

# PRESS BRIEFING

**“Major and chaotic shakeout predicted - 25% of Hotel Rooms need to be closed down – The Sector taken in its entirety is Insolvent”**

The Irish Hotel’s Federation (IHF) recently commissioned Peter Bacon & Associates, Economic Consultants to examine the issue of over-capacity in the Irish Hotel Industry and identify the required elements of a recovery programme.

The following is a summary of key points from the report and the IHF’s position

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Tourism is a major industry in Ireland generating considerable value in terms of exports, employment and tax revenues. It is estimated that 74c out of every Euro spent in the sector in Ireland generated income in Ireland so that the sector contributed 2.6% of GDP in 2008.

In the last 20 years the number of hotel rooms has grown from 21,000 to almost 60,000 today. The speed of growth accelerated significantly in recent years and since 2005 the number of hotel rooms in Ireland has risen rapidly - by about 15,000 or 32%. The rapid acceleration in growth has caused much concern in the industry as it has occurred during a period when demand for hotels has not been sustained.

This supply growth was driven largely by a number of factors, in particular, accelerated capital allowances for developers, the ease of obtaining finance and the wishes of planning authorities to incorporate hotels into development schemes. In many cases the commercial viability of the hotel business was not sufficiently prioritised, despite warnings from the IHF.

The global recession has resulted in a significant downturn in demand for hotel rooms, leading to the heavy discounting of room rates. Adjusted for inflation, revenue per available room fell from €57 in 2000 to just over €38 in 2008. This fall has accelerated and hotel prices have fallen by 26% in 2009 compared to 2008. This is the steepest fall of any major European country, making Ireland the cheapest Western European country for Hotel Accommodation.

Fáilte Ireland data show that bednights sold to out of state visitors rose strongly during the 1990s and peaked at just over eight million in 2000. However, it is of immense concern to hoteliers that results show that there has been no growth in overseas demand since then. Demand from Irish customers grew steadily during the Celtic Tiger years, but this market has now been seriously affected by the recession.

Hotel operators have attempted to address this downturn through lower prices. However, this has resulted in lower revenues and tighter margins. This damaging process is given added impetus by the actions of hotels with no long-term viability which are reducing prices to simply maintain a cash flow.

Normally, market forces would have forced hotels with weak business models to close. However, this has not happened, primarily due to the reluctance of banks to realise losses and write down loans granted to hotels that have no prospect of recovery. This is because of the additional pressure this would place on the capital adequacy of banks' own balance sheets and a reluctance to act in advance of the introduction of NAMA. Furthermore, new hotels need to remain open for seven years to allow investors to retain capital allowances.

The result is that the burden of excess capacity is not being borne by the new entrants that have caused the problem or by the banks that have financed the bad investments. This would be the case in a properly functioning market where failed entrants would be forced out. Instead, the burden of adjustment is, in effect, being transferred by banks away from themselves and onto the hotel sector as a whole, thus threatening the viability of hotels which are fundamentally competitive.

This is damaging the entire hotel sector. The downward spiral of prices is now threatening the survival of established and viable businesses, many of which are vital to the long-term strategic objectives of Ireland's tourism industry. Furthermore, the reluctance of banks to provide working capital to potentially solvent hotels is leading to liquidity problems that further undermine their businesses

The situation gets worse as one looks at the asset value of hotels. The significant drop in the value of hotel property combined with the high level of debt in the sector now points to a situation where, taken in its entirety, the sector is insolvent.

Official statistics show that 26,802 new rooms were opened in the period 1999-2008, with an estimated investment of €5.2 billion and debt of €4.1 billion. The stock of new hotels has been seriously insolvent since 2005. Indeed, in every year since 2002, new hotels have been insolvent from the year of their construction. There is also substantial debt incurred as a result of investment by existing hotels trying to compete with new entrants and from transactions to change ownership that have not included new development.

The consultants estimate that there is a negative net asset value of just over €17,000 per existing hotel room in 2008. This gives a total excess of debt over room assets for the hotel sector of €1,035 million in 2008. Given the ongoing and intensifying difficulties being experienced by the sector, it is reckoned that this deficit will have increased considerably in 2009.

Even if effective actions are taken as outlined in the recent Tourism Review Group report, the projected level of recovery for Irish tourism and hotel room demand will not be sufficient to maintain the viability of many of the existing hotels.

Unless urgent action is taken to remove the excess capacity the sector will undergo a major and chaotic shakeout over the next couple of years. It is unlikely, given the chaotic manner in which this would happen, that the profile of the hotel stock that would remain (in terms of location and grade) would be optimally suited to the long-term interests of Irish tourism.

The consultants conclude that the fundamental issue is one of over supply and this can only be dealt with by the planned and co-ordinated removal of around 15,000 rooms from the existing stock. The aim should be to agree a speedy and orderly decommissioning of supply in a manner that leaves the profile of substantially reduced supply appropriate, in terms of geography and grade, to the long-term demand for Irish tourism.

While the answer is clear, the means of achieving this are more problematic.

