AlixPartners

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HOTEL DISTRESS ON THE HORIZON?

A perfect storm is forming in the UK hotel sector, but how should those at risk best respond to the challenge?

It's an uncertain time for the UK hotel market. After seven years of solid performance, revenue per available room (RevPAR) growth is decelerating and costs are mounting. Delivering profit growth, upon which many previous investment and lending decisions have been based, appears increasingly challenging.

At AlixPartners, we believe that the signs point to the UK hotel market reaching a cyclical valuation high and that an increasing amount of restructuring is on the horizon. But how have we reached this point, and what should investors, lenders and operators do?

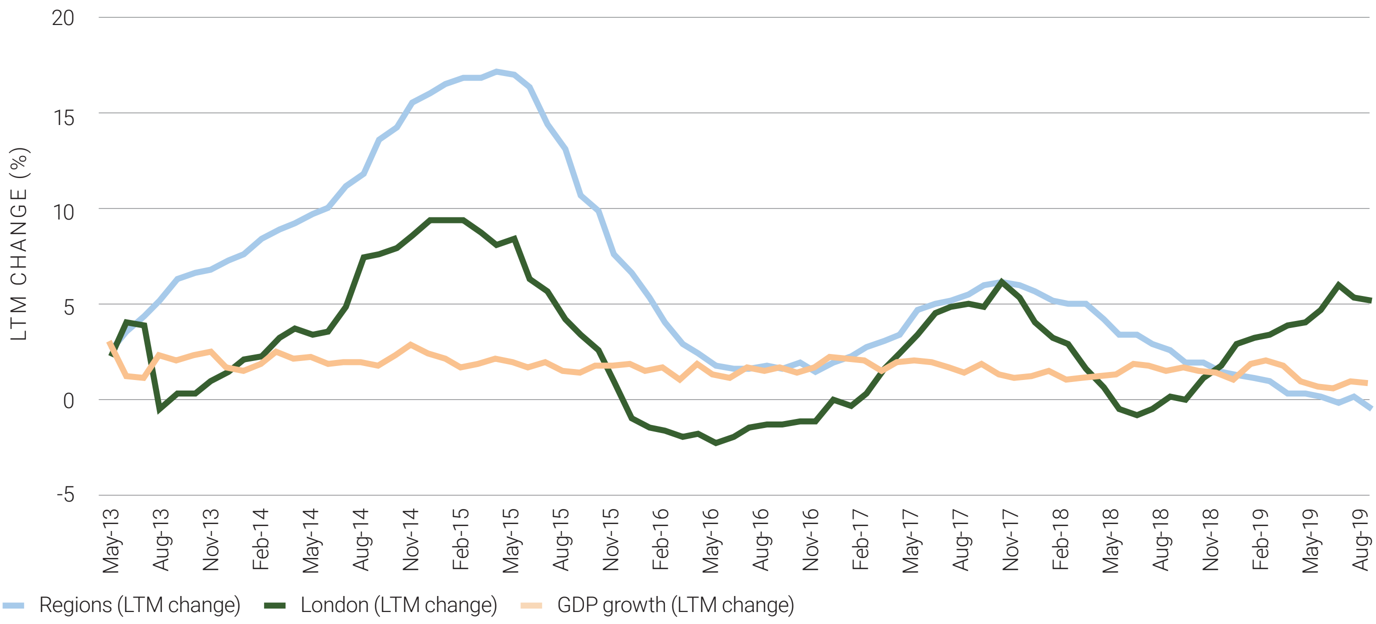
The story so far – exceptional growth

Coinciding with the London Olympics, in 2012 the hotel sector began a period of exceptional year-on-year RevPAR growth. This peaked in 2015, when London and the regions reported 10% and 17% increases respectively.

While growth hasn't hit these heady heights since, it has continued, with a further bump in 2017, when a weakened post-Brexit pound bolstered domestic and overseas visits to UK hotels, especially in London. In a sector that historically tracks GDP growth, seven years of virtually uninterrupted top line growth is exceptional – particularly when UK GDP growth has been anaemic in recent times.

Developers have reacted to this by opening a significant number of new hotel bedrooms. Since 2012, nearly 100,000 rooms have opened (more than 35,000 of these in London), representing 18% of the market supply in 2012. This illustrates the incredible robustness of the hotel market through this period, as all these rooms have been absorbed by the market and RevPAR has still grown at pace.

