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# The Global Corporate Advisor

August 2015

## The Corporate Finance newsletter of Crowe Horwath International

Welcome to the August issue of The Global Corporate Advisor.

In this newsletter, from our London office, we have an insightful article on the global hotel real estate market in 2015. Overall, the hospitality industry is braving geopolitical instability, and stagnant growth in some regions, to show accelerating activity and optimism in most markets.

Globally, this year hotel transaction volumes are inching towards 2006 levels, though they are a long way from the pre-crisis peaks of 2007. How the recent economic events in the Asian markets affect this remains to be seen.

In general corporate finance, we take a closer look at the locked box mechanism used in sale and purchase agreements, which is useful in simplifying transactions and thus avoiding negotiations on adjustments mechanisms, among its other benefits. On a final note, Chinese stock markets have been volatile in recent weeks, in turn affecting other capital markets. The extent of impact of these developments on mid-cap corporate finance is yet to be determined. In principle, a lot of cash still exists and many deals are being driven by strategic reasoning. However, if the demand in emerging markets decreases, it is likely to affect the profitability of companies and may subsequently result in lower enterprise values, especially in companies which have an above average dependency on these regions.

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## Contact Us

The GCA team is here to respond to your needs relating to M&A transaction support, valuations and advisory services. If there is a topic you would like us to cover in future issues of the GCA newsletter, don't hesitate to contact Peter Varley, Chairman of GCA, at *peter.varley@crowecw.co.uk.* Alternatively, please contact your local GCA team member to discuss your ideas.



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# The Global Hotel Real Estate Market in 2015

**By James Chappell, London**

The global hotel real estate market in 2015 is displaying signs of high volatility, which is hardly surprising considering the difficult and uncertain trading conditions. Greece is still in the Euro, just, but how exposed are the banks in the Eurozone and what will it mean for liquidity in other fragile nations, such as Spain and Portugal, and what will this mean for Britain's own membership referendum?

In early July, Chinese stocks capped their biggest three-week decline since 1992 as the country's $2.8 trillion rout deepened. The Shanghai Composite Index slumped 6.9%, with mainland markets pummeled by profit taking and margin traders calling in their bets. Markets continued to sell off, even after margin-trading rules were eased, interest rates were cut and pension funds given permission to buy stocks. At the end of August, China's benchmark stock index has racked up a decline of almost 40% since June. Factory activity, indicated by the purchase managers index (PMI) has dropped below 50, indicating contraction, adding to global fears about an economic slowdown of the Asian giant.

Even amid geopolitical instability and stagnant growth in certain regions, the global hospitality industry is developing rapidly in a cycle of accelerating growth, and optimism prevails in most markets.

This month, we provide a comprehensive overview of global hotel and real estate business. We will look at trading conditions for the hotels, global transaction markets and deals, and identify significant trends in the industry.

## Hotel trading performance

In the hotels and tourism sector, the specialty of Horwath HTL, trading conditions generally match the performance of the wider economy and as such the industry is highly cyclical. The industry performance standard indicator for trading performance – revenue per available room, or RevPAR – is positive except for Asia Pacific and the Middle East.

### Americas

According to STR Global, RevPAR in North America grew 7.8% year to date (YTD), which is at level with previous peaks. An unexpected bonus of the global financial crisis has been a lack of new hotel supply to absorb. After several years of very strained capital availability, developers have not had financing to build, meaning that when demand has improved, the market has not had to deal with the impact of new hotel supply. This means that even when pricing power has been poor, the market has been able to support an occupancy led recovery. However, there are signs that this will change over the next two-three years. The latest data from Top Hotel Projects estimates that just over a thousand hotels accounting for 217,000 rooms are in development in North America.

South America is higher at a 17.8% RevPAR growth, thanks to last year's World Cup in Brazil, and they do not have anything like the same number of hotels under construction, with only 129 projects in development, according to Top Hotel Projects.

