Time to Invest

Proposals to Restore Financial Sustainability to the Irish Hotel Industry

Alan Ahearne

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Executive Summary

- The Irish hotel industry has been particularly hard hit by the economic and financial crisis. Since 2007, reported revenue per room has fallen 30 per cent and profit per room has dropped 44 per cent. The average room rate achieved has fallen from €97 in 2007 to €72 in 2011. Despite the reduction in average room rates, occupancy rates have declined from nearly 70 per cent in 2007 to 61.4 per cent in 2011.

- Hotels have a critical role to play in contributing to recovery in Ireland's tourism sector and in the wider economy. Tourism provides an estimated 196,000 jobs, equivalent to 11 per cent of total employment in the country. More than 50,000 people are employed by hotels and guesthouses. Tourism adds €5.3 billion in spending to the Irish economy.

- New equity investment in hotels is required if the sector is to survive and prosper. Banks are becoming increasingly saddled with repossessed hotels because prospective buyers do not have access to finance. This trend has to be addressed. The scarcity of new equity finance to purchase repossessed hotels represents a market failure that is gumming up the recovery process in the hotel industry.

- The Irish hotel industry is severely overleveraged. There is an estimated €6.7 billion of debt in the sector. Assuming reasonable growth in profits over the next five years, a reduction in debt of 38 per cent (€2.5 billion) will be required to lower the debt overhang to sustainable levels.

- International tourist arrivals are projected to grow steadily over coming years. Domestic consumer spending is forecast to return to meaningful growth in 2014. These projections underscore tourism's potential to be an engine for job creation across the country. A financially sustainable hotel industry is crucial if this potential is to be realised.

Recommendations

This report identifies what is required of Government to increase the availability of equity finance and facilitate an orderly restructuring of the hotel industry.

- Employment and Investment Incentive Scheme could be extended to include restructured hotels, thereby providing incentives to private investors to inject equity into restructured hotels.
- Hotel Restructuring Fund could use funds from the National Pension Reserve Fund and the sale of state assets to invest in hotels that have reasonable prospects for profitability, growth and providing sustainable employment.
- Qualifying Investor Fund for hotels may be attractive to private investors, especially from abroad, who would like to invest in Irish hotels but do not wish to own hotels directly.

Chapter 1: Introduction

1.1 Introduction

The Irish economy remains moribund, with real GDP edging down about ½ per cent in the first half of this year compared with the same period in 2011. Exports are a bright spot, having grown strongly over recent quarters, but domestic demand continues to contract.

The sluggishness in economic activity is weighing heavily on the labour market, with employment down by 33,400 (or 1.8 per cent) in the second quarter of 2012 from a year earlier. Total employment now stands at a bit below 1.8 million. A return to robust economic growth is essential to maintain jobs and create new jobs, to boost incomes and living standards and to put the public finances and levels of private and public debt on a sustainable footing.

The credit-fuelled boom in the 2000s was driven by disproportionate expansion in the construction sector and spending on consumer durables. The return to economic growth and resumption of job creation relies on other sectors of the economy. As indentified in the National Recovery Plan 2011-2014, recovery must be built on Ireland's strengths in sectors such as agri-food, tourism, life sciences, information and communication technology and internationally traded services.[1]

Small- and medium-sized enterprises (SMEs) are critical to the resumption of positive growth. SMEs account for more than half of economic activity in Ireland and nearly three-quarters of employment in the private sector.

1.2 Balance Sheet Recession

A key factor restraining economic growth is the need for households and businesses to repair balance sheets following a period of excessive debt accumulation. Many households and SMEs rapidly accumulated debt during the boom on the basis of what turned out to be overly-optimistic expectations for future assets prices and income. Since the crisis hit, incomes and asset values have declined sharply, resulting in a debilitating debt overhang in parts of the economy. The intense pressure on many borrowers to rebuild their balance sheets is depressing consumer spending and business investment.

The hotel industry is a critical part of Ireland's tourism sector. It is the largest component within the Irish hospitality sector, comprising hotels and guesthouses, restaurants, pubs and clubs, and self-catering units. The balance sheet of the Irish hotel industry has been particularly hard hit by the financial crisis. Although capacity expanded rapidly during the boom years, hotel profitability remained robust as demand for bed-nights and other hotel services grew at a solid pace.

The rise in demand was driven in large part by domestic residents with rapidly rising disposable income and spending power. The increased capacity was financed largely by debt. The sharp increase in leverage during the 2000s rendered many hotels highly vulnerable to the dramatic change in economic conditions over the past few years.

[1] "The National Recovery Plan 2011-2014", Chapter 2, available at: www.finance.gov.ie/

