FORSTERS

HOTELS & LEISURE

WEATHERING THE STORM

The future for hotels

The Covid-19 pandemic created a perfect storm for the hotels sector and, despite ever improving signs of recovery, the resulting devastation will take time and innovation to repair. Unprecedented economic life-support provided by the UK government over the last two years has kept the gathering clouds at bay, but there could well be casualties in 2022 and beyond. This was the conclusion of a roundtable discussion hosted by Forsters on 10 November 2021.

At the event, featuring members of Forsters' hotels group and industry guests, participants reflected on the catastrophic impact of Covid-19. While the decimation of business travel, perhaps for the longer term, and only a limited return of leisure tourism are cause for concern, there is optimism about the rise of the staycation in some locations.

The roundtable recognised the difficulties created by a scarcity of hotel workers that has led to withdrawn or trimmed services like reduced restaurant opening times and restricted menus. Add in construction and refurbishment cost increases, energy price hikes, a supply chain crisis, and the threat of rising interest rates and inflation, and it is easy to understand widespread anxiety and pessimism. At the same time, landlords and tenants are having to negotiate and resolve disputes over rent arrears, while lenders are no longer able to provide the same level of compassionate funding that was handed out during the early days of the pandemic.

A path out of the crisis: innovation and diversification

Like many other industries, the hotels sector has been forced to innovate and the pandemic has accelerated this process. Business models are being radically adapted for long-term change.

Henrik Muehle, General Manager of Flemings, a 5-star deluxe hotel in Mayfair, says that innovation is a natural consequence of the challenging climate. He says that hotels have to remain operational with reduced staff, a symptom of a workforce exodus during the pandemic and perhaps exacerbated by Brexit. Mr Muehle reveals that Flemings has identified a number of solutions, including moving to tasting menus in its high end restaurant Ormer, enabling it to maintain superior standards with fewer chefs. In fact, profit margins have actually increased.

Naomi Trinh, a Partner in the Corporate team and a member of the Hotels group at Forsters, has witnessed a wave of diversification spreading through the industry, such as the accelerated growth of aparthotels as many customers seek a different experience. For some, relying on restaurants and room service for days on end is not

always appealing and the freedom and peace of mind provided by having one's own living space during these times is seeing an increase in demand.

Roundtable participants also highlighted the growth of self check-in, through apps and web-based portals, requiring fewer receptionists to welcome guests. There is the option of reducing room cleaning for longer-term guests, towel and bed linen changes, tapping into customers' growing concerns for climate change and broader environment, social and governance (ESG) priorities. The turn-down service, for example, is one that can easily be eliminated without substantially impacting the guest's experience, although whether these are appropriate solutions will depend on where the hotel sits in the market.

This ability to respond to the unprecedented challenges posed by the Covid crisis has heartened our roundtable attendees. Melvin Gold, a specialist hotel consultant at Melvin Gold Consulting, comments: "We have more hotel rooms in this city [London] than any other in Europe. So the question is, how long will it take us to get back there? All of these other things are building blocks along that road. But fundamentally, I'm an optimist in the long term."

And there are signs of recovery on the horizon. The roundtable participants point to the influx of American tourists as travel restrictions have been lifted. Sarah Pass, a Consultant in Forsters' Commercial Real Estate group, suggests that several hotel clients have seen a surge in bookings thanks in part to the return of US travellers.

A defined career path: addressing labour shortages

An increase in bookings following the relaxation of social distancing measures and travel restrictions, is naturally welcome news for the hotel industry. But as hotel guests begin to drift back through the front doors, it is not easy to instantly staff up to cater to every requirement. The exodus of hotel workers during the Covid pandemic has become a grave concern. It has proven especially difficult to attract them back. Some have blamed this on Brexit, but was there really a Brexodus?

Melvin Gold points to high levels of employment in the UK and notes that staff shortages also appear to be a feature of the market elsewhere across Europe and other parts of the world.

Henrik Muehle does not entirely agree though, indicating that shared accommodation in London, where many of his staff are living, have lots of empty rooms. He says that applications for roles at Flemings dramatically dropped after the UK completed its departure from the European Union. Mr Muehle believes that changes in the visa application process are needed to make it easier for foreign workers to find positions in the UK hotels sector.

Making the industry more attractive to aspiring workers is now more imperative than ever. "We have to lay out a clear career path and make our sector sound attractive to those that are seeking employment or seeking opportunities," says Melvin Gold. "I think over the long term, the industry has not been doing that effectively and the chickens have now come home to roost."

