EIGHT ADVISORY

European hospitality industry amidst the pandemic

EIGHT INTERNATIONAL

Edition #1

Assessing the **state of the industry**
& its **outlook** for the future

During the last twenty years, the European hospitality industry has undergone a profound strategic change, flexibly adapting to the changing world and new customer needs.

Back in 2019, the outlook for the sector was extremely promising. Its fundamentals were strong and it had seen a lively interest from institutional investors. Then, however, the Covid-19 pandemic struck, and multiple lockdowns made the sector one of the biggest economic victims of the global health crisis. The measures introduced by public authorities in Europe, coupled with cost reduction plans and major changes in hotel business models, have made it possible to temporarily cushion the sector's drop in activity, but will not preserve it in the long term.

Fortunately, hoteliers are not waiting around, implementing vast cost reduction plans, opting for lighter and more defined business-focused brands, developing mid-range products and adopting more variable rent models. The winners of this crisis will be those able to respond quickly by implementing operational and financial transformation plans, and - in particular – to address the daily challenges of a low occupancy rate, while taking the opportunity to act as a consolidator in the sector.

There are clear signs that at the end of the pandemic, the fundamentals of the hospitality industry should be protected, and the sector will regain its attractiveness.

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#2 “The measures granted by public authorities, coupled with cost reduction plans, have made it possible to cushion the drop in hotels’ activity, but will not secure the long term.“

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#4 “Favoring the development of mid-range products will reverse the trend of recent decades.”

#5 “The winners of this crisis will be those able to respond quickly by implementing operational & financial transformation plans and acting as consolidators in the sector.”

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A view to the past

During the last twenty years, the hospitality and tourism industry have undergone a profound strategic change. At first, this change was reflected in a segmentation of the offering and the refocusing of services around customer experiences, particularly through the creation of new concepts. We have witnessed a shift in the market whereby the reinforcement of the entry-level and the premiumization of high-end options has led to a deterioration of mid-range brands without a distinctive concept or identity. As a consequence, the share of high-end products in the overall sector has more than doubled in 8 years, to reach almost 30% in 2019.

Since the1990s, this strategic change has been accompanied by an evolution of the operating model, introducing the Asset Light principle based on management and franchise contracts (e.g. Hilton spinning off its real estate into the two publicly traded companies Park Hotels & Resorts and Hilton Grand Vacations).