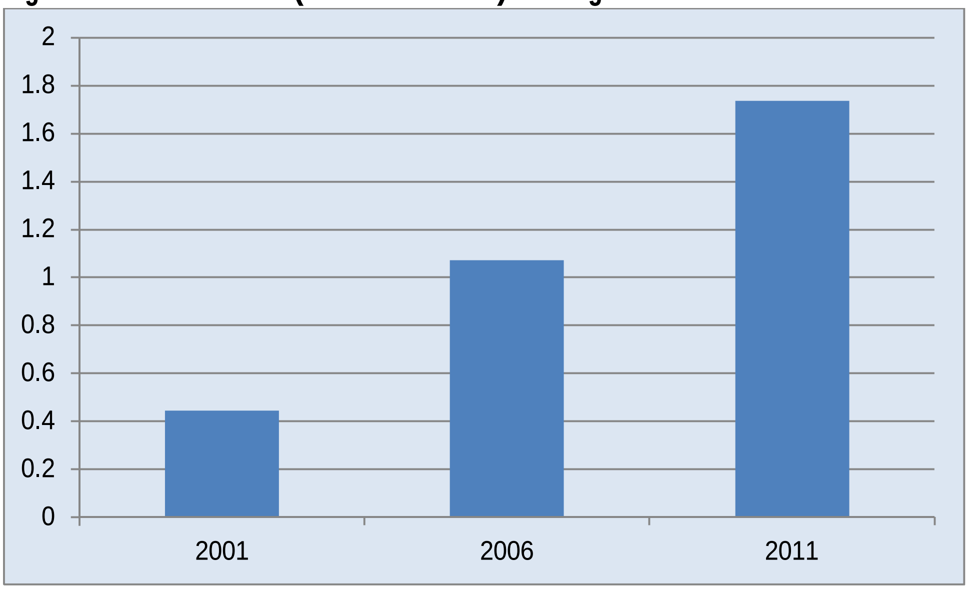
Box 1: Ireland's Balance Sheet Recession

- Household debt as a percentage of disposable income is about 210 per cent, compared with 100 per cent in the euro area on average. The household savings rate has surged to 14 per cent as households attempt to reduce debt, putting a marked drag on consumer spending.
- Non-financial corporations' debt stood at 170 per cent of GDP in late 2011, compared with an average in the euro area of 105 per cent. Data for SMEs show that debts are especially high in the construction and hospitality sectors. High debt levels in the business sector are associated with low rates of capital investment and high risk of insolvency.
- General government debt is expected to peak at 120 per cent of GDP in 2013. Projections by the Central Bank of Ireland show that public debt could arise to 140 per cent if positive economic growth fails to materialise.[2] Necessary budgetary adjustments to contain the accumulation of public debt are contributing to weak domestic demand. Moreover, the overhang of public debt is damaging investor confidence.

In addition, the hotel industry has suffered collateral damage from the boom in the construction of residential property. During the boom times, developers were encouraged by tax incentives and planning regulations to build new hotels in conjunction with residential construction projects.[3]

The downturn in demand for bed-nights and the steep cuts in room rates charged by hotels have reduced profits in the hotel sector. As a result, the market value of hotels has dropped sharply. In addition, property prices have collapsed since 2007. The slump in asset values on a mark-to-market basis (that is, if hotels are valued at fair market value in their balance sheets) has left the hotel sector with an aggregate balance sheet that is unsustainable.

Figure 1.1: Hotel sector (mark-to-market) leverage



Source: Author's calculations based on Hotel Industry Survey data. Market value of assets = Present value of future earnings (EBITDA), assuming unchanged earnings in the future and a discount rate of 12.5 per cent.

[2] "Fiscal Compact – Implications for Ireland," Economic Letters Vol. 2012, No. 9.

[3] See the discussion of the role of capital allowances in hotel investment in Peter Bacon (2009) "Over-Capacity in the Irish Hotel Industry and Required Elements of a Recovery Programme," Chapter 5.

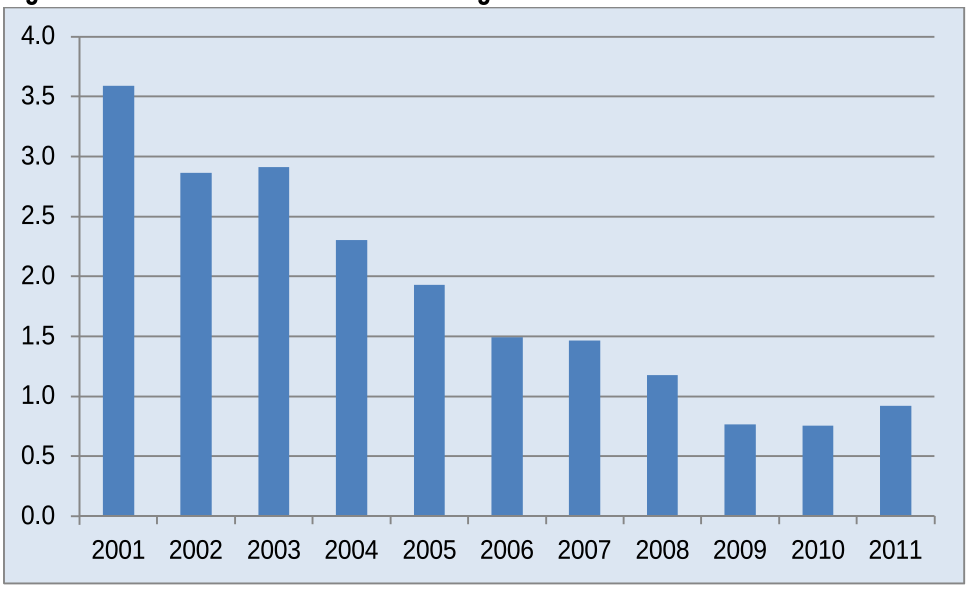
1.3 The Debt Overhang Problem

The Irish hotel industry is suffering from a significant debt overhang problem which is curbing recovery in the sector. A resolution to this debt overhang is urgently needed if the tourism sector is to fulfil its potential as a key driver of growth in output and employment in the Irish economy.

Taken as a whole, the Irish hotel industry is potentially profitable. Despite the downturn, hotels on average are generating operating surpluses, although the situation varies from hotel to hotel – with significant regional disparities. These earnings, however, exclude the costs of servicing debts, as well as depreciation, rent (if the hotel is leased) and taxes.

