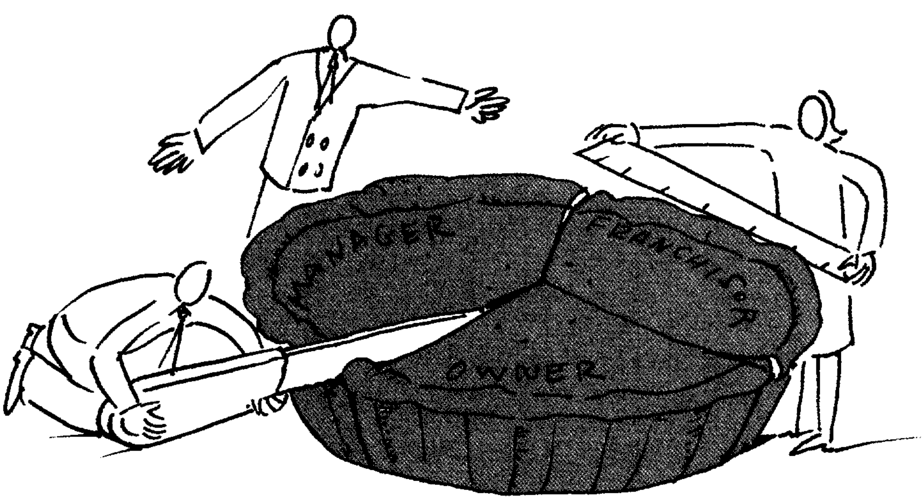
Trends in hotel management contracts
Sangree, David J;Hathaway, Peter P
Cornell Hotel and Restaurant Administration Quarterly; Oct 1996; 37, 5; ProQuest Central
pg. 26

Trends in Hotel Management Contracts

Shorter Lengths and Changing Fee Structures

A 1996 survey finds a vastly different landscape for hotel management contracts compared to the halcyon days of the 1980s, with far more risk for operators but also more incentive to perform.

by David J. Sangree and Peter P. Hathaway



In April 1996 we were commissioned by Nomura Asset Capital Corporation to report on current trends in provisions of hotel management contracts and to examine how those provisions have changed over the past ten years. To do this we surveyed 25 management companies that collectively manage more than 900 hotels, reviewed the provisions of 32 management contracts (also with 25 different management companies), analyzed 657 financial statements from 256 hotels,

David J. Sangree, *MAI, CPA, is national director of hospitality consulting and* ***Peter P. Hathaway*** *is an associate with U S Realty Consultants, Inc. (Columbus, Ohio). Both are graduates of the Cornell University School of Hotel Administration.*

and compared our data with information from Smith Travel Research, PKF Consulting, Laventhol & Horwath, and James J. Eyster's authoritative text on management contracts.

As discussed in this article, we found that, compared to the contracts of the 1980s, recent management contracts contained fee structures based more heavily on operating incentives, as well as termination clauses making it easier for the owner to remove an underperforming operator. The trend toward operators' contributing equity to a hotel project, first noted by Eyster in 1992, continues in 1996.[1]

The tables in Exhibits 1, 2, and 3 present the average base fee, incentive fee, and length of contracts for 1986, 1991, and 1996, according to the survey responses. We segmented responses as follows: independent operators (i.e., hotel-management companies such as Interstate Hotels, Richfield Hotel Management, Wilson Hotel Management, and Winegardner & Hammons), chain management companies (i.e., first-tier hotel chains such as Hilton, Westin, Marriott, and Wyndham), and institutions (i.e., institutional investors such as Prudential, GE Capital, and Banc One Capital). The subset of institutions represents owners and comprises contracts with both chain and independent operators.

The survey responses reveal a downward trend in contract length over the ten-year period, as shown in Exhibit 1. The overall 1996 mean contract length was 52-percent shorter than the 1986 contract length. In each category except for chain management companies, the shortest contract length occurred in 1991. Current contract lengths are slightly longer than those of the early 1990s when many distressed

Exhibit 1
Management-contract duration by segment

	1986 Mean	1986 Range	1991 Mean	1991 Range	1996 Mean	1996 Range
Independent operators	13.1	5.0–22.5	4.4	1–10	6.6	1.5–15
Chain management	18.6	5.0–25.0	11.4	5–25	10.8	5.0–25
Institutions	16.2	3.5–25.0	4.3	1–7.5	5.0	2.5–7.5
Total sample	*15.3*	*3.5–22.5*	*6.9*	*1–25*	*7.9*	*4.0–25*

Contract lengths given in years based on a survey of 25 operators and institutions by U S Realty Consultants.

Exhibit 2
Base fees by segment

	1986 Mean	1986 Range	1991 Mean	1991 Range	1996 Mean	1996 Range
Independent operators	4.4	3.0–5.5	3.1	1.8–4.0	3.1	2.0–4.3
Chain management	4.0	3.5–5.0	2.8	1.5–4.0	2.8	2.0–3.5
Institutions	3.8	3.5–4.5	3.3	2.5–4.5	2.6	1.5–3.0
Total sample	*4.2*	*3.0–5.5*	*3.0*	*1.5–4.5*	*2.9*	*1.5–4.3*

Base fees given in percentages based on a survey of 25 operators and institutions by U S Realty Consultants.

properties involved contracts of less than one year. The shortest contract length for chain management companies, however, was reported for 1996. Most respondents remembered longer contracts from the 1986 period, although our research indicates that the downward trend was most evident for large, full-service hotels such as Marriott and Hyatt, and less evident for smaller hotels.

