

IS HOTEL SALE AND LEASEBACK DEAD?

Derek Gammage discusses whether hotel sale and leasebacks are a thing of the past

It is now 10 years since I started banging the drum about the benefits of 'Bricks and Brains' split. Indeed, for several years in the early 'noughties', I was the biggest bore on the subject. With hindsight I ran the risk of being somewhat evangelical about this as being the way to go. Whether I was right or wrong I will leave to you, but the question I am constantly being asked today is whether such structures are yesterday's news?

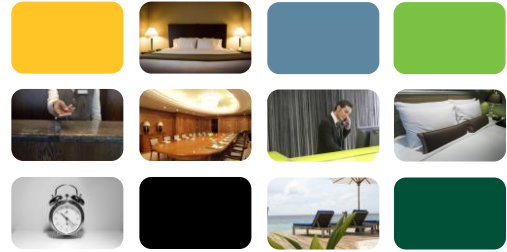
When answering, (and putting the budget sector aside) the first question I ask is 'why are you looking to create a lease'?

I am only too aware how difficult it is to fund an hotel development. The constraints around debt mean the promoter and its lender in most (albeit not all) cases will certainly seek a lease from the hotel operator as a way of securing debt and I mean the plain "vanilla" senior debt, let alone any mezzanine or "stretch" lending. This of itself begs a further question 'why do we in Europe rely so heavily on Balance Sheet lenders'? The US is not reliant on banks to anything like the same extent!

I am on record saying that hotel operators – who for dull accounting reasons we all know about do not want to create leases – could use their own Balance Sheets to help drive development pipelines. For instance, why don't hotel groups help seed hotel debt funds which would be both off Balance Sheet and aimed specifically and exclusively at their own developer base? Big subject I know but surely a better use of resources than the liability associated with a guaranteed lease for many years?

I can see such initiatives addressing the need (as things currently stand) for hotel companies to create leases – in certain key locations – to provide a basis for a promoter to create a strong strategic presence for them in key locations. So no, leasing should not be dead.

That said, assuming we are at or near the bottom of the cycle, and that rent (on an existing asset) is set at the 'correct' level for today's market - i.e.: a sensible percentage of its trailing 12 month EBITDA, leased hotel assets are superb things to buy. One should be able to rely on EBITDA increases, the rental cover clearly likewise. As the Vacant Possession values are based on EBITDA multiples, in the round the value of the investment increases – happy days.



As an hotel owner then there is, in my view, a strong argument you are selling at the wrong time. For all the reasons given above as to why now is a good time to buy, the converse is true for sellers. Whilst only hind-sight will reveal the truth, common sense tells us that the value of the post rental EBITDA (i.e.: the Tenant's leasehold interest) simply has to be worth less than the EBITDA as if the real estate were 'whole'. Indeed is there even a market for leasehold fully rented hotels at the moment? So if EBITDA increases in the short to medium term, the rental as a proportion of profit will obviously fall if one assumes this rent is linked to inflation only. As such the current owner/seller is essentially failing to capitalise that EBITDA at the higher yield.

So is Sale and Leaseback technology dead? Answer: no. Is it suitable technology in all cases? Answer: most definitely not. As things to buy, leases can be a great investment especially if the rental cover is sensible in today's market. Are Sale and Leaseback structures right for hoteliers and brands looking to increase distribution? Answer: certainly, as this may well be the only way to drive development in this market. Are they the right structures for existing owners looking to raise equity? Answer: I would argue probably not, but if you are cash constrained I guess you may have no choice. However, goodness knows what this does to you long term – in short are you selling off the family silver?

Finally to give some context, as sellers of hotels across Europe we have strong demand for leased hotels and either vacant possession or franchised hotels. In other words the market clearly divides into passive investors collecting the rent and other investors who want to have direct access to the moving parts so they can influence them.

The market is much more limited for anything in between, such as over rented leases, 'hybrid' leases involving Cap Guarantees, weak covenanted leases and all manner of 'weird' structures created 3-4yrs ago (for the avoidance of doubt I am not lumping Management Contracts under the 'weird' banner). All these types are frankly struggling to achieve their potential, so in truth these leases may well need to unravel if they are ever to achieve proper value. As is often said, these structures 'are just too clever for their own good' and are almost certainly a result of market conditions we are unlikely to see again for a very long time.

There – I feel better for that!

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