Estimates of the hotel sector's interest coverage ratio (that is, earnings before interest and taxes divided by interest expenses) show that the industry as a whole is not generating sufficient earnings to cover interest payments on outstanding debt. The interest coverage ratio deteriorated from 3.6 in 2001 to a low of 0.8 in 2009, before recovering somewhat to 0.9 in 2011.

Figure 1.2: Hotel sector interest coverage ratio



Source: Author's calculations based on Hotel Industry Survey data.

Profitability has begun to improve in the industry following several years of decline and future earnings may rise to levels that allow the sector to cover interest payments. Even then, the debt overhang will mean that, after paying interest payments, the industry will not have sufficient earnings to re-invest in the hotel stock, make principal repayments to reduce leverage, or deliver a reasonable risk-adjusted return to equity investors.

The debt overhang is detrimental to the prospects for recovery in the hotel sector because it leads to underinvestment in maintenance, refurbishment, renovation and innovation in the hotel industry. Over time, this underinvestment may result in deterioration in the quality of product that Irish hotels offer consumers.

Given the important role that hotels play in the wider tourism industry, the debt overhang in the hotel sector is a concern for the entire tourism sector.

Box 2: Capital reinvestment and renovation in hotels

According to industry experts, hotel owners every 5-7 years typically spend an amount of between 15-20 per cent of annual revenues on capital investment and renovation.

This spending translates into an expense of 3 per cent of revenues each year, which in 2011 was equivalent to about 25 per cent of the average operating surplus for that year.

The underinvestment associated with debt overhang arises from three main sources.

- First, operating earnings that would normally be used for re-investment in hotels are being used instead to service debt payments.

- Second, the debt overhang acts as a disincentive for owners to inject fresh equity into the business to maintain the hotel's value.

- Third, debt overhang acts as a disincentive for owners to exert effort to improve the hotel's performance. The additional earnings from such efforts would simply accrue to the lender in the form of higher service debt payments.[4]

Faced with debt overhang, many hoteliers, on whom the industry relies for innovation, structural improvements and growth, may feel that they are essentially "working for the banks." In extreme cases, debt overhang may induce so-called "strategic default" by borrowers. Most hotels in Ireland are economically viable, but in many cases balance sheets will need to be restructured to reduce the debt burden and increase the level of equity in the business.

1.4 Resolving Debt Overhangs: The International Experience

Many countries have experienced credit booms and busts in business sectors over recent decades and have faced the challenges of working out distressed assets. The historical experience in other countries highlights several methods available to lenders to restructure hotels. The choice of which method to use should be taken by lenders on a strictly commercial basis.

Hotels that are economically non-viable should be closed. The international evidence clearly shows that maintaining credit flows to non-viable borrowers reduces the profits for healthy businesses, which depresses investment and employment growth.[5] In practice, a hotel that is unable to generate an operating surplus, even after restructuring of its business model, is unsustainable and should cease to trade.

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[4] For a discussion of how a drop in asset values and owners' equity can lead to weak incentives for owners to manage the business, see David Brown, Brian Ciochetti and Timothy Riddiough, "Theory and Evidence on the Resolution of Financial Distress, " Journal for Financial Studies, February 2006.

[5] See (1) Alan Ahearne & Naoki Shinada, 2005. "Zombie firms and economic stagnation in Japan," International Economics and Economic Policy, December; (2) Joe Peek & Eric S. Rosengren, 2005. "Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan," American Economic Review, September; and (3) Ricardo J. Caballero & Takeo Hoshi & Anil K. Kashyap, 2008. "Zombie Lending and Depressed Restructuring in Japan," American Economic Review, December.

In the case of a viable but over-indebted hotel:

- The lender may decide to put the hotel into receivership and the Receiver sells the hotel as a going concern at market value to new owners. The new owners usually finance the purchase of the hotel with a mix of debt and equity. If there are no acceptable bids for the hotel, the lender may choose to lease the hotel with a view to selling the business at a later stage.

- The lender may decide to restructure the loan and the current owners continue to operate the hotel with lower debt payments. The restructuring deal sometimes includes a debt-for-equity swap, which gives the lender upside potential. Along with reducing the debt, it is common for lenders to require the owners (or some third-party investors) to inject new equity into the hotel to provide funds to restructure the hotel's business model and improve the hotel's operating performance.

From a lender's perceptive, it is important that decisive action is taken to resolve the problem of debt overhang and repair balance sheets. A strategy of forbearance invariably ends up raising the cost of distressed loans to the lender. After restructuring, viable hotels are returned to a financial position where they can operate on a long-term sustainable basis.

Box 3: Debt Restructurings and Hotel Performance

In a recent econometric study of 115 over-indebted Austrian ski hotels, Giroud et al (2010) find that reducing a debt overhang by restructuring debt leads to a significant improvement in operating performance (measured by return on assets and net profit margin).[6] In particular, a reduction in leverage leads to a decrease in overhead costs, wages and input costs and to an increase in sales.

The authors also provide a case study of a hotel located in a small village with famous ski areas nearby. The hotel is managed by the owner and his family. The hotel has an average of nine employees (not counting family members) and 34 rooms. The owner is individually and personally liable for all of the hotel's liabilities.

The hotel experienced a sharp decline in demand in the years prior to the debt restructuring. Compared to four years before the debt restructuring, the number of nights stayed dropped by 32 per cent. As a result, the hotel's net profit margin (EBITDA/sales) dropped sharply in the two years prior to the debt restructuring. The hotel's return on assets in the year prior to the debt restructuring was only 6.3 per cent.

In the debt restructuring, the hotel received substantial debt forgiveness. The hotel had only one lending bank, which agreed to forgive about €830,000. As a result, the hotel's (book) leverage ratio was reduced from 1.84 to 1.41. In response to the debt forgiveness, the owner family agreed to contribute funds of their own.