There is an opportunity to innovate with shift patterns, attracting people that have other responsibilities or priorities at different times of the day and would benefit from perhaps an early stint to prepare or serve breakfast to hotel guests. The variety of roles and the availability of technology and processes to enable multiple shift patterns could attract more individuals to the hospitality sector.

Yet more immediately there is a concern that London and other UK destinations will lose their magnetism if fewer foreign workers results in linguistic limitations. Henrik Muehle says that Flemings has welcomed a steady pipeline of affluent Brazilian customers over the last decade, many of whom appreciate the availability of Portuguese speakers amongst the hotel's staff. He is concerned that the well-heeled market may shift to other premier destinations, like New York or Paris, if their expectations are not met in London.

Upping the tax burden: addressing VAT and business rate increases

The VAT rise to 12.5% in October and its return to 20% in April 2022, will do nothing to ease the recovery of the hotels and hospitality industry. Despite calls from within the sector to give it more time to convalesce, the increase in VAT rates creates yet another difficulty. Although business rate discounts have been extended to the 2022/2023 financial year, the prospect of them returning to pre-pandemic levels means the longer-term outlook is even more challenging.

Our roundtable participants feel that the hotel industry has historically lacked a strong voice or

representative body to engage with government and influence policy and regulatory changes, partly due to its fragmented nature.

In October 2021, UKHospitality called on the government to make the current 12.5% VAT rate permanent under its #VATsEnough campaign. So far, the campaign has not succeeded.

For hotels, facing up to deferred taxes, VAT rises and the need to increase salaries to attract more workers paints a potentially gloomy future.

Available capital: pent up investor appetite but a tougher lending climate

While there are some reasons for optimism, there are still tough times ahead. A significant amount of capital is waiting in the wings to be deployed in the hospitality sector, according to Will Kirkpatrick, the Head of Hotels and Extended Stay team at Gerald Eve, the real estate advisory business. The problem though is that there is a widespread expectation that valuations will be discounted. At the same time, there is a lack of transactional data from 2020 and 2021 to support accurate pricing.

Elevated construction costs are also a deterrent for investment, says Mr Kirkpatrick, indicating that there is a high level of stock being built, but charges have gone up by 10% or more over the last two years.

Investors are circumspect about charging ahead. And foreign investors are still hindered by remaining travel restrictions, preventing them from assessing assets in person and meeting with key stakeholders.

Many financial sponsors are also waiting for distressed assets to come onto the market. Yet with recent government support and sympathetic lenders, the fallout from the pandemic has yet to become fully apparent.

Victoria Edwards, Head of Banking and Finance at Forsters, also expects to see a tougher lending climate in 2022 and beyond: "The mainstream banks have sort of disappeared, the tier one banks aren't really there. There's a few alternative lenders in the market, but they're expensive. The cost of debt has gone up, but the availability of debt has gone down. And so I think it's a challenge for any hotel operator now to refinance or to find new funding." Despite this, Victoria has come across a few select lenders that are still keen to provide financing, even if mainstream lenders cannot remain as accommodating as they have done during the height of the pandemic.

"I believe that there is some pain coming down the road," comments Melvin Gold, "Why would you press the button on a hotel and foreclose on a debt and put it into the market in the middle of a pandemic, with no guarantee. You're going to get your money back? So they've been patient, but that doesn't mean that there's not a lot of pain under the waterline. And I think that we will see that at some point what happens when the tide goes out and who's wearing or not wearing a costume?

Will Kirkpatrick agrees that the industry is being pushed into a potentially dark spot: "The problem is that a lot of companies have deferred taxes. You've got VAT, debt and the furlough. It is just a perfect recipe next year for lots of problems."

Development and construction: escalating costs for hotels

The health of the sector is also determined by the capacity to build and refurbish. Investor and developer appetite is strongly influenced by the construction environment, which is facing its own challenges. The industry has commonly used fixed-price contracts for hotels and other developments, but now with labour shortages, escalating building material costs, and further problems in vital supply chains, it is proving difficult for contractors to eke out their traditionally slim profit margins. For hotel developers, this is resulting in additional costs and longer projects. The temptation to cut costs and deliver a lower quality finished product is intensifying.

