

Hotel Ownership

Is the Tide turning for Hotel Operators?

“Hotel Investment Deals plunge 80%”
FT – 21 January 2009

“Fears grow over Commercial Property Defaults”
FT – 14 May 2009

“Capital Values down 8.7% in latest IPD results”
Estates Gazette – 5 May 2009

Vincent Cable: “This recession is very far from over”
The Independent – 19 June 2009

“UK economy shrinks at fastest rate for 50 years”
The Times – 30 June 2009

The last 12 to 18 months have been dominated by countless negative headlines from the UK's more authoritative media regarding the economy and state of the commercial property market. Clearly the economic recession is continuing to have a significant impact on commercial property values, real estate development and income levels. In several cases this has resulted in property owners defaulting on loans (leading to administration), equity erosion and the prospect of banks having to convert their debt into an equity position. The sector is also increasingly faced with the prospect of empty buildings (mostly offices and retail) and unfinished developments. With this backdrop in place, it is no surprise that there has been a strong reduction in property investors' willingness and ability to invest and, crucially, for banks to lend at the high loan-to-value ratios that the real estate world had grown accustomed to. **A vicious circle if ever we saw one!**

The hotel sector has not been exempt from the impact of these economic challenges and has witnessed the demise of a number of hotel companies including the Real Hotel Company, Folio Hotels and Golden Tulip. In addition, as trading performances throughout most of the UK have diminished, the sector as a whole has lost some of its appeal from an investor's standpoint. With these 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 measures that may need to be revived in order for the sector to remain an attractive investment opportunity and to maintain the development/investment process in the coming years.

So where now for a sector in which the most desirable international operating companies appear reluctant to share in the ownership risk of new or repositioned hotel assets?

Riding the Crest of a Wave...

“Hotel ARR Performance in the UK improved Year on Year”

Five Year Performance – All UK (2004-2008)				
	Occupancy	ARR	RevPAR	Variance – RevPAR %
2004	73.9	83.16	61.43	
2005	73.4	86.32	63.34	3.1
2006	76.0	92.13	70.02	10.5
2007	75.8	98.12	74.33	6.2
2008	73.9	100.33	74.10	(0.3)

Source: Hotel Britain 2009

The trend of major hotel companies to divest of assets and focus on brand ownership and operational management started in earnest during 2004 when IHG brought 73 UK hotels to the market subject to management contracts. This was largely prompted by the increased appetite of investors (private equity funds, high net worth individuals and traditional property investors) to invest in hotels as sharper yields in more traditional asset classes meant higher risks and lower returns. In addition, debt was cheap and, as the seemingly ever improving trading results underpinned capital values, highly leveraged deals in excess of 70% became the norm with many reaching even dizzy heights.

A selection of high profile deals:

- March 2005 – Accor sells to Foncière des Murs on a Sale and Lease back basis various Mercure, Novotel and Ibis hotels. The portfolio comprised some 17,000 bedrooms over 128 hotels, with rents reportedly producing a yield of c.7%.
- March 2005 - IHG sells a portfolio of 73 Holiday Inn, Crowne Plaza and Express by Holiday Inn hotels to LRG Acquisition Ltd on a Sale and Manage Back basis.
- November 2005 - Hilton sells various hotels (comprising approximately 3,000 bedrooms) to Managed Hotel Unit Trust on a Sale and Manage Back basis.

The last significant portfolio deal which saw hotel companies disposing of their assets was the Accor deal of 57 hotels in November 2007. This deal comprised the sale of several Novotel, Mercure, Ibis, All Seasons and Etap branded properties to a Real Estate Consortium comprising Caisse des Dépôts et Consignations and two investment funds managed by AXA Real Estate Investment Managers.

Few major hotel companies were left with significant asset ownership

The Consequences

A key consequence of this strategic change in direction meant that the hotel companies, by and large, eliminated much, or all, of their exposure to the underlying property market. Consequently their income now largely comprises fees derived from management contracts and franchise agreements while gains from buying, selling and asset management of owned properties have become much more limited.

Shareholder's wealth, which was already bolstered by the proceeds of the asset disposal programmes (IHG's sale of its UK estate for £1bn resulted in a return of funds to shareholders of circa £767m), was maintained by ever improving trading performances which in turn

enhanced the value of management contracts as fee levels increased. The latter was underlined by the fact that subsequent hotel transactions were brought to the market “enhanced by” a management contract rather than the more traditional “encumbered” description.

The combination of increased investor’s appetite, cheap debt and a strong trading environment resulted in unprecedented levels of hotel development throughout the UK, with most developers eager to align with a reputable operator. This significantly enhanced the management contract/franchise pipeline for the main operators ensuring organic growth as well as brand expansion.

This change in industry dynamics offered operators the opportunity to enter into more favourable contract terms, often providing limited opportunity for the owner to exit and few, if any, guarantees. Contracts which did not include performance tests and/or ‘termination on sale’ clauses were also rife.

