The Next Steps - Restoring Financial Sustainability to the Irish Hotel Industry

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June 2014

Summary

- Tourism has proven its potential to play a critical role in contributing to recovery in employment and the broader Irish economy over the last few years. With international tourist arrivals projected to grow steadily and domestic consumer spending expected to recover gradually over the medium term, there is huge potential for further employment growth in tourism across the country.

- A financially sustainable hotel industry is crucial if this potential is to be realised. Since the publication of the report *"Time to Invest - Proposals to Restore Financial Sustainability to the Irish Hotel Industry"* almost two years ago, the Irish hotel industry has made progress in repairing balance sheets. The level of debt in the sector has decreased from €6.7 billion at end-2011 to €5.3 billion at end-2013. Debt per room has decreased from €113,250 per room to €92,750 per room over the same period.

- Progress has been uneven, however. As anticipated in *Time to Invest*, advances have been made in urban areas, especially Dublin city, which attract international investors. However, many medium-sized and smaller hotels, especially outside of urban areas, are too small to be of interest to international investors. As a result, there is an enduring problem of indebtedness in the hotel industry outside of Dublin.

- A debt overhang is detrimental to the prospects for recovery in the hotel sector because it leads to underinvestment in maintenance, refurbishment, renovation and innovation. Under some scenarios considered in this paper, the current level of debt would require a further reduction of €1.4 billion to reach a sustainable level for the industry as a whole.

- The next steps should focus on restructuring balance sheets to restore financial strength to the industry outside of Dublin. Making funds in the newly announced Ireland Strategic Investment Fund available to hoteliers, as recommended in *Time to Invest*, to assist where market failure still exists for hotels that are viable but undercapitalised, should be part of the solution.

1. Introduction

The October 2012 report, *"Time to Invest - Proposals to Restore Financial Sustainability to the Irish Hotel Industry,"* commissioned by the Irish Hotels Federation, identified the critical role of the hotel industry in contributing to recovery in Ireland's tourism sector and in the wider economy. The report pointed out that a high-quality stock of well-run hotels spread across the country attracts tourists from abroad and encourages Irish consumers to spend in the domestic market. Maintaining a high-quality stock of hotels, however, requires investment.

The analysis in *Time to Invest* revealed a large debt overhang in the hotel sector in 2011. As the report pointed out, a debt overhang is detrimental to the prospects for recovery in the hotel sector because it leads to underinvestment in maintenance, refurbishment, renovation and innovation. Over time, this underinvestment may result in deterioration in the quality of product that Irish hotels offer consumers. Given the hotel sector's income prospects, interest rates and the average maturity of the debt at the time, the report concluded that the level of indebtedness was not sustainable and balance sheets would need to be restructured to increase equity and reduce debt.

Time to Invest also identified the lack of funds available to prospective new owners to finance the purchase of distressed hotels and to current owners to inject new equity into their hotels as a market failure preventing the repair of balance sheets in the sector. A symptom of this market failure was the large number of hotels in the hands of receivers. At the time, banks were becoming increasingly saddled with repossessed hotels.

The report called on Government to take action to increase the availability of equity finance and facilitate an orderly restructuring of the hotel industry. In particular, the report discussed a number of equity support schemes that could be introduced to attract new equity investment into viable but undercapitalised hotels.

- Employment and Investment Incentive Scheme (EIIS) could be extended to include restructured hotels, thereby providing incentives to private investors to inject equity into restructured hotels.
- Hotel Restructuring Fund could use funds from the National Pension Reserve Fund and the sale of state assets to invest in hotels that have reasonable prospects for profitability, growth and providing sustainable employment.
- Qualifying Investor Fund for hotels may be attractive to private investors, especially from abroad, who would like to invest in Irish hotels but do not wish to own hotels directly.

Nearly two years on from the publication of *Time to Invest*, now is a good time to review what progress, if any, has been made in repairing hotels' balance sheets, and to consider what the next steps should be to restore financial sustainability to the hotel sector. To that end, this paper provides an update of the industry's financial strength, taking into account recent developments in the hotel sector and in the wider tourism industry.

