require completely different skill sets and experience levels. New hotel owners who don't understand how different owning a hotel is from other real estate classes are likely to make mistakes that will cost them money. The hospitality industry is ruthlessly competitive, so what you don't know always ends up hurting you. **This podcast is aimed at explaining some of what makes hotel development different from other real estate developments and discuss some of the more important issues in the basic hotel development deal documents. These documents include (i) the franchise agreement, (ii) the third-party management agreement and (iii) the technical services and development agreement. Can you take a moment to describe each? Please begin with a description of a franchise agreement is and what it does. Dan:** Certainly. The "franchise agreement" is the license agreement between the owner and the brand that sets forth the rights and obligations of the owner to operate the hotel under the brand, or "flag" as it's sometimes referred to. Franchise agreements are drafted by the brand, are fairly one-sided, and most brands are extremely resistant to making any substantive revisions to their national forms. Nevertheless, owners are usually happy to sign these agreements since, as I mention above, by some estimates, the right flag can add upwards of 30 to 50 percent to the value of a hotel when compared to other brand options. Issues that are frequently negotiated in franchise agreements are (i) franchise fee “ramp up” discounts, (ii) rights of first refusal, (iii) property improvement plans (PIPs), (iv) key money, (v) limitations on personal guarantees, (vi) reserve fund contributions, (vii) areas of protection and (viii) early termination options. **You’ve also mentioned a third-party management agreement. What is that agreement and what does it do? Dan:** A “third-party” management agreement is the operating agreement between the owner and its unaffiliated third-party manager. A third-party management agreement is different from what we refer to as a “branded management agreement.” In a branded management agreement, the flag both manages the hotel and licenses the brand to the owner. In most cases where there is a third-party management agreement, there will also need to be a franchise agreement in place. Issues that are frequently negotiated in third-party management agreements are (i) length of term, (ii) fees, (iii) GOP guarantees, (iv) defining manager’s duties and limitations to its authority, (v) early termination options, (vi) liquidated damages, (vii) performance tests, (viii) budget approval process, (ix) operating standards, (x) employment matters (such as who the actual “employer” is: owner or manager, (xi) lender protections such as SNDA obligations, (xii) reserve account amounts and access, (xiii) areas of protection, (xiv) owner indemnification of the manager, (xv) guest data and cyber liability, and (xvi) manager self-dealing restrictions. **Talk about the technical services and construction management agreement and what to expect with this document. Dan:** Occasionally, a developer with experience in developing retail or office projects will want to include a hotel in their mixed-use project, but acknowledges that it does not have the hotel development experience necessary to reliably develop the hotel component. In these situations, the project developer will hire (or joint venture with) a hotel developer to provide the expertise needed to develop the hotel component. These agreements are not at all standardized but are generally referred to as technical services and construction management agreements. Issues that are frequently negotiated in technical services and construction management agreements are (i) advisory/development fees, (ii) defined responsibilities of the construction manager from pre-development through hotel opening, (iii) development budget preparation and approval process, (iv) owner required approvals, (v) accounting responsibilities, (vi) insurance and indemnification obligations, and (vii) limits on the construction manager’s authority and obligations. **This is just a small sampling of all the issues that can arise in a hotel transaction, which is why Dan decided to do this in a three-part series. Dan, tell us about the next two podcasts. Dan:** Thanks. Our next podcast will be *Hotels 201: Legal and Business Issues in the Purchase and Sale of Hotels, What You Don’t Know Can Hurt You.* As common sense would dictate, given the interrelated nature of the business and real estate components of a hotel, the best informed investors typically get the best deals. This podcast will explore what legal rights an investor needs in order to evaluate a hotel as a possible investment, including the due diligence process, documentation and closing considerations. Our final podcast in this series will be called *Hotels 301: Legal and Business Issues in Hotel Management Agreements, an Owner’s Guide.* As we just briefly discussed in this podcast, hotel management agreement sets forth the basic relationship between the owner and the operator of a hotel property. These documents have terms anywhere from 3 years to 50 years, so there is obviously a lot at stake in “getting these documents right.” Because hotel managers are responsible for a hotel’s day-to-day operations, including employee relations, marketing and advertising, and maintenance and capital expenditures . . . the negotiation regarding the rights and obligations of the owner and the manager in connection with the hotel manager's duties is critical, and the provisions of a hotel management agreement can result in the success or failure of a hotel venture. This podcast will try to demystify how these complex documents work and explain the competing interests of the owner, the manager, the franchisor and the lender. We hope you will join us again. *To learn more about our commercial real estate and finance group, visit carltonfields.com/realestate. 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