

Christie + Co Market Commentary

Back to Basics

When, not if, the recovery takes hold in the hospitality industry, those who will be able to apply the lessons learnt and adapt to the inevitable changes will stand to benefit through the next cycle.

Firstly, any meaningful recovery is likely to be some way off and the road ahead will invariably be a challenging one. That being said, the industry will bounce back as it always has. One must only look at the significant demand shocks to our industry in the last decade, including 9/11, SARS, and the 7/7 bombings – all of which were overcome despite them impacting our industry more significantly than most others. The real question will be how the face of the industry is likely to change following the worst recession in recent memory.

Whilst impossible to cover all areas of potential change, the following four—trading, development, transactions and operators— are likely to see a shift away from the “risk taking” experienced in recent years. We can couple this with an expectation that there will be a move towards the underlying operational principles of the business and less focus on the pure real estate aspects that many investors have previously concentrate on.

Trading - Focusing on the operational business

In recent years, much has been written about the latest and greatest hotel developments. The biggest deals, the newest brands or the latest IT system. Meanwhile some of the most vital ingredients of our industry - customer service quality and the underlying operational structure - have been also-rans. As hotel assets established themselves as an acceptable investment class for mainstream property investors, there has been a reduced focus on the operational aspects that add value to these assets. It was, of course, much easier for a junior analyst with no industry expertise to focus on cashflows, yields, ROI, etc. as they are more easily quantifiable than service quality and operational efficiencies.

It is the GMs and their staff on the ground who are left to fight on the frontline and to make sure that they are doing everything possible to hang on to that extra bit of occupancy and rate. You would be forgiven if you were to believe all the trade press doom and gloom - how RevPAR has gone off a cliff and it will take 10 years for it to recover. The fact is that in many instances the RevPAR declines forecasted by many have yet to materialise (some forecasts suggested declines in London RevPAR of 25-30% in 2009). The rate of decline has started to slow and operators appear less pessimistic about the future, underlining that many of those who are on the front line have been able to limit some of the damage and that all the data, stats, and economic models only tell part of the story – usually only after it has already happened.

Development - Increased debt availability at sensible LTVs a must

Hotel development has undeniably slowed and is likely to remain at reduced levels in the short-term. The key obstacle limiting hotel development is the fundamental lack of available debt financing. Until some sort of normality returns to the debt markets it is difficult to see a return to any significant levels of activity.

There is also likely to be a shift away from secondary and tertiary sites, which in a normalised market just about wash their face, but experience immediate erosion in performance during a downturn. That being said, there are still a number of opportunities for (re)development across the UK, but these opportunities have to be supported by business fundamentals and not purely driven by the hope for capital appreciation of the underlying real estate.

Transactions - A steady stream, not a flood

We will unfortunately continue to see further distress in the market, with banks looking to restructure, reset covenants, explore debt for equity swaps or indeed place assets into administration. Distressed asset sales were initially limited in the early part of the year, but the number of instructions we have received from banks and insolvency practitioners has steadily increased. Although the bid/ask divide is narrowing, we believe that it is still too wide to see the volume of transactions accelerate rapidly over the coming months.

The widely expected landslide of distressed assets coming to market has failed to materialise as lenders continue to hold on to assets, favouring the prospect of a recovery over permanently crystallising a loss through write offs. As these turnaround situations result in value recovery, we can expect to see a steady stream of assets being brought to market over the next three to five years, but it appears increasingly unlikely that we will witness the 'dumping' of assets.

The metrics used to assess these deals have been reset, with a key consequence being that more sensible forecast and valuation variables will be required to avoid a similar overheating of the transactional market in the mid-term. Furthermore, investors will be looking to do the 'right' deal, not just 'any' deal.

Operators - The pendulum swings towards flexibility

With challenging conditions set to continue for some time, the stance taken by many operators to maintain their strategic decision to operate hotels under management contracts (and franchise agreements) is coming under greater scrutiny. Measures such as guarantees, key money or alternative structures such as leases and, dare we say it, a return to asset ownership are, as yet, not fully (re)accepted by the operators. However, it is such flexibility that may need to be revived in order for the sector to remain an attractive investment proposition and to reinvigorate the hotel development pipeline in coming years.

Several leading hotel operators have indicated that they are more willing to be flexible when it comes to providing guarantees and/or key money to support hotel development. Obviously this is very much opportunity driven, with the potential to secure a management contract for a hotel in central London triggering a higher level of flexibility than an opportunity in a less desirable provincial location.

Nonetheless, we expect this trend of increased flexibility to strengthen and spread to more operators as this offers them the best means of maintaining their development pipeline without exposing themselves to too much risk – an opportunity that many would see as foolish in passing up in the current climate.

It is clear that most hotel companies have provided excellent value for their shareholders in recent years by taking full advantage of opportunities offered to them by the prevailing market conditions. As market dynamics have significantly changed during the last 18 months, it will be interesting to see if, yet again, hotel companies can show this degree of adaptability in order to capitalise on the opportunities that the new market dynamics invariably will offer.

Lessons learnt?

There are of course those who believe that the next bubble is just around the corner and that the lessons learnt will be soon forgotten or ignored. Unfortunately, history would lead us to believe that they are right. As Alan Greenspan, former Chairman of the Federal Reserve recently said “It’s human nature – unless somebody can find a way to change human nature we will have more crises”. However, those who learn from this downturn and apply the key lessons may just stand a better chance of staying one step ahead through the next cycle.

+ The above article first appeared in the October issue of Hotel Report

To discuss any of the issues from the above article or any of the wider issues affecting the hotel sector in the UK and across Europe, please call Andreas Scriven, Head of Consultancy at Christie + Co on 0207 227 0700, or email him at: andreas.scriven@christie.com.