Will the bounce be high enough?

The hotel sector post-lockdown

PKF

Whether you are still facing the challenges of closure and preparation for re-opening, deciding how to change your marketing strategy or dealing with possible insolvency – these are very challenging times for the hospitality sector.

It's over a year since Covid 19 hit Europe and during this period the UK hotel industry has experienced its worst ever recorded 12 months. The sector is reeling and hospitality and leisure businesses are counting the cost of the pandemic and wondering what the next twelve months will bring.

The roadmap out of lockdown has been published and the government have confirmed continuing short-term financial support. The UK's vaccination programme is the best in Europe and fewer people are now contracting, being hospitalised or losing their lives to the virus. This bodes well for a gradual reopening of businesses and, with it, the potential resurrection of the hospitality industry, which in 2019 accounted for about 9% of GDP and 11% of all jobs in the UK.

With all but a few hotels still closed, and reopening decisions taken out of the control of owners and operators, what can we expect for the lodging industry in the next few years?

Action during lockdown

Hotel owners and operators have done their best to reduce costs to a bare minimum without allowing their properties to fall into disrepair. They have tried to keep core teams available to reopen their hotels when permitted. Not knowing when this might happen, and whether they might be forced to close again with little notice, has made longer term decision-making very difficult.

Uncertainty is creating an agonising set of circumstances for owners, operators, investors and their supply chains. The Government has provided funds for furloughing staff, VAT reductions, business rate holidays, and low interest credit facilities to ease the financial burden on beleaguered hospitality businesses. Lenders and landlords have also generally been cooperative in the face of this calamity.

Who will your customers be?

Having permission to re-open will represent a positive step towards recovery. Most operators have had time and practice to develop hygiene protocols to allow them to operate safely and provide good, albeit limited, services to their guests.

In the US, where hotels have been mostly allowed to open through the crisis, occupancy levels have been higher than those in other parts of the world with more severe lockdowns. US operators generated some cash from the demand for needing a place to stay. Similarly, we can assume that in the UK base demand will return once people are able to travel and believe it is safe to do so. Hotels will likely be needed when visiting relatives, attending weddings and funerals, making necessary business trips, if affected by displacement from home, for key workers, and as temporary relocations and for quarantine/self-isolation).

In summer 2020 we saw how desperate our city-based populations were to escape lockdown to country and coastal hotels, campsites, and holiday lets. This brought in some reasonable revenues outside the main city centres. With international travel bans and slower vaccination rollout in the key destinations abroad, the UK's regional holiday locations will likely benefit again in 2021 and into 2022.

If the vaccine proves successful and the rollout is improved in other countries, UK hotels may even benefit from some inbound tourism – once vaccine passports, testing regimes and quarantine regulations make it possible.

Impact on business travel

It will likely be a different story for city centre hotels. These traditionally benefit from large numbers of international visitors, big cultural and sporting events and plenty of midweek business travel. Corporations in Britain and overseas will be keen to get back to business. But senior management will have noted the significantly lower travel costs during the pandemic – in some cases enough to improve the bottom line. Finance directors will want to protect these savings and we expect to see a slower uptick in corporate travel in the next few years, as businesses maintain some meetings online.

Large gatherings and events will also be less popular in the near term, until the public gains confidence in the vaccines.

Forecasting and investment

This doesn't sound optimistic for an industry that has already gone through so much. Valuers and forecasters don't have solid ground to stand on, with few relevant benchmarks to show a route to recovery. Most experts suggest the market will return to 2019 levels somewhere between 2023 and 2025. Of course nobody knows. But it's good to remain positive and prepare for a range of scenarios for the near and longer term.

Despite everything, the appetite for investment in the industry remains strong. Many international and UK investors are well capitalised and looking at the crisis as an opportunity to buy at a discount. There's little evidence of deep pricing corrections at the moment. But, compared to values at the peak in 2019, owners forced to sell will see a decline in asset values – in particular for older, unrenovated properties in less favorable locations.

