

Future turmoil in the hotels sector:

How to weather the storm

Contents

- 2 Introduction
- 3 Hotel Owners
- 4 Hotel Operators
- 6 Disputes
- 6 Contacts



Introduction

The travel industry is no stranger to turmoil. Having emerged phoenix-like from the ashes of the COVID-19 pandemic, last year started with a pent-up demand for global travel, and room rates generally soared to record levels. However, with rising inflation, squeezes in consumer spending and acute labour shortages plaguing the industry, what can asset owners and operators do to weather this next recessionary storm?

Key factors to consider will be profitability, cost structures, the affluency of targeted hotel guests and the size of any debt or loans.

Hotel Owners

Debt

Asset owners will no doubt be keen to ensure any debt and/or loans remain manageable in the wake of rising interest rates. Owners who are struggling to service their debt would be advised to approach their lenders to renegotiate sooner rather than later, as interest rates are predicted to continue to rise in the short to medium term. Conversely, owners who are locked into favourable interest rates may well find themselves at an advantage, shielded from costly fluctuations on the cost of borrowing whilst taking advantage of higher interest returns on other investments, which may actually increase their overall liquidity.

Construction/renovation

As global supply chains continue to face pressure, the costs of opening new hotels and renovating old ones has skyrocketed for owners. The cost of construction and raw materials has increased exponentially. There are reports of pressures beginning to ease in global supply chains, but increased industrial action, China's only recent emergence from its zero-COVID policy, Russia's war in Ukraine and military exercises in the Taiwan Strait point to continued congestion and disruption in the months and possibly years ahead.

Asset owners may sensibly cut back on conducting significant refurbishment projects in the near future, focusing instead on essential repairs. However, inflation may be further compounded by the postponement of large-scale construction projects. Delaying refurbishment may not be an option for all owners. Franchisors and operators will want to ensure their brands are being represented in the best possible condition, and many hotels may simply not be able to sustain the post-pandemic revPAR they have thus far enjoyed without refurbishment.

If refurbishment cannot be delayed, owners will have to consider their hotels' ability to increase room rates whilst looking for cost efficiencies elsewhere. Being in a position to attract affluent and business travellers, who may be less affected by the cost-of-living crisis, will be a key consideration.

Portfolio differentiation

Some hotel owners may seek to take advantage of the market instability to strengthen or differentiate their asset portfolio, to introduce more flexibility or to free up capital.

Others might choose to sell burdensome assets, focusing instead on lower cost, asset-light portfolios or "safer" assets. Selling can increase liquidity (to service debt, pay off loans or invest elsewhere). We may see an increase in sale and leaseback deals, an option which keeps the operation and brand at the hotel intact, such as Único's 20-year sale and leaseback of the Grand Hotel Central in Barcelona to Schrodgers (which contains an option to buy the hotel back).

Certain owner operators may look to outsource their hotel management to reduce their costs. Large scale operators often benefit from long term backing from their investors that will enable them to withstand volatility in a way that other market players cannot. We may also see an increase in leading hotel management companies purchasing rival brands to bolster their global revenue share.

Hotels may still be an attractive investment for certain investors during an inflationary time, as their profitability and demand can be measured on a daily basis instead of less frequently. Some owners may choose to go on the offensive, looking for opportunities to buy depressed assets from owners under strain, weakened by the covid pandemic, in the knowledge that the short-term costs will be temporary, and that tourism will eventually rebound, particularly in city centres and resort locations.

Operator performance

Owners are likely to be keeping a close eye on operator performance, as we emerge from the covid pandemic. It will be important for owners and operators to maintain open lines of communication to ensure that performance tests and thresholds put in place to monitor or improve performance are realistic and achievable. Owners will also want to understand operators' rights of cure when faced with consistently underperforming assets. Owners and operators are advised to seek advice early, instead of waiting until things deteriorate beyond repair, in the hope that the relationship can be salvaged with some minor changes or a time-limited improvement plan.

Hotel Operators

RevPAR and performance thresholds

With room rates soaring in Europe, the first summer season after COVID has seen high demand for travel. However, with a recession on the horizon and inflation hitting a 40-year high, top room rates are unlikely to be sustainable, and occupancy levels will continue to be hampered by ongoing labour shortages, both of which leave operators facing a perfect storm.

Operators may, understandably, have concerns about achieving the performance thresholds in their hotel management agreements, which were likely paused or renegotiated during the COVID pandemic and are now looming large. Again, early communication with owners will be key to navigating a sustainable path through these challenges. Performance indicators may need to be discussed and, ultimately, renegotiated to avoid any breaches in performance tests.