Key Observations

- + Rather than operating a diversified portfolio of hotels (owned, leased, managed and franchised) to spread the risk, hotel companies are now largely reliant upon income derived from management contracts. Shareholder value, therefore, can only be enhanced if trading performances continue to improve and/or the number of hotels under management increases. As trading performance is now under pressure, the latter has become critical!
- + The key components of a management contract (base fee and incentive fee) align the interests of owners and operators as it offers a share in improved trading performance by the operator. This was increasingly attractive on the back of improving ARR’s with much of the upturn converting into additional profits.
- + New investors with limited or no experience of the industry were able to benefit from improved trading performance and attractive lending terms thereby exposing the industry to insufficiently knowledgeable asset owners who were carrying all the risk.
- + Asset-lite hotel companies are unable to benefit from potential capital appreciation of their assets, but, likewise, there is no risk of depreciating asset values either, arguably making this ownership model less volatile.
- + The decision to sell hotels is often not influenced or controlled by the operator highlighting the need to include terms such as “right of first refusal” or a “non disturbance clause” in the management contract.

The Tide has Turned...

May 2009

Five Year Performance – All UK May Year-To-Date (2005-2009)				
	Occupancy	ARR	RevPAR	Variance – RevPAR %
2005	70.4	73.45	51.68	
2006	71.6	78.43	56.14	8.6
2007	71.6	84.69	60.62	8.0
2008	72.1	88.33	63.71	5.1
2009	68.6	84.02	57.63	(9.5)
<i>Source: Hotstats – UK Total Hotels</i>				

- + The UK hotel market has witnessed a significant decline in RevPAR performance in 2009. The average statistics as presented above hide the fact that some regional markets have (May to date) experienced a c.20% decline in RevPAR.
- + Few hotel transactions have taken place since mid 2008 due to the lack of debt availability and deteriorating trading conditions, however, we consider that there is a ready pool of experienced and equity rich buyers for assets that provide a good location, strong brand and good management.
- + The current challenging trading environment has diminished fee income significantly. While the decline in Base Fee is linked directly to turnover, the resultant decline in profit linked incentive fee has been more pronounced due to the fixed cost base incurred by hotels. As such, where top line revenues have declined by, say, 10%, fee income is likely to have diminished by a greater margin.
- + We are witnessing more conservative lending criteria. Lower LTV's are now the norm as banks are modifying their risk exposure and are generally unwilling to provide more than 60% debt funding. As the spread between LIBOR rates and Bank of England base rate has widened, borrowing money has become comparatively more expensive. And this is not the only impact - Banks will look closely at the strength of covenant, track record and existing relationship with the developer/owner and operator, with only those parties that stand up to scrutiny being able to secure funding.
- + Clearly, the development pipeline is drying up and many have been mothballed until trading conditions improve and/or alternative financing can be secured, such as equity participation by the operators. The latter scenario would bring about a reduction in debt requirement while enhancing the covenant strength of the application.

Some positives

- + Our research indicates that hotel development cost reduced by circa 10% in 2008 with a similar reduction expected in 2009. In some areas builders are offering to develop "at cost" to keep their business going – a fundamental shift from 18-24 months ago.
- + As the recession continues, more distressed hotel assets are anticipated to come to the market. In many cases this may include poorly maintained hotels in secondary locations. There is also likely to be a fall out over the next six to 12 months particularly from highly leveraged deals struck at the top of the market and non-core underperforming assets.
- + Hotel owners continue to seek hotel management expertise as established brands with proven distribution systems appear best placed to mitigate the downturn.
- + According to many recent media reports the value erosion of commercial property (including hotels) is now showing initial signs of slowing and this may now be the moment to seize the opportunity to invest. As the old adagio goes "if you're looking for prices to hit the bottom, you will have missed it".

What next?

As a whole, brand standards are a good thing, their provision of clarity of quality and service to the customer being one of the main benefits. However, rigid brand standards might work against some operators in respect of distressed assets, which we anticipate will become increasingly available in the short to medium term. This is because the cost to convert would be beyond any revenue/profit uplift that could be delivered by operators. Operators that can offer a so-called “conversion” brand which offers less rigid minimum brand standards (such as Doubletree by Hilton or Accor’s Mercure) are likely to benefit most as they can more easily incorporate distressed assets in their distribution system without having to commit to large sums of capex. Companies which do not offer a clear “conversion” brand may therefore be a less attractive partner to operate these non standardised assets. Alternatively, operators might consider taking onboard hotels on an “affiliated” but non-branded basis. This would minimise the risk of brand erosion while still being able to provide access to their respective distribution network and loyalty schemes.

What will operators do if forced to go further? Would they contemplate taking an equity position in hotel developments or hotel acquisitions? A number of factors indicate that this could happen:

- As illustrated above, values are at their lowest point in recent memory and development costs have also witnessed a substantial decline providing the opportune moment to take on some calculated risk.
- The alignment of operational expertise with an equity position/ownership would provide a strong platform for banks to lend against.
- Providing an economic upturn does materialise, there is scope to reap rewards on the back of improving trading performance and, subsequently, capital values.
- What is the alternative when considering the diminishing pipeline?

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, which is an opportunity in the current climate, that many would see as foolish in passing up.

It is clear that most hotel companies have provided excellent value for their shareholders in recent years by taking full advantage of opportunities offered by then 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 offer.