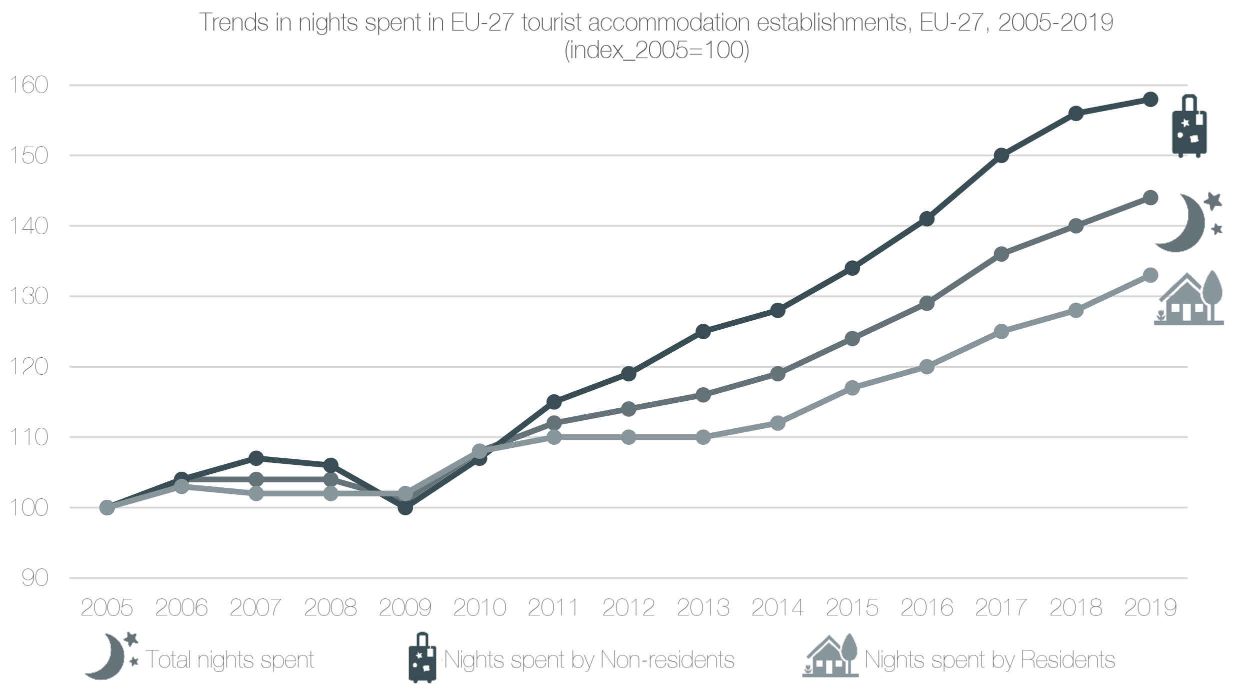
These strategic and operational developments have enabled the sector to cope with new challenges such as the newly developed trend of slow travel, the increasing sensitivity of customers to corporate and social responsibility, and the growing appetite for original concepts. The success of the Mama Shelter concept and boutique hotels is a great example of the new customer demands.

Back in 2019, the outlook for the sector was extremely promising. According to the latest HVS data, key hotel markets such as the UK, France and Italy continued to show significant demand growth both from within the continent and from overseas visitors. Eurostat data (Exhibit 1) showed that the number of nights spent in tourist accommodation in the EU continued to grow in 2019, increasing by 2.5 % to reach almost 2.9 billion nights.

Exhibit 1

Continuous growth in the tourist accommodation sector until 2019

Source: EC/ "Tourism statistics – annual results for the accommodation sector"/ October 2020



Note: EU-27 aggregate estimated for the purpose of this publication using available data

Source: Eurostat (online data code: tour_occ_ninat, tour_occ_nim) via EC

The European hotel industry as a whole has seen demand-led RevPAR growth. Furthermore, institutional investors continued to show an interest in the sector. According to RCA cited by HVS, as of November 2019, European hotel transaction levels had increased by 2% compared to the previous year.

Covid-19 firepower

With the Covid-19 pandemic came an almost complete freezing of the tourist industry, making the hospitality sector one of the biggest economic victims of the global health crisis.

The pandemic first affected the primary driver of this sector, namely attendance and occupancy rate, resulting in the closure of establishments and a very sharp drop in turnover. Occupancy rates in Europe are currently at15%, the same level as in the first lockdown. By extension, this resulted in a reduction in RevPAR of -72% in 2020 compared to 2019 (Exhibit 2). The decline is much worse than during the two previous crises for the hotel sector, following the global financial crisis of 2008-2009 and terrorist-related attacks in Europe (Exhibit 3).

Exhibit 2

European Hotels RevPAR (Rooms Revenue per Available Room) 2019-20

Source: HVS/ "The Impact of COVID-19 on the European Hotel Sector"/ September 2020