Changes in competitive set

The competitive set of any particular hotel is likely to have been affected in some way by the COVID pandemic, with hotels changing ownership or brand, M&A deals bringing hotels under shared ownership and/or hotels closing down for good. Operators would be advised to approach owners about revisiting the competitive set for any given hotel to ensure it is still reflective of comparable hotels in the area, so that performance thresholds measured by reference to that are set at a fair and meaningful level. Parties should consider all relevant factors when adjusting the competitive set, such as location, size, facilities, quality, seasonality and the mix of business (i.e. tourists, families, business and group travel) as well as the core identifiers such as occupancy, ADR and RevPAR.

Relying on a less than optimal competitive set will lead to other adjustments in performance targets being necessary so that the management agreement can remain in place and is, ultimately, in neither party's interest. Consulting early with relevant experts during the annual budgeting exercise in relation to the competitive set is recommended.



Focus on the consumer and market

Operators will be considering where to focus their marketing efforts. Attracting US tourists to Europe whilst the dollar is strong may be a worthwhile pursuit for European operators, particularly as consumers in the UK and Europe continue to feel the pinch of energy and goods price inflation. Although increasing airfares may be a barrier for consumers across the pond.

Luxury operators and hotels may not see a marked drop in demand as compared with more affordable brands. Those consumers with above average spending power are, of course, less likely to be affected by the cost-of-living crisis. Business travel may find itself adversely affected as businesses look to reduce costs as we enter recession, which will include reining in travel expenses. Redundancies may hurt leisure demand too.

Countries and hotels dependent on Chinese tourism may also continue to be affected through much of next year, as China's pause on international tourism is anticipated to last until at least mid-2023. Russia's war in Ukraine will continue to affect hotels in those regions. And hotels in countries with high debt loads may find themselves vulnerable as interest rates spike, e.g. in Italy, which is at risk of default.

Millennials and Generation Z represent huge markets with high potential spending power. Savvy operators will be considering ways of engaging with these consumers via social media platforms, using influencers as a way of boosting brand exposure at minimal cost.



Technology

Major players in the industry have already recognised and embraced the use of technology in the sector. Many are looking to create a broad and connected ecosystem across all brands and touchpoints for the benefit of their customers. Online purchasing, contactless technologies and food delivery services have grown exponentially during the covid pandemic and are here to stay, an expectation of the millennials and Generation Z consumers that are becoming a real focus point.

By the same token, online visibility and brand recognition through social media platforms is key for future marketing strategies. However, brands must find a way to distinguish themselves in order to develop deep customer loyalty which drives repeat custom and the all-important word of mouth recommendations.

Labour Shortages

Hospitality staff shortages, caused by an exodus of workers during the COVID pandemic, have hit a record high in the UK and are similarly being felt across Europe. This is hampering the industry's ability to trade at a level that meets demand. Understaffed resorts and gridlocked airports are also beginning to have a negative effect on consumer appetite for travel.

Operators will be devising recruitment strategies in order to attract and retain the best talent, including through offering better pay and conditions, more holidays, health insurance, career progression and meaningful training programmes including around mental health and wellbeing.

Thousands of UK workers, including a small number in the hospitality sector, are currently trialling a four day working week. It remains to be seen if the trial will result in greater productivity and increased staff welfare and retention as hoped. However, a focus on flexibility, and an acknowledgment that staff likely have other commitments which need to fit around their shift patterns, would appear to be a key message to relay in any recruitment drives.

Climate Change and ESG

Climate change is adversely affecting tourist destinations across Europe. With temperatures soaring above 40 degrees in many European cities this summer, tackling climate change has become ever more urgent.

Consumers are also becoming more and more aware of the environmental impact of their choices, and some consumers, particularly millennials and generation Z, will choose hotels which are seen to be making a positive environmental impact. Restoration of natural habitats, wildlife protection, energy and water conservation measures, the fight against single use plastic and the use of local and sustainable produce are all attractive concepts to these consumers.

Similarly, social drivers such as anti-racism initiatives, mental health awareness and diversity and inclusion measures are likely to become ever more important considerations for younger consumers.

Disputes

It is inevitable that, even in the most amicable of partnerships, owners and operators may clash in their approach to weathering the current storms. Operators may ask owners to refurbish or invest in the infrastructure of the hotel in order to attract the most affluent clientele who are less likely to be affected by the cost-of-living crisis. At the same time, owners will be looking for ways to reduce overhead costs in order to continue to service any debts or loans as interest rates rise and will be looking to their operators to maximise the profitability of the hotel. This conflict will inevitably lead to disagreements. Outside forces such as labour shortages and supply constraints may simply add fuel to the fire. Communication and, where appropriate, compromise will be key to navigating these challenges, as well as understanding and enforcing rights where necessary.

An inflationary environment is not all bad news for the hotel sector. Inflation can be a positive for hotel pricing power and ADR, provided the hotel can continue to attract consumers with spending power. Whether hoteliers push for growth or apply the brakes will largely depend on their target market. But even for those more affordable hotels, there is a wealth of market potential.

