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Dear Readers,

All over the world, countries, local authorities and businesses are fighting their way back into the world of yesterday. But how can we live, work, consume, celebrate and travel with this virus constantly on our minds? Where initially there had been hope that Corona would soon pass, we are now preparing to live with it – in the meanwhile painfully gained awareness that this pandemic has caused the worst worldwide economic downturn since 1930. And it will take years for production, consumption and service providers to recover from this shock.

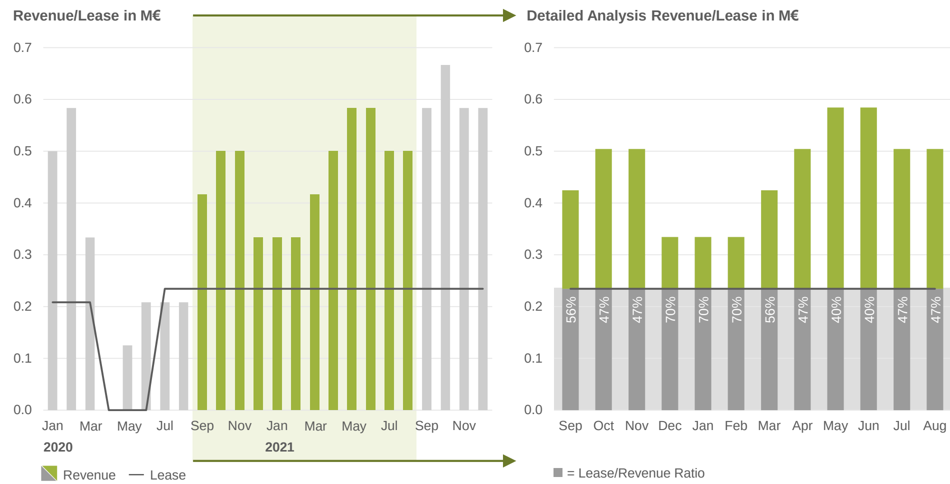
How is the hotel industry doing?

As equity and KfW loans are quickly used up in view of the dramatic drop in sales it is struggling for its existence. The current frequently seen deferral of three months lease or repayment rates as well as short-time work and the expected economic stimulus will in many cases not be sufficient to ensure the solvency of a hotel or a hotel group. Why is that?

At the moment it seems as if demand will recover only very slowly this year and next. Currently, we are seeing a faster recovery in holiday destinations, as city hotels still are suffering. If even a holiday country like Austria expects a drop in overnight stays of 36% for the current year, an even more massive slump will be expected in the cities, where demand depends on business trips, congresses and trade fairs.

We will demonstrate what such a drop in sales means for a city or business hotel.

Display of a hotel with annual turnover of € 10M and a fixed lease of € 2.5M



This specimen/exemplary city hotel was able to generate an annual turnover of € 10 million prior to the pandemic, with 75% room occupancy, a high proportion of conferences and a typical annual lease of € 2.5 million. The lease has been deferred for April, May and June 2020 and will be repaid in 24 monthly installments starting July. As a result, the monthly lease increases from around € 208,000 to around € 234,000. At the same time the recovery is only slowly taking hold so that in July and August the lease payment will even exceed sales. Starting September demand will pick up again, but the hotel will remain well below the pre-crisis level. The detailed analysis of a year - 12 months starting from September 2020 - shows a typical demand pattern with monthly occupancy rates between 35% and 70%, i.e. an average occupancy of 50% over the 12 months. This corresponds to a decline in occupancy of around 33%. However, due to the massive drop in the conference share the loss in sales amounts to 45% as shown in the diagram on page 2.

Full Service Hotel

The diagram illustrates the situation of an exemplary 4 star city hotel with 200 rooms in a regular year: 75% average room occupancy, 120 € average room rate (ARR) and a 63 € F&B revenue per occupied room with a clear focus on the catering and event business. The operating profit, as typical for hotels of this structure, is 6% of sales or 600 k€.

In a crisis year, as we have shown in the diagram on page 1 for the months of September 2020 to August 2021, the occupancy rate drops by roughly a third to 50%. Assuming that the hotel will primarily lose conference business, the proceeds from catering (F&B) and ancillary departments will decline more significantly. For the sake of simplicity we have not changed the ARR. The standby costs of a 24/7 full service operation are high: Therefore the hotel cannot save enough costs to compensate the loss of revenues. As a result, the loss in the crisis year was € 1.7 million even though, for the sake of comparability, we did not increase the lease of € 2.5 million by the repayment of any deferred leases during the lockdown.

Limited Service Hotel

In order to demonstrate the impact of a comparable decline of demand on a limited service hotel (bed and breakfast only) we have – for an easier comparison – picked a property with an annual revenue of € 10 million in a stabilized year. This purely fictional hotel, categorized with 3 stars and 400 rooms. As with the 4 star hotel we assumed an occupancy rate of 75%, and reduced the average room rate as well as the F&B revenues according to the product. The higher profitability of the hotel, which incidentally pays a lease of € 3 million, is already evident for the regular year. But with an occupancy rate of 50% and a loss of approx. 600 k€ even this business slips into the shortfall. This is of course also due to the high lease, which indeed is typical for excellent locations and typical for newly signed contracts.

