INDUSTRY REPORT

Restructuring Hotels - Distress and De-Stress

NOVEMBER 2020

As the country celebrated Diwali, the hotel industry smiles and hurts simultaneously. The smile is what we inevitably offer our guests; the hurt is real – and visible, no matter how hard we try to mask it behind the mask.

Leisure destinations are doing very well; city hotels, much less so – remember that about 80% supply is in cities and towns. October and November have been better than the entire summer, but nowhere close to being busy enough. The wedding season has finally arrived (later than usual this year), with a mood to celebrate – that augers well, even if guest numbers are restricted to 50-200.

The relief package of 12 November again by-passed the hospitality industry; but should we at all have been expectant? The problem is the deeper underlying message conveyed – to lenders, investors, funds, local authorities, the stock market even – that hospitality is considered of little relevance in the larger scheme of India's economic activity.

Why Hotels

So let's look at a few key aspects:

a. Does India need hotels?
b. Can India achieve its economic and political goals and status, without hotels of global quality and standards?
c. Will it suffice to have only 3 and 4 star hotels? Will these meet the needs and expectations of global political and business leaders?
d. Do the people of India aspire to stay in high quality hotels (gosh – even 5 star hotels)?
e. Where will I stay on my next business trip in India?
f. More roads and airports will bring more visitors. Where will they stay?
g. Where can businesses, nay even the country, host quality meetings and conventions? What about security?

Ponder over these questions truthfully, and you will hopefully realise the importance of hotels to a nation's economy.

Hotels are an essential part of the country's infrastructure – this is yet not recognised

Hotels are a great place to stay, eat, relax, entertain, meet and wed. They are a great place to do serious work from, to host high profile persons. And oh – by the way – they are job creators, foreign exchange earners, and significant GST contributors. An 'industry' too, as recognised by Maharashtra.

Hotels are a Business

Amidst all this 'happiness and fun', we almost forget that hotels are also a business; the quality and service you enjoy requires material development and operating cost, and needs income flows.

Hotels need support too - because they have two characteristics of opposite tenor.

Hotels are capital intensive long term assets; and yet they are highly perishable

Hotels are perishable because every night a room remains unsold (including during a lockdown) is a room-night lost forever.

The hotel industry has been battered by Covid-19 pandemic. Prolonged shutdowns, capacity and travel restrictions, controlled rates, and lack of visibility for business travel resumption have created huge challenges for a sector that is capital intensive and also service intensive. Positives from the leisure sector, and from demand for weddings and social events are a breather; however, the future will remain deeply pressured till normal business travel (including inbound travel) resumes. And the severe impact of the past six months remains a gaping wound.

Hotel owners and operators have reacted as effectively as they can from an operations standpoint – the temptation to say that they reacted 'in the best way they can' is held back, as it doesn't seem right amidst massive job losses and salary cuts.

Several hotels are now seeing an operating profit – breaking even at the level of much reduced operating costs. However, EBITDA is marginally in the black, or likely in red ink, so that the burden on debt service continues unabated. Regulatory restrictions have stymied the calling of defaults, but defaults are inevitable as the operating scenario remains stressed over the next several months.

So what is critical for the next six months?

Distress or De-stress

Distress and de-stress are two scenarios stemming from the same root. One is a condition, the other a potential salvation. The under-lying condition is a difference of degree – several degrees, in fact; but it is a real difference and not just smart semantics. The difference is also in the potential for correction, and the nature, timing and speed of correction.

Timely de-stress can help avoid or overcome distress. The root cause provides the true solution

Does the industry have sufficient avenues to distinguish these positions? Will lenders, investors and funds have the willingness and sagacity to recognise and facilitate the possibilities? How will they position themselves? Will RBI recognise the value and potential of the industry?

For the banking sector, frankly it's a question of also helping itself from a plethora of NPAs. NPA resolutions will be time consuming with a potentially over-loaded NCLT and a limited set of buyers; the asset will likely deteriorate in this period. For investors and funds it's a question of spotting opportunity and value, striking deals to recover assets which are then ready when the tide turns in a few months; or simply waiting for distress to deepen before striking a bigger bargain. One is not making a value judgement, because each organisation has strategies and compulsions – but it will be interesting to see how money behaves.

If the root cause of distress is the general economic environment, and its run-on effect on basically reasonable project debt, there is longer term value that needs protection. Such cases can be addressed through distress mitigation or de-stress approaches.

If, however, the root cause is a fundamental lack of commercial or financial viability – wrong location, wrong positioning, poor management, wrong brand, business shift, too much cost, too much leverage - the action steps then are harsh; or even terminal. If a portfolio is draining cash and value due to such an asset, that asset needs to be removed, even at a loss, to de-stress the portfolio.

One assumes that the diagnosis has been done over the last 6 months – comprehensively, without emotion or motivated advice. Motivated advice hampers clear assessment of branding and operating arrangements – independent, franchised or management contract. Emotion hampers true assessment of the positioning, quality and capability of the hotel. Clarity of approach will beget the best answers and long-term results.

