Leisure

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Waking up to reality

David Thame asks if sweet dreams could turn into nightmares for the UK hotel sector

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A good night's sleep – it is the hotelier's classic promise. Yet, for many landlords and lenders to the UK hospitality sector, sweet dreams are turning into nightmares.

The crisis at Travelodge climaxed in October when the firm completed the restructuring of its £635m debt. The company voluntary arrangement involved writing off £235m and repaying £71m, while GoldenTree Asset Management, Avenue Capital Group and Goldman Sachs injected £75m capital into the business. In the process, 49 hotels were slated for sale, and rents slashed at another 109. This is from a 500-strong portfolio spread across the UK, Eire and Spain.

Yet concern is growing in the hotel world that the Travelodge CVA could be the tip of the iceberg. According to specialist accountants, surveyors and hospitality experts, the hotel sector faces a perfect storm. A combination of refinancing, rising input costs and property empires in need of restructuring means 2013 could be a sleepless year, they warn.

But easily the biggest problem is the hotel sector's massive debt burden, with much of it requiring refinancing during 2013 and 2014.

Travelodge has now cut its debt, but other hotel groups – both big and small – face looming problems as they attempt to refinance. Many of the most seriously indebted were boom-time clients of HBOS. Despite growing turnover, profits have been cut by the burden of high interest payments.

For instance, Macdonald Hotels has a £330m facility due to be refinanced in September 2013. "We are already in advanced discussions with Lloyds Banking Group regarding a new longer-term facility," says a company spokeswoman.

Meanwhile, De Vere Hotels completed a £650m debt-for-equity swap with Lloyds. The deal cut its debt, but it still owes £1.1bn. Banking facilities were extended to December 2013.

David Harper, director at Leisure Property Services, explains: "Basically, the hoteliers borrowed money from the wrong bank. HBOS would like to get out of those positions, and the other banks are reluctant to lend. The answer will probably be that some hotel groups will be broken up, but even here there will be problems because there are so few potential buyers with cash."

Sarah Rayment, business restructuring partner with accountant BDO, is a specialist in the hotel sector. She says that under-capitalised and over-borrowed hotel groups could be facing big problems.

Says Rayment: "If they acquired property in the mid-2000s, hotel groups are at risk of breaching loan-to-value ratios, and the probability is that those loan facilities are coming up for renewal now. The valuations will be out, and the questions everyone is asking is how this is going to be refinanced, since the banks are now stricter on loan to value, looking for as much as 50%.

"It could mean debt-for-equity swaps, it could mean some new form of mezzanine finance to fill the gap between what the banks will lend and the owners' capacity to borrow. It could be overseas money. We just don't know – although we do know it will be incredibly difficult," adds Rayment.

The debt problem is compounded by the need to spend heavily to keep hotels looking fresh, while being unable to raise room rates because of strong competitive pressures. Rising costs and shrinking room rates are, hints Rayment, a recipe for disaster.

"Hoteliers have to upgrade accommodation to keep the customers coming and to meet legislative requirements. At the same time, they are undercapitalised and trying to match the prices of the branded budget hotel groups. This is difficult to do and make a profit. Even beautiful wedding venues,

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LEASE DECISIONS

Patrick Grant, a director at CBRE, who was involved with the Travelodge CVA (from the landlords' side), says that its leasehold-only portfolio contributed to Travelodge's woes – and could damage other hotel groups, too.

Grant says: "Travelodge has a wholly leasehold portfolio – which means it is difficult for it to churn the bottom of the estate in the way that pub companies do when they regularly sell off the poorly performing pubs, or those that will require too much capital investment."

"If Travelodge's hotels had been freehold, it could have sold them off, but they were leasehold and difficult to assign, so Travelodge couldn't get rid of its old stuff. Combine that with the lack of capital expenditure on improving the hotels, and you had a ticking time bomb."

Other branded hotel chains have avoided putting all their eggs in the leasehold basket. Whitbread mixes freehold and leasehold with Premier Inn, while Accor mixes freehold, leasehold and franchise.

Grant adds: "The lesson for other hotel operators is that if you can't churn your property estate, then you must invest."

Travelodge managing director Paul Harvey says leases appeal because they are flexible. He says: "The leasehold model provides strong earnings compared to management contracts or franchising, and allows you to explore many different types of development."

BRAND POWER

The expansion plans of the budget hotel chains are based on assumptions about brand power. Customers, they think, will follow the brands.

But brand power may not be as great in the hotel sector as Travelodge, Premier Inn and their rivals hope. Recent research from Cornell University shows that branding may not add much value to a hotel – and could even reduce value.

David Harper at Leisure Property Services is undertaking a PhD looking into the power of hotel branding in the UK. He says: "Branded chains are popular with the banks, which think [they are] safe. It is said it can add 25% to the value of a hotel, but does it really enhance performance to the extent that the banks think it does?"

which you might have expected to have an advantage, will find price an issue today," she says.

The profits squeeze is likely to become more intense, say researchers at PwC. Even the London market – by miles the UK's most profitable – will fall back, they say.

London occupancy is likely to fall from 80% this year to 77% – the lowest since 2005. And although the average daily room rate has just hit a record high of £143, it will not stay that way for long. Revenue per room is also set to fall in 2013. PwC says occupancy rates in the regions are sliding, too, and will be down to 68% in 2013.

The continued rapid expansion of hotel supply inevitably cuts profitability. London is likely to see supply growth of around 7% in 2012 and 3.8% in 2013, which means more than 8,000 new rooms in 2012 and 4,900 in 2013. In the regions, pockets of supply also remain above average levels and new branded budgets continue to force down average rates.

