A&M INSIGHTS

What next for the U.K. hotel sector and its lenders?

Despite the various lockdowns and the difficulties with inbound international tourism materially impacting trading performance and cash generation, the U.K. hotel sector has seen relatively limited restructuring activity since the start of the pandemic. Furlough and other government support measures have helped to cushion the blow and lenders have generally been willing to support operators with covenant waivers, facility extensions and debt service forgiveness as long as sufficient liquidity is in place.

Whilst the outlook for the sector has gradually improved as the vaccination programme has rolled out and restrictions have eased, many support measures have already begun tapering off; furlough ended on 30 September 2021, the commercial rent moratorium is due to be lifted on 25 March 2022 and the 66% discount on business rates is due to end on 31 March 2022.

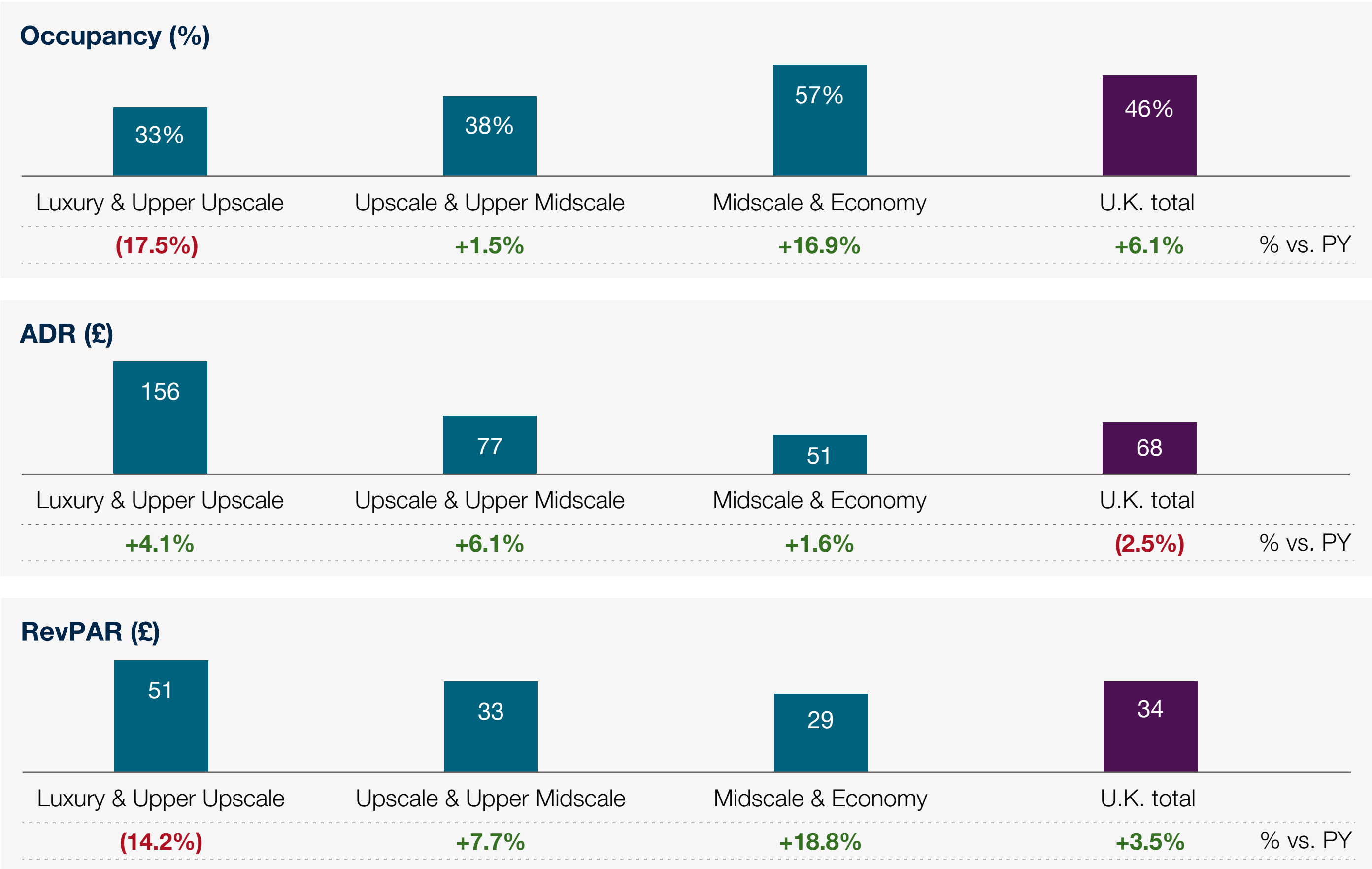
As such, the coming months are expected to be extremely challenging for hotel operators and further support may be required from lenders particularly as we come out of the summer period and see a reduction in travel and leisure demand.

