

Restructuring in the hotel sector:

What does the future hold?

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Publication

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Synopsis

Whether internal or inbound generated, tourism is a significant contributor to the UK economy. Over the last decade, the sector has been among the fastest growing in terms of employment and, prior to the COVID-19 pandemic, analysts forecasted that it would contribute almost £260 billion a year to UK GDP by 2025.

However, COVID-19 triggered a near total shutdown of international tourism and corporate travel, with many businesses in urban and city centre locations unable to benefit from the staycation boom that materialised between lockdowns. Hotels play a huge part in the tourism and hospitality sectors' success and have therefore been some of the businesses most impacted over the past 12 months.

Looking ahead, estimates from VisitBritain suggest that inbound tourism in 2021 will only recover by 21 per cent of 2020's figure of 9.7 million visits¹. To put it into context, this would still represent less than a quarter of the pre-pandemic total of 2019. So while the hotel sector will rebound strongly in coming years as the economy recovers and travel restrictions are fully lifted, the immediate focus remains one of survival.

Here, we assess the state of play and discuss how individual hotels and groups will likely adapt through the course of 2021.



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What is the current state of play in the hotel sector?

Of all the sectors impacted by the COVID-19 pandemic, the hotel industry is certainly among the most affected.

Numerous lockdowns, a decline in foreign tourists to the UK, a substantial reduction in business travel and corporate and personal events and the introduction of travel corridors – along with talks of a COVID vaccination passport – have resulted in a significant challenge for hotels of all sizes and in all locations.

While a fraction of hotels have been fortunate enough to secure government contracts, including those for NHS staff and those acting as quarantine hubs for overseas travellers, the vast majority have remained closed or scarcely occupied.

How has the COVID-19 pandemic impacted the sector?

An uneven picture has emerged across the hotel industry, and location continues to be a major factor in the fortunes of individual businesses. For example, coastal hotels enjoyed a busy summer season in 2020, as we embraced staycations following months of lockdown. Many of these businesses are already modelled for winter closure, so despite further lockdowns, have been largely insulated from the challenges that the wider hotel sector has faced.

Conversely, city centre hotels have struggled due to the lack of both corporate and family events, with large-scale conferences and social activities cancelled, and inbound tourism and city breaks significantly reduced. Neither are likely to return in earnest until at least 2022. The hotel industry is hugely varied; operators might be small bespoke hoteliers or part of a worldwide chain. They could run a freehold or leasehold property, and their model could be managed or owned. These factors have all influenced the impact the pandemic has had on individual trading over the past year. More importantly, such factors will also determine what the future will hold.

What issues are businesses in the sector facing?

The most pressing issue facing the industry is the challenge of reopening and operating cost-effectively until the new level of fair maintainable trade is attained. Hotel owners simply don't know what's on the horizon, which makes planning difficult. The challenges of reopening fall into three categories: Government, operational and financing.

Government support measures

The UK economy including the hospitality sector has been cushioned by government support measures and funding schemes. Hospitality investors and operators will sensibly have taken advantage of the Coronavirus Business Interruption Loan Scheme (CBILS), the furlough scheme, reduced VAT and rates relief, as well as business grants.

Importantly, such funding support was also braced by the introduction of the moratoria on forfeiture and winding-up petitions, which effectively estopped enforcement action by suppliers and landlords.

As a result, the prevalence of distress and failures in the hotel sector is currently muted, but the eventual and necessary phasing out of government support measures will create the greatest challenge yet for all stakeholders.

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The operational perspective

From an operational perspective, recommissioning a hotel that has been mothballed means remobilising teams and supply chains.

The industry is heavily reliant on employing people from overseas, with almost half of workers in the hospitality and tourism trade non-UK nationals. The potential impact as a result of Brexit and the end of free movement has been well-documented over the past five years, and it's clear that resourcing is likely to be a significant challenge now the transition period regarding the settled status of workers is coming to an end.

Similarly, supply chains are unlikely to be as robust as they were before the pandemic. It's likely that suppliers will have their own viability issues to which hotel owners and operators will need to be alive to, particularly among smaller yet essential suppliers who have been unable to pivot their offering while hotels have been closed. Having survived on emergency government support – which both hotels and suppliers will need to start paying back soon – these businesses are likely to demand certainty before committing to supplying their products and services. This could mean a period of contract renegotiations, price increases and changes to working capital profiles due to tightened credit creating the potential for an overtrading dynamic to develop.