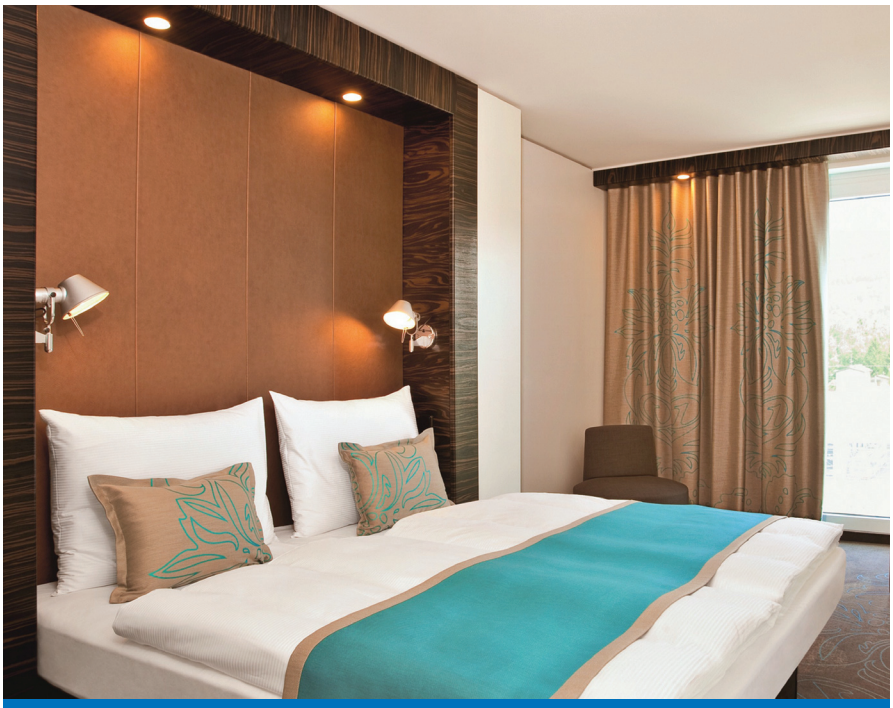
Meanwhile, the conference market – the mainstay of mid-price hotels – is stagnant.

Liz Hall, head of hospitality and leisure research at PwC, does not want to overstate the problem – London's performance, she says, is still "pretty good" by most international standards – but says that many hotel groups' business models will need to be rethought.

"We are forecasting weak demand, and for the squeezed middle – and for everyone else – that means opportunities for new business models. It is about getting that model right. But the fact is that hotels do well in buoyant economies with lots of employment and not too much new supply – and those factors are missing for some locations."

Hall adds: "It is getting harder to make money, and hotels have not been able to pass on their costs. In the regions, revenues are about 10% below what they were in 2007, and that shows the extent of the problem."

However, there are still plenty of optimists. Whitbread, owner of the Premier Inn chain, faces no imminent refinancing needs, which perhaps explains the upbeat tone of John Bates, its head of hotel and restaurant acquisitions.



NEW ENTRANTS

New entrants to the UK hotel scene are keen not to repeat the perceived mistakes of Travelodge.

German chain Motel One is stepping into the UK with two hotels opening, two more on site, and three deals signed. Another four could be signed by the end of 2012, all trading on upfront design and low prices.

Stefan Lenze, Motel One's London-based deputy head of legal, says: "We are going to have a flexible mix of leasehold and freehold, more like Whitbread than Travelodge. We have decided against management agreements, because it is important to us to control branding and quality of the premises. We have to be able to protect our assets."

THE FUTURE OF TRAVELODGE

Travelodge has massively slashed its expansion plans, in the wake of its CVA.

Instead of opening around 3,500 bedrooms each year – as it has in the past three years – it is planning around 1,500 bedrooms in both 2013 and 2014.

"There is a natural slowdown after the CVA process, and because it is harder to find the right sites," says Travelodge managing director Paul Harvey.

A £55m catch-up investment in upgrading hotels is promised, along with around £13m-£15m a year for regular facelifts.

While Harvey insists that heavy repayments on £1.1bn debt starved the business of the capital it needed, Travelodge admits that some operational decisions contributed to its problems.

Buying and rebranding existing going-concern hotels is something it will now approach with care. "It is not a complete prohibition, but we will do a lot less," says Harvey. Hotels with banqueting or conferencing reputations do not fit well into the Travelodge model, he says. "We have learned our lesson and changed our strategy."

Out of 514 Travelodge hotels, 90 were going concerns and the vast majority were untroubled by the CVA. However, one sixth of the 49 hotels scheduled for disposal were going concerns.

Bates believes there is still scope for growth in the branded budget hotel sector.

He says: "The total proportion of UK budget hotel stock that is held by branded operators like Premier Inn is still low compared to other international markets, such as France and the US. There is certainly more capacity in the market for more rooms and that is why we are targeting an increase in our trading portfolio from 49,000 bedrooms today to 65,000 by 2016."

However, Bates is more cautious about the hotel property scene. "Hotel operators need a very clear property proposition for development partners and investors," he warns.

Julian Troup, head of leisure agency at Colliers International, says talk of a refinancing crisis in the hotel sector is misplaced. He says: "I don't think it is in the interests of the banks to cut the independent hotel groups adrift. They will look for solutions. But I don't expect to see a flood of hotels coming to the market. I am seeing nothing that points that way."

More sleepless nights for hotel owners and landlords? By this time next year we will know the worst.