Within this paper we discuss current market performance, the industry's view on future demand, M&A and pricing trends. These factors then feed into our view on the challenges ahead for operators and the key considerations for lenders as they are met with further requests for support.

This paper reflects our current view on the sector, which we will update regularly over the coming period, as we believe we are now at the point where we will start to see increased levels of operator distress that, as a result, will require lender support and / or intervention.

Current market performance

Figure 1: U.K. year to date (YTD) performance by Chainscale vs. previous year (PY)



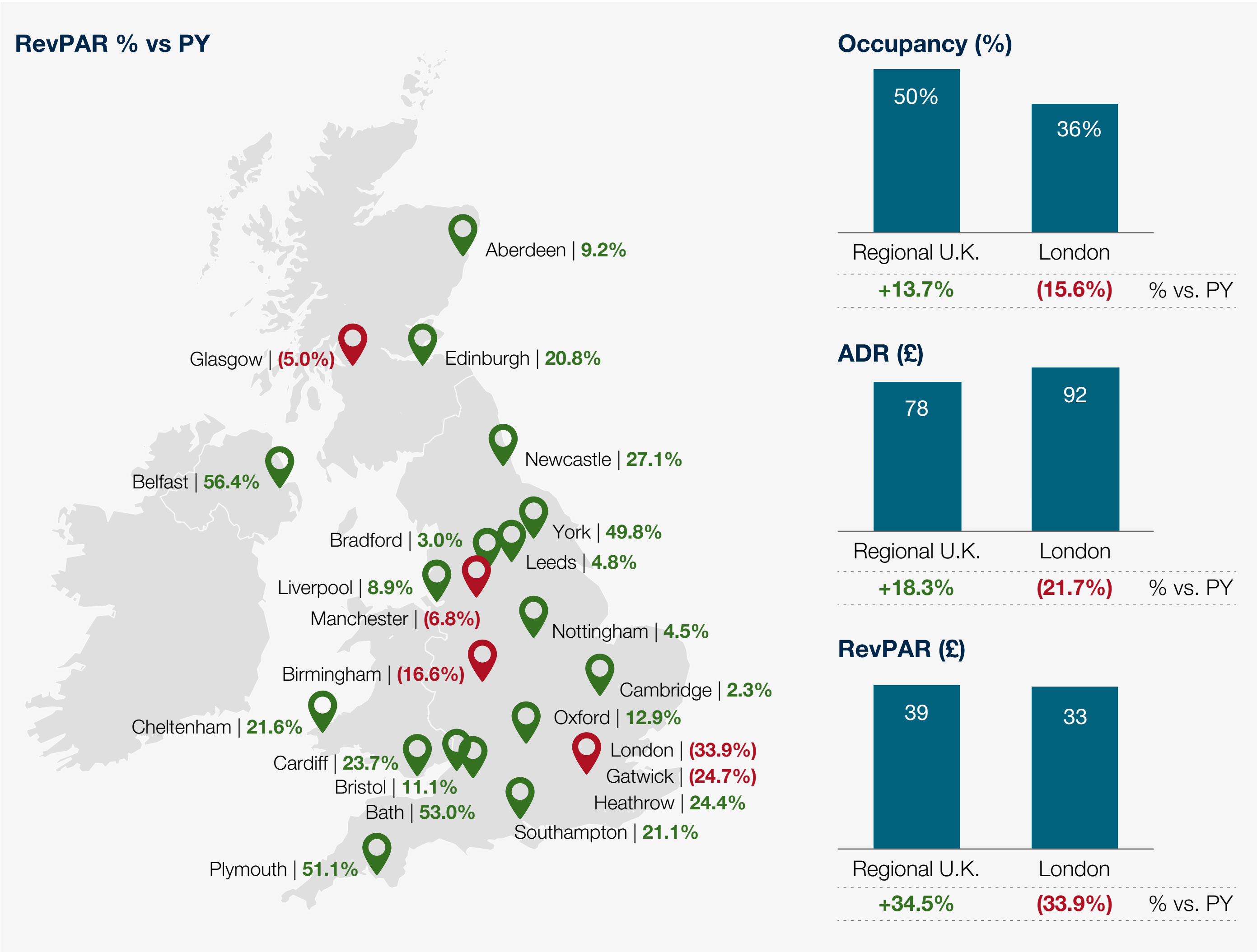
Note: August 2021 YTD
Source: Co-Star

August 2021 YTD revenue per available room (RevPAR) for U.K. hotels increased by 3.5% despite the restrictions in the first four months of 2021 due to pent up demand over the summer period and the August bank holiday. This overall decline masks a clear split in performance across different chain scales and different regions/cities.

RevPAR in the Luxury & Upper Upscale segment was down by 14.2% despite an increase in average daily rate (ADR) due to a decline in occupancy (17.5%). Upscale & Upper Midscale and Midscale & Economy hotels posted positive RevPAR growth of 7.7% and 18.8% respectively due to positive growth in both occupancy and ADR with these chainscales able to tap wider segments of demand not impacted by travel restrictions (e.g. blue collar workers, domestic leisure etc.).

U.K. KPIs	August 2021 YTD	% change
Occupancy	46.2%	6.1%
ADR (£)	74.08	(2.5%)
RevPAR (£)	34.22	3.5%