### Europe

Europe posted a solid 5.6% RevPAR growth, although individual market performance is very mixed. Key gateway cities continue to post very high performance figures, with London and Paris, for example, having 80% occupancy year-to-date in 2015, according to STR Global. Others are suffering, although Moscow is just below 60% occupancy and St Petersburg just above at 61%. Both markets were significantly higher before the Crimea crisis of 2014. In terms of new supply, Europe has so far benefited in the same way as the US, but development has started apace and Top Hotel Projects are tracking 1,039 projects equating to 196,000 rooms set to open over the next four years.

### Middle East and Asia

Even before the recent economic earthquakes in China, the whole region was struggling to absorb a large amount of new room supply. The 0.5% that Asia Pacific RevPAR is down is reflective of supply absorption rather than a lack of demand, but that will change if the economy continues to deteriorate. On its own this would be a concern, but the bad news does not stop there. Top Hotel Projects has 1,123 new projects under development, which means that an additional 300,000 rooms are set to open over the next four years. The Middle East is down 1.8%, but the Dubai and Abu Dhabi markets are performing as well as they did pre-crisis.

As with all supply figures, there will be a discrepancy over what is on the books, and what ends up coming out of the ground as projects lose financing. Whatever the actual number, expect new supply to become a hugely significant factor over the next few years.

## Hotel transactions and capital markets

### Global overview

According to Jones Lang LaSalle (JLL), at the end of 2014, global hotel transaction volumes reached nearly $60 billion, a 10% increase over the year before. To put this in context, before the financial crisis, there were $30 billion worth of hotel transactions in 2004, $50 billion in 2005, $80 billion in 2006 and $140 billion at the very peak in 2007.
The fact that global turnover volume is approaching 2006 levels shows that there is a tremendous amount of optimism and activity in the market. The general expectation is that levels in 2015 will rise to almost $70 billion.



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According to Real Capital Analytics (RCA), in the first quarter of 2015 there were $22 billion worth of transactions, a 46% increase year-on-year.
So what is driving this? Private equity investors have tremendous amount of cash and are under pressure to invest funds. Asian money, driven by outbound Chinese capital, is growing rapidly due, in part, to increased activity from insurance companies. The recent purchase of the Waldorf Astoria in New York for almost $2 billion by the Chinese insurance company Anbang is a good example of this.

## USA

We can expect, as in recent years, the Americas to drive global transaction volumes. In the U.S., investors are disposing of assets purchased at the onset of the recovery cycle and taking capital gains. Momentum is further fuelled by the weight of private equity pursuing portfolio deals. According to RCA, there were just over $13 billion worth of hotel transactions in the first quarter of 2015, a 71% increase.
Significant transactions to date include the sale of the Waldorf Astoria, as mentioned, the Park 55 Wyndham in San Francisco to Hilton worldwide for $530 million, and the Manhattan at Times Square for $520 million.

## EMEA

Europe, the Middle East and Africa (EMEA) growth will continue to accelerate with a projected $24.7 billion in hotel trades in 2015. According to RCA, there were over $7 billion worth transactions in the first quarter of 2015, a growth of 61% compared to the previous year. Outbound capital from the Middle East is anticipated to remain strong, with the Qatari Investment Authority (QIA) particularly active.
The bulk of its transaction activity will be driven by large single-asset deals with London and Paris at the centre. Several trophy assets are believed to be on the market, such as the Grosvenor House hotel in London. Portfolio deals are anticipated in the U.K. and Germany.

Significant transactions to date include the sale of the Kenzi Mecca Hotel to the Al Tayyar Group, and the purchase of the Intercontinental Paris - Le Grand by QIA. Top portfolio deals so far are ARC hospitality trust buying the Equity Inns portfolio for $1.77 billion, and private equity giant Lone Star's purchase of Project Laser for $1.4 billion.