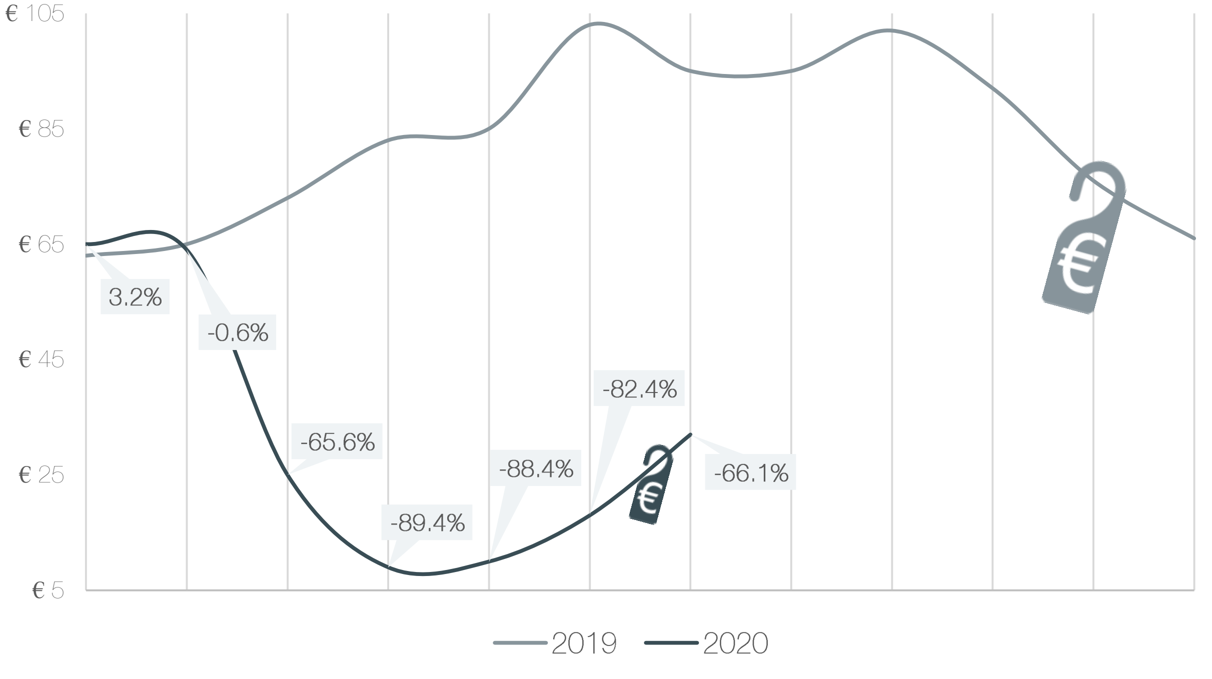
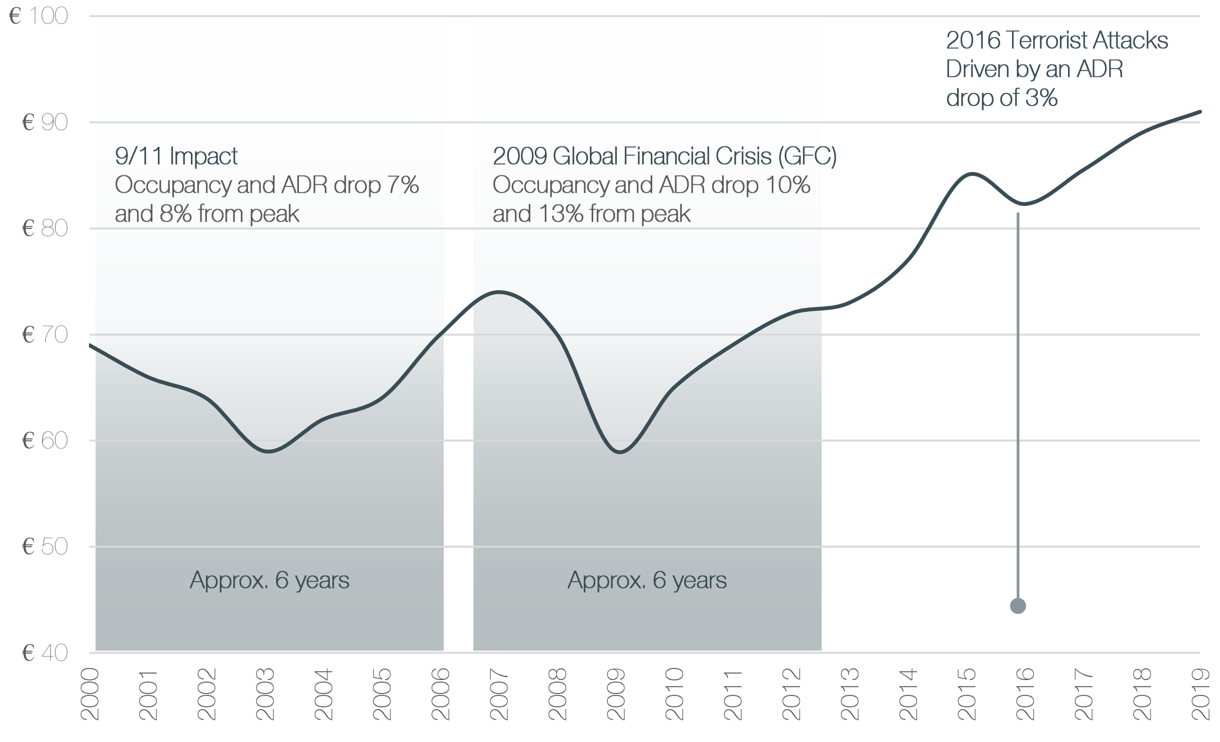