Figure 2: Regional U.K. vs. London year to date performance



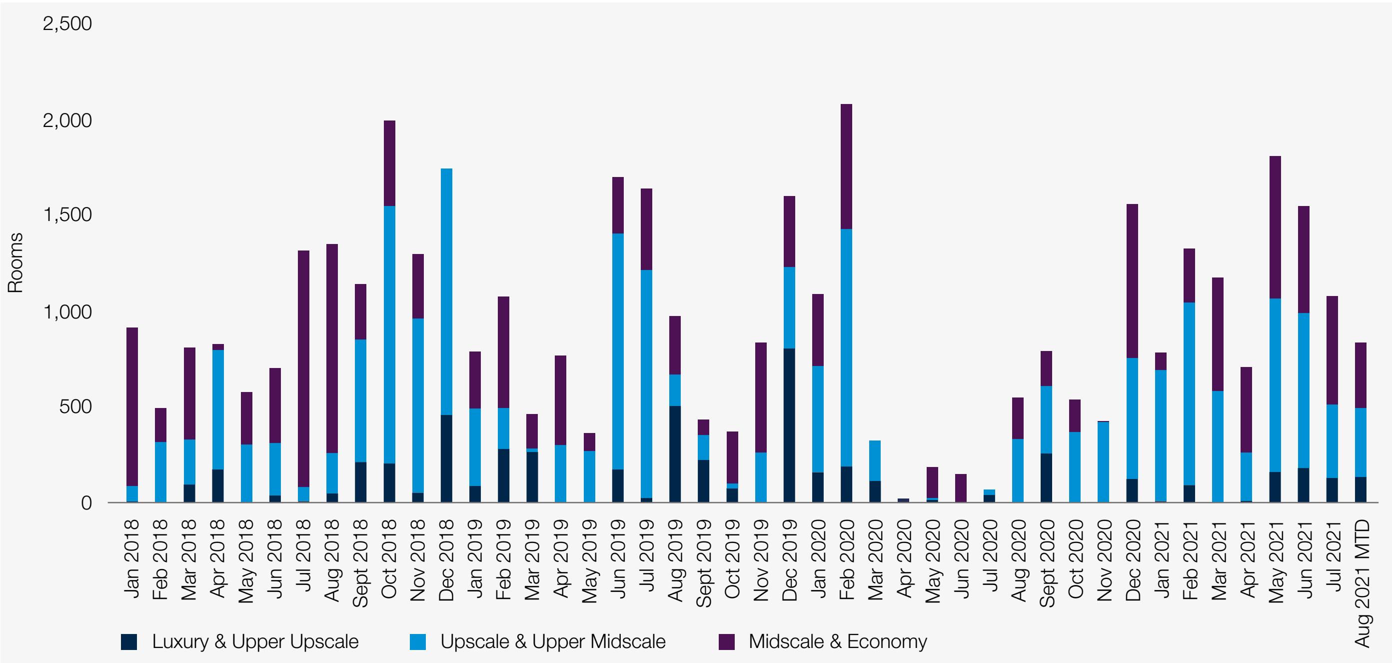
Note: August 2021 YTD
Source: Co-Star

Leisure markets, in particular coastal and rural areas, have performed well benefitting from the U.K.'s successful vaccination programme, a phased reopening and the staycation boom. Regional localities such as the Lake District, Devon, Cornwall, Dorset and the South West have seen occupancies reaching the 80% to 90% mark and ADR seeing significant growth similar to trends seen in the summer of 2020. In addition, Regional U.K. cities with a high reliance on leisure including Plymouth, Bath, Belfast and York also saw significant RevPAR growth on the previous year.

August 2021 YTD RevPAR in London however was still significantly down on the previous year by 33.9% due to the market's reliance on international travel and corporate demand. London Gatwick August 2021 YTD RevPAR was also down by 24.7% with London Heathrow up by 24.4% due to hotels capitalising on quarantine demand. Birmingham and Manchester – markets both highly reliant on corporate and M&E demand — posted RevPAR declines on the previous year at -16.6% and -6.8% respectively.

Supply considerations

Figure 3: U.K. rooms delivered by class



Note: August 2021 YTD
Source: Co-Star

Hotel construction has continued throughout the pandemic with 140 projects delivered over the past 12 months and activity driven by completion of projects that had begun prior to the pandemic, also forming most of the existing development pipeline. This is partly influenced by the fact that there is a 9 — 18 month lag time on supply changes as many projects will have been past the point of no return where its more expensive to halt development than complete it.

To date in 2021, nearly 9,300 rooms have been delivered with the majority in the Upscale & Upper Midscale segment (53% of rooms), followed by the Midscale & Economy segment (39% of rooms).

The Economy and Upper Midscale sectors will continue to lead supply growth however the pace of new developments is expected to decline over the next two years with projects either being delayed or abandoned as funding becomes more challenging and some schemes no longer feasible as a result of changing demand trends and increased building costs. Markets including Manchester, Liverpool and Edinburgh already have significant pipeline however present a risk of oversupply in the medium term and therefore speed of performance recovery to 2019 levels.

The industry’s view on future demand

In June 2021, A&M hosted a roundtable with senior industry leaders to discuss lessons from the pandemic and what lies ahead. The full insights from this roundtable can be found here and below we have summarised some of the key takeaways:

Demand in the Corporate sector is expected to remain **subdued** for the remainder of the year.