## Asia Pacific

Whereas Asia Pacific was expected to bring a steady increase in transactions, with JLL predicting volumes of $8.5 billion in 2015, the reality has been somewhat different with RCA reporting just $1.9 billion worth of transactions in the first quarter, down almost 40% on the previous year. Australia is expected to remain an active market with its stable government and rise in investment interest from China make it a continued safe haven for growth.

Significant transactions to date include the sale of the Intercontinental hotel in Hong Kong for just over $1 billion. This sale was on behalf of the Intercontinental Hotels Group to a local Hong Kong Chinese company, Supreme Key. This is consistent with the asset light strategy of most major hotel companies.

## Hotel real estate ownership

In mature markets, institutional investors – private equity funds or real estate investment trusts – own almost 50% of full service hotel stock, offering very few opportunities for more imaginative deal making. This is not so in emerging countries which, according to JLL, have nearly half of their high-quality stock owned by developers, corporates and groups tied to high-net-worth investors, which would represent an opportunity for institutional investors when these markets mature sufficiently, or when the appetite for returns outweighs the risk.

## Trends for 2015

## Africa

Africa represents the last largely untapped frontier for hotel developments, with Nigeria and Angola especially seen as booming hotel markets.

But investing in Africa is no easy proposition and the overall difficulty of doing business cannot be overstated. Hotel investment in Africa often depends on other investments related to infrastructure and natural resources. Hotels can also take a long time to get off the ground due to an inadequate pool of local development and management partners, infrastructure problems and complicated ownership structures.
Be that as it may, the sheer lack of significant hotel supply in the continent, combined with major hotel companies' desire to increase the number of flags they have, means that Africa is very much in focus in 2015.

## Mergers and acquisitions in the hospitality industry

The fact remains that there are probably too many hotel companies and brands. For several years, confidence in the economy and in deal markets has improved, as shown by the recent surge of mergers and acquisitions. M&A activity overall and in the sector is driven by a need for incremental growth and the availability of debt and equity. There is also the situation where a hotel company can be seen to have been falling behind its competition, with its very reason for existing coming into question. In 2015, there has been one very high profile example of just this scenario. Starwood Hotels and Resorts has been placed very publicly on the market. While it is not clear whether they will be bought by a rival hotel company or broken up and sold as individual brands, it is clear that this will not be the last big deal.



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## BRIC countries are a lot less attractive than they were

Investors are avoiding Russia for now, given the near-term economic outlook and overall hotel related opportunities are muted, to say the least. This is a significant blow to the major hotel companies, all of which had very large pipelines before the Crimea conflict of 2014. These companies remain bullish, although it remains to be seen just how many of these projects make it out of the ground. India remains one of the most difficult places to develop and invest in hotels. Expensive land costs, bureaucracy, red tape and high interest-rate, have all combined to slow the rate of development.

In Brazil, there is an imbalance of high demand versus poor quality hotel supply, even in very high tourism destinations such as Rio. Like India, high interest rates and even higher land costs make it very difficult for projects to make financial sense.

China has a very significant set of economic issues to deal with. In addition to very high supply levels, with more coming, there have been the recent devaluations of the currency and massive drops in stock market prices, factors which are combining to push down consumer confidence and growth expectations.

## Outbound investment from Asia Pacific

Perversely, the poor economic situation at home will mean that investors from Asia Pacific and, specifically China, will continue to spend big abroad. As government cools intervention for domestic real estate, local buyers will be pushed towards investing offshore to find the returns they are looking for. At the same time, institutional investors have been, in effect, ordered to invest a certain percentage of their funds abroad, leading to significant purchases in cash. The purchase of the Waldorf Astoria in New York is the perfect example of this. Other markets are feeling the effects of the huge overseas investments being made by the Chinese, with Australia, in particular, benefiting from capital inflows from China. Sydney recently overtook London as the global leader in average residential house prices, as a direct result of this effect.

## Conclusion

There is no doubt that in spite of significant economic headwinds in some regions, the global hotel real estate market remains of considerable interest to investors.