Customer demand in the short to medium term will also be difficult to predict. Pent-up appetite for leisure will likely fuel an initial surge of bookings but there is potential for widespread job losses to materialise through the course of this year, particularly within low skilled industries, and many people's ability to plan and afford a holiday could sadly be compromised with the resultant knock-on impact on hotel revenues and profitability. Wealthier demographics on the other hand are likely to continue spending the additional disposable income generated during lockdown which will benefit demand for higher-end accommodation, though inbound tourism will likely be curtailed until travel corridors and vaccine passports are established.

Finally, to add more pressure to occupancy or Revenue per available room (RevPAR) metrics and therefore viability challenges, analysis by CBRE Hotels indicates that over 65 new hotels each with more than 100 keys, are due to open in the UK in the next 18-24 months with investors and developers continuing to seek new sites.

The financing challenge

With the easing of lockdown and the staggered re-opening of the hotel and hospitality sectors, there will be an unavoidable financing challenge. As previously highlighted, government support schemes such as the furlough scheme is currently due to end in September 2021 and CBILS repayments will need to commence at some point as well. Combine the working capital requirements of reopening to the eventual unwind of legacy liabilities (supplier, landlord, and HMRC liabilities), and the scale of the financing challenge becomes apparent.

Lenders to the hotel sector have been patient so far – whether due to tacit pressure or pragmatism. With the high level of uncertainty around reopening and underlying asset values, lenders have to-date provided substantial financial support through capital repayment holidays and covenant waivers. However, the reopening phase will test the ability of an asset to service debt (whether legacy or CBILS) and in particular a secured senior lender's appetite for additional funding whether through the Recovery Loan Scheme or otherwise. Such senior secured lenders will be reluctant to tread into commercially unsecured positions without significant justification and belief in a recovery.

One aspect that has yet to unfold is the interaction with ground rent financing structures. During lockdown there has been limited EBITDA or cash generation to finance ground rent obligations. Such obligations reside in-between operational expenses and traditional debt obligations, and in practice will absorb the early cash generation of a hotel which would otherwise support working capital and the servicing of more traditional secured debt.

Without a common objective, a robustly constructed new money investment thesis and agreed financing platform between lenders and owners, there will need to be some serious discussions over long-term recovery or exit strategies.

What trends do we anticipate seeing across the sector over the next 12 months and beyond?

The self-catering staycation sector is likely to see substantial growth in the 2021 summer season, with its promise of relative isolation and, crucially, a sense of normality. To this end, a lot of new stock is already being built – for example, family-run cabins in rural or forest locations – which may also benefit from the changing working patterns being mooted by many organisations that could see longer holidays interspersed with periods of remote working.

The future performance of staycation businesses will become increasingly interesting should overseas holidays reignite in the next five years. However, the short-term forecast is certainly positive.

While all this takes place, those who are exposed to lower demand will be considering their options. Hotels are complex and, strategically, operators might have the right asset but in the wrong location or conversely, the wrong asset in the right location. Those businesses will need to consider how they reposition their asset, the cost of doing so and the impact this has to their revenue and EBITDA model. Repositioning will also impact the asset's valuation and the amount of leverage they can sustain.

These considerations are likely to lead to a high level of restructuring across the sector as owners and operators are likely to find themselves, through no fault of their own, within the wrong capital stack. Notably, there are a lot of debt, equity, dislocation and special situation funds on standby with capital to deploy which is being borne out in transaction values even during the pandemic. Their strategies are likely to prioritise businesses with healthy EBITDA prospects, and for those in more challenging situations we will see price arbitrage.

Where hotel groups are underpinned by a leasehold portfolio, there is also the possibility of more Company Voluntary Arrangements (CVAs) and Restructuring Plans under Part 26a of the Companies Act 2006 materialising, potentially with government extending some of the emergency support available to businesses. Indeed, larger hotel groups would benefit from the use of Restructuring Plans to rearrange complex capital structures in an efficient and commercial manner.

260

Billion pounds a year forecasted to contribute to UK GDP by 2025 before COVID-19

21

Percent of inbound tourism to recover in 2021 of 2020's figure of 9.7 million

65

New hotels due to open in the UK in the next 18-24 months

Notes

*1 VisitBritain. 2021. 2021 tourism forecast. [online] Available at: <<https://www.visitbritain.org/2021-tourism-forecast>> [Accessed 15 April 2021].

What does the future hold?

Conclusion

The hotel sector faces the prospect of a long recovery but is generally resilient; the speed of recovery will be dictated by a number of factors including asset size, scale, location, reliance upon international travel and business versus social use mix.