Survey respondents indicated that the 1996 contracts had easier termination clauses than preceding agreements. Owners have included performance guarantees allowing for termination of the contract if the management company does not perform. Some institutional owners reported contract lengths of one year with the ability to terminate upon sale of property.

The survey also revealed a continuing downward trend in base fees, as shown in Exhibit 2. Over

[1] See: James J. Eyster, "The Revolution in Domestic Management Contracts," *Cornell Hotel and Restaurant Administration Quarterly*, Vol. 34, No. 1 (February 1993), pp. 16–26.

Exhibit 3

Changes in incentive fees by fee basis

	1986 Mean	1986 Range	1991 Mean	1991 Range	1996 Mean	1996 Range
Percentage of defined GOP	10.3	7.5–15	12.5	10–15.0	7.9	7.5–10.0
Percentage increase in GOP	15.0	10–20	15.8	15–17.5	14.0	10.0–17.5
Percentage beyond preferred return	10.0	10.0	16.3	15–17.5	17.1	12.5–25.0

Incentive fees given in percentages based on a survey of 25 operators and institutions by U S Realty Consultants. GOP is gross operating percentage, which may be defined differently from contract to contract.

the ten-year period, independent-operator base fees declined 29.5 percent, chain-operator base fees declined 30 percent, and institution base fees declined 31.6 percent. The decline in base fees does not necessarily mean a decline in overall management fees, however, as more contracts now include higher incentive fees. Base fees for chain management companies (first-tier hotel chains) were generally lower on a percentage basis than base fees for operators (independent management companies) due to the chain management companies' operating predominately full-service hotels. The survey respondents indicated that base-fee percentages for limited-service hotels are at the high end of the range, typically 4.5 to 5 percent, although we have other evidence indicating lower base fees for limited-service hotels. Full-service hotels have a base-fee average of 2.5 to 3 percent with additional incentive fees. Full-service hotels' incentive fees ranged widely while limited-service hotels had fewer incentive fees.

One of the most interesting findings of the management-fee survey was that independent operators had slightly higher base-fee percentages than chain management companies. The average 1996 base fee for independent operators was 3.1 percent while for chain management companies it was 2.8 percent. The reason for the disparity is that many of the chain management companies operate full-service hotels, which almost always have lower base-fee percentages than limited-service properties (but much higher room revenues and, thus, higher overall fees).

Incentive fees. The survey found a variety of incentive clauses, which have gradually increased in number over the ten-year period (see Exhibit 3).[2] The method of calculating those incentive fees has also evolved. We must note that the increased prevalence in incentive clauses was coupled with the decline of base fees. Many participants agreed that averages are difficult to calculate as each contract has individual terms and conditions. The definition of gross operating profit, for instance, on which many incentives are based, may vary depending on the contract and negotiating terms (as we discuss in a moment). The market has continued to push management companies to lower base fees and to increase incentive fees, particularly for full-service hotels. Fewer than 50 percent of our survey respondents indicated that incentive fees were commonly used in 1986, while more than 75 percent indicated that incentive fees were common in 1996. We expect the trend for a heavier weighting of incentive fees will continue.

Franchise-fee effects. We investigated whether management fees changed according to franchise company. The least-expensive franchise companies, such as Best Inns, charge an initial fee of $10,000 and 4 percent of gross revenue for royalty, advertising, and reservation fees. More-expensive franchises, such as Days Inns, charge an initial fee of $35,000, and 8.8 percent of gross revenue (including royalty, advertising, and reservations fees). Our survey respondents indicated that management companies set the same management fees regardless of which franchise flag was on the property. Some respondents also observed that the strong revenues of upscale hotels allow high-end chains such as Westin and Wyndham to charge low management fees and no franchise fees (they do charge marketing fees).

Portfolio. Survey respondents were asked about the hypothetical impact on management fees when the management of a portfolio of hotels was under consideration. The survey respondents indicated that an opportunity to manage such a portfolio usually results in a decrease in the overall management-fee percentage due to economy-of-scale advantages and a large total dollar amount. Most respondents indicated that the extent of the decrease in management fees would depend on the size of the portfolio and the types of hotels included. One respondent noted that fees would be further reduced with the use of central accounting systems.

Review of Past Contracts

Our review of 32 different hotel-management contracts from the files in our Columbus and Atlanta offices covered contracts for 25 different

[2] Exhibit 3 shows increases and decreases in incentive fees; however, the prevalence of incentive fees was much higher in 1996 than in 1986.

operators with starting dates ranging from 1978 to 1995. The contracts analyzed were for both limited- and full-service hotels, and were with both chain and independent management companies. The average length of the full-service contracts was nearly 11 years, but those contracts contained a variety of early termination clauses. The average length of the limited-service contracts was six years, but again many contracts contained early termination provisions. The table in Exhibit 4 summarizes the findings.

We found that the mean base fee for full-service hotels was 2.8 percent, while incentive fees varied widely. Incentive fees were typically calculated as a percentage of the amount over a specified goal, a percentage improvement in gross operating profit, or a percentage of net operating income. The average base fee for limited-service hotels was 4.4 percent, substantially higher than the full-service base fee. The range of base fees was from 3 percent to 6 percent with only one contract at 6 percent.

Our research indicates that incentive fees are uncommon for limited-service hotels. In fact, incentive fees were nonexistent in the limited-service contracts we reviewed. Presumably, owners of limited-service hotels are more comfortable in setting up a base-fee-only payment system as there are fewer variables in limited-service hotel operations. Additionally, revenues are lower for limited-service hotels so management companies require a higher percentage.