There are several reasons for this being likely to continue over the course of 2015 and into 2016. Operating performances for hotels globally continues to be strong and underperforming assets have been sold or restructured since the global financial crisis.

At the same time, there is a significant amount of capital that is looking for a home as local private equity funds and institutional investors compete with outbound Asian investment and Middle Eastern sovereign wealth funds. We fully expect the global market to remain very active in 2015, with transactions, including significant M&A amongst hotel groups leading to the strongest year since 2007.

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# Using the Locked Box Working Capital Mechanism in SPAs

**By Matthias Linnenkugel, Hamburg**

The agreed purchase price mechanism is one of the fundamental factors in a sale and purchase agreement (SPA). Depending on the deal structure, several weeks or even months elapse between signing and closing. During this time, the buyer is exposed to changes in the value of the target, accompanied by a lack of control over current business operations. To prevent value leakage and profit reduction, two typical mechanisms are applied. The closing accounts method is characterized by a preliminary purchase price, which has to be adjusted after closing for actual cash, debt and working capital amount in the target on the closing date. If the parties decide to deploy the locked box mechanism, in the simplest form, a fixed purchase price is agreed. In this case, a protection against leakage is essential for a successful deal.

## Locked box mechanism vs closing accounts

The locked box mechanism typically differs from the closing accounts method in terms of timing and not in the way in which the target is valued. The most essential difference between the two mechanisms is the date of transfer of economic risk. When a completion accounts mechanism is applied, risks and opportunities do not fully pass to the buyer until the closing date. Therefore, the preliminary purchase price is adjusted to reflect differences between selected balance sheet items as at signing and closing date. When deploying the locked box method, economic risk and benefits of the business pass on the locked box date to the buyer. Since the purchase price is fixed in reference to a balance sheet prepared before signing, post-completion adjustments are not necessary.

The locked box mechanism implicates that any movement in working capital is recognized in net debt under the condition that no leakage has occurred. Therefore, the buyer's position is not affected if the balance sheet differs between locked box date and closing. For instance, as seen in figure 2, with passing of the economic interest on the locked box balance sheet date December 31, 2014 subsequent changes in the composition of target's balance sheet until closing date May 30, 2015 are irrelevant to the buyer, as the value of the target remains the same.