Operational correctives are a must, to indeed be effected swiftly and in full measure. Financial or structural distress is harder to tackle as it concerns ownership, control and ego – the ability to provide working capital or to service debt, and the consequences of failure. These are real issues and simply cannot be wished away; the longer these are allowed to fester, the deeper the disease.

Restructuring debt with lenders is an ideal option. However, this is mired in regulation and may provide succour in far fewer cases than necessary. If debt restructure is possible, with practical long-term repayment schedules and realistic interest rates, the industry would be deeply benefitted and fewer assets will be lost. Undoubtedly, this pre-supposes that the asset is commercially viable, has intrinsic value and the restructured debt reflects the asset's debt carrying capacity – in this context, the Kamath Committee parameters need a re-look. Debt restructure will likely require the asset owner to provide partial support funding.

Debt restructure could also require branding and management changes (independent hotels becoming chain affiliated, stray change of brand or operator, waterfall mechanisms at least for a limited duration etc.); one hopes these can be effected in a practical way, without having to wait for NCLT action to negate existing contracts.

Distinguish between distress and de-stress; between a distressed asset and a distressed owner

Another option for financial restructuring is asset sale, or partial equity sale in an asset or a portfolio. In such cases, the distinctions between distress and de-stress, between a distressed asset and a distressed owner become very relevant.

A distressed asset may have materially diminished its value proposition – due to competition, age, lack of reinvestment, lost appeal, business shift to a different part of the city. A buyer is justified in seeking deep discounts, provided there is even a modest business case.

A distressed owner on the other hand is heavily over-leveraged, over committed. No matter how good the asset, the owner's financial commitments are impossible to meet. The owner lacks the resource, or intent, to enable an effective restructure. Such an owner often acts late, and yet seeks a fuller value for the asset. Buyers see the distress and opportunistically push down prices; recognise that beyond a point, it is better for the owner to submit to NCLT than do a pre-NPA deal.

In each situation, as in life, value and valuation is a key challenge. Buyers expect deep discounts; sellers want fuller valuations. Each has a perspective - neither is completely wrong; nor is anybody absolutely right. Hence the need to distinguish between distress and de-stress, with the nature of the underlying asset being a key determinant.

A buyer seeking to squeeze the pricing as best as possible, is a given; however, one sees buyers walking away simply because discount expectations are set too high. They fail to see that the inherent worth is more than the heavily discounted deal they are seeking because that is the path they have set for themselves.

The valuation gap is exacerbated when the basic prompt for a transaction is de-stress and not a distress. A discount is undoubtedly expected, and even given – and yet there is a fine balance of value which must be achieved. A recognition of much stronger long-term potential even if the price is not deep discounted; because the seller is not under distress and is unwilling to do a deep discount. And therein lies the art of picking a good deal – not the most discounted deal, but a good deal. A deal that reflects a value gain, is closed on time and which enthuses the seller to make a bargain because it enables an effective de-stress.

Is there such a buyer? Is such a deal at all possible? It certainly is. It needs a buyer with the business acumen to smell the deal, rather than calculate it on excel sheets. The percentage upside may be smaller, but the underlying asset quality lowers the risk, provides a healthy upside in absolute numbers, possibly carries even stronger upside potential, and likely a more certain exit potential than a distressed asset.

A vibrant hotel sector carries immense economic value

Industry participants know the value of what we have, and provide. Greater recognition of its economic contributions will enhance the lending and investment energy for hospitality.

Horwath HTL

Horwath HTL is the global hospitality consulting brand of Crowe Global an international network of independent accounting and consulting firms with 765 offices in over 146 countries – ranked 8th globally.

Horwath HTL has independent member firms in 39 countries, with 49 offices, across Asia Pacific, North and South America, Europe, CIS countries and Africa. In 2015, Horwath HTL celebrated 100 years of professional involvement in the hospitality industry.

The consulting experience of Horwath HTL India covers over 110 Indian cities, towns and destinations and 20 international destinations. Assignments have been undertaken for hotel chains, promoters, development companies, private equity investors and international lenders.

Horwath HTL Offices

AFRICA
Ivory Coast
Rwanda
South Africa

ASIA PACIFIC
Australia
China
Hong Kong
India
Indonesia
Japan
Malaysia
New Zealand
Singapore
Thailand

EUROPE
Andorra
Croatia
Cyprus
France
Germany
Greece
Hungary
Ireland
Italy
Netherlands
Poland
Portugal
Serbia
Spain
Switzerland
Turkey
United Kingdom

LATIN AMERICA
Argentina
Brazil
Chile
D. Republic
Mexico

MIDDLE EAST
UAE &Oman

NORTH AMERICA
Atlanta
Denver
Los Angeles
Miami
Montreal
New York
Norfolk
Orlando
Toronto