This means the possibility of disputes arising between employers, developers, contractors and other stakeholders has rocketed. "I think it's a very difficult world for contractors to make ends meet," says Andrew Parker, a construction partner and Head of the Hotels group at Forsters. "It's always very difficult, they were on very tight margins anyway. This particular climate makes it even more difficult."

He has also witnessed a steady increase in cladding claims in the aftermath of the Grenfell Tower tragedy and the changing regulations, which have become a "movable feast". Tighter rules, while clearly necessary, do add expense and also potentially reduce interest from investors and funders.

Joining the ESG movement

One form of regulation that is likely to significantly impact the

hotels sector will be driven by ESG obligations and in the wake of COP26, the hotels sector cannot take its eye off the issue. On top of governments and regulators, customer behaviours are increasingly governed by ESG factors, including the impact of travel on the planet. Corporate travel has been decimated by the Covid pandemic and it is only gradually returning. While the World Travel & Tourism Council (WTTC) says that spending on business travel looks set to rise by more than 25% in 2021 and by a further 34% in 2022, it is not clear if air travel will ever reach the levels of 2019 again.

The video conferencing revolution that took off after the Covid outbreak is now very much embedded within corporate culture, further reducing the necessity for business travel. On top of that, the public is becoming increasingly concerned by climate change, dampening down the glamour or aspirational aspects of travel. Flight shaming is now a recognised phenomenon.

Institutional investors now put ESG priorities at the forefront of their strategy and asset managers are naturally following suit with their own ESG products. Green leases and sustainability-linked loans are also increasingly prevalent in the market, a trend the hotel sector must to be attuned to.

Hotel guests themselves will also drive change as they seek to lessen their own environmental impact. Many already seek environmentally friendly products and prefer that towel and bed linen changes occur less than daily. These will become factors in how hotels market themselves to consumers in the immediate and long-term future.

Rent arrears: protections extended for tenants

More pressing perhaps is the current relationship between landlords and tenants as they continue to navigate the twists and turns of the Covid pandemic and its longer-term impact. Although business is moving back towards some form of normal, the UK government has recently introduced the new Commercial Rent Code of Practice and is progressing legislation to enact the Commercial Rent (Coronavirus) Bill that it announced on 9 November 2021. The new code and bill seek to encourage landlords and tenants to engage constructively over outstanding rent arrears. Tenants who can pay, should pay, and parties should be transparent and candid about their ability to do so.

For rent arrears relating to periods when businesses were required to close premises due to government requirements, parties who cannot resolve the issue amicably will be able to submit the matter to a swift arbitration process for resolution. “It remains to be seen whether the threat of a swift third party determination will lead to more settlements, more insolvencies or more litigation,” comments Sarah Pass.

On the rebound: a new hotels landscape

The word ‘uncertainty’ has become worn-out by the Covid crisis. Yet it is entirely applicable to the hotels industry and its unpredictable future. Nobody can truly foresee whether business travel will return to anything like 2019 levels, although it is safe to assume that a new ‘Zoom’ culture has made some journeys redundant. Equally, public engagement with environmental and sustainable factors is changing the way people approach leisure travel as they seek to limit their contribution to climate change.

The hospitality sector must respond to these market dynamics, but at the same time overcome the immense challenges posed by more limited access to financing, the prospect of higher taxes and business rates, tighter regulations, labour shortages, supply chain difficulties and higher development and construction costs. It creates a jittery environment, where disputes and tensions are more likely to surface.

The outlook is challenging, but the market’s strong fundamentals can provide the basis for a sound recovery. Inevitably the industry is going to face significant financial distress, but more positively there is capital available and investors are ready to deploy plentiful reserves. Melvin Gold believes that the prospect of a rebound is not fanciful: “We had the most successful hotel industry in Europe. And one day, we will again, because we have a tremendous tourism product. We have a great hotels sector.”

Contact our experts

ANDREW PARKER

Partner, Head of Hotels

T: +44 (0)20 7863 8483
E: andrew.parker@forsters.co.uk

VICTORIA EDWARDS

Partner, Head of Real Estate Finance

T: +44 (0)20 7863 8366
E: victoria.edwards@forsters.co.uk

NAOMI TRINH

Partner, Corporate

T: +44 (0)20 3872 1177
E: naomi.trinh@forsters.co.uk

SARAH PASS

Consultant, Commercial Real Estate

T: +44 (0)20 7863 8468
E: sarah.pass@forsters.co.uk

"

Provides a high level of expertise and delivers a very professional service.

Chambers UK Guide