Prepare to adapt

Owners and operators who can keep hold of their businesses are looking carefully at their strategy and business model to adapt to the changed environment in 2021 and beyond. Flexibility will be key. Relying on historic sources of demand to return may well result in a slow and painful demise. Ignoring renovations and capital expenditure needs will create other problems when the recovery comes. Nimbler, better capitalised hotel businesses will increase their market share at the expense of others.

So ask yourself, how will your property compete with newer lifestyle ones: aparthotels, or hotels which renovated when demand was low? How have the profiles and needs of your guests changed and how should you structure your sales and marketing for this new environment? What business is out there and how can you reach it most effectively? Is your hotel's positioning and branding appropriate? Are you working with your supply chain to build in flexibility and reduce operating costs? Can your stakeholders, supply chain and partners help in the recovery? Is your product relevant, is your team motivated and have you optimised your systems?

What to do if you cannot continue

Not all owners and operators will be able to retain their properties. Let's suppose for a moment that you have taken advantage of the Government's financial support schemes, but the reality is that the business is insolvent (your liabilities exceed your assets). You may have potential investors, but they are reluctant to use their cash to plug the black hole in your finances.

Before we explore your options, a word on good governance. As soon as directors realise (or ought to realise) the company they run is, or is likely to be, in financial difficulty, their fiduciary obligations shift from shareholders to creditors. All their actions thereafter are judged on how they manage their responsibilities to creditors and whether the position of creditors improves or worsens. This may have personal implications too if they appear to have acted without sufficient regard for creditors' interests.

Good governance looks like this:

- Board on top of the business
- Good financial information
- Regular board meetings
- Written analysis underpinning strategy and decision making
- Outline of alternative options and 'what ifs'
- Professional advice

What are your insolvency options?

If you have determined your business is insolvent, that in itself is not a reason to run up the white flag. But the board should attempt to answer the following questions:

- Can the company reasonably expect to trade out of its difficulties?
- Will the business quickly return to profitability?
- What cash requirements does the business have over the next 12 months?
- How can it fund those cash requirements?
- Are there any cost savings that can be made in the meantime?

Let's assume the business has a deficiency to creditors of, say, £500,000, which it expects to be able to repay from profits within 12 months – with a peak funding requirement in month three of £100,000. In this case, funding should be readily available and creditors ought to be supportive.

But what if the situation is not so straightforward? The business is likely to be profitable at some stage but that may be many months away. The funding requirement might be too great or the deficiency to creditors too high.

That means a formal insolvency process to save the company or its business. These are your options.

Administration

Administration comes with a hierarchy of three statutory objectives:

- Rescuing the company as a going concern
- Achieving a better result for creditors than a liquidation
- Payment of secured or preferential creditors

The first objective assumes either an imminent investment or, more likely, a Company Voluntary Arrangement (see below), although it's fair to say that Administration facilitates the survival of the business rather than the company.

To simplify:

- Administrators are appointed
- They trade the company while attempting to sell its business and assets for the best possible price
- A separate entity acquires the business and assets (but not the liabilities)
- The administrators distribute the sale proceeds to creditors per the prescribed order of priority

Administration is an appropriate process where there is a business to sell which is either profitable or likely to become so. On the other hand, liquidation is a terminal process for a business which has no prospect of becoming profit making.

Pre-packaged administration

This is a misunderstood and much-maligned process. Trading on as an administrator does come with risks, notably the very real threat that the company trades at a loss while a purchaser is sought and the administrators are unable to sell the business.

A pre-packaged administration removes that risk, as the sale of the business is agreed before the appointment of administrators and completed immediately upon their appointment.

Certain businesses need to be sold this way. Contrast a bakery in administration with a retailer of bespoke furniture. In the former, customers can see that the company is in administration but, as they can leave the store with their purchase, it means nothing to them

But the furniture retailer will ask the customer for a substantial deposit before placing the order. The customer will see the notice advising that the company is in administration – and keep their money in their pocket. That sort of business has to be 'pre-packed'.

So where do insolvent hotels sit? We would argue there's no need for a hotel to be pre-packed and we have traded many, often for many months, so can substantiate that view. A hotel can be pre-packed but we would suggest the purchaser should pay a demonstrable premium in return for the market not being tested. In other words, they would need to pay top dollar.

