Over Capacity in the Hotel Industry and Required Elements of a Recovery Programme

This recently published comprehensive report by Peter Bacon, Economic Consultant, was commissioned by the Irish Hotels Federation. The Executive Summary is reproduced with the kind permission of Peter Bacon and The Irish Hotels Federation and makes for very interesting reading.

Executive Summary

1. 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. However, the number of visitors to Ireland has fallen sharply in 2009 in line with other European countries.

2. The number of hotels and the number of available rooms rose rapidly in the period after 2003. Supply rose faster than overseas demand where growth was weak and although growth in the domestic market kept occupancy rates steady up to 2007, the slow-down since 2008 has shown that there is considerable excess capacity.

3. Hotel operators have attempted to address this situation through lower prices but inelastic demand for the sector in aggregate means that this results in lower revenues and margins as competitors react. This damaging process is given added impetus by the actions of hotels with no long term viability which are reducing prices to maintain cash flow.

4. In the years prior to 2008, decisions to invest in hotels increasingly came more from a wish to avail of associated capital allowances for tax purposes and were less related to the fundamentals of the industry. The allowances provided incentives to a range of decisionmakers to promote greater investment but none had compelling reason to be concerned about the potential impact of excess supply on the viability of existing businesses or the sector overall.

5. The situation is being made worse by the high cost base of the Irish economy. With the second highest electricity prices in the EU-14 and inflation in protected sectors of the economy still in double figures, operators are caught in a vicious trap of lower prices, higher costs and a sector that is being driven by decisionmakers whose short term objectives and interventions are detrimental to the industry.

6. The rapid growth in capacity has been accompanied by a huge growth in the indebtedness of hotels. There were 26,802 new rooms added to the register in the period 1999-2008, with an estimated total investment of €5.2 billion and debt of €4.1 billion. This debt relates primarily to new hotels and in particular to hotels developed after 2004.

7. In aggregate, the hotel sector has been insolvent since 2008 given the level of debt and asset values based on current profitability. The stock of new hotels has been seriously insolvent since 2005. The analysis shows that in every year since 2002, new hotels on average have been insolvent from the year of their construction. Insolvency is a characteristic, on average, of all major segments of the hotel industry but appears to be worst in higher grade hotels, medium size hotels and in hotels outside Dublin.

8. The insolvency problem is largely the result of excess capacity that has been created. Weakness of demand in recent years has served to turn a bad situation into a crisis. The situation is particularly bad in respect of hotels constructed in the period 2005 to 2008. These comprise 217 hotels with about 15,600 rooms.

9. In a properly functioning industry, insolvency would be contained to the weakest businesses and the problem resolved as these exited the industry. However, the most insolvent hotels are remaining in business for a number of reasons. Among these is the need of hotels to remain open for seven years to allow investors to avail of capital allowances and to avoid the creation of a tax liability due to a clawback of allowances that have been claimed already; the reluctance of banks to realise losses and write off loans granted to hotels with no prospect of recovery because of the additional pressure this would place on the capital adequacy of their own balance sheets; and the reluctance to act in advance of the introduction of NAMA.

10. The result of these factors is that the insolvency problem is being spread through the industry and is damaging the whole stock of hotels by pushing prices down to non-viable levels. This is leading to a contagion of insolvency as the burden of adjustment is transferred from banks to otherwise viable hotels. At the same time, the reluctance of banks to provide working capital is leading to liquidity problems that further undermine the businesses of solvent hotels.

11. Unless demand can be expected to recover strongly, then action is required to remove the excess capacity to prevent this contagion from undermining the entire sector. Forecasts, even when an effective promotional initiative is built in, do not suggest that demand can grow sufficiently. Instead, reasonable expectations of recovery, assuming an effective programme of actions is implemented to promote the industry and improve competitiveness, suggest that the current situation, where demand for room-nights is about 50% of the available supply will only improve marginally to about 55% by 2013. This would not be sufficient to allow hotels to stabilise.

12. This implies that in the absence of action to address the imbalance by removing capacity, the sector will undergo a major and chaotic shakeout over coming years. This process is unlikely to result in an industry with the optimal mix of hotels in terms of grade, location and facilities necessary to underpin the growth of tourism in the medium to long term.

13. Based on current capacity, it is estimated that between 12,300 and 15,300 hotel rooms need to be removed, if an appropriate balance is to be achieved that would allow the sector to recover to a stage where it can provide adequate returns and regain overall solvency. The higher end of this range recognises that there are considerable risks that demand could be weaker than expected in the next few years.

