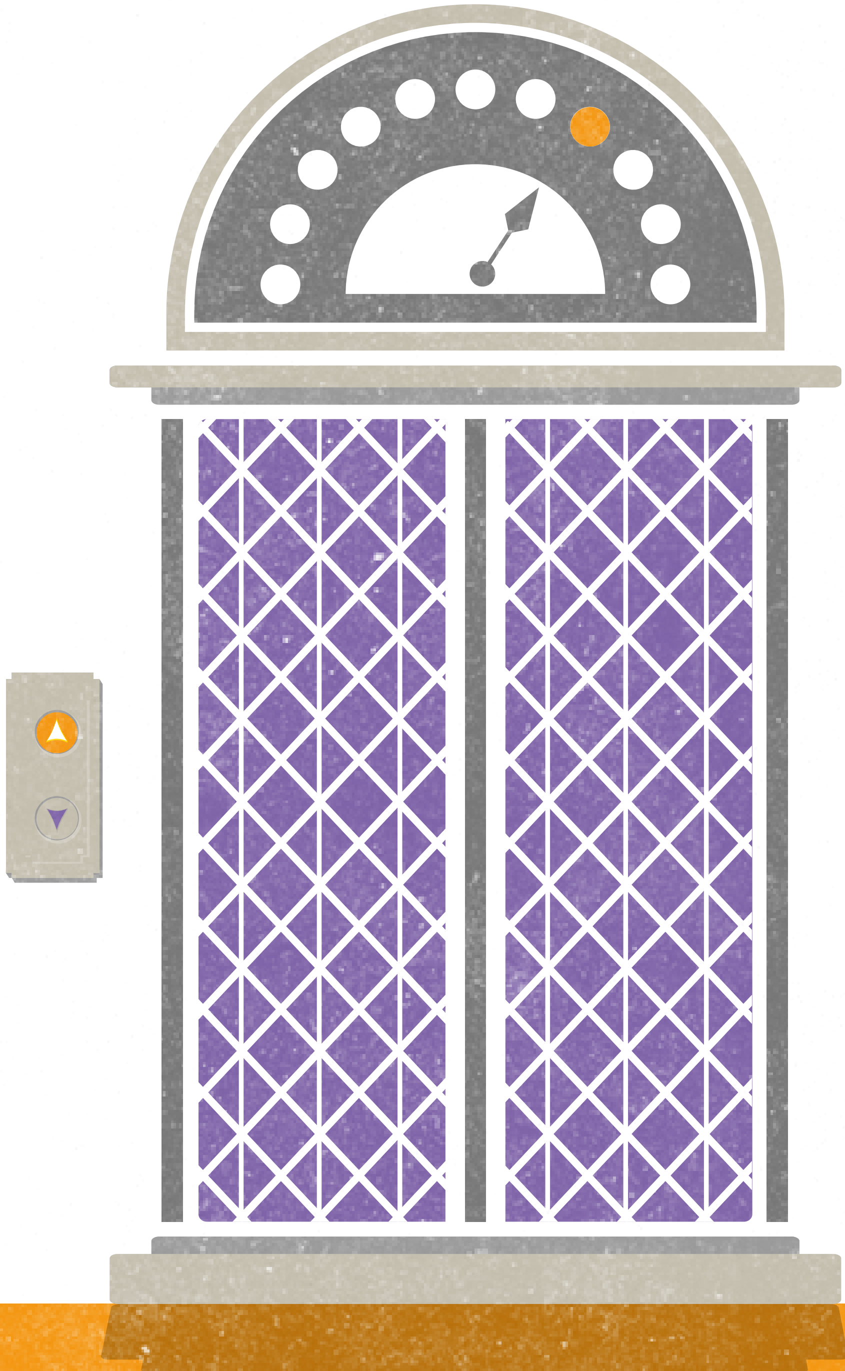
Grant Thornton
An instinct for growth™



Hotel investment 2014: finance on a different level

Top-down summary

The global financial crisis had a major impact across all industries, and the global hotel industry was no exception. The crisis led to a widespread fall in asset values and, for a time, a restrictive lending environment.

