Performance tests – time for change?

What are they?

Most hotel management agreements ("HMA") include some form of owner termination right where the operator is performing badly. Known as "performance tests", they are generally based on the operator's financial performance, with the two most common tests being:

1 a comparison of achieved gross operating profit ("GOP") against the GOP forecast by the operator in the annual budget process; and

2 a comparison of the revenue per available room ("RevPAR") achieved by the hotel against the RevPAR achieved by a selected group of comparable and competing hotels ("Competitive Set").

Other common features of performance tests are:

- the operator is not expected to achieve 100% of the forecast GOP or Competitive Set RevPAR, but is instead expected to achieve a pre-agreed percentage of this figure, typically negotiated as between 80% to 90%;

- the operator is usually allowed a stabilisation period before the performance test kicks in to take account that most new hotels take several years to become profitable. Stabilisation periods typically run from two to four years following the hotel's opening;

- the operator is assessed over a "test period", which is usually two to three financial years. This allows for the odd bad year, without prejudicing an otherwise well-performing operator. The owner's right to terminate the HMA is triggered where the operator fails the performance tests in each of the test period years;

- operators typically must fail <u>both</u> 1 and 2 above before the owner can trigger its termination right;

- operators seek to exclude any test period years where external factors beyond the operator's control materially impact the hotel's revenues. For example, force majeure events, a compulsory purchase or taking, damage or destruction to, or a major renovation of, the hotel or its facilities; and

- operators will also seek "cure rights" to remedy a failure of a performance test by paying some form of compensation to the owner, typically measured as the shortfall in budgeted GOP or RevPAR which the owner has suffered over one or both of the failed test period years. Well-advised owners seek to limit the operator's cure rights. A limitation of two cure payments in the initial operating term, and one cure payment in any renewal term, is considered market.

What is the issue with performance tests in their current form?

Frankly, the typical performance test clause offers a fairly impotent tool to owners seeking to terminate the operator for underperformance because they are generally too difficult to fail.

This can be down to a number of reasons (in addition to the fact that most such clauses are drafted by the operator):

- whilst the owner is involved in, and ultimately approves, the GOP forecast as part of the annual budgeting process, the operator is the one operating the hotel and producing the relevant figures, and can therefore heavily influence the benchmark against which they are tested;

- if the market as a whole is performing badly, the operator can still pass the market based RevPAR test even if its performance is worse than its competition, because everyone is doing badly. This issue can be exacerbated where the performance test benchmark is set below market at say 80% or less. So the owner has to show that the operator is underperforming against an underperforming market and underperforming by 10 to 20%!;

- the external factors beyond the operator's control and allowing for disregarding a failed test year are usually widely drafted, and give the operator much room to argue their failure to perform is due to reasons other than their own poor performance; and

- where an operator has cure rights, it is generally not financially burdensome for them to make the cure payments, particularly when compared to the greater financial burden of their underperformance on the owner.

The cure payment remedy is of further limited benefit to the owner because operators will usually seek to limit the cure to topping up the GOP and/or RevPAR shortfall to the pre-agreed 80% to 90% threshold. So even where the owner receives a cure payment from the operator, the owner is still 10% to 20% out of pocket versus the budget or third party competitors, and stuck with an underperforming operator.

How can an owner address these issues?

There are a number of ways that performance based termination rights could be improved:

- **non-financial performance tests**: owners could seek to move partially away from the traditional GOP/RevPAR performance test measures to tests which measure other areas in which operators are expected to perform or add value. For example, distribution; in the age of OTAs and social media, one could make a case that the distribution systems of well-established operators are being diluted. So instead test the value that the operator actually brings by:

    - assessing the number of materialised reservations which the operator generates through its distribution systems compared to those that are generated by OTAs/third parties. This is particularly relevant, as owners are often obliged to pay a centralised marketing and distribution fee to the operator for each booking at the hotel, even where the booking was not generated by them; or

    - requiring the operator to maintain certain ratings on social media and online review sites, for example, TripAdvisor. A well-run hotel should generate good reviews and ratings, and promptly respond to bad ones. If the operator consistently receives bad reviews or ratings, an owner should be entitled to get rid of them;

- **shorter operating terms**: HMAs are generally long term, ranging from fifteen years to sixty years, depending on the operator in question. This length of term, and the general lack of an exercisable owner termination right, can lead to complacency on the part of the operator. If HMA terms were shortened to, say, five to ten years, operators would be motivated to focus more on their performance, because if they didn't, their owners would be less inclined to renew for further terms;

- **owner no fault/termination for convenience rights**: owners can push for a no fault/termination for convenience right to terminate without the owner having to show any breach on the operator's part, or poor performance. Such rights present some obstacles for owners since, in return, operators would justifiably seek some form of compensation payment for early termination. It is also questionable whether it would be financially viable for an owner to change operators on a regular basis, given the significant expenditures required to rebrand an existing hotel. However, if these obstacle can be overcome, this type of termination right does give owners the flexibility to inject new operating blood into their hotel;

- **real cure payments**: if financial tests are retained (and we are certainly not arguing for their complete removal or their irrelevance), the percentage thresholds need to be increased, so that operators properly compensate owners for their poor performance; and

- **convertible HMAs**: making HMAs convertible to franchise agreements at the owner's option would give an owner the flexibility to bring in a third party operator to replace an underperforming operator, whilst still retaining the branding of the hotel. However, this would increase the length of HMAs (and the time and cost of their negotiation), as they would need to include the terms of the optional franchise arrangements.

Conclusion

The hotel industry and distribution has changed dramatically from when the HMAs (and performance tests) currently in use were developed, and do not allow a means to measure how well an operator is reaching today's internet savvy, brand disloyal hotel guests.

Operators have grown complacent, a situation made worse by owners who just accept the "market position" because that is the price they have to pay to get an established operator to manage their hotel.

There needs to be a long overdue re-think and re-balancing of the relationship between operators and their owners, and performance based termination rights are a good place to start.

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