*Figure 1.*

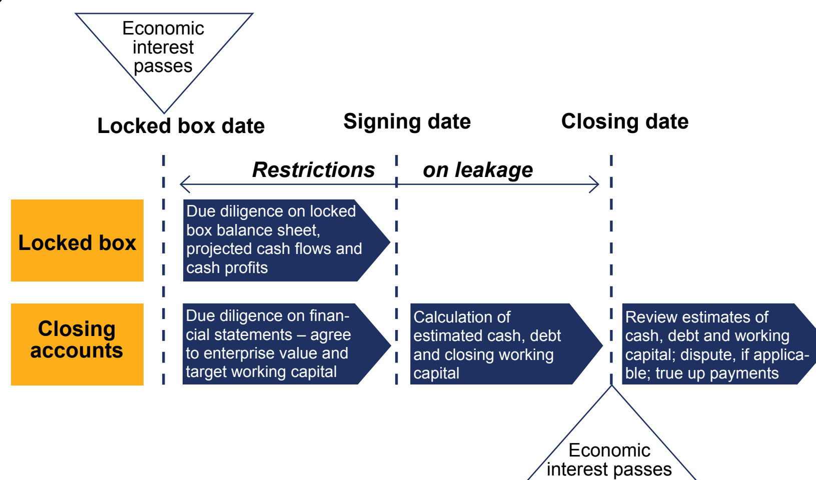


*Figure 2.*

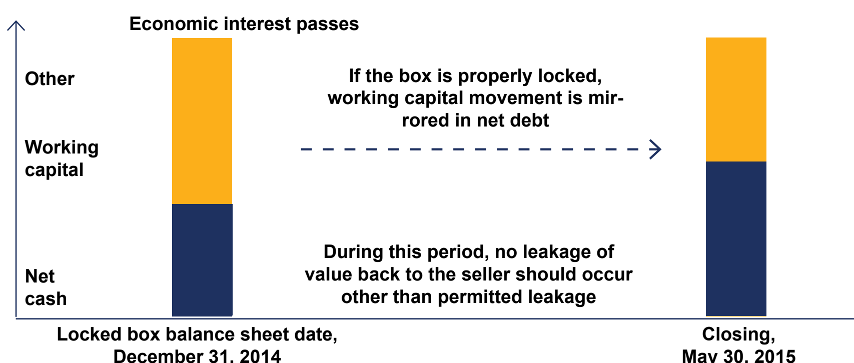


*Figure 3. The most common examples of prohibited and permitted leakage can be summarized as:*

| Possible sources of prohibited leakage include | Possible sources of permitted leakage include |
|---|---|
| Dividends, returns of capital, management fees, bonuses etc paid to the seller | Dividends paid to the seller and identified in the SPA (with an appropriate purchase price reduction) |
| Seller group corporate charges – although such charges may represent the target's share of legitimate overhead costs, such as rent and insurance | Remuneration in the ordinary course of business |
| Waivers of rights or claims against members of the seller group or third parties | Permitted trading arrangements between the target and members of the sellers group |
| Changes to any permitted trading arrangements between the target and members of the seller group, or any new arrangements | |
| Transactions costs incurred by the target | |

## Leakage

As the economic risk and interest pass to the buyer as on the locked box date, the buyer requires protection against potential value erosion and leakage between the locked box date and the



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closing date. Leakage comprises any form of value extraction from the target, during the period between signing and closing, that benefits the seller. The parties have to identify possible sources of leakage and a differentiation between prohibited and permitted leakage is required. Whereas permitted leakage includes those categories of payments which are necessary to allow the target company to continue operating in the ordinary course of business, the prohibited leakage only benefits the seller. The buyer will normally insist that the SPA contains extensive covenants and indemnities to protect against prohibited leakage.

*Figure 4.*

| | Pros | Cons |
|---|---|---|
| Both parties | Price certainly at signing | Seller's agency issue |
| | Parties avoid negotiating completion accounts in the SPA | Shifts the focus of negotiations from completion accounts to gap controls |
| | Parties avoid preparing and disputing completion accounts post transaction | Potential disputes on effective date accounts warranties |
| Seller | Control of the effective date accounts and flow of information | Special purpose effective date accounts may be required |
| | Avoids potential for the buyer to exploit completion accounts adjustments after completion | |
| Buyer | Avoids potential for the seller to exploit completion accounts adjustments during the gap period | Potential for the seller to exploit leakage |
| | | Normally controls the completion accounts and the flow of information |
| | | More extensive financial due diligence |

## Summary of pros and cons for locked box mechanism

As a fixed price mechanism, the locked box method excludes the possibility of price adjustments on the closing date. This approach avoids disputes over price adjustments clauses in the SPA and disputes over the closing accounts themselves. On the other hand, there are concerns regarding value erosion between signing and closing. Therefore, the SPA must provide for permitted and prohibited leakages, and the consequences thereof. In addition, the economic value created by the enterprise to be sold between the locked box date and the closing date can be allocated to the seller by charging an interest on the locked box equity value between these two dates.

Although there are some obvious advantages to the seller, a number of these upsides will also benefit the buyer.

## Conclusion

The locked box method results from efforts to simplify the transaction and avoid negotiations on adjustments mechanisms. The agreement of a fixed price is clear and simple. However, the risk of value erosion has to be taken into consideration as there is usually a time gap between signing and closing, as well as between the transfer of economic interest and effective control of the target. Nevertheless, a locked box can be beneficial for seller and buyer.

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