HOTELS & HOSPITALITY – STRESS TO DISTRESS?

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Light at the end of the tunnel?

Many in the industry anticipated that the impact of the last fifteen months would lead to widespread distress in the hotel and hospitality industry with investors having dry powder to invest and take advantage of the anticipated opportunities. This has not yet been the case but there are some key issues that are keeping our clients (borrower and lender side) awake at night. With the stress of the pandemic coming to an end for the industry, does this mean that we will not see any of that stress turning into distress?

If the last fifteen months have been hard, the next fifteen may be harder, with pressures on cashflow both in terms of operations as well as capital expenditure requirements (whether because of maintenance or to adjust the model to support different trading models or the sustainability agenda).

CURRENT PRESSURES

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- operating models have changed to meet the circumstances of the pandemic but will need to be rethought for the long term (e.g. changes to F&B, cleaning intervals, touchless entry, elevators etc.) all of which will involve additional costs;
- any additional debt taken on (through government measures such as the UK's Covid Corporate Financing Facility (CCFF), Coronavirus Business Interruption Loan Scheme (CBILS), Coronavirus Large Business Interruption Loan Scheme (CLBILS) and bounce back loans or capitalising interest and liquidity facilities) will need to be serviced and repaid;
- planned capital expenditure will almost certainly not have occurred over the last fifteen months but will now be required to bring hotels up to scratch and to meet brand standards (there will need to be conversations with brands to reschedule planned capital expenditure and time for action to be taken);
- FF&E (and other) reserves have been dipped into or used to meet working capital and will need to be replenished;

- higher costs in employing and retaining staff now that the UK is no longer in the European Union and the end or winding down of furlough arrangements (such as the UK's Coronavirus Job Retention Scheme); and
- other government interventions (such as temporary reductions in the rate of VAT and deferring payment of VAT) will start to be unwound.

Whilst many hotel owners and operators have rethought service delivery and staffing levels to find cost savings and efficiencies, will they be satisfied to offset some of the additional costs and pressures on cashflow?

As insolvency related measures end, such as the suspension of winding-up petitions and orders where a company's inability to pay is as a result of the pandemic, restrictions on issuing statutory demands (the usual first step to winding-up or the threat of it), relaxing directors' liability for wrongful trading and restrictions on landlords taking steps to forfeit leases for the non-payment of rent, directors will need to have their duties at the forefront of their decision making. Not easy when facing uncertainty in relation to hard restrictions, quarantine, coronavirus passports and cashflow pressure.

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There are also wider policy issues which create further uncertainty – when will travel restrictions and quarantine requirements be lifted? Will there need to be common standards to allow travel? Will coronavirus passports be required?

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REFINANCINGS

Up to now lenders have taken a pragmatic approach. With many (if not all) borrowers defaulting on leverage, interest or debt service cover financial covenants and other operational covenants such as "keep open" obligations, lenders and borrowers have been engaged in a rolling series of covenant waivers and forbearance and longer term restructurings.

Measures have included suspending (or even removing) financial covenants, capitalising interest, suspending and rescheduling amortisation, permitting FF&E (and other) reserves to be used for working capital, extending maturity, additional recourse through sponsor guarantees or security and sponsors providing more liquidity.

However, borrowers will need to consider their refinancing strategy for any upcoming refinancing deadlines. Existing financings will be suffering from higher leverage and valuations still subject to material uncertainty.

Will existing lenders extend maturities to allow for a period of stabilisation and if so on what terms? Or will lenders require repayment, triggering the need to refinance at lower debt levels with uncertainties over valuation and stabilisation of revenues? Either way sponsors may need to put in more equity to bridge the gap.

Sponsors may need to look at different sources of capital: banks, insurers and debt funds with their differing risk appetites and cost of capital.

STRESS TO DISTRESS?

However quickly trading stabilises, it's likely that additional capital is going to be required to continue to own and operate hotels over the short to medium term to meet the cashflow pressures and capital expenditure requirements outlined above and to deal with any upcoming refinancing deadlines.

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Sponsors with access to capital will be able to take a longer term view to support assets through to stabilisation and to provide the capital expenditure that will be required.

Sponsors without access to capital but willing to take a longer view will need to find capital to see them through – new equity investors (strategic and financial) or taking on additional short term funding with mezzanine debt or preferred equity structures or longer term funding from debt providers willing to lend at higher leverage and higher loan to value.

If sponsors are not willing or able to finance any additional capital requirements we might start to see the movement towards distress. Sponsors may need to sell assets, raise additional capital from other investors or lenders might start taking enforcement action or look to drive distressed sales. We are unlikely to see lenders looking to sell loan books or portfolios – this is a not a lender side liquidity crisis.

Investors with flexible strategies will be able to deploy capital for the opportunities which arise: single asset and portfolio acquisitions, co-investments and providing debt to support refinancings if other lenders step back from the market or are only prepared to lend based on lower debt levels.

Stress may yet become distress for those who run out of capital or patience.

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