

# Hotels

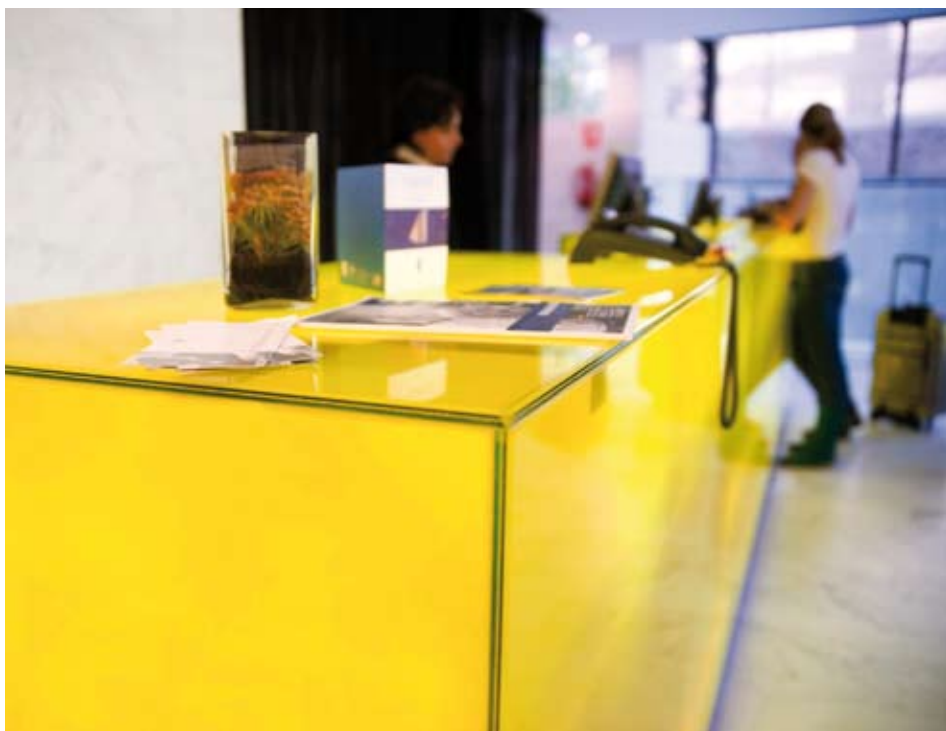
2011

## Breaking the transaction market log jam

“With the top line improving and most groups having worked on their cost structures, there’s a strong 18 months of improving profitability in the making. After all, how much better are the dynamics going to get before you go to market?”

A distinguished panel of hotels and finance professionals recently participated in an industry round-table, debating the drivers and barriers to delivering deal flow in the UK hotel sector.

The global hotel transactions market went through a lacklustre period in 2008, in line with the wider property market, as caution and a lack of debt served to slash the number of deals that investors were willing, or able, to make. However, as confidence in the global recovery has started to grow, there is renewed interest not only in property investment, but in hotels as an asset class.





*"A number of supporting factors can all mean that now is the right time to go to the market – there is certainly the appetite from buyers."*

## **Is a wall of product just around the corner?**

The much-vaunted 'wall of money' – a term frequently used during the boom years around 2007 – is set to be replaced by a 'wall of product', according to panellists at a debate hosted by CBRE Hotels.

The loosening-up of the transactions market has been whispered about since the start of the year, but it has only been the recent sale of the MSREF Intercontinental portfolio and arrival of the Mint and Von Essen Hotels portfolio along with the bank's decision to take back control of the 42 Marriott hotels in the UK which has raised hopes of a number of multiple-site deals coming to market.

The reasons behind the expected rise in transactions put forward by the panel contrasted between changing sentiment within the banks controlling these assets, improvements in trading fundamentals and belief that trading had reached a peak, all encouraging sellers.

One opinion that the panellists shared, however, was that the pace of transactional activity would increase soon, with Patrick Fitzgibbon, senior vice president of development, Hilton Worldwide Europe, Middle East and Africa, identifying the third and fourth quarters of this year as likely busy periods. He said: "We'll see a huge step up. Banks are starting to deal with stuff – they've said: 'Enough's enough.'"

David Hargrave, partner at Ernst & Young, agreed, adding: "There are a number of factors for sellers. There is the wider strategic imperative of institutions that need to drive a de-leveraging over time. There is also effective deal fatigue when assets have remained stagnant within portfolios for a period. A need for capital investment in the properties or issues with CMBS funded structures where there is a finite amount of time to deal with debt, can all mean that now is the right time to go to the market – there is certainly the appetite there from buyers."

"With the top line improving and most groups having worked on their cost structures, there's a strong 18 months of improving profitability in the making. After all, how much better are the dynamics going to get before you go to market?"

The rising prospect that the market was set to shift against buyers without their realisation was of interest.

Fitzgibbon said: "A lot of buyers are terrified of missing the boat. One of the real drivers is equity saying: 'The market is turning, but how quickly will it turn?'" Fitzgibbon said that Hilton had chased numerous portfolios in the past 3 years "with very little actually transacting - but the cash chasing deals has been incredible. There will be a marked change in the next couple of months. There will potentially be a lot more off-market activity. More and more funds are picking up the phone. The banks are conscious of that too and it's all becoming a bit self-fulfilling."

He added that, although a lot of interest was likely to be shown, there were only 'five or six' players who would actually acquire anything, particularly around portfolio deals. Despite the increase in interest in the hotel sector, it was felt by the whole panel that the most prominent players would remain those already active within it.