- As anticipated in *Time to Invest*, tourism has acted as a powerful vehicle for job creation over the last few years. Data from the CSO show that the accommodation and food service sector added 17,000 jobs over the past two years, representing an increase in employment in that sector of 14 per cent. Compared with its recent low in 2011:Q1, employment is up

more than 21 per cent in the sector. With international tourist arrivals projected to grow steadily and domestic consumer spending expected to recover gradually over the medium term, there is huge potential for further employment growth in tourism across the country. A financially sustainable hotel industry is crucial if this potential is to be realised.

- The Government extended EIIS to include hotels, under certain conditions, from 1 January 2013. In addition, the Government announced recently that EIIS will no longer be subject to the High Earners Restriction, with the aim of attracting more funds into the scheme. Although there have been some initial technical issues in applying EIIS to the hotel sector, the attractiveness of this mechanism is becoming more apparent and EIIS will undoubtedly have an increased role to play in restoring investment to the industry in the next few years.
- The Government in June 2013 announced the Ireland Strategic Investment Fund (ISIF) to reorient the €6.8 billion in the discretionary portfolio of the National Pension Reserve Fund towards commercial investment in the Irish economy. As proposed in *Time to Invest*, the log jam in the market for hotels creates an opportunity for the ISIF to invest money in solid investment assets on a strictly commercial basis. In doing so, the ISIF would not only be aiming for higher returns, but would also be giving a boost to an important indigenous export industry. Within ISIF, a dedicated Hotel Restructuring Fund (HRF) could target the hotel sector. ISIF could commit €100 million to the HRF. These funds could be augmented by private sector capital funds, consistent with the ISIF's objective of "leveraging resources by attracting private sector co-investment." The HRF could invest in hotels that have undergone balance sheet restructuring and have reasonable prospects for profitability, growth and providing sustainable employment.
- The Finance Act 2013 introduced legislative changes to enable Real Estate Investment Trusts (REITs) to be introduced to Ireland. The past year has been an active period for several newly-incorporated REITs.

2. Tourism: Recent Developments and Prospects

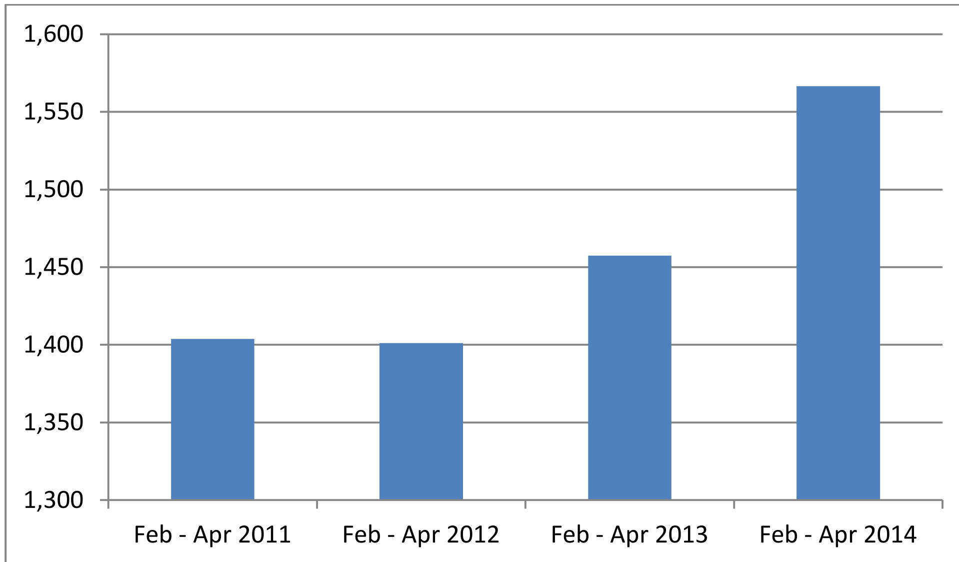
As predicted in *Time to Invest*, tourism has proven its potential to play a critical role in contributing to recovery in employment and the broader Irish economy. The accommodation and food service sector added 17,000 jobs over the period 2012:Q1-2014:Q1, representing an increase in employment in that sector of 14 per cent.[1] That sector alone accounts for more than one of every four net new jobs created in Ireland over this period. Employment in the sector has increased by 24,000 jobs (21 per cent) from its recent low in 2011:Q1.

