ADDLESHAW GODDARD

OWNERS, OPERATORS AND OUTSOURCING

Food and beverage ('F&B') outlet management contracts and the synergies with hotel management contracts

Hotel management contracts are an accepted form of hotel operation which grew rapidly in the 1970s. The application of the management contract principle (where an operator takes over a property and on behalf of the owner, will manage it for a fee and then remits the net proceeds to the owner) is still relatively new in its application to F&B outlets. To maximise freedom of control F&B outlets are typically owned or leased. F&B management contract fees are usually less lucrative but play an important role in two specific types of situations:

- when an owner develops an F&B outlet and wishes to lease it to an operator, but the operator is not willing to assume the risk and liabilities associated with a lease; and
- when an owner develops and operates a hospitality or other multi-purpose facility (e.g. a conference centre, amusement park or sports club) but wishes to employ an operator to manage F&B operations.

Simon Numphud, Director of Sales at PSL (one of the country's largest, most successful food solutions partners, with a focus on food procurement, recipe costing and allergen management in several sectors, such as the hospitality, restaurants, pubs, hospitals and education sector) has commented on the increased use of the management concept:

"Given the proliferation of casual dining, restaurant brands, continual developments such as street food and recent growth of delivery models such as Deliveroo, it comes as no surprise that F&B management agreements are becoming more common place. Combined with the ongoing challenge of recruiting and retaining skilled people both in the kitchen and front of house, the outsourcing option becomes increasingly attractive for many. However, this is still a relatively new area for owners and operators of the sectors within which we operate and there are many issues, both pros and cons, above and beyond the commercial imperative."

There are many synergies with hotel management contracts, as to the benefits and disadvantages for entering into such an arrangement, which are as follows:

Advantages for Owner	Disadvantages for Owner
► Potential return is higher than leasing	► Fees paid to operator

▶ The operator is responsible for management of the outlet ▶ Potential capital increase in the real estate value of the outlet if it is profitable ▶ The operator is incentivised to do well (if the basis for payment of fees is well-negotiated) ▶ Financing is typically easier with a reputable operator	▶ Difficulty of contract termination ▶ The owner bears the full risk of the outlet's inability to meet operating expenses and debt repayment ▶ The owner relies on the operator's discretion – loss of operating control

Advantages for Operator	**Disadvantages for Operator**
▶ The operator can expand its brand and footprint with making minimal capital expenditure ▶ Low/no risk to the operator as the outlet is managed for and on behalf of the owner	▶ Dependence on the owner's financial strength (to make up cash deficits in working capital and capex) ▶ Minimal influence on ownership decisions regarding the sale of the outlet ▶ Termination of the contract prior to the end of the agreed term can result in the operator's loss of an outlet and potentially a competitive location and loss of prestige

Operator and owner responsibilities

Operator and owner rights and responsibilities closely resemble those in hotel management contracts but involve a much higher degree of cooperation. Both parties will have a vested interest that what the other is doing and when, compliments the other's activities.

The owner is usually obliged to provide the F&B outlet, adequate working capital and insurance coverage; grant the operator the sole and exclusive right to control the operation of the F&B outlet (subject to appropriate owner approvals); compensate the operator through basic and incentive management fees; and reimburse the operator for operator system-reimbursable expenses.

The operator's responsibilities for managing the day-to-day operations on behalf of the owner closely resemble those in a hotel management contracts and are typically carried out in the owner's name and include establishing all employment policies; conducting marketing and advertising; negotiating and entering into service supply and maintenance contracts; purchasing supplies and operating equipment; procuring all necessary repairs and maintenance to the outlet, and applying for and maintaining all operational licenses and permits.

Contract Negotiations

Contract negotiations tend to centre on similar critical themes which closely resemble those negotiated in hotel management agreements and which go to the heart of the arrangement as follows:

Determination and Coordination of Operating Policies

Whereas a hotel operator will be required to keep the hotel open on a 24 hour basis, F&B outlets do not usually operate on a 24-hour basis. It can be crucial for the overall success of the other facility operations, for an owner to insist upon the specific hours, days of the week, and seasons that the F&B outlet trades. If the F&B outlet supports other facility operations (such as conferencing or sports events), the owner must ensure that F&B outlets complement these operations. Structuring the management fees in an effective basic-incentive mix can reinforce the trade-off between setting opening hours that will maximise both revenues and profits.