Investors suffered losses, with many emerging from the crisis determined not to repeat their experience. The recovery is well underway: globally hotel trading fundamentals are strong and some regions are experiencing strong bottom line growth. Whilst the outlook is improving, a key structural feature is that the lending landscape has changed. New sources of finance are emerging and more creative ways of structuring debt are being explored. Changes are also taking place in the global movement of capital to fund development and growth.

This report describes the critical issues affecting hotel finance in 2014. It draws from in-depth interviews conducted with 20 hotel industry experts, including: senior representatives from hotel brands, banks, private equity and Grant Thornton partners who advise hotel industry clients.

We also draw data from Grant Thornton's International Business Report (IBR), which surveys 3,000 business leaders globally.

Our research indicates that finance is no longer a significant constraint on growth. This is echoed by a recent report by Jones Lang LaSalle (JLL) which predicts global deal volume in the hotel sector of US$50 billion in 2014 – a five-year high. This is a 10% rise on 2013, which was in turn a 35% increase on 2012.[1]

The approach of investors and banks is changing for hotel businesses. They are becoming more sophisticated and lending requirements of traditional players more stringent. Most significantly, there is a market-wide recognition of investing in hotels as business enterprises rather than property plays. Instead of the historical focus on loan to value ratios (LTVs), specialist hotel finance teams are analysing EBITDA and leverage multiples – checking whether debts can be serviced and cash flows sustained.

In response to this new level of sophistication, Grant Thornton has identified five key elements needed for a robust proposal capable of attracting funding and financing growth:

- An experienced and incentivised management team that understands the industry, local market drivers and has a stake in the venture's profitability; this is critical to ensuring that the interests of all stakeholders are aligned
- A compelling equity story which demonstrates the commitment of existing investors as part of a robust financial plan
- A business plan containing detailed performance projections including revenue and channel management, and which also demonstrates tight cost control
- A marketing strategy articulating clear target markets and how channels will deliver to these markets
- A strong brand that resonates and creates loyalty with target markets, particularly outside of major capital cities.

[1]Jones Lang LaSalle - Hotel Investment Outlook – Global 2014.

Starting at the bottom

Funding through the financial crisis

"Investment collapsed during the financial crash from 2008 to 2010 and there was almost no lending for hotels at all."

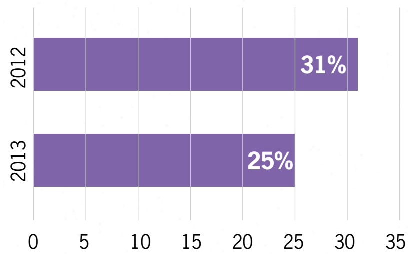
Alvin Wade
Partner
Grant Thornton US

"In South Africa 2005/06/07 were boom years for the hotel industry. This led through the normal hotel sector cycle to a period of overcapacity that was exacerbated by the Football World Cup in 2010, although this sustained the industry for that year. All this took place at the same time as a financial crisis impacted on South Africa and led to an almost total freeze in investment in the hotel sector in 2011 onwards."

Gillian Saunders
Global leader hospitality and tourism
Grant Thornton

The Grant Thornton IBR indicates that shortage of finance has been a major constraint in the hospitality sector, affecting a third of all sector businesses during 2012. However, that problem is now receding with less than a quarter of businesses reporting access to finance as a problem in 2013.

% expecting shortage of finance to constrain expansion in next 12 months

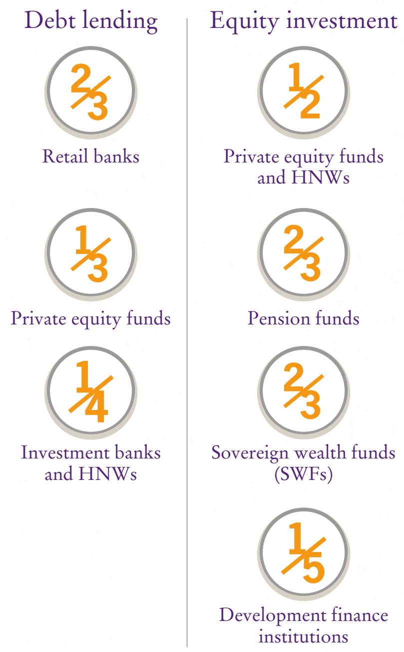


"In Canada, lenders have been more risk averse since the financial crisis. As a result there have been fewer hotel finance transactions through traditional lending sources."