FIGURE 1: ROLLING LTM REVPAR GROWTH COMPARED TO LTM GDP GROWTH



Source: STR, Office for National Statistics

'Not now Basil' – a swing towards quality

Since the previous downturn, the level of quality and transparency in the hotel sector has increased – largely driven by the increasing popularity of third-party booking and review platforms.

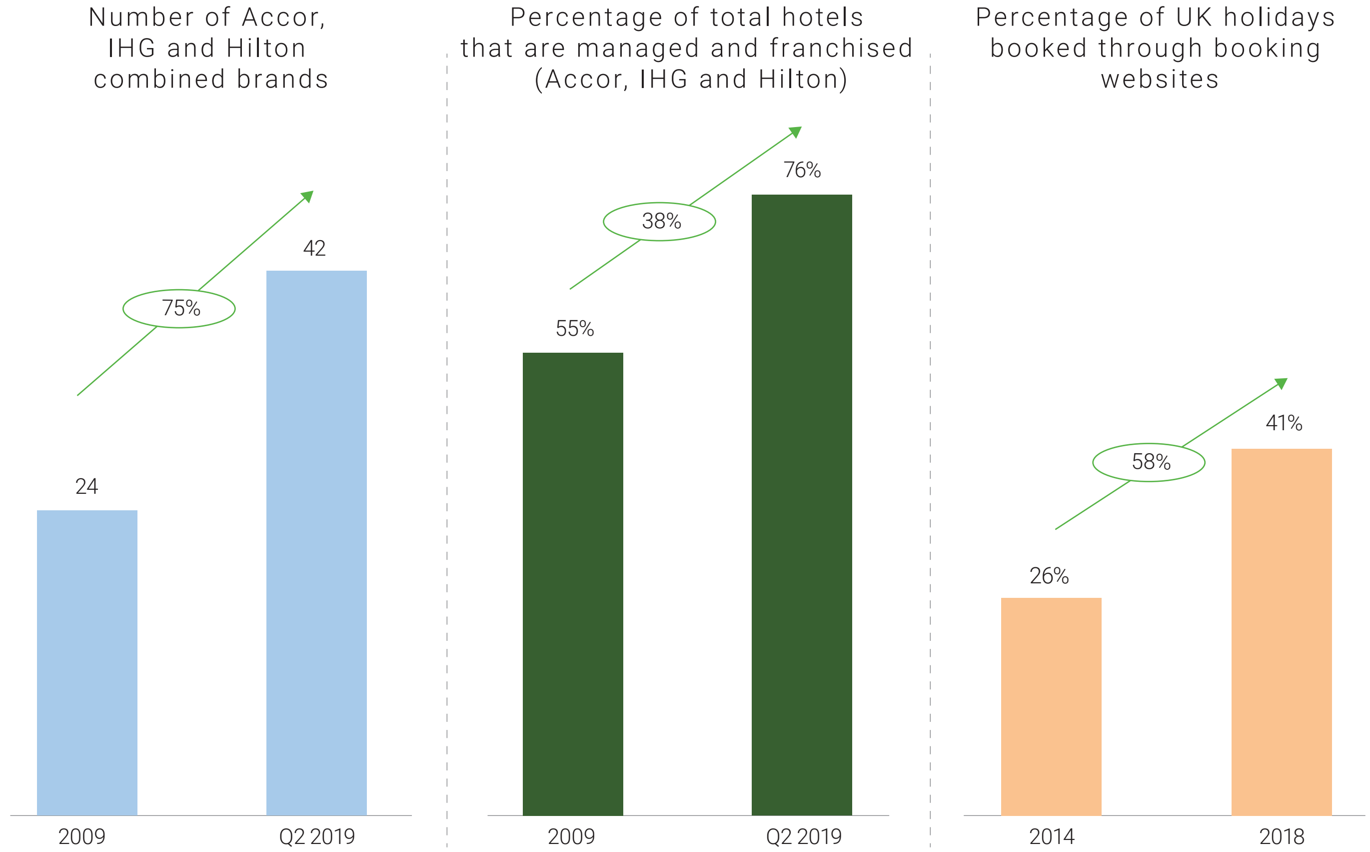
In 2014, only 26% of consumers booked their UK holidays through booking websites such as Expedia or Trivago. By 2018, this had risen to 41%, and this trend shows no sign of slowing. With consumers increasingly likely to book their holidays online, the review culture has become much more important. Operators require an even greater level of customer care to stand out in a fiercely competitive market.