In the years after the debt restructuring, the hotel's performance improved substantially. Return on assets increased from 6.3 per cent prior to the debt restructuring to 10.9 per cent in the three years after the debt restructuring.

[6] Xavier Giroud, H. Mueller, A. Stomper, and A. Westerkamp, "Snow and Leverage", Review of Financial Studies, 2012.

It is important to note that these restructuring methods require that fresh equity is invested in viable hotels to return hotels' balance sheets to sustainable levels of equity and debt. The combination of reduced debt burdens and new equity investment restores financial sustainability.

In other countries, there are several sources of new equity to help rebuild hotel balance sheets, including banks, life insurance companies, pension funds, real estate investment trusts (REITs) and commercial mortgage-backed securities markets.[7] The availability of such funds in previous boom-bust cycles has proven crucial for recovery from balance-sheet recessions in the hotel sector.

For example, it is expected that private-equity firms will help drive an increase in hotel transactions this year in smaller cities in the United States. In addition, foreign investors are reportedly active buyers of high-end properties in larger U.S. cities.[8]

1.5 Limited Access to Finance

In Ireland today, there is a scarcity of funds available for investment in the hotel sector. Certainly, large, high-profile hotels that are for sale are likely to attract the interest of international investors. However, many medium-sized and smaller hotels, especially outside of urban areas, are too small to be of interest to international investors.

While Irish banks could be expected to lend to potential domestic investors to buy viable hotels, the banks will only do so if buyers bring to the table sufficient equity capital. The lack of funds available to prospective new owners to finance the purchase of distressed hotels and to current owners to inject new equity into their hotels is preventing the repair of balance sheets in the sector.

This lack of funds constitutes a market failure that is gumming up the recovery process in the hotel industry. In the meantime, the debt overhang is damaging the sector and the wider tourism industry through underinvestment in the hotel stock.

A symptom of this market failure is the large number of hotels currently in the hands of receivers. If a pool of funds were available for potential buyers, then, having foreclosed on defaulted loans, lenders should be able to sell the hotels relatively quickly.

However, because many prospective buyers do not currently have access to finance, lenders have no choice but to retain ownership of the hotel in the expectation that it will be sold at some future date. The debt overhang problem and difficult trading conditions mean that banks are becoming increasingly saddled with repossessed hotels. This trend has to be addressed.

Retaining ownership of the hotels is costly for banks. Moreover, banks, by the nature of their business, do not have a direct, long-term strategic interest in developing the hotel sector. Arresting the growth of -- and eventually reducing -- the stock of unsold hotels under bank control is in everyone's interest.

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[7] For a thorough description of the capital sources available for investment in the United States, see Rushmore, Stephen, "HVS Hotel Investments Handbook" 2002.

[8] "Private-Equity Firms to Increase Hotel Investments in Smaller U.S. Cities," Bloomberg, 17 January 2012.

Chapter 2: Why the Hotel Sector is Important

2.1 Introduction

Hotels have a critical role to play in contributing to recovery in the tourism sector. A high-quality stock of well-run hotels spread across the country attracts tourists from abroad and encourages Irish consumers to spend in the domestic market.

In turn, tourism has been identified by Government as a key driver of Ireland's economic renewal. Ireland has a comparative strength globally in tourism owing to natural advantages, substantial past investment in the tourism product and infrastructure, and expertise and skills built up by those working in the sector.

Irish tourism by the numbers

2.7% of Ireland's GDP	196,000 jobs	€5.3bn spending by tourists
4.5% of Ireland's services exports	6.6m overseas visitors	€1.3bn in tax revenues

2.2 Contributions to the Irish Economy

Tourism is a major contributor to the Irish economy.

Employment

As a strategically important, labour-intensive sector, tourism is a major source of employment in Ireland. The results from the latest Quarterly National Household Survey (QNHS) produced by the Central Statistics Office (CSO) show that 115,000 people were employed in the accommodation and food service sector in the second quarter of 2012. This figure compares with a peak employment level of 134,000 in 2007. Industry sources estimate that more than 50,000 people are employed by hotels and guesthouses.[9]

Encouragingly, the accommodation and food service sector added 6,300 jobs over the past year, representing an increase in employment in that sector of nearly 6 per cent. Strikingly, only one other sector of the economy, the information and communication sector, registered positive employment growth over the past year.

The figure of 115,000 jobs in the accommodation and food service sector significantly underestimates the number of jobs provided by the tourism industry, as it excludes jobs in other

[9] Irish Hotels Federation estimates.

tourism activities such as passenger transport (railway, road, water and air), cultural and recreational activities, and tourism-related retail trade.

Recent research from the CSO uses the CSO's Business Demography database to get a more accurate measure of the contribution of the tourism industry to employment.[10] Based on the most recently available data, the CSO estimates that there were almost 190,000 people employed in tourism in 2009. For comparison, the QNHS reported 120,000 employed in the accommodation and food service sector that same year.

Moreover, the figure of 190,000 jobs derived from the Business Demography database does not include proprietors, casual and temporary workers. Including these groups brings the figure for persons engaged in the tourism industry to 205,000 in 2009. This accounted for 10.7 per cent of total employment in the economy in that year.

Using these results, it is possible to map from reported QNHS figures to a more accurate measure of the numbers working in the tourism industry. Applying this mapping to the latest results from the QNHS suggests that tourism provided roughly 196,000 jobs in the second quarter of 2012, equivalent to about 11 per cent of total employment in the country.