There needs to be recognition and acknowledgement by all stakeholders, especially financial institutions, that failure to foreclose on insolvent hotels is damaging the long term interests of the hotel and tourism sectors. There is a reluctance to do this at present as banks are anxious to avoid having to write down bad loans, as would happen if an indebted hotel closed and they were forced to recognise the insolvency. The resulting write down would strain the banks' capital adequacy at a time when there are already serious questions regarding its adequacy.

The consultants recommend that the financial regulatory authorities should consider the economic arguments with respect to insolvency, and the consequences for the hotel sector at large of a lack of foreclosure against fundamentally insolvent hotels.

Based on this, the authorities should ensure that banks fully recognise bad loans within the hotel sector and face any capital adequacy issues that might follow.

Should foreclosures come about and debt be written off, measures are needed to ensure that these hotels do not continue to trade as this would do nothing to reduce over supply, but simply add to pressure on existing viable operations. As a result, the consultants recommend that the hotel sector should prepare a strategy for the orderly elimination of approximately 15,000 rooms and that this process should begin before the 2010 peak season. However, while the answer is clear, the means of achieving this are more problematic.

Barriers to the exit of insolvent hotels must be removed and the Consultants recommend that a special provision be introduced in the Finance Act 2010 to allow relevant hotels to exit the industry without disadvantaging the initial investors in terms of availing of or retaining capital allowances. The costs to the Exchequer of removing this barrier to exit would be zero

A further initiative would be to consider the establishment of a hotel restructuring fund to arbitrate and assist in scenarios where the case exists for maintaining hotels that are insolvent but that are of strategic importance to the wider economy.

The report recommends that a formal mechanism be introduced immediately to validate the partial, or full, closure of hotels for all or part of the year. Furthermore it is suggested that this would be recognised in an appropriate adjustment to commercial property rates liabilities. For example, a hotel closing for three months would have a 25% reduction in rates or if a hotel formally closed a certain percentage of its rooms then its liability would be reduced by a similar percentage.

Other recommendations suggest the consolidation of hotels into groups where there is sufficient management capacity in order to promote a reduction in average debt per room in operation.

Further research is required, but it is possible some opportunities may exist for hotels to be converted to alternative use and operate in sectors that do not threaten the stability of the sector. These might include care homes or language schools.

While the fundamental problem for the sector is over supply, small but important measures to stimulate demand and help remaining hotels are also needed.

Liquidity is a serious concern for many otherwise viable hotels and there is a serious risk that strategically important hotels might be forced out of business before an effective adjustment programme can be developed. The consultants recommend that a Government Loan Guarantee Scheme, modelled on the UK Enterprise Finance Guarantee, should be introduced and provided to hotels with viable and proven business operations.

The report identifies the heavy cost base in the sector as a barrier to recovery. Hotels continue to face high rates bills that are unrelated to the actual business conditions and a review of rateable valuation requires immediate review. The consultants recommend that this process under the Valuation Act 2001 should be prioritised in respect of hotels.

Action is needed on other costs such as energy where Ireland has the second highest electricity costs in the developed European countries and a freeze on public service charges at 2008 levels is recommended.

New programmes to promote Irish tourism overseas are being developed and it is recommended that these should be supported. Operators will need to co-ordinate promotional activities and work closely with the national agencies to promote Ireland and grow tourism.

The IHF supports the views of the Tourism Renewal Group that recently reported and created a framework for action up to 2013. Their report places considerable emphasis on the near term challenges and the need for actions to sustain the sector through the difficult period that are likely to persist for the next few years. In terms of the short term survival strategy, the report's recommendations include the need for the overall level of investment in marketing to be maintained, the abolition of the air tax, spending on tourism-related investment to be prioritised, the control of costs and for access to working capital to be improved.

While these measures are needed urgently to allow normally viable businesses to survive, the work by Peter Bacon & Associates shows the importance of a speedy and orderly decommissioning of supply in a manner that does not damage the long term strategic needs of Irish tourism.

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## **The Importance of the Hotel Sector in Ireland**

Tourism is a major industry in Ireland generating considerable value in terms of exports, employment and tax revenues. A total of 7,435,000 overseas visitors came to Ireland in 2008 and it is estimated that there were 8,339,000 domestic trips taken. It contributed €1.5 billion in taxes in 2008 of which €1.1 billion came from foreign visitors. Accommodation revenues account for almost 30% of the total and hotels supply 23% of all bednights spent by overseas visitors.

It is estimated that 74c out of every Euro spent in the sector in Ireland generated income in Ireland so that the sector contributed 2.6% of GDP in 2008.

Tourism has a wide geographical distribution and employs personnel with a wide range of skills. It has thus served to draw many into work that previously were not part of the labour force. Research by Fáilte Ireland estimate that nearly 200,000 people were employed in the tourism industry in 2007.

The hotel sector is a major part of the Irish economy and its performance is a key element in the determining the performance of the overall tourism sector.

Hotels are a major source of employment and the Fáilte Ireland survey estimated total employment in hotels in 2007 was just less than 72,000, up from 54,000 in 2005.

## **The IHF**

Founded in 1937, the Irish Hotels Federation (IHF) is the national organisation of the hotel and guesthouse industry in Ireland. The primary functions of the Federation are to promote and defend the interests of its members. The IHF represents almost 1,000 hotels and guesthouses nationwide, employing over 70,000 people and is a key stakeholder in the Irish tourism sector.

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