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# The Hotel Management Company: A Critical Choice

By: Daniel H. Lesser

**L**ike most real estate investments, lodging facilities consist of land and improvements (buildings, permanent equipment, parking areas, swimming pool, etc.). Hotels and resorts are unique, however, in that they contain many elements not typically found in income-producing properties, namely values derived from furniture, fixtures and equipment, and going concern or on-going business. These unique characteristics affect the risks and benefits associated with hotel investments and illustrate the highly specialized nature of this type of real estate. Since buyers and sellers of lodging facilities base their investment decisions on a property's earnings, a hotel's total property value is directly tied to its bottom line cash flows.

Lodging facilities require specialized and highly trained management that consequently bear a direct relationship to value. As a labor-incentive, retail-type business that depends on customer acceptance, a hotel's or resort's business value is very high in comparison to other types of real estate. Unlike an apartment or office building where tenants sign leases for one or more years, a lodging facility experiences a complete turnover of patronage every two to four days. A bad reputation spreads rapidly and can have an immediate effect on occupancy. Hotels must also provide many services that pure real estate investments do not require. A sample of these include: daily cleaning of guestrooms and public areas, operation of a restaurant and lounge, accounting and collection of guest charges, wake-up calls, and luggage handling. Additionally, hotels must be professionally marketed in order to

attract a steady flow of patronage. The implementation and supervision of the service aspects of a hotel investment is the business of operating a hotel.

During the past decade, with the growing popularity of passive hostelry ownership, hotel management companies have become a significant influence on the lodging industry. Since a lodging facility's profits and success can be tied directly to the quality and expertise of management, the selection of the proper hotel operating company is essential. Furthermore, structuring the contract to induce optimal performance, which minimizes risk, is also an important consideration.

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Essentially, a management contract is an agreement between a management firm and a property owner whereby the management firm is paid a fee based on a prescribed formula. The owner has no voice in operational policies, procedures and day-to-day management. The owner, however, is ultimately responsible for the real estate and, if required, must furnish operating shortfalls.

Hotel management contracts provide a vehicle for inexperienced

owners to participate in the benefits of hostelry investments. Management firms provide a chain image, professional talent, proven methods of operation, marketing programs and a reservation system. Because some chains do not offer franchising opportunities, a management contract is the only way an owner can obtain the benefits of a potentially profitable affiliation.

In addition, numerous lenders are willing to make loans on lodging facilities that are managed by reputable management companies rather than by individual operators.

As an outgrowth of my hotel valuation activities, I have counseled hotel owners and developers on selecting an operator. With the vast array of professional hotel management companies throughout the nation, how does one decide which firm represents the optimal choice?

The following checklist provides, I believe, some areas to examine before making this crucial choice:

1. The management firm's property requirements, including physical specifications pertaining to size, layout, design and decor.
2. The total number of properties and rooms the firm currently operates, and the locations of the properties.
3. The firm's expansion plans—in other words, the number of properties and rooms it plans to control within the next three, five and ten years.
4. The total properties the firm owns, either outright or maintains a partial equity interest in.

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5. The firm's marketing ability, including an analysis of the number of national sales offices, their staffing and advertising budgets.
6. The operating statements for all the facilities the firm manages, allowing for a ratio analysis of food and beverage revenues in relation to room revenues and

an examination of departmental and undistributed operating expenses. In addition, to illustrate the firm's forecasting ability, a comparison should be made between actual and projected sales.

7. The type of pre-opening services that are provided for a new property, as well as the degree of regional and home office

technical assistance that is available for major areas such as food and beverage, personnel and labor relations, marketing, property tax representations, and so on.

8. The firm's typical fee structure (including reserve for replacement requirements) for management contract. Included in an analysis should be the firm's willingness to subordinate any or all of its fees to debt service and/or ground rent.
9. The firm's willingness to invest in a project's initial working capital, inventories, furniture, fixtures and equipment.
10. In addition, if the firm has a franchise division, an analysis should be made by region and property type of the number of lodging facilities and rooms that are affiliated with the chain, and projected to be affiliated within the next three, five and ten years.
11. If the firm maintains a central reservations number, an investigation should be made into the percent of room nights booked through the system.

Since a hotel's value is comprised of several elements including going concern or business value, the engagement of a competent managing agent can enhance a property's market value. While these eleven items do not represent all of the issues that should be addressed when considering various operators, they do cover the most critical areas of concern and provide a basis for comparison. □



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