Pre-packs are controversial, both because they are sometimes used unnecessarily and because creditors struggle to see how a business sold within 15 minutes of the administrators' appointment can possibly achieve the best price.

Successive governments have attempted to legislate to rectify the misuse of the process. The Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021 in our view have only made the process more bureaucratic, rather than addressing the issue.

To simplify:

- Business and assets are advertised for sale by way of administration
- The proposed administrators aim to find competing purchasers to drive up the price
- Administrators are only appointed once a sale is agreed, funds deposited and contracts signed
- Immediately upon appointment, they complete the sale

Company voluntary arrangement (CVA)

This is essentially a contract between a company and its creditors within a statutory framework. It removes debt from the company's balance sheet, in return for a better return than creditors could expect in an alternative insolvency process (administration or liquidation). Typically this could involve a one-off investment, monthly contributions for up to five years, or a combination of the two – to pay creditors in part or in full.

The pros of the process are:

- The board maintains control of the company
- The business retains its trading record
- Keeps existing bank account, VAT registration number, company number, PAYE reference
- No need to advise anyone other than existing creditors (you don't have to tell customers)
- No need to find funds to buy back assets (as in alternative insolvency processes)
- Tax losses are retained to shelter future profits

And the cons:

- A dominant unconnected creditor owed over 25% of the total liabilities (such as HM Revenue & Customs) can effectively dictate terms
- The arrangement may remain for up to five years (alternatives conclude much more quickly)
- Secured creditors' rights are unaffected
- Creditors often insist on restrictions for the lifetime of the arrangement (such as no dividends or greater than inflationary pay increases for management – which may affect recruitment or retention of key staff).

Cross-class cramdown

This new process, a restructuring plan based on the existing scheme of arrangement, was introduced in 2020. It initially appeared expensive (requiring two court hearings) and over-complicated, so was not expected to be widely used. But the re-introduction of 'crown preference' in December 2020 is likely to lead to increased use of this process.

Unlike a CVA, both secured and unsecured creditors are bound.

The votes of senior creditors can be forced onto dissenting junior classes as long as they won't be worse off than in any other insolvency process – though they may still receive nothing. That means HMRC might be in a senior class of one (as the only preferential creditor). If it approves the plan, its assent can be 'crammed-down' on to the unsecured creditors who will be forced to accept it.

It's still early days, so this might turn out to be a Goldilocks process, ie one which will only be used if everything is just right. However, there's no doubt that HMRC's new preferential status will make this a process worth considering – in the right circumstances and where the cost can be justified.

Conclusion

Once hotels re-open, owners are going to be faced with a dilemma; do they work for the next 5-10 years (on average) to repay the government backed loans which kept them afloat during the biggest crisis of our lifetimes or do they sell their businesses and assets to newcos thereby ridding themselves of the burden of the black hole in their balance sheet? For many the decision will be taken out of their hands; investors like to invest in the future not in making good the past. If investment is required, it will inevitably require an insolvency process and a clean vehicle to drive it. Other factors then come into play and to avoid the laws of unintended consequences, hotel owners will need professional advice from appropriately qualified professionals to make sure they avoid criticism or worse.

At PKF, the Hotel team comprises the whole spectrum of professional advice that hotel owners, operators or lenders can ever require, from help with acquisitions or disposals to strategic restructuring and everything in between. PKF have been doing this for approaching one hundred years and we will be delighted to provide you with the benefit of our experience.