In the long-term, the **Corporate sector faces significant structural change,** which will impact the form and timing of the recovery. This change remains uncertain and makes it very difficult for operators to currently forecast.

Potential **winners** could be operators that are already adapting to new ways of working by **reimagining** their **spaces, services** and how they respond to the emerging expectations of remote workers in search of flexibility and well-being.

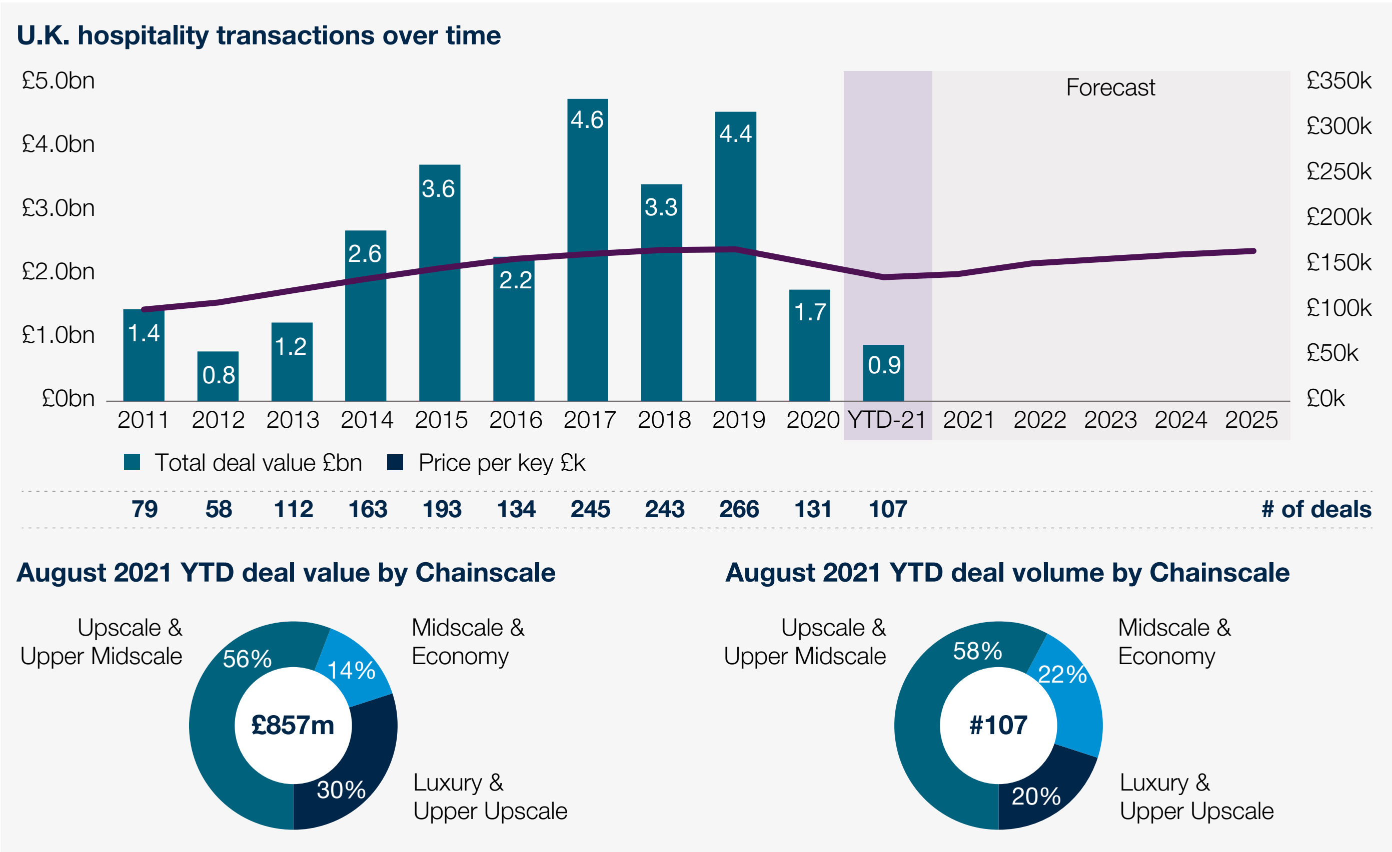
Smaller meeting venues may also be more greatly challenged by the increased use of virtual meetings. However, larger meeting venues may benefit from increased demand from companies, who have reduced their office footprint and moved to remote working, needing to bring their teams together and re-engage staff.