This growth in employment has been driven in large part by a recovery in the number of overseas visitors to these shores over the past few years. Tourism in Ireland has benefited from the growth in international tourism, with arrivals worldwide reaching a record 1,087 million in 2013.[2] In addition, initiatives such as the Gathering, the Great Western Greenway and the Wild Atlantic Way have boosted the number of visitors to Ireland.

[1] CSO, Quarterly National Household Survey.
[2] UNWTO World Tourism Barometer.

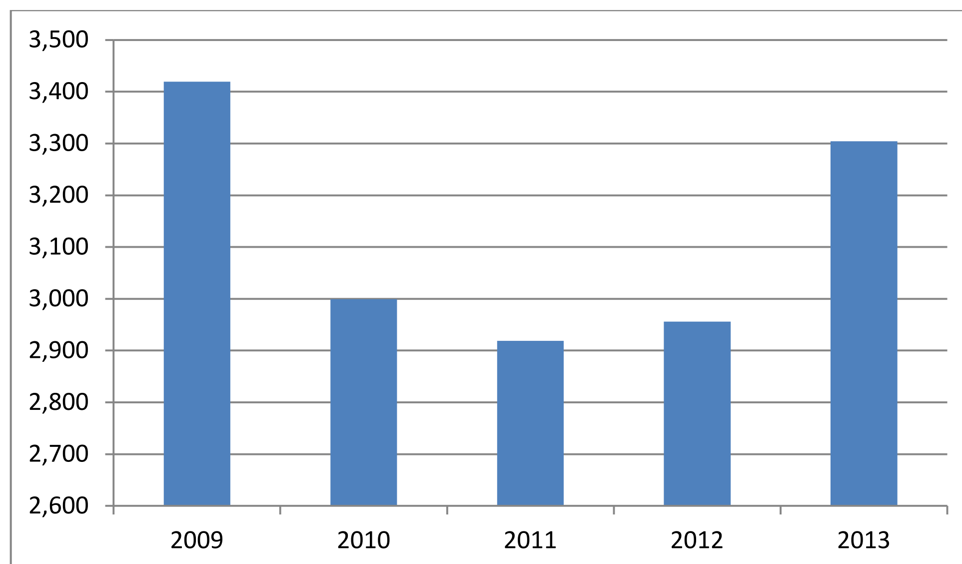
As shown in Figure 3, the number of visitors from overseas increased in the February-April period in both 2013 and 2014 compared with the same period a year earlier. This increase in visitor numbers contributed to an increase in tourism revenues (Figure 4).

Figure 3: Overseas tourist arrivals in Ireland (000's)



Source: CSO.

Figure 4: Tourism revenue from overseas visitors (€million)



Source: CSO.

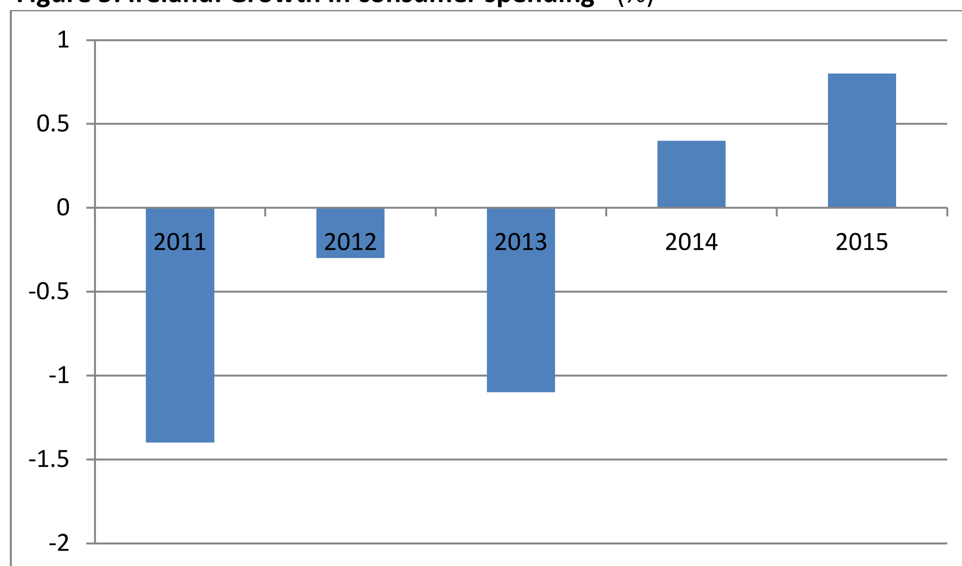
Looking ahead, Ireland's tourism performance with respect to overseas visitor numbers will continue to be strongly influenced by the overall trend in international tourist arrivals. According to the latest UNWTO World Tourism Barometer, international tourist arrivals are projected to grow by 4 per cent this year, with solid growth expected over the next decade.[3] If Ireland can maintain market share,