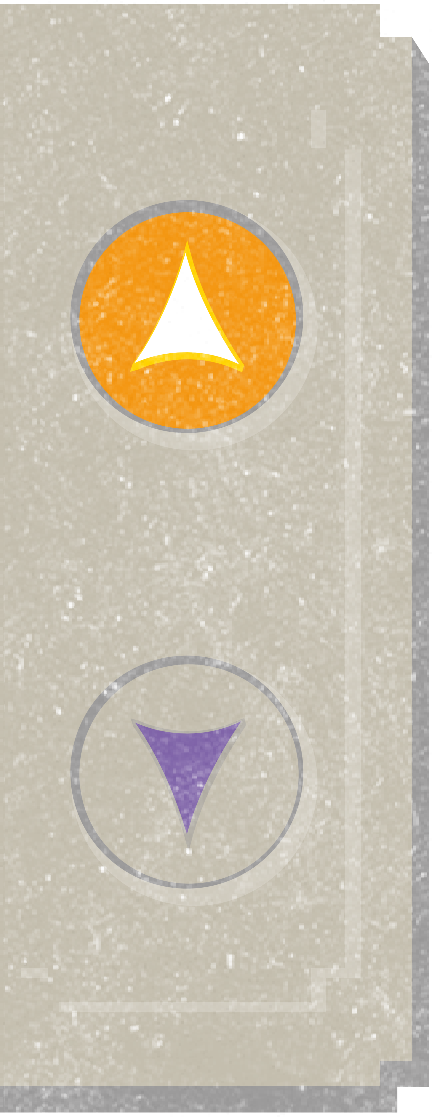
Doug Bastin
Partner
Grant Thornton Canada

Some investors were still active in this period, with sovereign wealth funds and high net worth individuals in particular continuing to invest in trophy assets. However, there was a major squeeze on the amounts available for lending. In many places the financial crash coincided with a cyclical period of over-capacity in the hotel sector to create a perfect storm of weak lending conditions.

Principal sources of funds* over last three years



*Proportion of respondents citing type of lender as source of funding.



Going up

Appetite for investment

"Now is a good time to be looking for finance."

Global Retail Bank

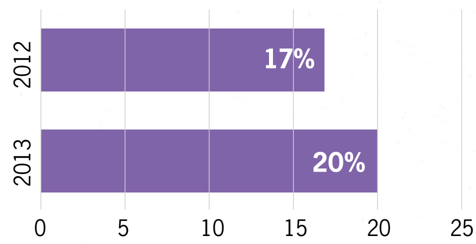
The message from hotel industry experts, lenders, hotel owners and operators is that the growth outlook for the sector is improving across almost all geographical regions. The US is ahead of this trend and even in some danger of overheating. Recovery is strong in the Asia Pacific region and even Europe and Africa are now finally joining in.

"The corner has definitely been turned for the hotel sector and 2013 was a reasonable trading year for the first time in some years. The growth outlook for 2014 is even more positive."

Gillian Saunders
Global leader hospitality and tourism
Grant Thornton

JLL's research shows hotel transaction volumes up 30% in the US, up 17% in EMEA and up 100% in Asia Pacific in 2013.[2] Grant Thornton's IBR also indicates a positive outlook for investment in new buildings in the hospitality sector for the next 12 months.

% expecting investment in new buildings to increase in next 12 months



[2]Jones Lang LaSalle – Hotel Investment Outlook – Global 2014.

Where the funds will come from

Globally, Middle Eastern and Asian investors are pursuing the US gateway market. US investors are looking to Europe for value investments to escape their rapidly heating market. Middle Eastern and Far Eastern investors are seeking equity opportunities in Africa. An increasing trend is for international banks from the Middle Eastern and Chinese regions to seek lending opportunities in more established markets such as London.

"Everyone is interested in Africa now. Expatriate African bankers, who had lost their jobs, started to come back home and added to the expertise of local banks, who can now lend in dollars. They have started to take an interest in hotels, pushing out the European banks. Middle East SWFs and HNWs are looking all over Africa and South East Asian investors are looking at East Africa."