Adding **non-traditional** but complementary services, such as co-living and co-working, will become **increasingly valuable**, even necessary, by both operators and investors as they seek to diversify their offering to appeal to future demand trends. Smaller meeting venues could conversely benefit from this shift in demand.

There has been an **increased focus on environmental, social and governance** (ESG) issues and this focus is only expected to increase going forward, emphasising the importance of operators having an effective ESG agenda.

M&A and pricing trends

Figure 4: U.K. hospitality transactions



Note: August 2021 YTD
Source: Co-Star

The U.K. hotel sector has seen limited product coming to the market since the beginning of the pandemic with deal value reaching £1.7bn in 2020 (-58% on 2019 levels) and August 2021 YTD activity reaching £0.9bn. Transactions to-date have been mainly driven by deals in the Upscale and Upper Midscale segment accounting for 56% of deal value and 58% of volume/number of transactions.

Whilst the market has seen single asset sales to release liquidity, transactions have not necessarily seen the discounts expected due to a lack of supply in combination with significant liquidity waiting on the side-lines to invest.

Investment appetite and transaction activity has seen increased momentum more recently in 2021 as consumer confidence has started to improve, the majority of owners are still adopting a watch and wait approach as they recuperate losses, capitalise on strong leisure demand and until more certainty and evidence on transaction pricing and yields is available.

Meanwhile, the lifting of the Material Uncertainty Clause (MUC) has resulted in a wave of valuation instructions from both owners and lenders over the summer period which in combination with the wind down of government support to the sector, is likely to impact underperforming assets and may drive some distress to the market. Competition around discounted assets however will require fast action from new investors given the strong appetite to invest in the sector.

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The challenges ahead for operators

Structural issues and the unprecedented circumstances posed by COVID-19 has left the sector facing many short to medium term challenges including, but not limited to, uncertainties on predicting future demand, addressing labour shortages and continuing to manage costs effectively. In addition, the working capital requirements of reopening and building capacity along with the unwind of liabilities built up through the pandemic present an equally significant financing challenge.

Predicting customer demand – Operators and owners need to **think boldly and differently about forecasting** in order to respond to changes in customer behaviours and segmentation trends. This includes **removing the pre-pandemic dependence on historic and market comparison data** and utilising wider data sources in order to build a picture of future demand. It also includes questioning the supremacy of historical booking channels and their associated costs.

Product – New customer and brand behaviours are emerging that will inform what the hotel industry will look like in the future with COVID-19 highlighting the requirements for businesses to be agile, resilient and responsive to change. Businesses need to ensure that they are able to address **new guest trends** from digitalization, contactless interactions, a heightened focus on wellness and mental health and offering space to those guests who have a more flexible and hybrid working structure. In addition to this, **ESG should be a key focus** but also a long journey with certain upfront costs required now.

Staffing – The current labour shortage is resulting in **significant operational challenges** for operators. In light of this, businesses need to be more innovative in attracting and retaining staff to ensure that service levels are not compromised whilst managing rising wages and payroll cost inflation risks. Simultaneously, hoteliers have demonstrated the ability to operate with lower staff numbers and there are risks as we approach normality in costs being added back in a way that is unnecessary. **Maintaining guest service with lower staff numbers and costs will be a key differentiator** going forward.