14. The conclusion is that instead a managed process of capacity reduction should be developed and implemented. One approach would be that the burden of adjustment would fall on the 15,600 rooms introduced since 2005 as many of these should not have been built given the emerging imbalance between supply and demand and the fact that the levels of associated debt make these the group with the highest degree of insolvency. Doing so would result in an industry with about 44,000 rooms in 700 hotels.

15. This strategy would hit hotels in the east of the country particularly hard and would also have a disproportionate impact on 4* and 5* hotels. Given that there are also high levels of debt associated with some older 5* hotels, it is questionable if this would be in the longer term interests of Irish tourism.

16. This work concludes that capacity must be reduced and indicates the magnitude of the adjustment that is required. However the process can only be implemented after an in-depth assessment of the needs of the tourism industry in terms of the optimal structure of its hotel stock has been undertaken. The conclusions point to a number of recommendations as set out below.

Removing Rooms from the Active Hotel Stock

17. The sector cannot rely on outside intervention to address the problems that have developed so, collectively, hotel operators must work to stabilise the industry. Demand growth will not be adequate to restore balance and stability to the sector. This means that the adjustment process will occur primarily on the supply side but this should be planned and co-ordinated and should not be allowed to be driven by actions of banks. ***It is recommended that the 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.***

18. The first requirement is that barriers to exit of insolvent hotels must be removed. ***It is recommended 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 capital allowances. It is further recommended that an accompanying provision be introduced to the effect that capital allowances that have already been claimed in respect of any hotel should not be subject to any claw back by the Revenue should that hotel exit the industry within seven years.*** Removing this barrier would facilitate the exit of some hotels from the industry but would not necessarily promote the exit of any particular hotel. The costs to the Exchequer of removing this barrier to exit would be zero given the situation that has arisen. Hotel related capital allowances which remain to be claimed have an estimated value of €527 million to investors. Allowances already claimed which potentially could be clawed back by the Revenue have a value estimated at €1 billion. For as long as the current conditions relating to capital allowances are retained, there is a very strong incentive for these hotels to remain open in the industry even in situations where they have no prospect of recovery. Investors will claim and retain these allowances.

    Therefore, allowing hotels to exit without consequences for investors in terms of the value of the tax allowances would have no financial implications for the exchequer compared with the situation where these remain open for the full seven years. However, the potential costs of retaining this barrier to exit are substantial for the hotel sector. ***It is also recommended that these provisions should apply similarly in respect of investors in hotels that close completely and those which are converted into alternative uses.***

19. It is imperative that a planned programme of closure must first identify the optimal future structure of the hotel sector in terms of location, grade, etc. It is recommended that a group be convened as soon as possible to begin this work including representatives of the hotel industry, tourism development agencies and the financial sector. ***It is recommended that 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 to the long term demand for Irish tourism.***

20. There needs to be recognition and acknowledgement, by all stakeholders, especially financial institutions, that failure to foreclose on insolvent hotels is damaging to the long term interests of the hotel and tourism sectors. Should this recognition not be sufficiently forthcoming, ***it is recommended that the relevant financial regulatory authorities should consider the economic arguments with respect to insolvency and the consequences for the hotel sector at large of lack of foreclosure against fundamentally insolvent hotels.*** Based on this, they

should ensure that banks fully recognise bad loans within the hotel sector and face any capital adequacy issues which might follow. In part, uncertainty as regards the transfer of loans from financial institutions to the proposed NAMA may account for a forestalling of action by the institutions against insolvent hotels. However, such vacillation is simply transferring the burden of adjustment from financial institutions to the hotel sector as a whole.

21. While there will be some degree of correlation between the level of insolvency of a hotel and its strategic importance to tourism, the optimal structure of the industry may mean that some insolvent hotels should stay open. ***It is recommended that detailed examination be made of the potential for establishing a Hotel Restructuring Fund. The objective of this fund would not be to preserve the existing stock of hotels but to arbitrate in situations where currently insolvent hotels are deemed to be important for the recovery of tourism against hotels which may be solvent currently but which have little or no strategic importance to the development of the Irish tourism product internationally. Such a fund could attract long term equity as well as participation by Irish financial institutions.*** A role could be to invest by way of long term equity in strategically important hotels whose reason for insolvency is excessive reliance on bank debt and cyclically depressed prices resulting from the current imbalance between demand and supply.