The inclusion of relatively small base fees and higher incentive fees poses both greater risk and greater opportunity for operators. Although the entire payment is not guaranteed, the contract structure more efficiently aligns the interests of both parties. If the hotel is doing well, the operator has an opportunity for greater financial reward than with a strictly base-fee arrangement. In our review of contracts, the following three methods of incentive payment were most common:

- Percentage of defined gross operating profit;
- Percentage increase in GOP; and
- Percentage beyond preferred return.

Of those three incentives, the most common was percentage increase in gross operating profit. As we indicated above, the definition of GOP changed from contract to contract. In some it included equity payments, while others considered income before fixed charges. Other incentive methods found within the historical contracts were:

- Percentage of GOP that exceeds a base-fee amount;
- Percentage of net income over $200,000; and
- Percentage of the amount by which cumulative cash flow exceeds cumulative set-aside amount.

The contracts identified differences in management fees for different hotel types. The high-end hotel chains such as Westin, Wyndham, Radisson, and Sheraton had fees ranging from a base of 0.7 percent of GOP with no incentive to 3.8 percent with an incentive of 20 percent beyond the preferred return. The mid-rate, mid-size properties such as Days Inns, Howard Johnson, and Courtyard by Marriott had fees ranging from a 1-percent base fee with an incentive of 4.5 percent of GOP to a 5-percent base fee with no incentive.

1980s' versus 1990s' contracts. The mean duration of contracts from the 1980s was 17 years, while

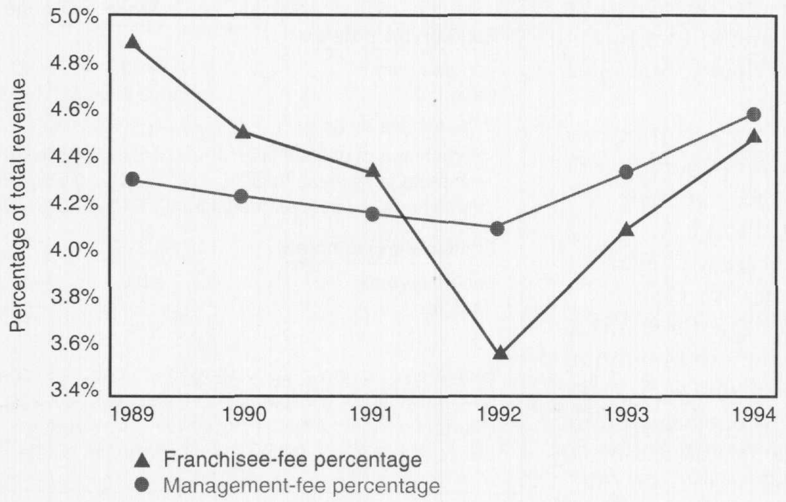
Exhibit 4
Provisions of management contracts, 1986–96

	Mean	Range
Full-service hotels		
Length (years)	11.2	1–30
Base fee	2.8%	0.7%–5%
Incentive fee by type		
Percentage of defined GOP	16.1%	4.5%–20%
Percentage increase in GOP	9.5%	8.5%–10%
Percentage beyond preferred return	17.1%	7.5%–20%
Limited-service hotels		
Length (years)	6.0	1–21
Base fee	4.4%	3%–6%

Based on a review of 32 management contracts spanning 1986 through 1996 by U S Realty Consultants. Fourteen of the contracts contained incentive-fee provisions, none of them for limited-service hotels.

Exhibit 5

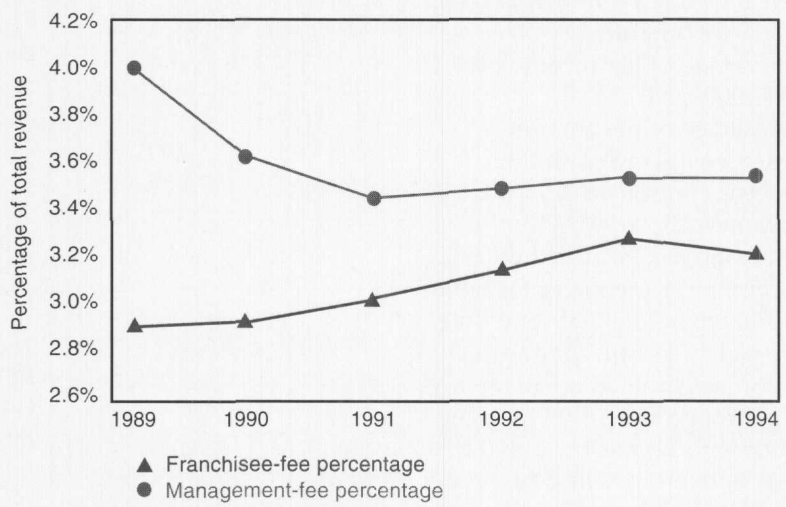
Management and franchise fees for limited-service hotels



Based on a review of hotel financial statements by U S Realty Consultants.

Exhibit 6

Management and franchise fees for full-service hotels



Based on a review of hotel financial statements by U S Realty Consultants.

contracts from the 1990s showed an average length of six years. Base-fee percentages for full-service hotels declined between the two decades. The average base fee for full-service hotels declined from 3.4 percent in the 1980s to 2.8 percent in the 1990s. The decline in duration and fees noted in our 32 contracts correlates with the results of the survey.