Branded International Hotel Group

Principal sources of funds* in next 12 months

Debt lending		Equity investment	
½	Retail banks	½	Private equity funds
¼	Investment banks	⅓	HNWs and SWFs
⅓	Private equity funds and insurance funds	¼	Pension funds

*Proportion of respondents citing type of lender as source of funding.

A better view
Investor mindset

"Our lending appetite is strong for the right group or owner in the right location at the correct leverage."
Global Retail Bank

The message coming from hotel groups, lenders and industry experts is clear: now is a good time to be seeking finance, but the lending landscape is almost unrecognisable from before the financial crisis.

Hotel industry experts agree that the appetite for lending has returned, but traditional investors are now much more cautious.

"Clearing banks have become much smarter and understand the hotel sector much better. Banks are there to lend money and they prefer asset backed investments."
Sarah Bell
Partner
Grant Thornton UK

A new approach from investors

Banks have become more sophisticated in their understanding of the hotel sector. Today, they view hotels as operational businesses rather than property investments. Primarily there is greater focus on the trading fundamentals, with LTV ratios now a secondary consideration to EBITDA profitability and the ability to service debt payments from cash flow.

"Banks are now bringing in specialist hotel advisers. It is a welcome change to see people brought in who really understand the business of hotels."
Multi-brand Hotel Group

Banks advise that they are now increasingly selective. They are drawn to national/international brands, rather than independents and they are prepared to scrutinise the business plan, the operational agreements, and rigorously assess feasibility.

Location and management team

Investors now have very specific requirements. They insist on assets with stable cash flows, strong management teams and primary market locations such as a gateway city or at an airport.

Proposals must be supported by a comprehensive plan around how to drive the business forward, a capital expenditure programme, a clearly defined stakeholder group and existing equity backing. There is a growing acceptance that a specialist manager can add value.

"Management teams in recent times have been more introverted, focusing on survival/cost down initiatives. Going forward, those with strong sales and marketing cultures will do well."
Global Retail Bank

New types of lending

The cautious approach by traditional banks and the collapse in LTVs has given rise to new market players which are driving creative lending structures. Solutions involving mezzanine finance and quasi-equity debt as part of the capital structure are also affording traditional banks additional protection thereby providing more stimulus in the market which is resulting in more liquidity for transactions.

More than an elevator pitch

Securing investment for your business

The outlook for funding in the hotel sector has turned a corner and the appetite to lend and invest is growing. At the same time investors are more measured and are becoming more demanding in what they want to see from investment proposals.

To meet this, hotel businesses seeking funding need a robust business plan and a compelling narrative when approaching potential investors. There are five areas they will need to address:

1 BRANDING

- Consider branding and whether to associate with a national or international brand and demonstrate the value of the distribution platform
- Independent operators will need a clear offer which establishes their ability to drive profitable volume from the various distribution channels
- Brand strength remains important to banks, particularly to protect revenue by allowing hotels to compete with online travel agencies (OTAs) and sell direct to customers

"There has been a shift towards the importance of brand. Lenders have become more comfortable working with international brands – it gives security and is now a key requirement."

Multi-brand Hotel Group

2 MANAGEMENT

- Lenders are now focussing much more on the strength of the hotel management team. General managers can be responsible for large turnover businesses and have to be competent business leaders
- Managers must be experienced and have a comprehensive understanding of the hotel business and have a clear plan of how to drive local channels
- The management team must be committed to the financial success of the venture and ideally have a direct financial stake in the company

"Lenders are seeking good operators and good managers. There is a growing acceptance that a specialist manager can add a lot of value."

Multi-brand Hotel Group

3 FINANCES

- The financial proposition must include robust cash flow and debt serviceability projections
- Proposals need a strong equity story, with existing investors committed to the project such that interests of all stakeholders are aligned
- Proposals must plan for the cyclical nature of the industry and sufficient headroom to ensure debt serviceability through interest rate rises. Banks want to see evidence that their investment is protected

"Choose the right lender; go to specialist banks used to financing hotels because they understand the business and the risks. Choose the right equity partner, because it will make the debt raising process much simpler."