22. In the longer term, there is the potential either through NAMA or the actions of the banks that hotels with debt written off could be recycled back into the market at low capital cost. This would have long term implications for existing operators. ***It is recommended that the industry examine how this possibility might be managed with a view to ensuring that such hotels reenter the industry in a manner that does not threaten the stability of existing businesses. The best option in this regard may be to promote consolidation of hotel (groups) where there is sufficient management capacity in order to promote a reduction in average debt per room in operation.***

23. Some opportunities may exist for hotels to be removed from the tourist accommodation sector and operate in sectors that do not threaten the stability of the sector. These might include care homes or language schools. ***It is recommended that a High Level Working Group be formed, including the IHF and representatives from the relevant Government Departments, to undertake the necessary research to assess the potential in this area, identify impediments to hotel conversion and co-ordinate with relevant agencies to maximise this potential. It is further recommended that the Department of Heritage, Environment and Local Government instruct local authorities to work with hotels in their areas to identify such opportunities and, in particular, to identify and remove such impediments in the planning systems as might be identified.***

Promoting Demand and Competitiveness

24. 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. ***It is recommended 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.***

25. While there are questions in relation to the long term performance of hotels in relation to attracting overseas visitors, there is no doubt that there has been a sharp downturn in recent years. New programmes to promote Irish tourism overseas are being developed and ***it is recommended that these demand promotion programmes should be supported.*** In particular, the focus should be on the British market with a particular concentration on specific parts of the market such as older age groups and the business segment. In addition, special incentives such as extending the free public transport scheme to all EU citizens while visiting Ireland should be supported.

26. As a vital element in the overall product, hotels need to be actively engaged in this process. ***It is recommended that the hotel sector co-ordinate its promotional activities within its industry and with the national agencies to promote Ireland and local regions as a destination for overseas visitors and grow the market that is available to the hotels.***

27. Improved competitiveness is essential to maximise the return from investment in promotion. The evidence shows that while there have been general falls in prices in 2009, inflation in the case of public services and regulated prices is still very high. ***It is recommended that direct action is taken to address this trend with a freeze on public service charges at 2008 levels.***

28. Hotels continue to face high rates bills that are unrelated to the actual business conditions, although there is emerging evidence that a review of rateable valuation in relation to hotels requires immediate review. ***It is recommended that this process under the Valuation Act 2001 should be prioritised in respect of hotels.***

29. It is important that all incentives are aligned to promote the reduction in the number of rooms on the market. In this respect, ***it is recommended that a formal mechanism be introduced immediately to validate the partial, or full, closure of hotels for all or part of the year and that this would be recognised in an appropriate adjustment to rates liabilities.*** For example, a hotel closing for 3 months would have a 25% reduction in rates or if hotel formally closed a certain percentage of its rooms then its liability would be reduced by a similar percentage.

Hotels' Pricing Strategy

30. Tourists' decisions to purchase are often only partly governed by rational thinking such as comprehensive comparison of the offerings that are available. Any element of confusion is a huge disincentive. ***It is recommended that the sector develop a single standardised format for pricing and that this is used exclusively in all promotional material.*** It is considered that, to conform with general international practice this should be on a cost per room per night basis, rather than the more usual practice of Irish hotels of a cost per person sharing basis. This of course does not affect the actual advertised room rate or disallow special offers or packages.

31. There is anecdotal evidence that prices offered on the international and domestic markets differ markedly with the perception that rooms are offered at relatively high prices abroad and the remainder placed at discounted prices on the domestic market. ***It is recommended that transparency should be introduced in this regard including comprehensive data sharing and cooperation between the hotels and inward travel operators.***

32. Aggressive price discounting does not work in terms of generating overall additional revenue. Reductions will soon be matched by competitors and the cycle undermines the finances of the industry without markedly growing the aggregate number of rooms that are sold. ***While recognising that intervention to limit price competition or to achieve collective price setting would be illegal under the Competition Acts, it is recommended that the IHF take the lead in ensuring that managers understand the implications of inelastic demand in the hotel sector and the potential for non-viable pricing, driven by the demand of banks to provide cashflow to destabilise the sector.***

Provide Consistent Data

33. Although there is a considerable amount of data produced on the tourism industry, there are some serious weaknesses in terms of its consistency. ***It is recommended that a detailed work programme should be developed and undertaken to address difficulties with the data and to provide a single comprehensive data source for the tourism sector to be used in developing policy and operational strategies and in assessing outcomes.*** ◆

The full report is available to download on the Irish Hotels Federation's Website at http://www.ihf.ie/press/091109peterbacon.htm