Review of Financial Statements

We analyzed 657 financial statements from 256 different hotels, most of them for more than one year. We did so to determine changes in the current versus the historical management fees and typical fees for different hotel chains. The sample of 657 statements included multiple years of individual management-fee percentages of total revenue for many hotels over the period 1988 through 1995. We also reviewed other financial statements that did not have management fees, because many hotels are managed by the owners. We included in the survey only hotels that reported management fees. For this purpose, the management fee includes base and incentive fees. Because of the different hotel types being analyzed each year by our firm, there was some inconsistency between years and chain types (e.g., limited-service economy vs. full-service upscale makes an awkward comparison). However, we feel the data allow a meaningful analysis of how management fees have changed over the past ten years for different hotel segments and chains.

Limited-service fees. Average management fees as a percentage of total revenue for limited-service properties ranged from 4.0 to 4.6 percent between 1989 and 1994. Fees dropped from 1990 through 1992—not a surprise considering the high level of competition and fee-cutting during this difficult period for the hotel industry. We had 289 data inputs for limited-service hotels during the period of 1988 through 1995. These included six with management-fee percentages over 7 percent of total revenue and nine at less than 1 percent. Of the remaining 274 data inputs, 62 percent were between 3 and 5 percent. During this period the average franchise-fee percentage of total revenue declined from 4.9 percent in 1989 to 4.5 percent in 1994. The franchise-fee percentage showed a relatively direct relationship to that of management fees, with both decreasing between 1989 and 1992 and increasing from 1992 to 1994.

Full-service fees. Full-service management fees as a percentage of total revenue have decreased from 4.0 percent in 1989 to 3.5 percent in 1994. The decrease in fees correlates with the results of the survey interviews, which also indicated that fees had dropped from their 1980s' levels. The full-service data included 368 data inputs for the period 1988 to 1995. These included 11 data inputs with management fees greater than 6 percent of total revenue and 14 data inputs of less than 1 percent. Two-thirds of the remaining 343 data inputs were between 2.5 percent and 4.5 percent. During this period the franchise-fee percentage of total revenue ranged from 2.9 percent in 1989 to 3.2 percent in 1994, with a high of 3.3 percent in 1993. As has been the case all through our analysis, no direct relationship was exhibited between management-fee percentages and franchise fees.

Base versus incentive fees. We also analyzed historical financial statements for information regarding base versus incentive fees. First, we reviewed our files to obtain the exact information for each financial statement. We were able to obtain definitive information on the base-fee versus incentive-fee compensation for approximately 22 percent of the hotel financial statements.

Exhibit 7
Base and incentive fees by hotel type

	Base fee	Incentive fee	Total fee
Limited service	3.8%	0.8%	4.6%
Full service	3.2%	0.6%	3.8%

Based on a review of 60 hotels by U S Realty Consultants. The fact that incentive fees appear on this table does not imply that all or even most limited-service hotel contracts carry incentive fees.

Exhibit 8
Management-fee percentages for hotel property by type

Property type	Affiliation examples	Management-fee range	Base-fee mean	Incentive-fee mean	Overall-fee mean
Limited-service budget	Econo Lodge, Knights Inn, Super 8	2.4%–7.2%	4.1%	0.2%	4.3%
Limited-service economy	Best Western, Days Inns, Howard Johnson	0.5%–10.5%	2.8%	0.4%	3.2%
Limited-service upper economy	Clubhouse Inn, Comfort Inn, Hampton Inn, Holiday Inn Express, Signature Inn	0.8%–12.4%	4.4%	0.4%	4.8%
Overall limited service		*0.5%–12.4%*	*3.8%*	*0.4%*	*4.2%*
Full-service midrange	Clarion, Holiday Inn, Quality Inn, Ramada Inn	0.1%–6.0%	3.4%	0.3%	3.7%
Full-service upscale	Crowne Plaza, Hilton, Marriott, Radisson, Sheraton	1.4%–8.7%	3.0%	0.3%	3.3%
Full-service luxury	Hyatt, Omni, Westin	0.7%–6.1%	2.2%	0.6%	2.8%
Overall full service		*0.1%–8.7%*	*3.2%*	*0.4%*	*3.6%*

Based on review of hotel financial statements by U S Realty Consultants.

Exhibit 7 presents the base and incentive fee averages for limited- and full-service hotels for the statements that provided such detailed information. Incentive fees for this group of limited-service hotels stood at 17 percent of the overall management-fee subsegment average, while incentive fees for full-service hotels constituted 16 percent of the average.

Fees by Segment

We have segmented the management fees for the hotels included in the survey into six property types as shown in the table in Exhibit 8. In cases where the financial statement did not break down the incentive and base fees, we have made what we believe to be conservative assumptions regarding base management fees to provide a more appro-

Exhibit 9
Management- and franchise-fee percentages

Property type	Mean franchise fee	Mean management fee
Limited-service budget	4.4%	4.3%
Limited-service economy	4.8%	3.2%
Limited-service upper economy	4.0%	4.8%
Full-service midrange	3.2%	3.7%
Full-service upscale	2.8%	3.3%
Full-service luxury	0	2.8%

Based on review of hotel financial statements by U S Realty Consultants.