Tourism has an especially important role to play in regional development. The employment provided by tourism has a wide geographical spread, with seven out of each ten jobs in tourism located outside of Dublin. Moreover, as pointed out by Deegan et al (2006), domestic tourism disproportionately favours the regions outside Dublin.[11]

Another benefit of tourism is that the sector provides job opportunities across a wide range of skill levels. In addition, few sectors of the economy provide as much opportunity for employees to work full time or part time as tourism.

The Exchequer

Tourism also makes a significant contribution to the Exchequer. According to estimates by the Irish Hotels Federation, the Government earns some €1.3 billion in direct and indirect taxes from tourism annually, representing 3.7 per cent of tax revenue.

GDP and Exports

Tourism added an estimated €5.3 billion in spending to the Irish economy in 2011, unchanged from the amount a year earlier. Of this amount, expenditure by 6.6 million international visitors amounted to €3.6 billion, including fares paid to Irish carriers. These earnings make up 2.2 per cent of Ireland's total exports (or 4.5 per cent of Ireland's services exports.) The remaining €1.7 billion represents estimated spending by domestic tourists.

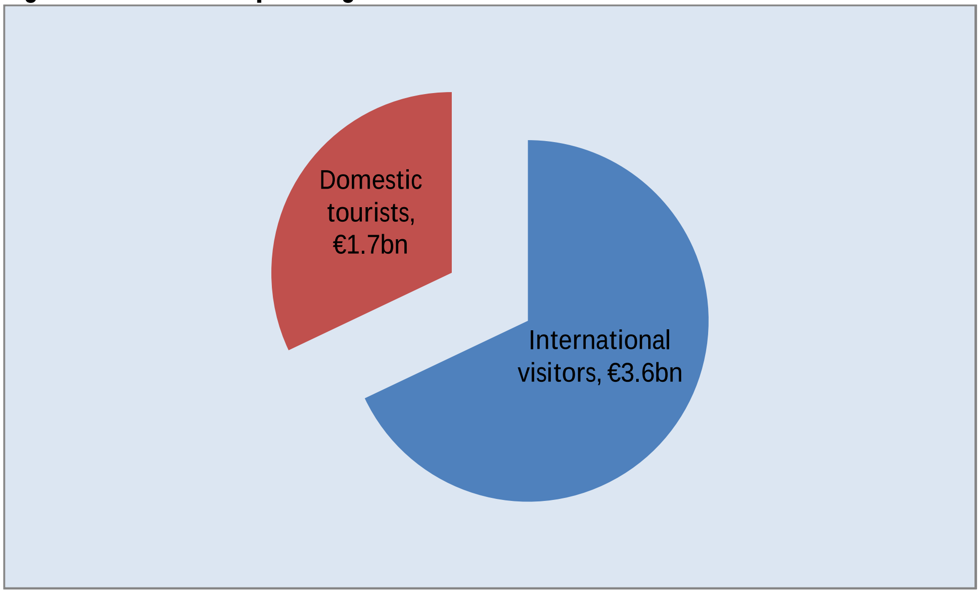
Tourism is mostly a service-based industry. In addition, many of inputs into the sector are produced in Ireland, including products from the agriculture and food industries. As a result, the import

[10] MacFeely, Steve, Jillian Delaney & Fiachra O'Donoghue (2011), "Business Survival and Employment: A National and Regional Analysis of Tourism in Ireland."

[11] Deegan, Jim, Martin Kenneally, Richard Moloney and Stephen Wanhill (2006) "Understanding the Economic Contribution of Irish Tourism to the National Economy," Paper presented to the 29th Annual Economic Policy Conference, Kenmare.

content of tourism activities is relatively low. The Irish Tourist Industry Confederation estimates that about four-fifths of every euro of tourism spending generates income in Ireland. This means that tourism spending accounted for €4.3 billion (2.7 per cent) of GDP in 2011.

Figure 2.1: Tourism spending

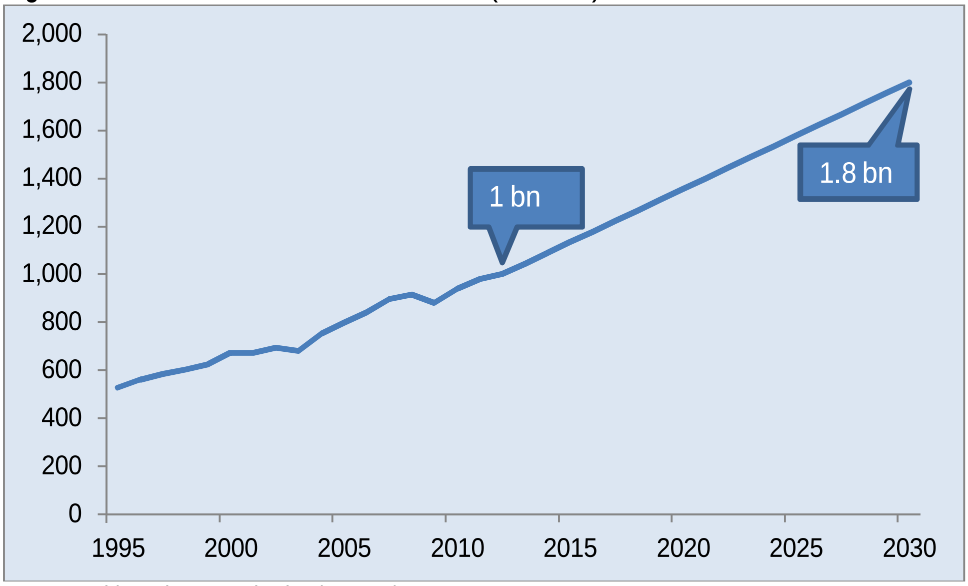


Source: CSO.