Exhibit 3

RevPAR Recovery Averaged 6 Years post-9/11 and post-GFC

Source: HVS/ "The Impact of COVID-19 on the European Hotel Sector"/ September 2020



Hotels are impacted differently based on their strategy, their ranges, and their geographical footprint. In particular, high-end products have suffered from a devastating drop in tourists and business trips. A French study showed occupancy rates between 12% and 15% during their reopening for high-end hotels in Paris.

Conversely, the mid-range market has shown better resilience (a decrease in occupancy rates limited to 11.7% for 3-star hotels in the summer of 2020 compared to the summer of 2019; while 4-star hotels registered a decrease of 26.9%). The study also indicated that hotels located outside the city center have remained more resilient (over the first nine months of the year, activity in Paris plunged by 61.1% compared to the same period in 2019, compared to 50.8% in the provinces (-23.5 points).

Some players and models have even managed to maintain their performance (eg. CenterParcs having recorded 1.4% increase on the rent from July to September 2020).

Finally, the reduced performance has been aggravated by the additional costs linked to health measures that must now be applied within hotels, including more regular cleaning and the closing of certain services such as spas, etc. These additional costs represent between 1% to 1.5% of revenues, further reducing profitability.

Although studies indicate that hotels that stayed open are outperforming their competitors which decided to close, some hotels have already announced that they will not reopen before the second quarter of 2021. A full recovery of the hospitality business is only expected in 2024.

Remedies

Together with the crisis caused by Covid-19, significant cashflow needs have emerged. These needs could be addressed through government aid such as guaranteed state loans, tax deferrals and wage support (95% of tourism sector companies have used furlough support schemes), and through the extension of these measures for this sector.

The measures introduced by authorities, coupled with cost reduction plans, have made it possible to cushion the drop in activity, in particular in terms of wage costs, which can represent between 20% (tourist residences) and 30% (hotels) of turnover.

On the other hand, they do not secure the long term future of the sector. In particular, the capacity to absorb rents (38.5% of turnover for hotels in 2019, 63.9% for tourist residences and holiday villages) remains an issue, with one out of two professionals not able to keep up with their rents. According to experts, this will result in reduced affordability ratios in the long term.

Some hotels decided to continue operations by adapting their business model (e.g. the conversion of hotels into restaurants or co-working spaces, as illustrated by the Fairmont St Andrews in Scotland that has launched a 'home office' concept); this shift reflects the continued development of "service hotels". However, as most hotels had only just begun to feel the impact of Covid-19 on trading performance in March 2020, many hotel owners will have met their financial targets for the12-month period ending in March. However, it had been widely expected that the vast majority of hotel facilities failed to meet their targets at the end of June 2020.