An owner will want to negotiate approval rights on the type and extent of services that will be offered. In a multi-purpose facility, such as a resort or conference centre, other services such as room service or outside catering could detrimentally affect other facility activities and overall profitability. An owner should ensure that all F&B offerings complement each other.

A decision mechanism is also necessary in multi-purpose facilities to coordinate pricing (e.g. the relationship between room and restaurant prices and possible sub-optimisation of one for the benefit of the operation as a whole), as well as the

respective room and restaurant revenue components on package pricing in which one combined price is offered to generate business during slow operating periods.

Term of the Contract

As opposed to hotel management contracts where terms typically range for between 15-25 years (historically, they were as long as 80 years) initial terms for F&B outlets range from three to ten years with the median term being five years. When initial terms are short, contracts usually give the operator an option to renew for one to two renewal periods ranging from two to four years each. It is rare for operator performance criteria to be tied to the operator's right to renew.

Management Fees

The owner's objective in negotiating fees is to develop a basic-incentive fee mix appropriate for the specific operation which will provide adequate incentive to maximise profitability and that will encourage cooperation with other revenue-producing efforts that may exist in the facility.

Basic fees are usually (1) a fixed amount; (2) a fixed amount plus a percentage of gross revenues; or (3) a percentage of gross revenues (usually between 2-5% of gross revenues). The fixed amounts and specific gross revenue thresholds are often indexed to inflation or to the CPI/RPI. The basic fee under an F&B management contract differs to hotel management basic fees which is (nearly) always a percentage of gross revenues and ramps up from 2% to 4% or 5% when the hotel stabilises.

Incentive fees are occasionally subordinated to debt service and are usually based on a percentage of gross revenue less, in some cases, direct marketing and advertising expenses conducted specifically for the F&B outlet. The incentive fee is typically between 12% to 15% of the net operating income. Incentive fees in hotel management contracts are (nearly) always based on total net operating profit (where all operational expenses are used to determine the net profit).

Basic and incentive fee components exist in most contracts. When only one component exists, it is the basic fee component. The incentive fee is the reward to the operator for maximising profits for the owner.

Contract Termination

F&B management contracts usually contain termination rights similar to those found in hotel management contracts. If either party fails to observe any (material) covenant; if the other party becomes insolvent; if the other party causes the outlet's licenses to be revoked or suspended, then the non-defaulting party usually has a right to terminate.

Performance tests and provisions giving the owner the right to terminate without cause are very rare in F&B management contracts although they are common in hotel management contracts. On the flip side, owners are compensated by having short operating terms.

Personnel

Personnel issues in F&B management contracts are similar to hotel management contracts. Owners usually want to pass on the employment liability and risk to an operator and to have approval rights in the selection of the manager.

Budgeting and Spending Limitations

As with hotel management contracts, most F&B management contracts require the operator to prepare and then submit an annual operating budget (including proposed capital expenditure). Funds for furniture, fixtures and equipment are rare in F&B management contracts but typical in hotel management contracts. An owner typically has the right to approve the budget, and operators are usually not required to obtain owner approval for budget deviations except in the case when the budget's overall expenditure amount is exceeded.

Restrictive Covenants

Restrictive covenant provisions are of major concern to owners of freestanding F&B outlets. These owners are often willing to permit the operator to manage other F&B outlets within the restricted area if they differ significantly in theme, concept and type of service from the owner's outlet. Geographical areas for restrictive covenants vary widely from as small as a few city blocks to as large as a 5 mile radius, depending on the concept of the F&B outlet and the nature of the local market.

F&B management contracts are only one type of F&B outlet operating form. Profitable options and opportunities generally exist for operators to own or to lease F&B outlets that offer good value and are targeted well to existing markets. The F&B management contract concept has, as has the hotel management contract concept, matured in recent years and can offer if negotiated astutely an equitable business agreement between an owner and an operator.

At the end of the day, we would agree with Simon that "Fundamentally, as with any partnership the most successful agreements are when both owner and operator are completely aligned to the vision, concept, offering and positioning of the food and beverage outlet and are equally committed to its success". To avoid potential disagreements between the owner and the operator, a clearly worded management agreement is the best solution – one which addresses the areas that cause concern between the two parties. These include issues such as owners not understanding when to make capital expenditure,

operators failing to adequately promote the outlet, operators not performing according to agreed budgets and owners 'interfering' in the management of the F&B outlet.

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