Exhibit 10
Management fees by chain

Chain	Fee percentage
Comfort Inns and Suites	5.1%
Knights Lodging	4.5%
Holiday Inn	3.8%
Days Inns	3.5%
Hilton Hotels	3.5%
Marriott	3.5%
Ramada	3.5%
Radisson	3.4%
Howard Johnson	3.3%
Sheraton	3.2%

Based on review of hotel financial statements by U S Realty Consultants.

priate analysis of incentive fees. We imputed a 5-percent base management fee for limited-service hotels, 4 percent for full-service midrange and upscale hotels, and 3 percent for full-service luxury hotels (although our survey results indicate that typical base fees may be lower).

Limited-service. We found that fees for the limited-service-budget segment and limited-service-upper-economy segment are the highest of the six categories. Part of the reason that the percentage is high for limited-service-budget chains (e.g., Knights Lodging) is that the inns have such a low average daily rate that management companies require high fee percentages to obtain a reasonable rate of return for operating these properties. The fees are high for the limited-service-upper-economy hotels (e.g., Hampton Inns or Comfort Inns) for a slightly different reason: these properties perform so strongly that the operating firm can justify higher management fees. The presence of incentive fees of 0.4 percent is partially due to the existence of a small number of properties with extremely high management fees. We estimated, for example, that the property with a 12.4-percent management fee had a base fee of 5 percent with an additional incentive fee of 7.4 percent.

Full-service. Our review of the full-service-property segments indicates that midrange hotels such as Holiday Inn and Ramada typically have a higher management-fee percentage than upper-end full-service hotels. As we explained above, the discrepancy arises from the lower total revenues recorded in the midrange properties compared to the upscale hotels.

The results for the full-service-upscale segment, including chains such as Marriott and Sheraton, indicate a downward trend in fees to 3.4 percent. This segment was unusual in that we saw evidence that some chains charged higher fees when no franchise fee was involved. A few properties in this segment showed high management fees due to strong incentives—with the highest percentage at 8.7 percent. The overall average of incentive fees, using an assumed base fee of 4 percent for those properties for which we did not have actual information, indicates the same 0.3 percent for both midrange and upscale categories. At 2.8 percent, luxury hotels such as Hyatt and Westin show the lowest overall management-fee percentage, based on the high revenue figures many of these properties generate from rooms, F&B, and other departments. Incentive fees were the highest at 0.6 percent in this segment, which also tends to have the highest prevalence of incentive clauses.

Management- and Franchise-Fee Analysis

In this section we look more closely at the relationship by segment between the overall management-fee percentage and franchise fees. Limited-service hotels generally had higher franchise fees and management fees as a percentage of total revenue than did the full-service properties. This phenomenon again extends from the high cash flow of a full-service hotel. Franchise fees are typically based on rooms revenue alone, while revenues from full-service hotels' other operating departments reduce percentage of total revenue represented by the franchise fee. The limited-service-economy segment had the highest franchise-fee percentage and the lowest management-fee percentage of the three limited-service segments. The appearance of a relationship between lower management fees and higher franchise fees is at least partially due to the data sample.

As shown in Exhibit 9, the full-service midrange segments showed the highest franchise-fee and management-fee percentages in our sample, because franchise fees are typically high for this group and it has a high ratio of rooms revenue to total revenue. All of the full-service luxury hotels were chain-operator-managed properties that did not pay a franchise fee. This group includes chain-operated hotels that historically have not franchised extensively and have been willing to reduce management-fee percentages in consideration of these hotels' typically high revenue figures. In our final analysis, as we indicated above, the franchise-fee percentage of total revenue is not in direct relationship to the management-fee percentage. However, a high franchise fee did result in a slight drop in the percentage of management fees for properties in the highest range of franchise fees.

Management Fees by Franchise Chain

Using those chains from which we had a minimum of 30 years of data, we calculated mean management fees by franchise chain for the 256 different hotels in our sample. The table in Exhibit 10 shows the franchise chains and management-fee percentages. We note no guideline established by a franchise company on what level of management fee should be charged for a specific franchise brand.

The averages indicate that Knights Lodging and Comfort Inns reported the highest management fees for the data sample. Comfort Inns constitute an upper-economy limited-service chain that has been successful in the marketplace, thereby justifying higher management fees than other chains. We had detailed management-fee information on seven Comfort Inns (with 21 data inputs) indicating total base fees of 4.6 percent and incentive fees of 1.2 percent. Knights Lodging has undergone major changes but has been a strong limited-service budget chain offering low room rates. The resulting low rooms revenue may be one reason for the higher management-fee percentage. The lower percentages recorded for Days Inns and Howard Johnson are due to fewer incentive fees and overall lower performance of these chains compared to many upper-economy chains.

The review of full-service hotel chains indicates the highest management fees as a percentage of total revenue for Holiday Inn, at 3.8 percent, and the lowest for Sheraton, at 3.2 percent. Once again, upscale chains including Radisson, Marriott, Hilton, and Sheraton were at the lower end of the range due to their typically large sizes and high total revenues. Some of the properties we looked at do not pay franchise fees as they were corporate-owned and managed. We had detailed management-fee information on 14 Holiday Inns (40 data inputs), which averaged total base fees of 2.9 percent and incentive fees of 0.5 percent. This subgroup had a lower total management fee than the overall average of Holiday Inn proper-

How the Study Came About

U S Realty Consultants, Inc., was commissioned in May 1996 by Nomura Asset Capital Corporation (NACC) to prepare a report analyzing trends in U.S. management fees. The purpose was to study how management fees for various sectors of the hotel industry have changed over the past ten years. The study assisted NACC in determining the appropriate management-fee percentage to use for hotel financial projections in loans.