Cost management – The pandemic has highlighted the need to **drive flexibility and variability into the operating cost model** and there are risks that unnecessary costs are added back. Maintaining guest service with **lower costs will be a key differentiator** going forward and revisiting shared service centres and central head office costs is critical to assess further areas for cost reduction and value optimisation (e.g. automation, outsourcing/offshoring, clustering etc.) to ensure a leaner cost model and higher efficiencies.

Working capital management – Ramping up performance and capacity requires working capital. Combining this with uncertain levels of demand, the unwind of liabilities that have been built up through the pandemic (e.g. rent arrears, supplier payments, HMRC deferrals) and a reduction of government support measures mean operators will have to **carefully manage their short term liquidity**. In addition to this, there is also a **capex bubble** in the U.K. hotel market with many hotels still requiring investment from pre COVID-19 which needs to be carefully managed.

The key considerations for lenders

Lenders relaxation of covenants and other forbearance measures during the pandemic in conjunction with furlough and government support measures have provided operators with valuable breathing space. This has predominately been done where these businesses could demonstrate sufficient liquidity and / or continued equity support but careful assessment of the risks will be required when assessing individual credit requests going forward.

In light of continued challenges faced by operators, lenders may start to see more requests for limit increases and new money requests, or might be expected to rebase debt terms or extend maturities based on business plans and cash flow forecasts which potentially have a high degree of risk, particularly in respect of operators whose hotels are in more challenged locations or segments of the market.

When considering a request of an operator and/or their shareholder(s), there are a number of key questions that lenders will need to have appropriately addressed:

01 Liquidity

- Is liquidity being **managed effectively**?
- Is there **cash leakage** outside the lender's security net?
- Is there **adequate liquidity headroom** in the short and longer-term forecasts to withstand shocks?
- What potential **cash levers** are available to manage through any potential liquidity pinch points?

02 Forecasting

- Is the operator's short-term cashflow **forecasting process appropriate and clear**?
- Is the longer-term financial forecast underpinned by a **robust strategic plan**?
- What key assumptions and **approach** has the operator taken to **forecasting demand**?
- Does the forecast assume any significant **cost reduction or value optimisation** plans?

03 Impact on capital structure

- Is the **capital structure appropriate** for the forecast cash generation and valuation outlook under the longer-term forecast?
- Does the covenant package provide appropriate **protection and control** if forecasts are not met?
- Are any **uncharged assets** available to strengthen the lender's security position?
- Does any revised terms provide adequate balance and **reward** for the investment risk and the contribution of various stakeholders?

How A&M can assist operators and lenders

A&M has a strong track record in the hospitality and leisure sector bringing fact-based, action orientated leadership to deliver rapid results. The team have extensive previous experience supporting both operators and lenders through restructurings across Europe and globally including AccorHotels, AccorInvest, Orbis Hotel Group, Aimbridge Hospitality, Dorint Hotels and Resorts plus a significant number of confidential engagements.

Our professionals have both operational and advisory experience, together with a proven track record in leading businesses and their stakeholders through tough, complex situations. We can provide a range of support to lenders from undertaking cashflow and business plan reviews to identify risks and opportunities through to assessing and implementing consensual solutions. If consensual solutions are not available, or desired, we can help to plan and deliver non-consensual enforcement options. We also can seamlessly step into interim management roles to lead in periods of distress or change as required.

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Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) for leadership, action and results. Privately held since its founding in 1983, A&M is a leading global professional services firm that provides advisory, business performance improvement and turnaround management services. When conventional approaches are not enough to create transformation and drive change, clients seek our deep expertise and ability to deliver practical solutions to their unique problems.

With over 5,400 people across four continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, leverage A&M's restructuring heritage to help companies act decisively, catapult growth and accelerate results. We are experienced operators, world-class consultants, former regulators and industry authorities with a shared commitment to telling clients what's really needed for turning change into a strategic business asset, managing risk and unlocking value at every stage of growth.

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