[3] See http://mkt.unwto.org/en/barometer

revenues from overseas tourists can be expected to continue to rise over the medium term and an additional 40,000 new jobs in tourism could be generated by 2020.[4]

Spending by domestic tourists has been at depressed levels since the onset of the financial crisis as disposable income and personal consumption has slumped. The European Commission projects moderate increases in real (that is, inflation adjusted) consumer spending in Ireland over the next two years (Figure 5), suggesting scope for some improvement in earnings from domestic tourism.

Figure 5: Ireland: Growth in consumer spending* (%)



*Source: European Commission, Spring 2014 Review. *Real personal consumption.*

3. Debt in the Hotel Sector

As discussed in the previous section, forecasts for growth in international tourist arrivals, along with the projected recovery of domestic consumer spending, underscore tourism's potential to continue to be an engine for job creation across the country. Sustainable balance sheets in the hotel industry are required if this potential is to be realised.

A strong hotel industry that has the capacity to continue to grow tourism is one in which:-

- Hotels are owned and operated by people with a long-term interest in the industry.
- Hotels are internationally competitive and commercially viable.
- Hotels have strong balance sheets with a sustainable mix of equity and debt financing.

The *Time to Invest* report presents estimates of hotel indebtedness through end-2011 using data published by the Central Bank of Ireland on loans to hotels by resident Irish banks. In *Time to Invest*, the perpetual inventory method is used to adjust the Central Bank's published data to take account of loans held by the National Asset Management Agency (NAMA) and the non-resident Bank of Scotland and to make some technical adjustments. (See Technical Box 3.1, *Time to Invest,* page 14, for more details).[5]

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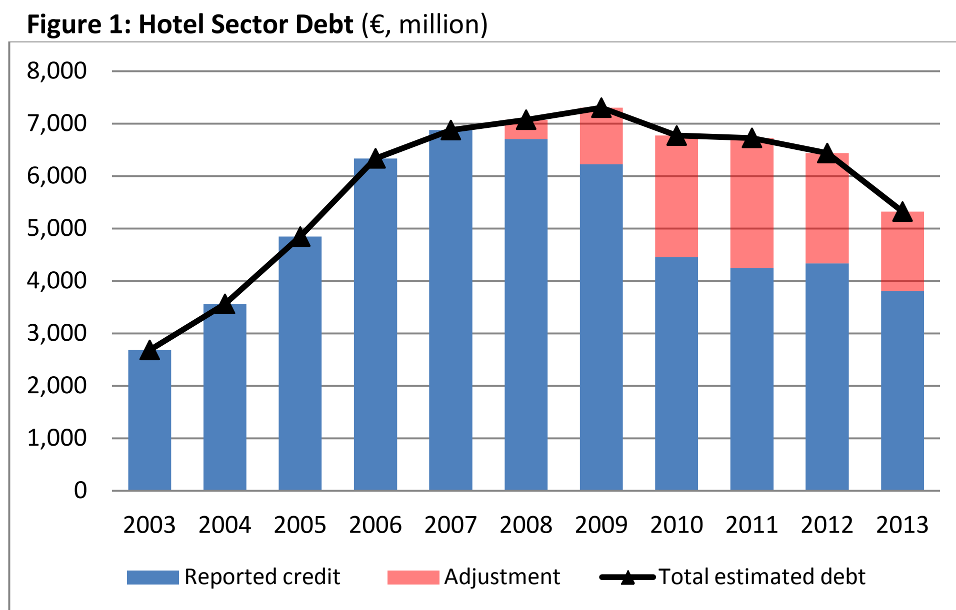
[4] "Submission to the Minister for Transport, Tourism and Sport on the Tourism Policy Review" IHF, Dec. 2013.