We conducted a survey of 25 management companies to determine their current base and incentive fees, as well as the number of contracts they held. These companies collectively manage over 900 hotels of all types. Additionally, we requested historical information from the survey participants to provide us with an indication of how management fees have changed over the past ten years.

From our files, we reviewed 32 management contracts, representing 25 different management companies, for information regarding base and incentive fees and contract duration. Additionally, we extrapolated management-fee percentages of total revenue from 657 financial statements of 256 different hotels, by which over 75 different management companies were represented.

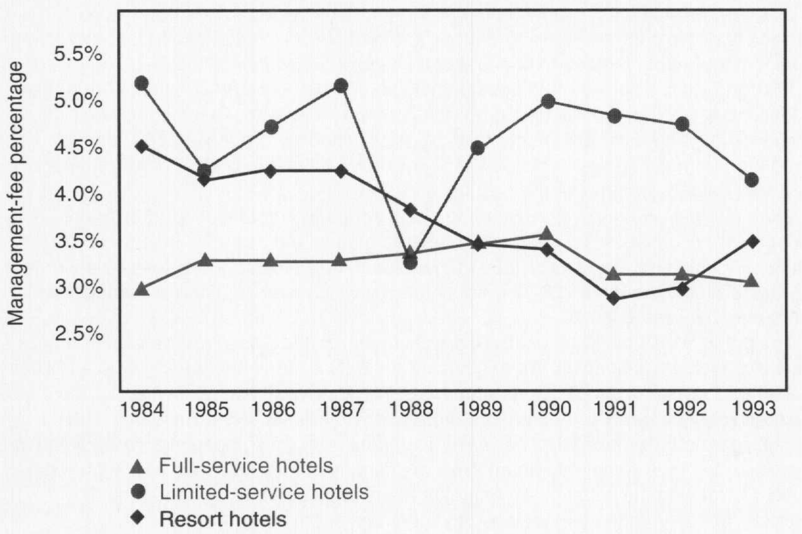
The hotels we studied are located throughout the United States and represent a wide range of franchise companies. We segmented the data on fees by property type and chain type without revealing specific hotel properties. We analyzed changes in management fees by examining various industry standard publications by Smith Travel Research, PKF Consulting, and Laventhol & Horwath. We used data from an authoritative textbook in this area. Also, we have completed an analysis of changes in franchise fees over a five-year period. Correlating the results, we confirmed the changing nature of management contracts, trends in management fees, and contract length.

This report is designed as a reference and management aid. It should not be construed as setting standards on policies or actions for any individual hotels, motels, associations, agencies, or their professional managers. The reader is advised that although we believe our information is reliable, we do not represent our data to be definitive or all-inclusive.

Our survey respondents were: Allen & O'Hara, Inc.; Banc One Capital; Coakley & Williams, Inc.; Colony Resorts; Cooper/CSS Hotels; Crown American Hotels; Davidson Hotel Company; Friden Hotel Company; GE Capital; GF Management; Hilton Hotels; Interstate Hotels; Prime Hospitality Corporation; Prudential Realty; Quorum Hotels; Remington Hotel Corporation; Richfield Hotel Management; Ritz-Carlton; Starwood Lodging Trust; Tollman-Hundley Hotels; Waterford Hotel Group; Westin Hotels; Wilson Hotel Management; Winegardner & Hammons; and Wyndham Hotels.—*D.J.S. and P.P.H.*

Exhibit 11

Management-fee percentages by property type, 1984–93



Based on data from *Trends in the Hotel Industry*, published by PKF Consulting

ties, although incentive fees were 17 percent of the total management fee for this group. The higher fees for Holiday Inn compared to Ramada are partially due to the higher incentive fees being achieved at many Holiday Inn hotels versus Ramada properties due to the typically higher revenue achieved at Holiday Inn properties.

Our analysis of historical financial statements indicates that limited-service hotels have higher overall (base plus incentive) management fees as a percentage of total revenue compared to full-service hotels. Our analysis of base versus incentive fees indicates that the incentive fee was approximately 10 percent of the overall average limited-service management fee for all data inputs of 4.2 percent and approximately 11 percent of the overall average full-service management fee for all data inputs of 3.6 percent. Full-service management fees have shown a slight decline between 1989 and 1994 and have remained at or below 3.5 percent since 1991, while limited-service fees remained relatively constant, with a slight decline during the early 1990s' down period. The type of hotel and segment of the hotel directly relates to the amount of management-fee percentage with luxury hotels having the lowest percentage and limited-service upper economy showing the highest.

Historical Standards and Fee Trends

We have analyzed the historical industry standards and management fee trends from three hospitality publications and one book: *Trends in the Hotel Industry* 1984-1993, Pannell Kerr Forster; *HOST Report* 1991–1994, Smith Travel Research and Arthur Andersen; *US Lodging Industry Report* 1985–1988, Laventhol & Horwath; and Cornell University professor James J. Eyster's book and subsequent article on hotel management contracts.[3]

[3] James J. Eyster, *Negotiation and Administration of Hotel and Restaurant Management Contracts*, Third Edition (Ithaca, NY: Cornell University School of Hotel Administration, 1988); and Eyster, 1993.

***Trends in the Hotel Industry* 1984–1993.** PKF produces a report that details annual income and expense information for all hotel types. The studies are widely read and recognized as a guide for hotel averages. We used the annual PKF studies for 1984 through 1993 (1994 data were not comparable, according to PKF). The graphs in Exhibit 11 illustrate the changes PKF recorded in management fees for full-service, limited-service, and resort hotels during this ten-year period. The PKF study does not separate base and incentive fees.

