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Hotel operator motives in UK sale and leaseback/management-back transactions

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Abstract

Sale and leaseback has become a major financing method in the hotel industry in the UK over the last 10 years, followed more recently by sale and management-back. This article, using interviews with current practitioners, examines the motivations of owner/operators in adopting these methods, identifying differences from generic motives in previous literature relating to the subject. It finds that, because of the integral part that hotel properties play in the delivery of customer service there are differences of opinion on the benefits of such an approach and there is a need to adopt some different considerations in the decision to use this method of funding.

Keywords: Sale and leaseback; Management contracts; Finance, Hotels, Leasing

1. Introduction

Sale and leaseback transactions (SLBT) of portfolios of hotels have become a prominent part of financing and property ownership arrangements in the UK industry in the last 10 years (Whittaker, 2005). Prior to this, as Hopper and van Marken (2001) noted, institutional investment in hotels had been limited. The hotel industry is not unique nor at the forefront in adopting this form of financing. Researchers have written generally on SLBT, discussing industries such as retail, telecoms, financial services and energy (Barris, 2002; Dixon et al., 2000), as well by governmental operations such as hospitals. However, no academic research appears to have been done in the UK on its application to hotels, though some practitioners, real-estate agents and accountants mainly, have published articles on the subject (Elgonemy et al., 2002; Redington and Hackleton, 2006).

The hotel industry arguably has certain peculiarities that affect the needs of both the hotel operator, as lessee, and the lessor, the lending institution. Not least of these are the integral part that property plays in the basic transaction of the hotel industry, the sale of space on a short-term basis (Jones Lang Lasalle, 2006), the consequent interaction between customer and property and a relative volatility of earnings (Redington and Hackleton, 2006). It has also been noted that SLBT work best when applied to 'generic' properties (Barris, 2002)–those that can be used for other purposes or by a range of industries with a minimum of conversion cost, which is generally not true of hotels. A further example is the difficulty of identifying clearly the profits of hotel operations from those attributable to the property itself.

At the same time the adoption of SLBT by companies in the hotel industry has been far from universal. Some have embraced it (see Table 1), while others have been noticeable by their absence, despite carrying large freehold property portfolios. At a forum attended by 175 [leading] industry figures (PKF, 2002) in 2002, 72% voted against the proposition, "Is the current vogue for hotel companies to sell their assets, and only retain operational control, in the long-term interest of their business?" In more recent times, operators have used the alternative of sale and management-back transactions (SMBT), whereby the operator sells the hotel and signs a long-term contract to manage the hotel on behalf of the investor. These conflicting views and strategies deserve to be examined, coming as they do from leaders in the hotel industry. Previous studies were done prior to the main growth in the

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Table 1
SLB/SMB transactions 1997–2006

Year	Operator	Lessor	Value (£m)
1997	Friendly (single hotel)	Scottish American Investment	5
1998	CHE (formerly Friendly)	Norwich Union/Farnsworth	N/A
1999	Jarvis	Norwich Union/ Farnsworth	69
2000	Premier Hotels	Accor/London & Regional	70
2001	Accor	London & Regional Properties	64
	Hilton Group	Royal Bank of Scotland	312
	Le Meridien	Royal Bank of Scotland	1,250
2002	Thistle [a]	Orb Estates	600
	Hilton Group	Rotch/Farnsworth	336
	Jarvis	Trefick/Lioncourt	150
2003	Hanover	Trefick	36
	Swallow Hotels	REIT Asset Management	49
	Accor (UK and Holland)	Goldman Sachs	400
2004	Accor	Heron/AXA Sun Life	40
	Travelodge	Prestbury/West Coast Capital	400
2005	Thistle	Topland	185
	IHG [a]	Lehmann Bros/GIC/Realstar	1,000
2006	Hilton (Metropole 2 hotels)	Tonstate	417
	Marriott/Whitbread [a]	Royal Bank of Scotland	800

Sources: Bock and Forster (2000-5) company press releases and press reports.
[a]Sale and management-back deals.

hotel industry and did not attempt to address the peculiarities of any particular industry, while many tended to focus on the impact on share prices (Devaney and Lazieri, 2004; Fisher, 2004) rather than the motives in adopting the process.

A clearer understanding of the issues will hopefully provide a framework against which hotel executives can formulate their decision-making in this area, and promote a greater understanding between hotel operators and the investment community. It will also make such knowledge available to the wider academic community, filling a gap in the current literature. This article, therefore, aims to identify and analyse the motives of hotel operators and thus the underlying drivers of SLBT analysing industry responses to generic frameworks in earlier studies. As a result it is hoped to provide greater understanding of those motives and make recommendations that might inform future decisions.

Table 1 although not comprehensive, provides an indication of the size of transactions year by year and the parties to the transactions.

2. Literature review

The growth of SLBT in corporate financing accelerated in the late 1990s. Dixon et al., (2000) note the extent of this growth both in terms of the range of industries and the size of transactions. As part of an extensive study they investigated the motivation of the buyers and sellers in these transactions, noting:

1. an increasing focus on creating shareholder value and the need to sell 'underperforming' assets, i.e. those assets which, if sold, will result in an increase in greater reported net assets under the current methods of reporting;
2. mergers and acquisitions tend to trigger SLBT;
3. a move towards 'total property outsourcing' involving a greater service element;
4. accounting issues were identified as an area for further research.

Two further potentially relevant points are made by [8] Dixon et al. They highlight the issue of the degree of control a company wants over its property. Hotel operators, for instance, might see certain locations as strategic to their brand image. In addition, citing Bon and Luck (2000), they note that leasing tends to flourish in growth conditions when the internal cost of capital is high (relative to interest costs), a pertinent point in relation to both the UK economy and hotel industry in recent years.

Barris (2002) focused on the motivations of sellers and buyers. The former he found were influenced by:

1. the need to raise funding for other purposes, such as debt reduction or operational expansion;
2. diversification of funding sources;
3. improving efficiency in managing property through outsourcing and in use through the need to pay market rates for it;
4. flexibility of occupation, particularly the ability to leave premises more easily;
5. disposal of low-returning assets.

It can be seen that some of these points are linked to those noted in Dixon et al. (2000) above, though the