However, the sector will bounce back and remains attractive as an asset class to investors and lenders as evidenced by the substantial pool of recovery capital waiting to be deployed. The challenge for hotel owners therefore is the ability to bridge potentially substantial financing needs in the interim; failure to convey supportable business plans and retain supportive capital will result in distress and likely enforced transactions.

Hotel businesses of all sizes should be actively engaging with key stakeholders regarding valuation spreads alongside operational, strategic and financial recovery strategies or, ultimately, exit options. The year ahead will undoubtedly be challenging but there are debt and equity solutions available that will help fuel the recovery of resilient, well-managed businesses.

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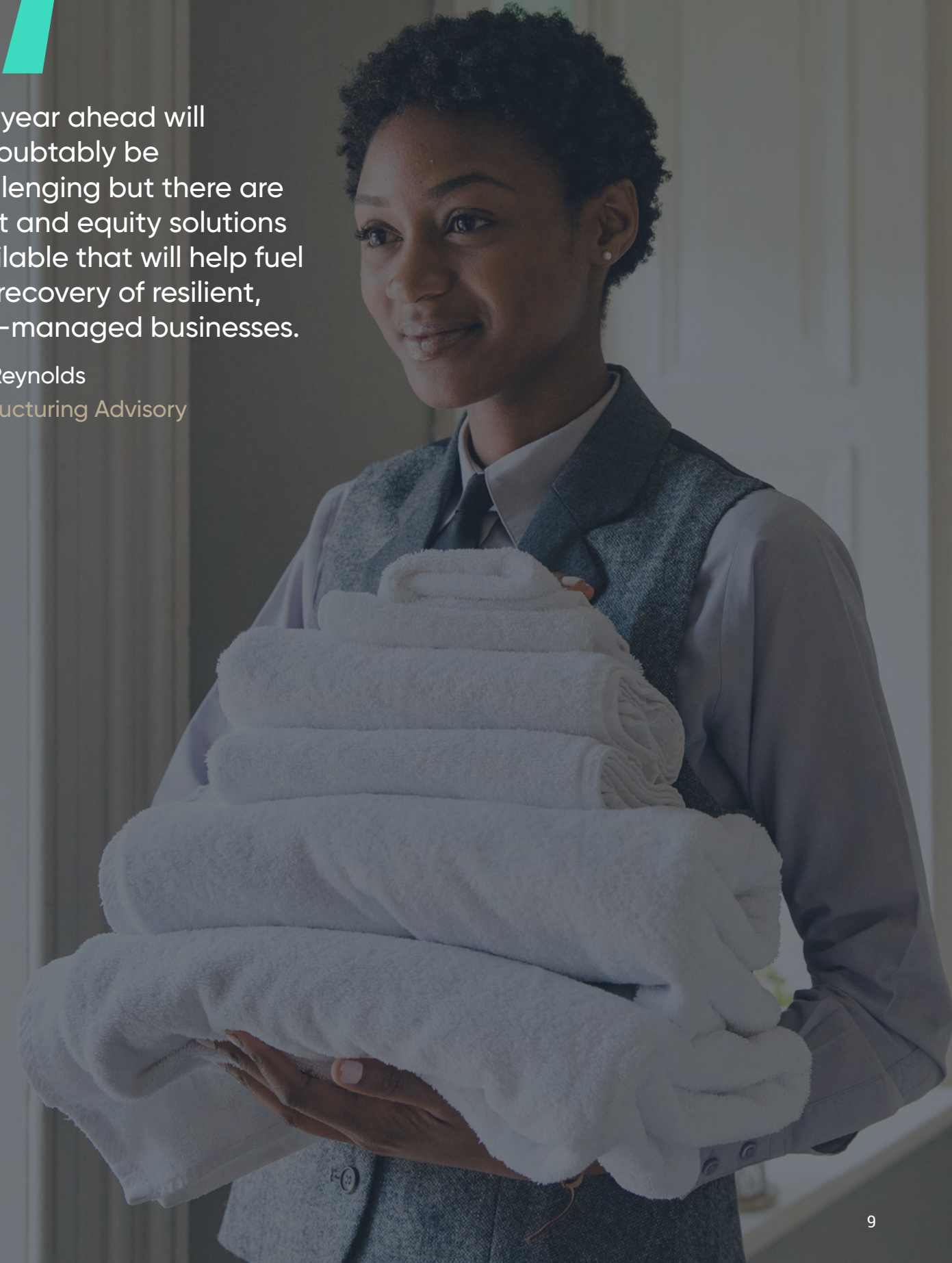
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The year ahead will undoubtedly be challenging but there are debt and equity solutions available that will help fuel the recovery of resilient, well-managed businesses.

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