2.3 Prospects for Tourism

The number of visitors from overseas increased 8 per cent in 2011 from a year earlier to 6.6 million. However, data for the first seven months of this year suggest that some of these gains have been retraced, with the total number of trips to Ireland down 1.4 per cent from the same period in 2011. Nonetheless, business confidence in the tourism industry has returned to near levels last recorded in 2007.[12]

Figure 2.2: International tourist arrivals (millions)



Source: World Tourism Organisation (UNWTO).

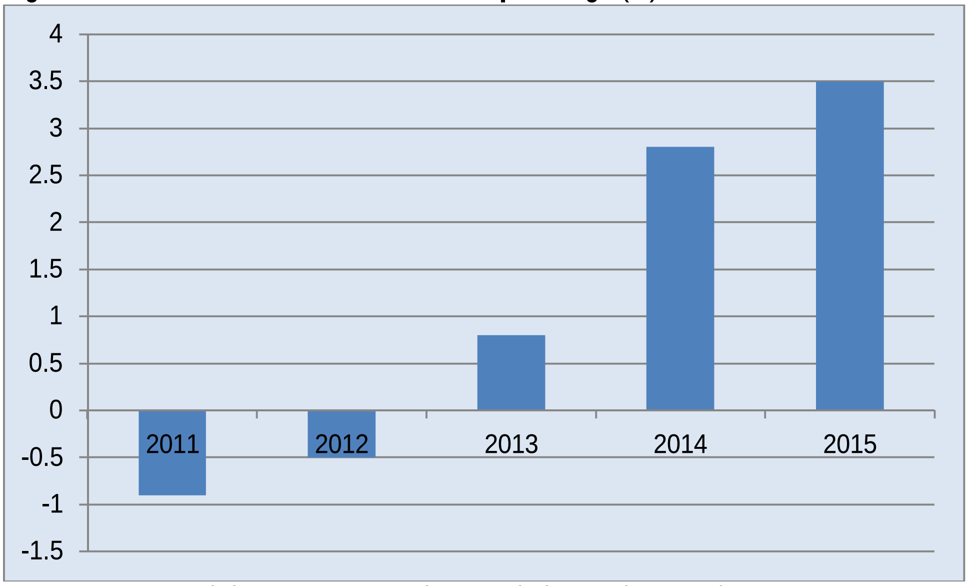
[12] Fáilte Ireland Tourism Barometer, April 2012.

Looking ahead, Ireland's tourism performance with respect to overseas visitor numbers will be strongly influenced by the overall trend in international tourist arrivals. Despite concerns of the global economy, international tourist arrivals are projected to reach one billion this year. By 2030, this figure is forecast to reach 1.8 billion (Figure 2.2).

If Ireland can maintain market share, revenues from overseas tourists can be expected to rise gradually over the medium term.

Spending by domestic tourists has dropped as disposable income and personal consumption has slumped from unsustainable levels during the boom. The European Commission projects moderate increases in (nominal) consumer spending in Ireland over the next few years (Figure 2.3), suggesting scope for some improvement in earnings from domestic tourism.

Figure 2.3 Ireland: Growth in consumer spending* (%)



*Source: European Commission, Summer 2012 Review. *Nominal personal consumption.*

2.4 Realising Tourism's Potential

Forecasts for growth in international tourist arrivals, along with the projected bottoming out of domestic consumer spending, underscore tourism's potential to be an engine for job creation across the country. Restructuring of balance sheets in the hotel industry is required if this potential is to be realised. Spending on international marketing is not a priority for a hotel with a debt overhang. In contrast, a restructured hotel seeking to gain share in lucrative international markets and looking to diversify its room sales demography from a predominantly Irish base would invest in such marketing.

A strong hotel industry that has the capacity to grow tourism is one in which:-

- Hotels are owned and operated by people with a long-term interest in the industry.
- Hotels are internationally competitive and commercially viable.
- Hotels have strong balance sheets with a sustainable mix of equity and debt financing.

Chapter 3: Measuring the Debt Overhang

3.1 Introduction

A hotel funds its assets using either owner's equity or borrowed funds (debt).[13] During the boom, the Irish hotel sector became highly leveraged as it increasingly relied on debt to finance its activities.

This high leverage rendered the industry vulnerable to the downturn in the economy that has accompanied the financial crisis. The severity of the downturn has destroyed the market value of equity in the sector and undermined the industry's financial strength.

3.2 Debt in the Hotel Sector

Like most SMEs, hotels in Ireland rely on credit from banks to finance assets because they have little or no direct access to financial markets. For that reason, a good measure of the indebtedness of Irish hotels is the outstanding amount of bank credit extended to the sector.

The Central Bank of Ireland publishes quarterly data on the outstanding amount of credit extended to the Irish hotel sector by credit institutions resident in Ireland. For the period up to 2007, these data provide a good measure of the indebtedness of the Irish hotel industry. For more recent years, however, the Central Bank's data need to be adjusted to reflect several developments.

- The National Asset Management Agency (NAMA) is not a credit institution as defined by the Central Bank of Ireland. The loans to the hotel sector owned by NAMA are not included in the Central Bank's figures even though the borrowers still owe the full amount of the loans to NAMA.

- Bank of Scotland (Ireland) was classified as a credit institutions resident in Ireland until it was merged into Bank of Scotland in the UK on 31 December 2010. After that date, borrowings by hotels from that institution are no longer included in the Central Bank's data.