[5] NAMA is not a credit institution as defined by the Central Bank of Ireland. The loans to the hotel sector owned by NAMA are not included in the Central Bank's figures even though the borrowers still owe the full

Applying this same approach, the evolution of hotel indebtedness over the decade through end-2013 is shown in Figure 1.

Figure 1: Hotel Sector Debt (€, million)



Source: Central Bank of Ireland and author's calculations.

The level of debt in the Irish hotel sector decreased from €6.7 billion at end-2011 to €5.3 billion at end-2013. The bulk of this decline occurred in 2013. From its peak in 2009, the indebtedness of the hotel sector has declined by €2 billion. In part, the reduction in debt reflects repayments of principal by some better-performing hotels. For these hotels, a question arises as to whether debt repayment is being over-emphasised at the expense of investment in maintenance and refurbishment that is needed to preserve and improve the value of the hotel stock.

In addition, there has been substantial restructuring of hotel debt over the past two years, achieved through loan portfolio sales and asset disposals (following loan enforcements) at discounted prices. As anticipated in *Time to Invest*, international investors with access to finance from conventional sources have been active in buying larger hotels in urban areas, especially in Dublin city. However, many medium-sized and smaller hotels, especially outside of urban areas, are too small to be of interest to international investors. As a result, there is an enduring debt problem in the hotel industry outside Dublin.

Credit to the hotel sector from domestic Irish banks (mainly, Allied Irish Banks, Bank of Ireland and Ulster Bank) declined roughly €0.5 billion over the period 2011-2013. It is important to note, however, that this is a net figure, which likely disguises some new lending by Irish banks to the sector (for example, new loans to finance hotel purchases or to refinance hotel debt formerly held with non-resident banks). In addition, significant deleveraging of its Irish loan book by Bank of

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amount of the loans to NAMA. Moreover, Bank of Scotland (Ireland) was classified as a credit institution resident in Ireland until it was merged into Bank of Scotland in the UK on 31 December 2010. After that date, borrowings by hotels from that institution are no longer included in the Central Bank's data.

Scotland at deep discounts and, to a lesser extent, disposals of hotels by NAMA has removed nearly €1 billion of debt from the sector.[6]

> Box 1: Calculating hotel indebtedness post 2011
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> The debt levels for 2012 and 2013 are estimated using data from the Central Bank of Ireland and information from several other sources:
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> - According to the Central Bank, the level of outstanding credit extended to the Irish hotel sector by financial institutions resident in Ireland (mainly, Allied Irish Banks, Bank of Ireland and Ulster Bank) declined from €4.3 billion in 2011 to €3.8 billion in 2013.
> - According to the annual financial accounts of Lloyds Banking Group (which includes Bank of Scotland) there has been substantial deleveraging of the non-retail Irish loans of the former Bank of Scotland (Ireland) over the past two years.[7] Lloyds has achieved this deleveraging through consensual asset sales by borrowers, loan portfolio sales and asset disposals following loan enforcements. The financial accounts for 2012 and 2013 show that Lloyds' outstanding loans to the Irish corporate sector (including the hotel sector) shrank 44 per cent from £6.9 billion in 2011 to £3.9 billion in 2013.[8] Applying this rate of deleveraging *pro rata* to the hotel sector would suggest a reduction of nearly €700 million in loans over the past two years.
> - NAMA in 2010 and 2011 secured loans attached to 134 hotels in Ireland. Over the past two years, NAMA has reduced its exposure to the hotel sector largely through asset sales. According to NAMA, the Agency has sold 19 hotels, 14 of which are in the Dublin and Greater Dublin area.[9] NAMA currently has a hotel portfolio with an (initial) value of €800 million.[10]

4. Sustainability of Debt

To make judgements about debt sustainability, it is necessary to consider developments in the amount of debt per room. According to the Fáilte Ireland Hotels Register, the number of registered hotels in the Republic of Ireland peaked at 915 in 2009, before declining to 883 in 2011 and 835 in 2013. The number of hotel rooms reached a peak of 60,217 in 2010. Room stock declined to 59,377 in 2011 and contracted further to 57,362 in 2013.