Simultaneously, in a continuation of a trend observed in the past decade, the biggest hotel companies have shifted their operating models. Hilton, Marriott, IHG and Accor are increasingly asset-light, customer-centric management and franchise businesses, rather than real-estate behemoths. Significant investment has been made by these operators in brand portfolios and loyalty schemes, with the aim of ensuring consistent quality at a wide range of price points.

These changes have coincided with the consolidation and expansion of third-party operators. Examples of this include Interstate's consolidation strategy and the creation of Redefine|BDL (now RBH Hospitality Management) in 2013, and the rapid expansion of Kew Green to become IHG's largest Holiday Inn franchise partner in Europe.

There is now little space for traditional 'mom-and-pop' style hotels in the UK. The impact of Travelodge and Premier Inn on the independent 3* and B&B market has been profound. These two brands have opened 25,000 rooms between them since 2012 and their reputation for low-cost and consistent quality across the country has forced many independent operators out of the market. Strong performance over several years and a significant increase in quality, has resulted in hotels – traditionally considered an alternative asset class – becoming attractive to swathes of institutional investors.

FIGURE 2: TRANSFORMATIONS IN CUSTOMER AND OPERATORS ATTITUDES



Source: Company websites, ABTA The Consumer Holiday Trends Report 2014 and ABTA Holiday Habits Report 2018.

Valuations driven to a cyclical high?

Since the credit crisis in 2009 and 2010, the market has passed through several identifiable investment phases, which together may point to an approaching valuation peak.

CRISIS PHASE

From 2009 into 2012, the market experienced extreme operational and financial stress due to a contraction in demand and 'the unavailability' of credit. During this phase, hotel transactions were forced sales, often through insolvency processes and debt-for-equity swaps, where creditors took control of groups to provide stability or amended debt terms to avoid precipitating a transaction.

DE-LEVERAGING PHASE

From 2012, as the market started to stabilise after the crisis phase, banks began to de-lever their balance sheets by disposing of hotels and other real estate assets through individual sales and non-performing loan (NPL) portfolio sales. The purchasers of these assets and NPL portfolios were typically US hedge funds and specialist hotel investment funds, which viewed deals as cyclical plays. They invested when regular market participants were not, on the judgement that the market was going to improve. Examples include Lone Star’s acquisitions of Somerston, Puma and Jury's Inn.

ASSET MANAGEMENT PHASE

Investors that acquired assets during the de-leveraging phase were typically shorter-term owners. After successfully completing complex NPL or distressed asset purchases, and subsequent restructuring transactions, these investors moved to realise value. Owners who had survived the crisis and de-leveraging also looked to exit portfolios.

From 2014 onwards, traditional private equity investors and trade buyers started to re-enter the market – seeing an opportunity to create value through active asset management in hotels that had been underinvested for some time. This involved investing in refurbishment and re-branding, cost reduction and portfolio churn. These investors typically had lower return requirements than the US hedge funds.

This strategy paid off handsomely for investors, as financial performance improved. KSL Capital Partners sold Malmaison/Hotel du Vin to Frasers Hospitality in 2015 for £363m, twice what was paid in 2013.

INSTITUTIONAL PHASE

As yields tightened in the wider real estate market, domestic and overseas investors took to hotels to deploy capital. The investment returns in the sector were highly attractive and insurance groups, sovereign wealth, and ultra-high net-worth individuals entered the market in earnest from 2015. Importantly, these investors became comfortable with the operational risk of hotels – enabling them to invest beyond traditional lease deals.