About PKF
Simplifying complexity for our hotel clients

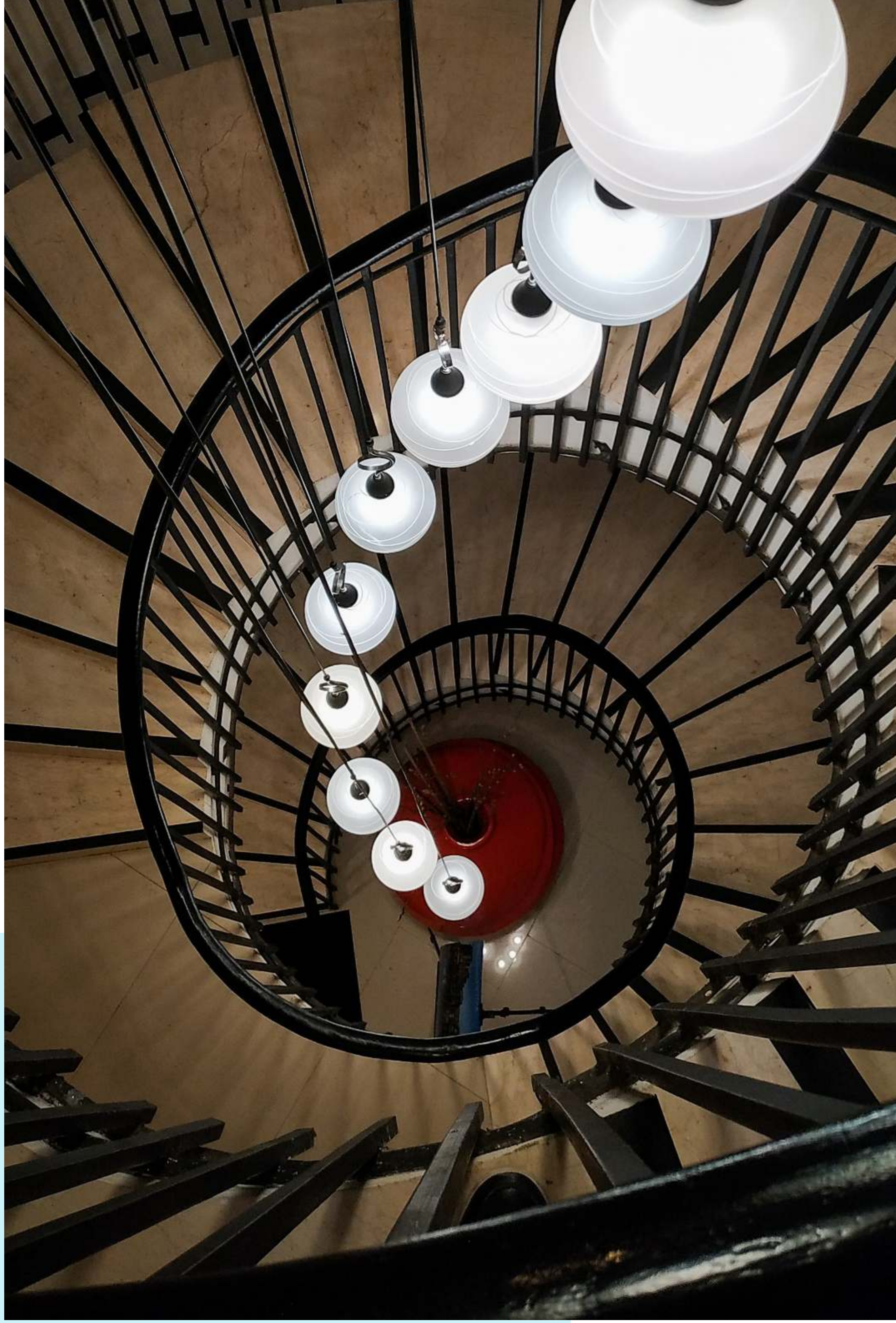
In challenging times you need to know you are in a safe hands and are working with people who not only have indepth knowledge of the hotel industry but also the expertise to work with you to find the right solution.

If you find yourself facing financial difficulties, or even the prospect of business failure, we can help. Whether it is offering an impartial and in-depth business assessment or practical proposals on recovery strategies, PKF is expertly qualified to be there for you if times get tough whether you are a hotel owner, lender or other creditor.

The PKF team is experienced in providing transformational and innovative restructuring solutions designed to help businesses grow, realise and protect value throughout their life cycle.

Our hotel restructuring team consists of a mix of both real estate professionals, experienced hotel general managers and strategic consultants, complemented by restructuring professionals and licensed insolvency practitioners.