Combining the data on debt in the hotel sector with those on the number of available rooms, Figure 2 shows the evolution of debt per room over the past decade. Indebtedness in the hotel sector has decreased from €113,250 per room in 2011 to €92,750 per room in 2013, but remains at elevated levels compared with the early 2000's. It is important to note that these figures refer to averages across the sector, and the picture differs from hotel to hotel.

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[6] These estimates recognise that some of this debt has been sold to other non-resident financial institutions (for example, U.S. private equity funds) and therefore has not been completely extinguished.

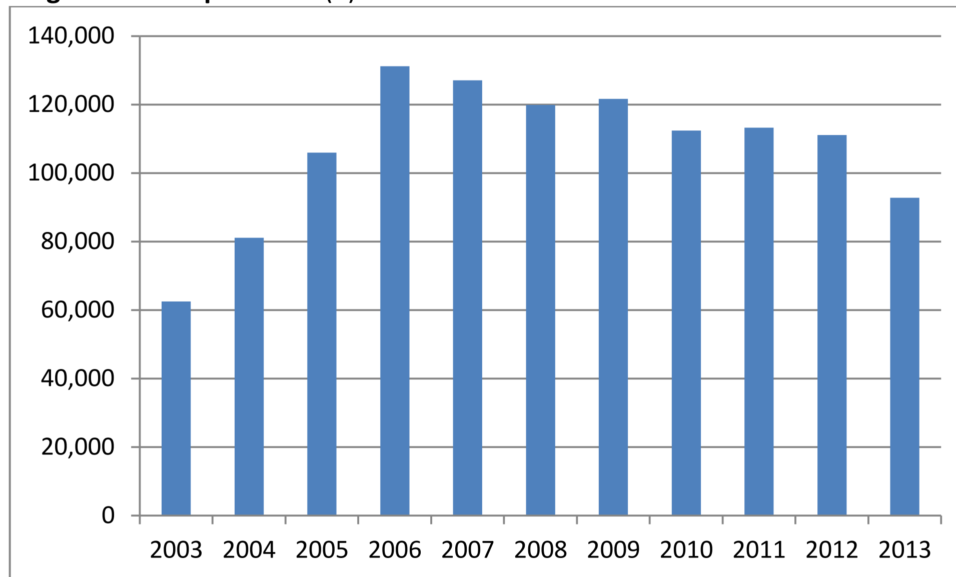
[7] www.lloydsbankinggroup.com/investors/financial-performance/lloyds-banking-group/

[8] Lloyds' corporate loan book consists of loans that are linked to the operating performance of companies, and therefore includes exposures to the hotel sector. In contrast, Lloyds' commercial real estate loan book consists of loans that are directly supported by cash flows from property activities. Lloyds' commercial real estate exposure to Ireland has dropped 50 per cent from £10.9 billion in 2011 to £5.5 billion in 2013.

[9] See presentation by Patrick Ryan, Senior Property Advisor for Hotels and Leisure, NAMA, at the Irish Hotels Federation Conference, 10 June 2014. According to various news reports, hotels sold on behalf of NAMA over the past two years or so include: Morrison Hotel in Dublin (sold for €22 million); Trinity Capital Hotel in Dublin (€35 million); Fota Island resort in Cork (€20 million); Clarion Hotel IFSC in Dublin (€33 million); Hilton Hotel in Dublin (€30 million); and the Clarion Hotel Dublin Airport (€15 million).

[10] Patrick Ryan, *ibid.*

Figure 2: Debt per room (€)



Source: Fáilte Ireland, Central Bank of Ireland and author's calculations.