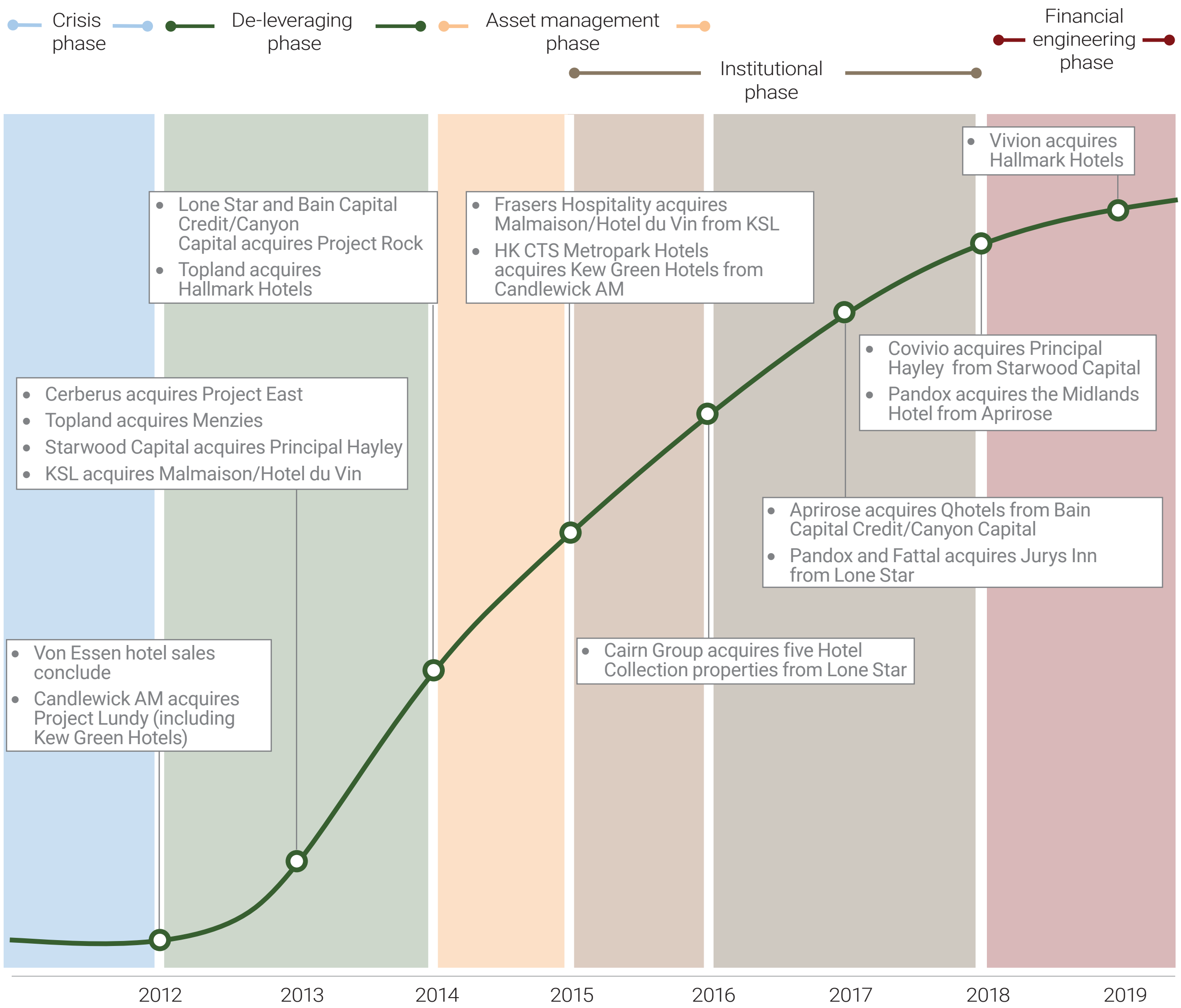
The lower return requirements of these investors helped to further boost hotel asset values. The fall in sterling following the EU referendum in 2016 also helped to make asset prices more attractive for overseas investors.

FINANCIAL ENGINEERING PHASE

As valuations have increased and profit growth has slowed, investors have become increasingly creative in structuring deals to try and create value. Since 2017, ground rent deals have become more common, sale and leaseback has returned as a deal structure, total leverage has increased, and hotels are being acquired by real estate investment trust (REIT) structures – Covivio's (formally Foncière des Régions) purchase of Principal Hayley, for example.