- Since December 2010, the Central Bank has reported the outstanding amount of loans on a gross basis. Prior to that date, the outstanding amounts of loans were reported net of impairment provisions recognised against them. These provisions were likely to have been moderate up to 2007, but would have increased significantly since then.

The Central Bank of Ireland also publishes data on quarterly credit transactions, calculated from quarterly differences in outstanding amounts adjusted for reclassifications, other revaluations, and any other changes which do not arise from transactions. Therefore it is possible to use the

[13] There is a large theoretical literature on the optimal capital structure for firms. This literature seeks to explain how firms choose between equity and debt in their financing decisions. Important contributions to this literature include Modigliani and Miller's (1958) who argue that the value of the firm is independent of its capital structure choice, and Myers' (1977) Pecking Order hypothesis which states that firms prefer to use internal funds rather than issuing securities, and prefer debt before equity. Empirical research on this subject points to the trade-off between tax and incentive benefits of increased debt and the greater risk of bankruptcy associated with higher debt.

transactions data to adjust the reported series on outstanding credit to hotels after 2007 to get a more accurate picture of the indebtedness of the hotel sector for the years 2008-2011 (See Technical Box 3.1 for more details).

Technical Box 3.1: Perpetual inventory approach to calculating hotel indebtedness

The Central Bank of Ireland reports data on credit extended to private-sector Irish residents by all credit institutions resident in the Ireland. Credit institutions are undertakings whose business is to receive deposits or other repayable funds from the public and to extend credit to customers. A resident office means an office or branch of the reporting institution which is located in the Republic of Ireland. The Central Bank provides a sectoral breakdown, which includes the hotel sector.

The outstanding amount of credit reported refers to the credit position recorded on the last working day of the reference period. All positions are recorded at the value in the reporting institution's books.

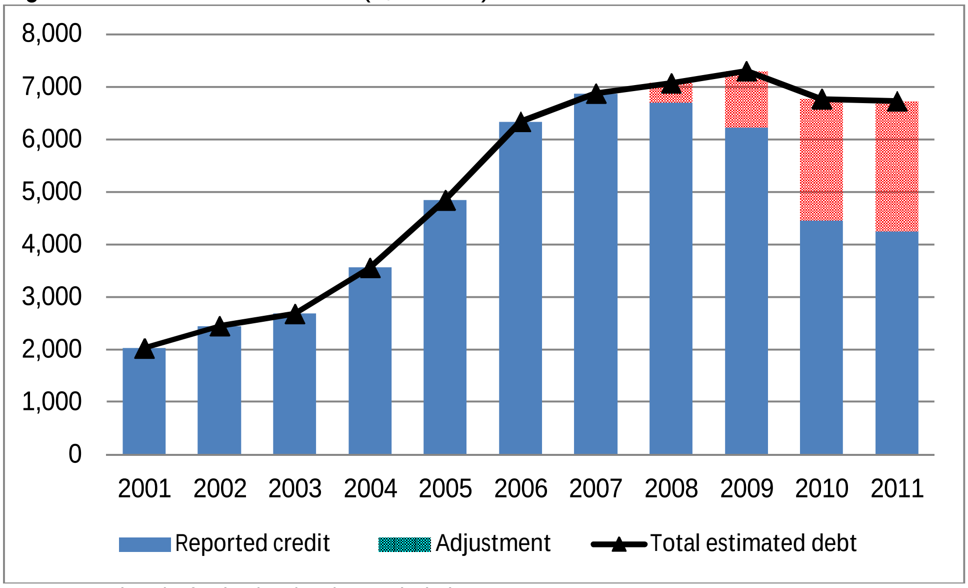
In December 2010, the Central Bank changed its methodology in reporting the data, which makes comparing the data in different years problematic. Since December 2010, the Central Bank has reported the outstanding amount of loans on a gross basis. Prior to that date, the outstanding amounts of loans were reported net of impairment provisions recognised against them. Interpretation of the data over time is also complicated by the purchase by NAMA of loans from Irish credit institutions in late 2010 and 2011. In addition, loans extended by Bank of Scotland (Ireland) were no longer included in the figures from December 2010 as that institution was closed and its loan book transferred to a non-resident institution.

A proper measure of the indebtedness of Irish hotels should include borrowings from NAMA and Bank of Scotland and should be on a gross basis. To correct the Central Bank's reported data, this report uses the perpetual inventory model. It is assumed that prior to 2008, the data on outstanding credit is an accurate measure of the hotel sector's indebtedness, as impairment provisions were likely to have been minimal. From 2008 onwards, an adjusted series is calculated using the stock of outstanding loans at end-2007 and quarterly data on credit transactions. These transaction data are not affected by loan reclassifications, other revaluations, and any other changes which do not arise from transactions.

For more details, see Central Bank of Ireland, *Business Credit and Deposits Explanatory Notes*, June 2011.

Figure 3.1 shows the evolution of hotel indebtedness over the past decade.