The key question for financial sustainability is whether earnings in the sector in the years ahead will be sufficient to service this level of debt. According to the most recent Crowe Horwath Annual Irish Hotel Survey, the average profit (EBITDA) per room in the Irish hotel sector rose to €6,497 per room in 2012 from €5,220 per room a year earlier.[11] Profit per room peaked at €10,238 in 2005. These figures highlight that the hotel sector as a whole is generating an operating surplus and therefore can sustain a certain level of debt. On the other hand, industry sources report that interest rates on bank debt have increased by 2 percentage points on average since 2011.

Updating the analysis in *Time to Invest*, Table 1 below explores the sustainability of debt per room under different scenarios about growth in profit per room over the next few years. For example, assuming an annual growth rate in profit per room of 3 per cent over the period 2013-2016, profit per room would reach €7,312 by 2016. Such a level of profit could sustain, at a maximum, a level of debt per room of €68,700. To lower the debt overhang to that sustainable level from the current level of debt would require a reduction in debt of 26 per cent. For the hotel sector as a whole, this would require a reduction in debt of €1.4 billion from current levels.

Table 1: Debt sustainability under different scenarios (€ per room, unless stated)

Growth rate in profit p.a. (%)	Profit in 2016	Maximum sustainable debt	Current debt	Restructuring required (%)
Zero	6,497	61,000	92,750	34.1
3	7,312	68,700	92,750	26.0
5	7,897	74,200	92,750	20.0
7	8,516	80,000	92,750	13.7
10	9,512	89,500	92,750	3.5

Source: Author's calculations.

[11] The Crowe Horwath Annual Irish Hotel Survey covers key issues in Ireland's hospitality sector including hotel performance, room occupancy, average daily rate, profit before tax and receiverships. Data for 2013 are not yet available. For details, see: www.crowehorwath.net/ie/

It is worth comparing these calculations with the corresponding figures in *Time to Invest* to get a sense of how the picture has changed. For example, under the scenario of annual growth of 3 per cent in profit per room, the aggregate debt overhang of €2.9 billion for 2011 reported in *Time to Invest* has been reduced over the past two years to €1.4 billion. This reduction largely reflects the combination of debt restructuring in the hotel sector (mainly in Dublin) and reported better-than-expected profitability in 2012, offset to some extent by higher interest rates.

The above analysis points to an improvement in the financial strength of the hotel industry over the past two years. Mirroring developments in the wider economy, however, the improvement appears to be largely confined to urban areas, especially Dublin city. The problem of unsustainable debt in the wider hotel industry has not been completely resolved.

Many hotels outside of Dublin remain undercapitalised and require the restructuring of their balance sheets and injection of new equity investment to survive and prosper. Unlike larger hotels in urban areas, however, these smaller hotels have not been attracting overseas investors or REITs. As a result, many viable hotels remain in the hands of receivers. Moreover, outside of the bank-owned hotels, there are still many viable hotels in need of equity investment to bolster their balance sheets. Domestic sources of equity capital will be essential to the restructuring and restoration of financial sustainability to these hotels.

If receivers are to find buyers at acceptable prices for bank-owned hotels, prospective buyers will need access to equity capital. The sharp drop over the past few years in offer prices for hotels should be attracting bidders. However, the market mechanism for the supply of equity finance to smaller hotels is not functioning. Potential buyers are unable to raise equity capital, even for the purchase of hotels with reasonable prospects for profitability and growth.

This lack of funds constitutes a market failure that is gumming up the recovery process in the hotel industry. In the meantime, the debt overhang continues to do damage the sector and the wider tourism industry through underinvestment in the hotel stock.

4. Conclusions

Sections of the Irish hotel industry have experienced progress in repairing balance sheets over the past two years. Debt restructuring and new equity investment associated with sales of hotels has helped to reduce the large debt overhang in the sector. Unshackled from unsustainable levels of debt, some hotels are now in a financial position to increase investment in maintenance, refurbishment, renovation and innovation. This investment is crucial if the sector is to maintain and improve the quality of product that Irish hotels offer consumers.

Progress has been uneven, however. As anticipated in *Time to Invest*, advances have been made in urban areas, especially Dublin city. The next steps should focus on restructuring balance sheets to restore financial strength to the industry outside of Dublin. Making funds in the Ireland Strategic Investment Fund available to hoteliers, as recommended in *Time to Invest*, to assist where market failure still exists for hotels that are viable but undercapitalised should be part of the solution.

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