PKF hotelexperts group offers a full portfolio of services for lenders, operators, and owners of hospitality assets – from operational reviews to increase efficiencies, to valuations and support in finding new operators and investors.



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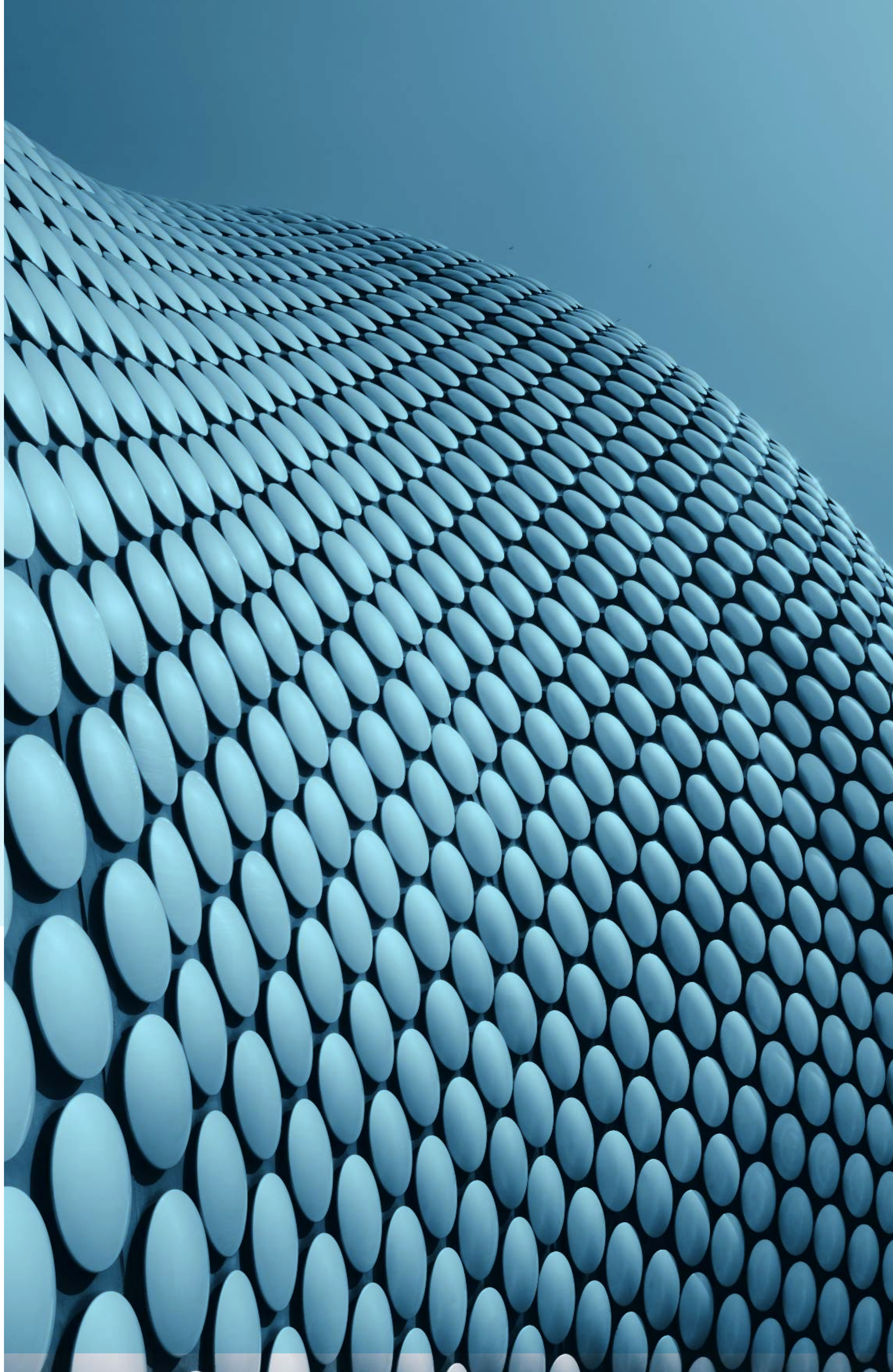

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