Hospitality and Leisure
Hospitality Directions Europe
Market briefing

No chance of a fire sale:

Debt restructuring prospects for UK hotels

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PricewaterhouseCoopers

No chance of a fire sale

Hotels slip to the bottom of a league table of attractive property investments

In PricewaterhouseCoopers (PwC) and the Urban Land Institute's recent survey "Emerging Trends in Real Estate Europe 2010" respondents were asked to rank the attractiveness of the key property sectors. Hotels dropped from second place last year to twelfth place in 2010, to sit firmly at the bottom of the table. In the survey existing hotel performance expectations are generally rated "modestly poor", while new hotel acquisitions are perceived to have slightly better prospects and are considered "fair."

Such downbeat views are confirmed by the fact that, according to leading hotel sector real estate players, hotel transaction volumes in 2009 sunk to their lowest annual level since the 1990s, as investors retreated and debt markets remained illiquid.

Foreclosure activity likely to increase in 2010

Despite the UK hotel market suffering significant financial stress, foreclosure activity so far has been at a much lower level than originally anticipated at the start of the recession. Banks and lenders have generally adopted a workout approach, which has focussed on extending loans and trying to recapitalise debt. Lenders are encouraging the borrower to put in more equity or to support the cash flow, rather than take foreclosure action. As a result, the number of distressed assets on the market in 2009 and in Q1 2010 to date has been extremely small.

However the number of distressed assets coming to the market is expected to increase in 2010, as lenders increasingly focus on clearing their balance sheets. This will probably lead to in some selective asset disposals. Although we anticipate a moderate level of increase in transactions as a result, we don't envisage a flood of distressed assets coming to market causing hotel property values to decline due to an oversupply, as we saw in the aftermath of the 1990's recession.

Hotel values reduced but stabilising?

Indeed, whilst UK hotel values as a whole have fallen by as much as 45% from the 2007 peak, London hotel values in particular, although reduced, have held up remarkably well, partly driven by the lack of available properties. An upturn in trading in Q4 of 2009 and the forecast improvement in trading for 2010, coupled with a continued shortage of available properties, should further enhance London hotel values over the coming twelve months.

In the UK Provinces values may now appear to have stabilised, but are unlikely to follow the potential growth trends in London, due to continued pressure on trading performance coupled with a current imbalance between supply and demand in some locations.

Recent and expected trends in key credit markets

Since we published our last UK Hotels Forecast in September 2009, there have been the first encouraging signs of confidence returning to bank lending.

The mild softening in pricing and longer tenors[1] in corporate lending, as well as the re-entry of banks into the hotel market (on a selective basis), all presages a more active banking market in 2010. There is also initial evidence that banks are considering taking underwriting positions, a key milestone in a return to more normal lending conditions.

The hotel property market has been one of the sectors most impacted by the credit crunch. Where borrowers continue to service debt, we have generally seen lenders taking a supportive stance of over-leveraged companies. However, if there is a payment default and/or a new money requirement, they can take a much more robust stance, in some cases taking a controlling equity stake.

Lenders' reactions to covenant breaches

Banks are drawing a clear distinction between those loans that are in breach because interest or principal are not being paid and those where just loan-to-value (LTV) breaches have occurred.

As a general rule, providing interest payments are met and borrowers are cooperative, most lenders are supportive, tend to ignore or postpone property valuations and are also likely to amend the terms of the debt, e.g. through providing an increased LTV. However, this support comes at a price. Lenders typically command an increase in margins and fees and, where possible, accelerated repayments (e.g. through disposals or new equity) with a view to reducing their exposure ahead of maturity.

By contrast, problems in meeting interest cover tests are likely to result in lenders taking a more robust stance in the negotiations with the existing shareholders. Currently, this form of breach is affecting development loans in particular where there is limited income and often a new money requirement to complete projects. In these cases, lenders have often required shareholders to contribute additional equity to support the business.

1: The period of time over which lending may be paid

Lenders have typically tried to avoid debt-for-equity swaps or selling assets so as not to crystallise losses

We have seen banks contribute more money to situations where this could improve their position in the medium term (e.g. to finish a development). Critical in the decision making process is also the size of any new money requirement. If this is significant, the banks are likely to require a substantial equity stake in the business (perhaps even taking full ownership) or another method of profit sharing so that they can take full advantage of the increase in value following the turnaround implementation and the market recovery. This may give rise to a variety of complex tax and structuring issues.

Where possible lenders prefer to continue to work with existing management teams, providing that they think the management is capable of delivering an agreed recovery strategy. Those borrowers with a limited track record who simply used hotel property as a tool for financial engineering are most likely to see banks step in.