This is to be expected at this stage of the cycle. As opportunities to add value through operational improvement and investment become harder to find, investors need to find ways to reduce their cost of capital to make valuations work. These developments do, however, reduce financial flexibility and the ability for hotels to weather any material downturn in performance.

FIGURE 3: EVOLUTION OF THE HOTEL TRANSACTION MARKET SINCE 2012



Source: Company websites, press releases

The perfect storm

While London continues to flourish, revenue growth in the regions has stalled. LTM RevPAR in the regions declined for the first time since 2012 in the 12 months to H1 2019. With macroeconomic uncertainty intensifying, even London faces a more sluggish growth outlook. This is particularly worrying given strong active pipeline levels, which represent 10% of current supply in London and 6% in the regions.

Hoteliers also face the prospect of increasing overheads. Rising costs are an unwelcome reality for all, particularly in the regions, where lower EBITDA margins leave hotels more susceptible to a performance downturn. But where are these cost pressures coming from?

- **Payroll:** Payroll costs have been increasing for some time and will continue to do so. The introduction of the National Living Wage in April 2016 squeezed profits, and further increases will do likewise. Given the hospitality sector's use of EU labour, Brexit is likely to further increase payroll costs. Hotels may soon face the prospect of paying fees for overseas workers, while further falls in the value of sterling are expected to result in existing overseas workers leaving the labour force.
- **Food and beverage:** Currency fluctuations, increases in global commodity prices and rising costs of production have seen year-on-year food price inflation continue through 2019. In March, food price inflation hit 2.5%[1] – its highest level in six years.
- **Utilities:** Well-publicised rises in utilities overheads, caused by increased consumption and price rises, are adding to the cost pressures piling up on hotel operators.
- **Rates:** The business rates changes introduced in 2018 have also had a significant impact on hoteliers in certain parts of the country – particularly in London and the South.
- **Online travel agents:** While the prevalence of online booking agents has increased the addressable market for hoteliers, operators can pay up to 30% for bookings through these sites. Larger operators have focused on direct bookings, but this is less feasible for those without the critical mass to justify a significant central marketing expense.

This is all bad news for stretch valuation purchasers who need to justify their purchase prices by delivering growth. It currently seems where it is more likely that flat top-line performance and increasing costs will result in profitability decline. Lending that appeared to be prudent in recent years may soon come under pressure if profits and valuations fall.

Hotels remain an attractive asset class and attract investment from many different groups, but transaction volumes in the UK have fallen from recent highs. If underlying profitability remains under pressure, it may become increasingly difficult to bridge the gap between market value and sellers' valuation expectations.

If these conditions continue, restructuring looks inevitable.

How to respond

In the current environment, operators, investors and lenders should keep three things in mind:

- **Investment strategy:** Amid current uncertainty, investors and lenders need to be particularly wary of aggressive business plans. While certain financing options can lower the cost of capital, it is important to choose a capital structure that is resilient to a dip in trading. That being said, there remains competition for the best credits so investors and operators should take the opportunity to optimise their capital structure.
- **Maintain a focus on day-to-day operations:** It is more important than ever to focus on the fundamentals of hotel operations. Maintaining close tabs on what the competition is doing, reacting to changing customer needs, and closely managing staff efficiency and departmental profitability is essential. At this time, it is imperative to maintain capital expenditure levels in preparation for a rainy day.
- **Preserve value:** If things start to go wrong, valuations have the potential to move very quickly. It is essential that investors and lenders have planned for a downside scenario, understand their exit options, and can if necessary, act quickly and decisively upon this to maintain value.

1. British Retail Consortium

Support when it really matters

Having advised in situations with more than 16,000 bedrooms in the UK in the past 10 years, AlixPartners has cemented its position as the market-leading turnaround and restructuring advisor in the hotel sector.

AlixPartners combines operational turnaround, financial restructuring, M&A and debt advisory expertise to help companies, investors and lenders protect and enhance value.

We can help you:

- Drive profit growth and cash generation in extremely short timeframes.
- Determine your optimal strategy for M&A and debt refinancing activity, providing access to our international network of investors and lenders.
- Manage liquidity and generate contingency plans in distressed situations.
- Advise on restructuring solutions for both lenders and borrowers and, if required, deliver formal insolvency solutions.

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ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.