Cost structures in a crisis mode: Full Service versus Limited Service hotel

Rooms	200	200	400	400
Occupancy	75%	50%	75%	50%
ARR	120 €	120 €	75 €	75 €
Share Rooms Revenue	66%	80%	82%	86%
F&B / Other Revenues	63 €	30 €	16 €	12 €

Operating Loss, Operating Profit, FF&E Reserve, Lease, Fixed Costs, Staff Costs, Variable Costs

For the sake of simplicity, our rough calculation compares two twelve-month snapshots: one of a regular year and one of a crisis year. We are aware that in the event of a prolonged crisis individual fixed costs can certainly be converted into variable costs (e.g. downsizing as a result of concept adjustments).

The estimated costs are also averages on a percentage base of various hotels from different operators that have been collected over the past years. They therefore do not reflect the data of a specific property and have no general validity for the hotel industry. Rather, the calculation model is intended to illustrate the influence of massive revenue losses on the lease coverage ratio of a hotel.

In this chart, “fixed costs” are understood as all fixed costs except for staff costs.

What is the solution?

Whether (and which) hotels survive is currently in the hands of the lessors and banks: will they show solidarity with the hoteliers throughout the crisis or will the property ultimately be used for other purposes? Will we see a wave of bankruptcies in October once the obligation to apply for insolvency is reinstated? And what is the point for lenders and banks? Which other tenant would step in? Might an active role of capital creditors even be helpful if operators strive for the not unrealistic scenario of a protective shield procedure or self-administered bankruptcy? Or would it be more constructive to find a special regulation for a transition phase until normal operation can be reached again - with or without an insolvency plan?

What specific questions do we have to ask ourselves?

To begin with the most difficult question: Is this hotel still needed in this location with this concept in the post-corona period? And then the second-most difficult one: Is it worthwhile making concessions - for example on the basis of a transitionally variable lease - to this operator or hotelier? Or are we artificially keeping a business model alive that - viewed in the burning glass of the crisis - no longer has a reason to exist? It is worthwhile, also as an owner or financer, to quickly put your hotel portfolio to the test according to these criteria.

The question of property valuation

As the most frequent argument against the part-time variable lease models are repeatedly brought up by the investment law. In our experience from the financial crisis, the investment law does not block sensible solutions. The special arrangement must be clearly defined as a temporary incentive compared to a permanent lease. And the question of valuation is also clarified in this way. The decisive factor is the very specific time limit for the phase of the acute crisis and the equally clearly limited start-up phase afterwards.

Ramp-up periods with lease incentives or staggered leases are already common practice for new openings. Just as crucial: Is the fixed lease, which will only be due again in a few years, really sustainable? Given today's uncertainty, this is the most challenging question as it forces us to take a deep look at the location, business model and operator concept. There's no way around it.

Aren't temporary variable rental models too tenant-friendly?

In view of the long undamped expansion strategy of hotel operators, the position of the lessors was very strong until recently. In existing contracts - pacta sunt servanda – lessors can act with the same strength in this crisis until their tenant is (threatened to become) insolvent. If an existing hotel is vacant without an alternative operator, the balance of power is reversed. Knowing this situation and knowing that, especially for institutional investors, a long-term lease agreement with a high minimum lease is of great importance, lease incentives for the tenant are an important means (for this purpose) that is worth believing in.

How to deal with bankruptcies?

When asked whether Lufthansa wanted to blackmail state aid through the threat of insolvency, CEO Carsten Spohr replied accordingly: "If the solvency of a company depends on the decision of a third party, the management is obliged to also work on a plan B." We do not hear this clearly from hotel operators, even though they are in a comparable situation. If you wait too long in the hope of reaching an agreement with your lessors and banks, you may lack the necessary liquidity and thus the time to draw up and negotiate a restructuring plan. If they start too early, the creditors could feel blackmailed and would not cooperate. And who would expose themselves to the supposed shame without need? Protective shield procedures and self-administration certainly offer face-preserving instruments with the aim of restructuring by the existing management. An active role on the capital side can show a constructive way out of this fundamental crisis.

Does time heal all wounds?

We think: yes! There will be a time after the crisis when hotel operators, their banks and lessors will look back on the jointly contested marathon, no triathlon, with justified pride. Many short-term investors who only invested in hotels because of their supposedly risk-free, easy-to-maintain and long-term leases have found new investment goals in warehouses and logistics centres. Some of them will have become avowed long-term investors in hotels. They will have come together with their tenants, learned to understand the core of the hotel business and struggled to find solutions. They appreciate the benefits of long-term hotel investments and the commitment of hotel operators to their locations.

The typically long lease agreements are not only suitable for renewal but also to extend repayments of deferred leases over a long period of time.

Because one thing has become clear: No business model in the hotel industry, not even the most profitable, is able to repay deferred rents which were postponed during the lockdown and the arduous time afterwards to owners or banks within a few years.

Even successful triathletes know from their experience:
„Everything is hard before it gets easy“

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Notice

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