

Hotel Finance: Developing Effective Performance Tests

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Hotel owners and operators have grown more sophisticated in crafting standards with which to project and then gauge the performance of their properties. As a result, these parties are also negotiating increasingly complex performance test provisions in operating agreements.

What is a performance test? Essentially, a performance test sets objective criteria for minimally acceptable financial performance of a hotel and, ultimately, provides the hotel owner with the right to terminate the management contract if the operator fails to achieve the goal. Beyond these basic concepts, performance tests come in all shapes and sizes. A savvy hotel owner will always demand that the hotel management agreement contain some type of performance test. Most hotel operators accept, albeit grudgingly, that such performance standards come with the territory of management contracts. Operators are usually concerned with limiting the scope of the test as much as possible and with negotiating cure rights that protect them from loss of the management agreement.

Many performance tests are based on economic criteria, such as the property's achievement of certain projected levels of gross operating profit, net cash flow, return on the owner's equity investment or other objective benchmarks. Other performance tests measure the quality of the hotel's performance against that of other similarly situated hotels over the same period of time. The majority of management contracts also offer the manager some protection against a rocky startup period or an otherwise "off" year by providing that the first two or three years of operation (depending on length of the term of the agreement) are not subject to any performance test and/or that the owner cannot terminate the management contract unless the operator fails a performance test for two consecutive fiscal years.

While some operating agreements contain only an economic performance test or only a quality based performance test, many contain a "two pronged" performance test with both types of standards. In such event, while the owner would prefer to be able to terminate the agreement if the operator fails only one of the "prongs" of the test, many major hotel operating companies will insist that the owner have no termination right unless both the operator has failed to perform to the standards of both "prongs".

The main reason that hotel managers, even the major operating companies, are willing to allow performance tests in most management contracts is that most such agreements allow the operator some opportunity to "cure" a performance test failure, usually by paying the owner a sum equal to the difference between actual performance of the hotel in a certain area and the minimum "passing" performance in the same area, as measured by a particular performance test. Some contracts allow the operator to effect the "cure" by other means, such as deferral of incentive management fees. Upon any such "cure" as permitted by a management contract, the owner is precluded from terminating the agreement based on that particular "cured" failure. The owner's major concern with such cure rights is that they not allow the manager to perpetually perform at a subpar level. Owners want their managers to produce results that exceed, rather than barely meet, projections and/or the market. Thus, most sophisticated owners will limit the operator's cure rights to a specific number of times or may insist that each subsequent "cure" require a payment greater than the amount needed to meet the minimum acceptable standard.

There are several problems inherent in performance tests. The main weaknesses of tests based on achievement of economic criteria are twofold. First, since the operator develops and manages the hotel's yearly operating and capital budgets, the operator may be incentivized to "lowball" its projections and goals for the hotel in the budget approval process. Second, tests based on purely economic factors do not take into account the effect of general economic and market conditions that are beyond the manager's control, as many operators have found in the aftermath of recession, September 11th or, in the case of certain locales, natural disasters. While an owner that is otherwise satisfied with a manager would probably not use a failure of performance test based on general market conditions as a pretext for terminating the management contract, a manager is naturally concerned that an owner dissatisfied on other fronts not have an easy "out"

based upon events outside of the manager's control.

Quality based performance tests also have inherent problems. In a world of increasing brand stratification, new hotel brands and market repositioning of existing brands, it is difficult to identify a competitive set of hotels in any given market. In certain locations (e.g., some parts of the Caribbean) or in cases of certain unique properties (e.g., an upscale boutique hotel outside of a major urban center), a competitive set of hotels may not exist, at least in the immediate area. In addition, more and more of today's hotel owners recognize that adherence to certain quality standards requires substantial costs that the owner may not wish to incur.

Hotel owners and operators should keep all these weaknesses in mind when creating a performance test that is appropriate to a specific property. Economic tests should be developed for easy enforcement based on objective economic criteria. In addition, the owner should make sure that the operating agreement provides that the performance test is tied to the projections and budgets originally agreed to by the parties for a particular year and not to updated projections and budgets that the manager revises if performance is not up to par. This requirement could contain certain exceptions for performance failures arising from factors completely outside the manager's control.

Owners should take care, however, that this language is carefully drafted and does not allow the manager too much leeway in blaming poor performance on outside conditions. In the case of quality standards based on a set of hotel properties that is most competitive with the hotel, both the owner and the operator will want to ensure that the competitive set of hotels is reevaluated at regular intervals and that the management agreement permits an objective third party to make a binding determination of the competitive set in the event the owner and operator are unable to reach agreement on that issue. Also, an owner should have the right to unilaterally remove a hotel from the competitive set if the owner determines that that hotel's standards are such that it is too expensive for the owner to pay for improvements to the hotel and service standards that are necessary for the owner's hotel to compete with that hotel.

Finally, some owners believe they can exert more influence over the performance of their hotels by having a greater role in certain decisions that impact the hotel's performance, such as decisions involving key executive staff of the hotel and the budget development, approval and revision process. However, by exerting increased power over such matters, owners may open themselves up to a charge by the manager that a performance test failure was based on poor business judgment of the owner and not of the manager.

Owners and managers have come a long way from the days of formulaic performance tests that varied little from agreement to agreement. Today's dynamic hospitality industry continues to challenge these parties to create performance tests that effectively meet their goals for a hotel without providing either a pretext for a manager's undeserved termination or an incentive for a manager's underperformance.

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