Full-service hotels. The PKF data show that management fees for transient and full-service hotels did not exceed 3.6 percent during the ten-year period. That fee percentage is below what was considered by many to be the norm for full-service hotels during the rapid expansion of the 1980s. These data run contrary to the results of our survey interviews, in which respondents recalled they could obtain a contract with a 5-percent base fee during the 1980s. The graphs also illustrate a downward trend in management fees, which is in line with our survey results. The PKF study shows the 1993 management fee for full-service hotels to be 3.1 percent, down from the 1990 level of 3.6 percent.

Limited-service hotels. PKF's record of management fees for limited-service properties (motels without restaurants for the period 1984 to 1988, and limited-service motels for the period 1989 to 1993) indicates a "fee roller coaster": fees declined, increased, and then declined again, coming to rest in 1993 at a nadir below 4.2 percent. From PKF's data, it appears that a management fee of 5 percent was possible during the 1980s.

Resort hotels. Management fees for resorts followed the general downward trend over the ten-year period, except for an increase from 1992 to 1993. The highest fees (mean of 4.5 percent) were obtained in 1984, while the lowest fees (mean of 2.9 percent) were recorded in 1991. The higher fees obtained during the early years of the study probably resulted from the presence of a limited number of management companies specializing in resort operation that could command a high fee. These fees declined with increased competition, as occurred in other segments. The decrease between 1989 and 1992 was due to the industry's recession.

***Host Report* 1991–1994.** Smith Travel Research and Arthur Andersen produce a report that details annual income and expense information for all hotel types. Like the PKF study, the *Host Report* is widely read and recognized as a guide for hotel averages. With nearly 3,000 participants, the *Host Report* is the industry's most exhaustive survey. The table in Exhibit 12 illustrates the changes in management fees for limited-service, full-service, all-suite hotels with food and beverage and all-suite hotels without food and beverage for the period 1991 through 1994.

The *Host Report* has revealed that there has been little change in total management fees with the exception of limited-service hotels, which experienced a 1-percent fee increase from 1991 through 1994. The management fees for the full-service segment in the *Host Report* ranged from 3.2 percent to 3.4 percent during the four-year period, fractionally higher than the fees reported in *Trends*. STR and Andersen found that management fees for the limited-service segment increased from 3.8 percent in 1991 to 4.8 percent in 1994, the opposite of *Trends*.

Management fees for all-suite properties with food and beverage increased from 3.4 percent to 3.9 percent from 1991 to 1992, and then declined to 3.4 percent in 1993.[4] The lower fees in this segment as compared to the all-suite properties without food and beverage are due to the higher overall total revenues. The *Host Report* found that all-suite properties without food and beverage experienced a percentage increase that was similar to that of limited-service segment findings during the same period.

***US Lodging Industry Report* 1985-1988.** The erstwhile consulting and accounting partnership Laventhol & Horwath produced a well-respected annual report of industry operating statistics until 1988. We took management-fee information from the report for the years 1985 through 1988, as shown in Exhibit 13. Similar to *Trends*, the *US Lodging Industry Report* revealed no major changes between 1985 and 1988 in management fees,

Exhibit 12
Management-fee percentages by property type, 1991–94

Year	Full service	Limited service	All-suite with F&B	All-suite, no F&B
1991	3.2%	3.8%	3.4%	3.3%
1992	3.4%	4.4%	3.9%	4.0%
1993	3.3%	4.7%	3.4%	4.4%
1994	3.3%	4.8%	NA	NA

Based on data from the *Host Report*, published by Smith Travel Research and Arthur Andersen Consulting.

Exhibit 13
Management-fee percentages by property type, 1985–88

Year	All establishments	Chain owned	Chain managed	Chain franchised	Independent
1985	3.5%	3.3%	3.2%	3.9%	2.9%
1986	3.4%	3.1%	3.2%	3.3%	3.5%
1987	3.6%	3.3%	3.5%	3.4%	4.0%
1988	3.4%	3.9%	3.1%	3.4%	3.1%

Based on data from *U.S. Lodging Industry Report*, published by Laventhol & Horwath.

[4] Smith Travel Research did not publish all-suite data in 1994.

Exhibit 14
Changes in common management agreements

Chain operators

1988	1992	Change
3–4% GR + 10% IBFC or 3% GR + 15% IBFC	1.5–3% GR + 8–10% GOP	1.5–2% decrease in GR% 0–2% decrease in GOP%
3-5% GR + 18–25% NCF	2–3.5% GR + 15–28% NCF	1–1.5% decrease in GR%
3–5% GR + 18–30% NCFAROE	2–3.5% GR + 18–30% NCFAROE	1–1.5% decrease in GR%

Independent operators

1988	1992	Change
4–6% GR	2–4% GR	2–4% decrease in GR%
3.5-4.5% GR + 10–18% NCF	1.5–3% GR + 10–20% NCF	1.5–2% decrease in GR% (Possible incentive increase)
2.5–4% GR + 6–10% IBFC	1.5–2% GR + 5–6% IBFC	1–2% decrease in GR% 1–4% decrease in IBFC%

Abbreviations: GOP—gross operating percentage; GR—gross revenue; IBFC—income before fixed charges; NCF—net cash flow; NCFAROE—net cash flow after return on equity.

