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HMA document: a must-read before acquiring hotel property

If you are fatigued by the phrase "distressed real estate," consider the optimistic indicators in the hotel sector. Valuation experts PKF Consulting and HVS both place Denver among top cities poised for recovery in hotel values and room revenue. With skier visit figures from the 2010-2011 ski seasons near record highs, Colorado resort hotels also report improved occupancy levels. Strengthening hotel performance nationally has finally pushed buyers and investors off the sidelines. U.S. hotel sales volume tripled in 2010 over 2009, largely due to a flurry of year-end deals and the success of several lodging real estate investment trust initial public offerings.

But aggregate signs of recovery for the lodging section do not alter the need to consider the stress of the last 18 to 24 months on individual properties. Most hotels financed between 2005 and 2007 are now overleveraged. By one report of the largest commercial mortgage-backed securities loans in Colorado, more than a dozen hotel loans have been moved to special servicers for workout or foreclosure, and another 20 hotels have loans on special servicer watch lists. Whether a hotel is acquired for its resurgent value or its depressed state, close analysis of the underlying hotel management agreement is critical.

Three types of HMAs are common: brand franchise agreements, brand managed agreements and independent owner-operator agreements. Each HMA type carries unique challenges for review and possible renegotiation in an acquisition. Key factors include: 1) term and termination fees; 2) management fee structure; 3) cash management; 4) transition of employees; and 5) lender relations.

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Franchised hotels are probably the most efficient properties to evaluate and, if necessary, restructure. In a franchise agreement, the brand licenses use of specific intellectual property, such as signage, logos, interior room design, and operating procedures, and may also provide centralized services, such as a global reservation system. But hotel licensees continue to own the underlying hotel real estate, manage day-to-day operations and employ hotel staff. Brand licensors retain exclusive ownership of their intellectual property and the right to terminate the franchise for failure to adhere to brand standards. The brand franchisor should be able to issue a "comfort letter" to the prospective buyer (and its lenders) relatively quickly as to whether the hotel continues to meet brand standard. Alternatively, the franchise HMA usually extends a right of the owner to terminate for convenience, upon payment of a termination fee, should the buyer wish to reflag the property. Cost and revenue accounting likely will remain at the specific property level with brand franchise fees easy to identify separately. Negotiation over transition of employees and key hotel assets, such as bank accounts and local permits, can proceed directly between seller and buyer without interference from the franchisor brand. Acquisition lenders will be able to review comparable performance data for the franchised brand as part of the underwriting analysis and will not be required to subordinate.

Independent hotels offer the same potential efficient transition of operations as franchised properties, but often are more difficult to analyze in practice. Colorado carries a long tradition of independently owned and operated hotels, most prominently in resort and historic towns. But HMAs are often just as unique and independent. The HMA may take the form of an interminable ground lease with an owner's affiliate or an annually renewing association management agreement combined with a collection of individual rental management agreements. Independent owners and associations may not have followed standardized hotel accounting practices, such as the Uniform System of Accounts for hotels, and may have undocumented intercompany rent payments, credits, debts and setoffs. As a result, it may be difficult to determine management costs and net operating income on an apples-to-apples basis in comparison with other lodging properties. Lenders may find underwriting the performance of such properties difficult.

Still, a brand-managed HMA may be even more difficult to analyze and restructure. In a brand managed hotel, the owner cedes day-to-day operational control and possession to the brand-management company. Along with the brand intellectual property, cash management, reservation services, employee benefits and insurance are highly integrated into the brand's centralized management. Hotel staff are usually employees of the brand manager. Brand management fees include assumptions of substantial incentive fees, based on hotel net operating income, after initial start-up. So with brand compensation tied to long-term performance, provisions related to termination in the HMA may be heavily weighted toward the brand.

The HMA may not be terminable without the ability to successfully arbitrate the brand operator's failure of performance. Brand performance is often examined through an "and" test requiring failure of the operator to perform to a property-specific standard (such as the hotel annual budget) "and" failure of the operator to perform at an equivalent level to its peer group. An owner's termination for convenience may be allowed after an initial "lockout" period with a hefty termination fee calculated to include the operator's future lost profits and incentive fees. Since property-specific operations are closely integrated into the brand's central services, restructuring negotiations during a hotel acquisition must involve the brand operator directly and the transition provisions in the HMA need to be closely examined.

When there is no desire to change the brand, the buyer's ability to assume a branded HMA also may prove cumbersome. Sometimes the brand operator has a right of first refusal, but it always will have some consent rights over the acquiring buyer.

Given these critical issues, the hotel management agreement should be the first document requested and reviewed in a potential hotel acquisition.▲