Continuing operations by adapting business models might be a good temporary solution but will not preserve a sector in which real estate developers make up significant proportions of stakeholders.

Consequently, the attractiveness of these assets will probably deteriorate for large private investors or even individuals. The time for the first bankruptcy filings has now arrived, and can be seen even in the upscale hotel industry but mainly for operators who did not own the premises.

As a result, cost adjustments have been crucial for the sector. New cost reduction plans (79% of industry professionals believed in April 2020 that they have to work on streamlining their cost structure) with lighter and more business and customer oriented brands are under construction, together with a detailed review of portfolios. For example, in spring, Accor announced a 60-million-euro savings plan and the dismissal of 1000 to 1200 employees worldwide. This savings plan relies on a redesign of the organization (including a change in reporting methods and the creation of two business units: "lifestyle" and "ultra-luxury").

Another interesting trend during the crisis will reverse the trend of recent decades, with a newfound focus on the development of mid-range products. These mid-range options have proved to be more crisis-resistant (for example, the brand B&B Hotels confirmed during the crisis a plan to open 150 hotels over the next 10 years in Germany alone).

Finally, a new deal is necessary with investors to restore the major balances (38% of professionals in the sector stated in April 2020 that they were considering a radical change in the business model) with more variable, more modest rent models - measures that call into question existing economic models of real estate companies and the associated debt.

Consolidation potential

M&A activity is generally speeding up in various sectors across Europe, bringing many distressed assets to the table. But is it time for consolidation in the hospitality sector too?

It is certain that the crisis has destabilized the whole sector and has deeply weakened a certain number of players in the market. The momentum to invest is key, as companies should find the right balance between the risk of restarting their business and the implementation of an aggressive acquisition strategy to position themselves for the many opportunities to come.

There will be significant opportunities once the uncertainty around the shape and speed of recovery of the hotel sector fades away.

The level of transactions in the European hotel sector in 2021 is forecast to be only 10 billion euros, whereas in 2019 the transactions amounted to 25.4 billion euros. According to data from Cushman & Wakefield, about 80% of this deal volume was agreed before the pandemic hit Europe. However, there were few significant transactions agreed after the Covid-19 outbreak, amounting to 1.2 billion euros. This is clear proof that investors perceive the current crisis as temporary and are confident about the long-term prospects of the hospitality sector. Such transactions included the inter alia acquisition of the 136-key Ritz London by a Qatari investor, and the purchase of the Nhow hotel in Berlin by Swiss-listed Eastern Property Holdings.

At the end of the pandemic, the fundamentals of the sector should be secured, and the sector will regain its attractiveness. The winners of this crisis will be those able to respond quickly by implementing operational and financial transformation plans. In particular, they will need to address the daily challenges of a dramatically low occupancy rate while taking the opportunity to act as a consolidator in the sector.

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The authors of 2021 Hospitality Report are part of our experienced dedicated teams across Europe, with a network of correspondents in over 20 countries on 4 continents, combining financial and consulting experience, focused on delivering value through in-depth analysis and a hands-on approach.

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Eight Advisory

Eight Advisory's history dates back to 2009 when **eight former Arthur Andersen and Big Four partners** decided to embark on an entrepreneurial journey and create **a brand new consultancy** on the market - independent, free of conflicts of interest, fully committed to its clients and offering a fresh approach.

Today Eight Advisory is a renowned global independent financial and operations consulting firm specialized in **Transactions, Restructuring, Transformation and Financial Engineering**. The firm provides guidance to company leaders, investors and banks for their corporate transactions, restructuring, transformations and financial engineering both in France and internationally. The firm's 460 employees, including 60 Partners, propose a financial and operational specialization dedicated to assisting managerial decision-making.

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