Based on data from: James J. Eyster, *Negotiation and Administration of Hotel and Restaurant Management Contracts,* Third Edition (Ithaca, NY: Cornell University School of Hotel Administration, 1988); and James J. Eyster, "The Revolution in Domestic Management Contracts," *Cornell Hotel and Restaurant Administration Quarterly,* Vol. 34, No. 1 (February 1993), pp. 16–26.

which ranged from 3.4 percent to 3.6 percent.

Cornell survey. Cornell University professor James J. Eyster published the third edition of his book *Negotiation and Administration of Hotel and Restaurant Management Contracts* in 1988.[5] The book contains a survey of management-contract provisions, which was updated in a February 1993 *Cornell Quarterly* article.[6] The book's extensive hotel-industry study included interviews with several hundred hotel owners, operators, lenders, and consultants.

According to Eyster, the primary categories for structuring a contract are base fee only; incentive fee only; base fee plus incentive fee (with no subordination of incentive fee); base fee plus incentive fee (with subordination of incentive fee); and base fee or incentive fee, whichever is greater. A comparison of the 1988 and 1992 fee structures outlined by Eyster provides an indication of the downward trend in management fees, the reduction in base fees, and increase in incentive fees. The tables in Exhibit 14 summarize changes to several common management-fee structures from Eyster's writings (1988 and 1993).

The exhibit shows a substantial decline in base fees for chain operators from 1988 to 1992. In 1988 the base fees were 3 to 5 percent of gross revenues, while in 1992 base fees ranged from 1.5 to 3 percent of gross revenues. Likewise, Exhibit 14 shows a significant decline in base fees for independent operators during the same time. In 1988 base fees ranged from 2.5 to 6 percent of gross revenues, while by 1992 that range had sunk to 1.5 to 4 percent of gross. Incentive fees on income before fixed charges declined from

[5] Eyster, 1988.
[6] Eyster, 1993.

6 to 10 percent in 1988 to 5 to 6 percent in 1992.

The sharp decline in 1992, which also appeared in our research, reflects the considerable industry restructuring in the early 1990s. It is interesting to note that Eyster's 1992 follow-up study allows for a special category "Caretaker Operator" due to the prevalence of distressed properties within the industry. According to Eyster, the typical caretaker operator had a contract term of one to twelve months. Our research indicates that 1996 fees show an increase over 1992 fees, but with no recovery to the levels achieved in 1988.

Changing provisions. In his 1992 follow-up article, Eyster identified ten shifts in provisions, involving the following areas. We also saw these in our review of historical management contracts, historical financial statements, and industry interviews. These are still important to consider in 1996: operator loan and equity contributions; initial term and renewals; management-fee structures; operator system-reimbursement expenses; operator performance standards; owner input in operational decision making to include policies, budgeting, and personnel; financial and operational reporting; contract termination at owner's option, on sale, and on foreclosure; restrictive (non-competition) covenants; and dispute-settlement mechanisms

Changing Structures

We examined the changes in management-contract terms in several different ways for this article. Our study documents considerable changes over the past ten years. Base fees have dropped; incentive fees are higher and more common; and contract length has diminished. A typical management fee (including base and incentive) in 1996 for a limited-service hotel is between 4.2 percent and 4.9 percent of total revenue. For a full-service hotel the overall management fees typically fall between 3.1 percent and 3.6 percent of total revenue. Management fees at trophy properties usually drop to less than 3 percent, and we found many cases between 1 percent and 2 percent.

The operators and institutions we surveyed indicated that management contracts carry greater risk now than ten years ago, due both to more liberal termination clauses and the fact that a greater share of fees is generated from incentive clauses. As a result, many companies stated they are investing equity dollars, with the expectation of higher fees and longer contracts. At the same time, several operators stated that equity investments had no impact on fees or contract length. Instead, owners want shorter terms, more performance provisions, and easier termination clauses than formerly.

An interesting finding came in the analysis of franchise fees for 20 franchise companies for the years 1990 and 1995. Franchise fees did not change significantly over that five-year period. The initial, royalty, marketing, and reservation fees all experienced only very slight increases in the overall averages during the period.

Owners in control. Our analysis indicates that contract provisions shifted in favor of the owner in the early 1990s as owners took more control over their properties to try to increase operating profits. Owners are expected to continue increasing their control in the operations of their hotels by creating change in traditional contracts. Based on our analysis, we anticipate that this will come out in the following four primary ways.

(1) Contracts will continue to have low base fees and high incentive fees. Management companies will have to meet benchmark profit figures in conjunction with those incentive provisions.

(2) Operators will have to offer written guarantees stating that management fees will be refunded if pre-determined GOP levels are not achieved by management.

(3) To obtain contracts, management companies will have to contribute even more equity or loans in the future than they do now. These contributions will result in longer terms with higher incentive fees than contracts that do not involve equity. The increasing prevalence of equity contributions may cause difficulties for small operators that have capital restrictions, with the possible result being a reduction in the number of management companies.

(4) Further changes in typical contract provisions will likely occur in the next five years, as many long-term agreements of the 1980s between owners and chain management companies expire. We anticipate the changes will favor owners, as they now have more options.

As a final note, the changes in management contracts have benefited the owners of hotels and large third-party management companies, such as Richfield, Interstate, and American General Hospitality. Smaller firms are having increasing difficulty succeeding in the management business. The improvement in operating performance by the overall hospitality industry is partially attributable to the increased competition and performance of management companies. **CQ**