We have seen a number of instances where lenders avoid taking over businesses or implementing debt-for-equity swaps as they are nervous about the associated bad publicity. Banks do not want to be seen as unsupportive to existing clients during the current difficult market conditions.

Refinancing issues

Refinancing with new banks is proving very difficult in high LTV scenarios, and in many cases extending maturity of the existing loans is proving to be the only option for both borrowers and banks. Given the contraction in available new lending, the refinancing process needs to start as early as 18 months in advance.

The commercial mortgage-backed securities (CMBS) market faces particular issues. More than £8bn of real estate securitised bonds are due to be refinanced by the end of 2010, with the same figure again due to be refinanced in both 2011 and 2012.

In the US, one response to this seems to be an agreement to extend the period of the loans to a point in time when the CMBS market would have potentially recovered. This solution however might not suit all groups of bondholders, leading to potential legal conflicts.

New Lending

There appeared to be some signs of renewed appetite for hotel lending in the second half of 2009. As a general rule, banks remain cautious and conservative and are often reluctant to advance loans to new customers. Consequently, any “new money” lend will be strictly examined and will take considerable time to be credit committee approved and completed.

The number of active banks has increased again, with most of the main commercial banks carefully returning to the market, together with some specialist European property lenders (mainly German).

In terms of advancing funding, banks will typically look for prime location branded hotel properties that have stable cashflow generation.

Typical margins for “new money” or restructured loans are in the range of 200 basis points (“bps”) and sometimes over 300bps, even for the most creditworthy of companies. As well as significantly increased margins, arrangement fees of up to 5% of the loan’s value are also quite common in the current market. The maximum likely maturity of newly granted loans secured on property is five years with LTVs of around 65% for senior debt. A small group of lenders can stretch this to 75% for the most prime of assets, by using a Mezzanine tranche.

Debt market outlook for 2010

Except for the potential impact of another substantive credit event, we believe there will be a continuation of the gradual improvement in bank confidence, driven by:

- an overall improvement in the UK and European macro-economic environment,
- banks’ balance sheets recovering from credit shocks
- a gradual increase in the number of banks (and possibly funds) providing enhanced liquidity,
- an initial number of underwritten deals being successfully sold-down into the wider bank market.

Whilst we expect pricing to be positively impacted by the gradual return of liquidity, there has been a structural change in the way credit charges are assessed and we do not foresee a rapid return to pre-credit crunch pricing.

What does all this mean?

For new prospective borrowers

Although there seem to be some signs of a renewed appetite for hotel lending and indeed pressure on lenders from Government to increase lending, banks remain cautious and highly selective, and lending criteria are focused toward more sustainable cash flow cover than LTV ratios. These more stringent terms are unlikely to be relaxed in the short or medium term.

For existing borrowers

On the surface the forecast embryonic recovery in demand (see PwC's latest Hospitality Directions Europe, '*UK hotels forecast 2010 and 2011: On the comeback trail', March 2010*) might seem to signal a return to business as normal for UK hotels, but this is still a long way off for many owner operators and hotel property investors.

As trading fundamentals have suffered and property values fallen, the majority of mid-tier UK hotel groups now find themselves in, or close to, negative equity and will need to restructure their debt. For many this restructuring will effectively involve negotiating debt for equity swaps with their lenders, who as effective economic owners of the business, will expect to benefit from the upside, as values improve. Following the 1990s recession values took between five to seven years to pre-recession levels. However, it appears likely that lenders will be keen to unravel their interests over a shorter time-frame, possibly via the consolidation of hotel assets in the short-term, prior to crystallising their interests at a future date.

Conclusion

A widespread fire sale of distressed assets seems unlikely. The short term release of assets into the market by lenders to reduce debt levels, is likely to be undertaken in a slow and controlled manner. At some time over the next three to five years though, lenders will expect to exit equity positions and the cycle of hotel property ownership will resume all over again.

Sources:

1. PwC Debt Advisory "Debt Market Update" January 2010.
2. "Emerging Trends in Real Estate Europe 2010" published by PwC and the Urban Land Institute February 2010

Contacts

To discuss any of the issues in this article, please contact:

Stephen Broome

Hotels Advisory Specialist

+44 (0) 20 7212 8510
stephen.broome@uk.pwc.com

David Chubb

Partner, Business Recovery Services

+44 (0) 20 7804 8139
david.chubb@uk.pwc.com

Simon Boadle

Partner, Corporate Finance Debt Advisory

+44 (0) 20 7212 4118
simon.boadle@uk.pwc.com

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