Spanish Private Equity Fund

4 BUSINESS PLAN

- It is important to have a robust business plan, detailed projections, a focus on cost control and an ability to flex the cost base
- Proposals should include a clear strategy and processes for operating the hotel
- Proposals must demonstrate knowledge of target market segments and have a business plan aimed at these channels
- Business plans should have a long term perspective. For example, not over-investing in upgrading stock when the market may be looking for middle range capacity

"Doing your homework upfront and developing a robust business plan is going to become increasingly important."

Ramón Galcerán
Partner
Grant Thornton Spain

"You need to have a really good proposal, with a good brand, and ideally some significant quality equity already in the project."

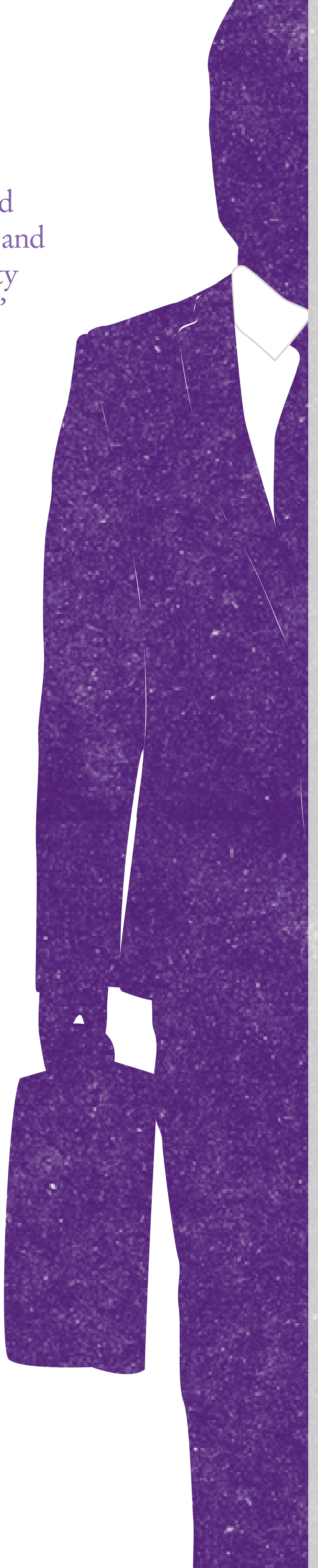
Gillian Saunders
Global leader hospitality and tourism
Grant Thornton

5 MARKETING

- Hoteliers need to build a story and have a compelling strategy to draw in customers
- There must be a plan to grow the business that is convincing for investors
- According to hoteliers the importance of a good social media strategy, as a way to build direct engagement with clients, will grow for lenders given that OTA sites are capturing a significant slice of the market and impacting revenues

"Hotel operators need to treat OTAs as key customers rather than suppliers and develop deeper client relationships whilst doing more to direct bookings via their own channels. To mitigate the competitive threat, a slick sales and marketing team is needed to maximise direct bookings. Hotels need to develop their own social media strategies to reach these audiences and foster loyalty with customers through greater engagement online."

Adrian Richards
Partner
Grant Thornton UK



Rising to the challenge

The appetite of lenders is returning but their approach to hotels is now much more sophisticated and demanding. This coupled with the improvement in the fundamentals in the industry indicates that lenders once again will commit to providing the sector with viable funding options into the future.

The emergence of cash backed investment and sovereign wealth funds allows hotel owner/operators to take advantage of viable acquisition and expansion prospects at competitive deal rates. The increased appetite of lenders and investors is also driving more creative lending structures and consideration should be given by owners/operators as to the most appropriate capital structure for the longer term viability of the trading operations.

This new outlook should be welcomed by the hotel industry. Banks are now keenly interested in how a hotelier's businesses will operate and whether it has a good chance of achieving growth and financial success. Lenders are better equipped to assess funding requests and make more rational and timely lending decisions.

Hotel businesses with a desire for growth must now meet this challenge with robust and comprehensive proposals. To succeed in this new age of lender and investor sophistication, hoteliers and hotel groups must move to another level too.

To find out more visit Grant Thornton at www.gti.org

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