There has never been such demand for wellness and escapism from the stresses and strains of 21st century life. Market players who are no strangers to entrepreneurship will no doubt find their way through these challenges and will innovate in order to service the needs of tomorrow's consumers today.

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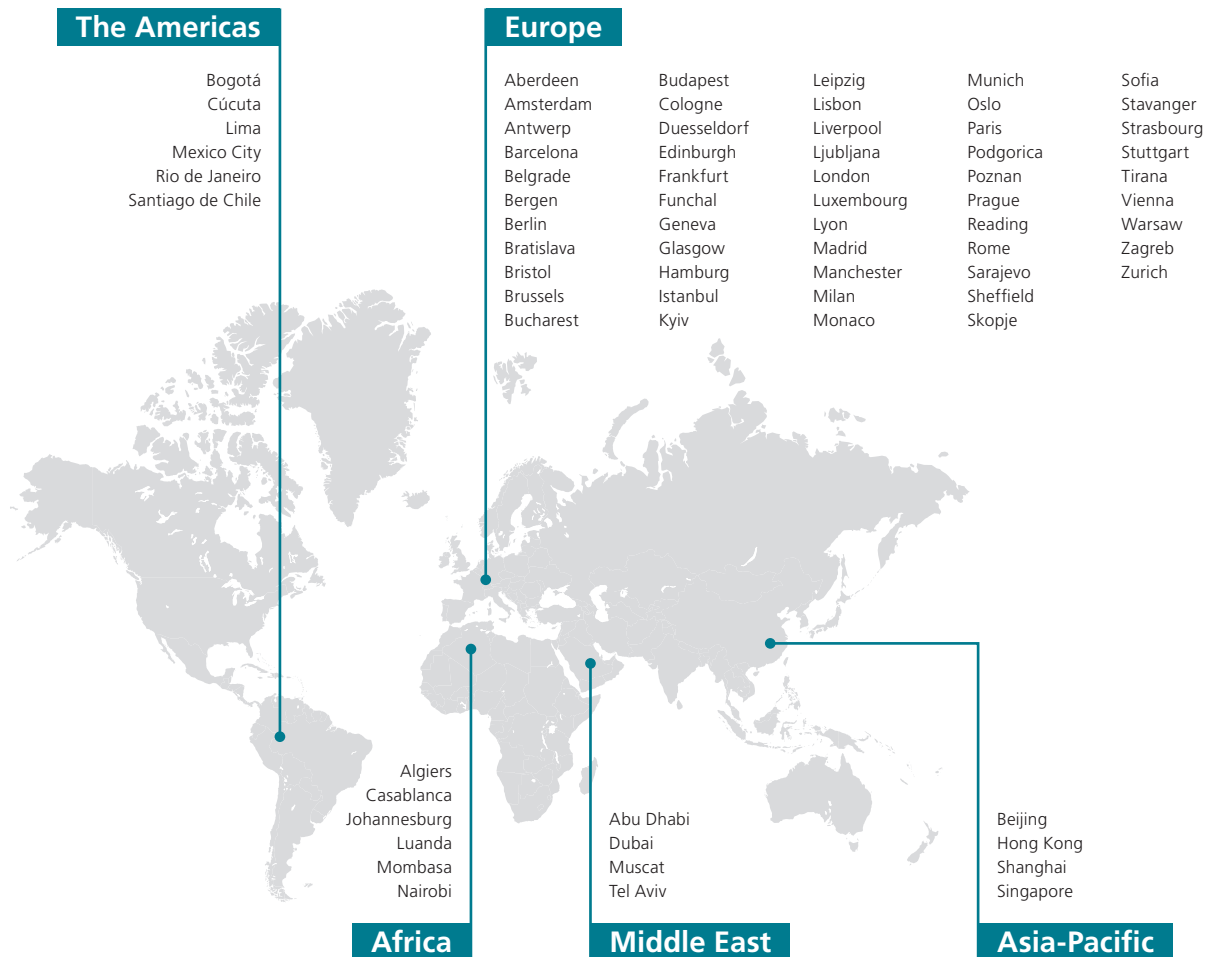
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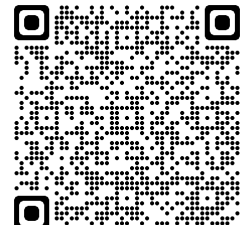
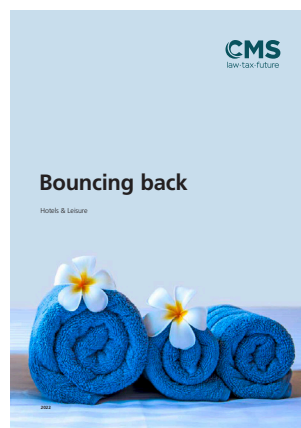
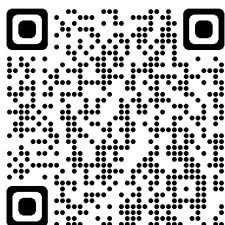
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