The recent recovery in trading (particularly in London) was expected to push much of the expected growth in deals. However, the panel met shortly after TRI Hospitality Consulting released data forecasting that, for the beleaguered provincial market, which has been the source of much of the product coming to the market, there would be zero growth in occupancy performance, and a marginal growth of 1% in average room rates, resulting in a 0.9% growth in RevPar for this year. This was expected to push those sellers who had stood on the sidelines waiting for further growth to enter the market.

In London, the forecast was a slightly better 3.4% increase in room rate while occupancy would remain stable, in line with comments from Fitzgibbon that London was "always strong, always surprises". Less positively, subdued revenue growth and rising costs meant that TRI was expecting Gross Operating Profit Per Available Room growth of only 1.1% in the capital.



*“Deal flow in the coming months will help to educate the market on value, but there remains today a valuation gap. Will people pay more than the headline price? Not sure.”*

## **Well invested assets are still likely to be the most sought after.**

One of the key issues for the panel was not the amount of equity available, but the continuing unwillingness of sellers to lower their prices. Hargrave said: “There are a lot of buyers ready to pounce, and a great deal of buyer interest in distressed assets, but otherwise it’s trophy assets and trophy asset buyers. Deal flow in the coming months will help to educate the market on value, but there remains today a valuation gap. Will people pay more than the headline price? Not sure.”

Kingsley Seevaratnam, executive vice president Europe, Westmont Hospitality Group, countered: “There are a number of groups which have a strong interest in the sector and money to invest. They have needed to maintain the required pricing to progress into the final round of processes. However, once there it can be difficult to justify the prices, especially for those who lost equity in the last cycle and need to hit a 20% return. The transactions which achieved the highest prices had a trophy asset which acted as an anchor for the entire portfolio. These transactions and those that have a strong cash yield will be best priced.”

Alongside a lack of enthusiasm on the part of sellers to drop their prices to a level which more accurately reflected the cashflows of properties on the market, the overriding problem holding the transactions market, particularly the sale of portfolios, has been debt.

Derek Gammage, CBRE Hotels’ managing director EMEA, said: “I don’t know where debt sits and that makes it very hard to tell where the market sits. It’s comfortably well off where it was, volume-wise, but not at 2007-levels. We’ve got to start looking at new methods of debt.” Fitzgibbon agreed: “You can’t rely on bank debt coming back in the same way.”

Concerns over under-investment and the so-called capex bomb were raised by the panel, with Hargrave commenting: “A number of properties have been run for cash, with essential day-to-day maintenance capex needs being met, but not longer term investment capex requirements.”

This has grown to become an issue for buyers, with the majority of the stock on the market at the moment likened by Gammage to: “The bit that lurks at the bottom of the U-bend – it’s where you want to put the Domestos and unfortunately that’s where 90% of it is. The problem is lack of capex.”

Jonathan Langston, managing director, TRI Hospitality Consulting, said: “You have to be incredibly careful about what you’re buying - there’s a lot of poor stock out there. I’d make the point that, in the early ‘90s recession occupancies fell a long way, but came back higher; rate didn’t reach pre-recession levels until 2006, but the industry drove RevPAR through the occupancy growth.

This time around we’ve not seen the big occupancy drop, ergo there’s not the bounce back potential, but I don’t feel there’s room to grow rate either. The under-invested mid and upper-scale product can only pull the price lever to compete and, combined with the big and growing budget offer, it’s going to be difficult to increase rate.”

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“The average hotel outside gateway cities is not well run. Local management, by and large, is over-reliant on the brand to deliver and is blinkered to the potential to grow non-rooms revenue. To take advantage of deal flow to grow, brands should woo investors not only by how many loyalty card carriers they have, but also by demonstrating they can convert to bottom line better than their competition.”

As hotel operators have sought to maintain their pipelines, there have been efforts made to be more innovative in terms of funding, with more brands making moves such as offering key money or guarantees, and even moving back into real estate ownership to secure key strategic opportunities.

# In the next cycle there will be more of a concentration of dedicated hotel investors.

Looking forward to the likely future for deals in the hotel sector the panellists commented on Marriott International's decision to use its balance sheet when promoting the Edition brand and also looked at the agreement between it and AC Hotels which has strengthened its position in Europe.

"The AC by Marriott deal is a pointer," said Fitzgibbon. "There is huge opportunity for consolidation in the sector. Rebranding will be a significant driver – there will be consolidation from branding if not ownership. We're already seeing a huge uptick."

The Arab spring had expected to see an influx of investment cash from the affected countries, which, Gammage said, had failed to materialise. "We had expected far more purchases from high net worth Middle East private offices and frankly have seen little of late compared to Indian/Asian interest."

## The Panel

- ▶ David Hargrave, Ernst & Young
- ▶ Kingsley Seevaratnam, Westmont Hospitality Group
- ▶ Patrick Fitzgibbon, Hilton Worldwide
- ▶ Jonathan Langston, TRI Hospitality Consulting
- ▶ Derek Gammage, CBRE Hotels
- ▶ Panel chairman: Andrew Sangster, Hotel Analyst

Our sincere thanks to all the round-table participants and to CBRE Hotels for hosting the discussion. June 2011.

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Seevaratnam added: "Private equity will continue to be around because they have volume. They want to be in hospitality and they want to be in Europe – and they have the relationship with the debt. Sovereign wealth funds will also stay around."

He concluded: "In 2007 a whole host of passive investors became active. In the next cycle there will be more of a concentration of dedicated hotel investors as the banks become more concerned about operators and market knowledge than financial engineering."

For those involved in hotel property investment, a period of inaction, with limited opportunities, looks to be coming to an end. While the sector is unlikely to see a return to the volumes of 2007, there is hope that the deals now being done will herald an era of confident, but sober, deal making.

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