Figure 3.1: Hotel Sector Debt (€, million)



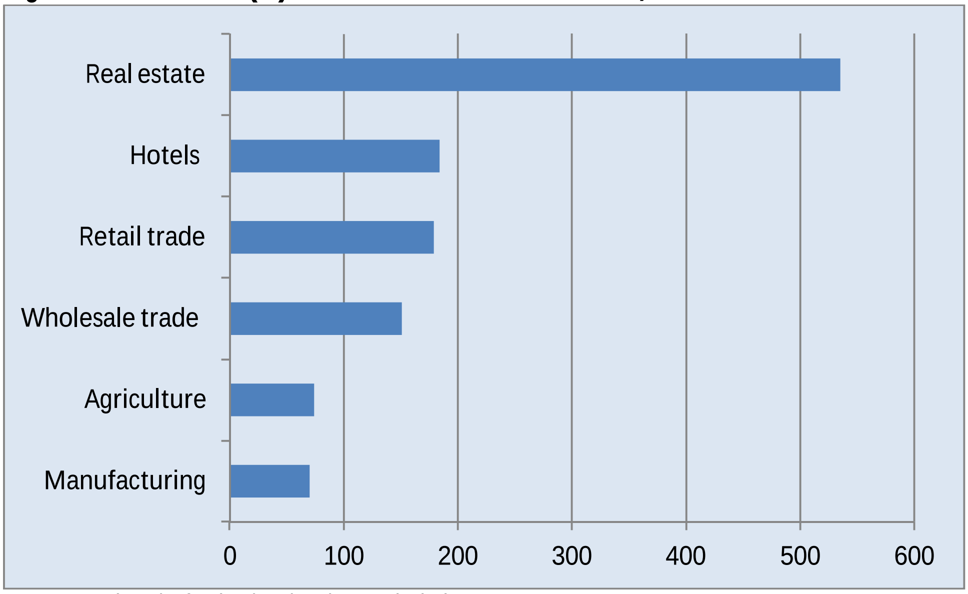
Source: Central Bank of Ireland and author's calculations.

The level of debt in the Irish hotel sector jumped from €2 billion at end-2001 to a peak of more than €7 billion at end-2009. This rapid increase in hotel indebtedness was driven by the opening of newly constructed hotels, refurbishment and upgrading of existing hotels, and the debt-financed purchase of existing hotels at elevated prices.

Over the period 2009-2011, the level of debt in the hotel sector decreased somewhat to €6.7 billion, perhaps in part reflecting repayments of principal by some better-performing hotels. It is also possible that some of this estimated decline (especially in 2010) in reality reflects the refinancing of hotel debt with non-resident financial institutions.

While indebtedness increased in all sectors of the economy during the boom, the pace of growth in borrowings by the hotel sector was especially fast. As shown in Figure 3.2, the cumulative increase over the period 2003-2009 in (adjusted) outstanding loans to the hotel sector of 184 per cent outstripped the increase in lending to all other sectors of the Irish economy, except real estate.

Figure 3:2: Increase (%) in credit for selected sectors, 2003-2009



Source: Central Bank of Ireland and author's calculations.

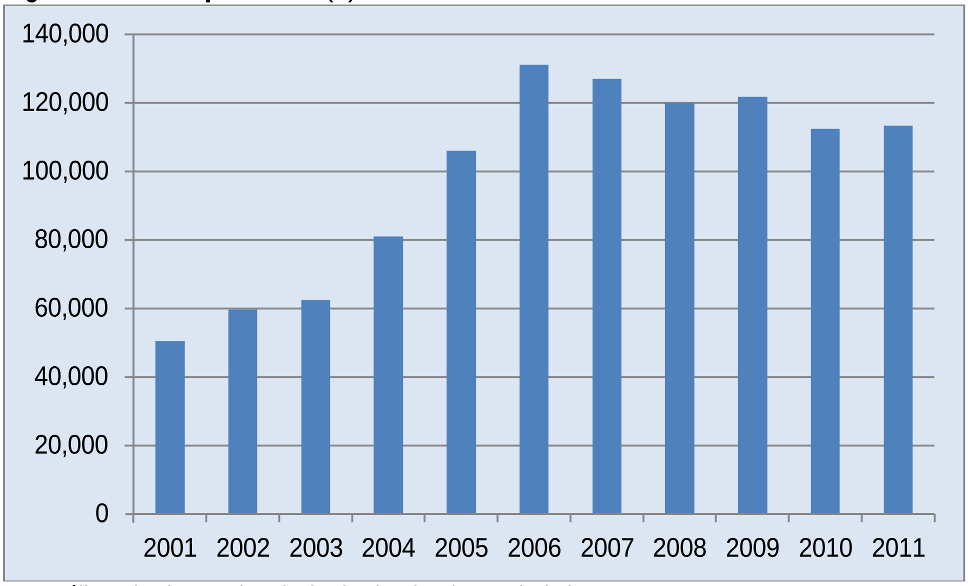
As of the rapid accumulation of debt in the hotel sector partly reflected increased borrowings to expand capacity, it makes sense to consider developments in the amount of debt per room.

According to the Fáilte Ireland Hotels Register, the number of registered hotels in the Republic of Ireland remained stable at around 850 between 2000 and 2005, before increasing markedly to reach a peak of 915 in 2009. By 2011, the number of hotels had slipped back to 883.

The opening of new hotels and the addition of new rooms by existing hotels resulted in a surge in the stock of rooms and bed capacity. The number of hotel rooms jumped by almost one-third from 45,700 rooms in 2005 to a peak of 60,217 in 2010. Room stock declined slightly to 59,377 last year.

Combining the data on debt in the hotel sector with those on the number of available rooms, Figure 3.3 shows the evolution of debt per room over the past decade. Indebtedness in the hotel sector has more than doubled from €50,500 per room in 2001 to €113,250 per room in 2011.

Figure 3.3: Debt per room (€)



Source: Fáilte Ireland, Central Bank of Ireland and author's calculations.

It is worth repeating that these figures refer to averages across the sector, and the picture differs from hotel to hotel.

3.3 Earnings in the Hotel Sector

Indebtedness in the hotel sector, at €113,250 per room in 2011, is currently at elevated levels compared with the recent past. The key question for financial sustainability is whether earnings in the sector in the years ahead will be sufficient to service this level of debt. The section examines recent trends in the profitability of the sector.

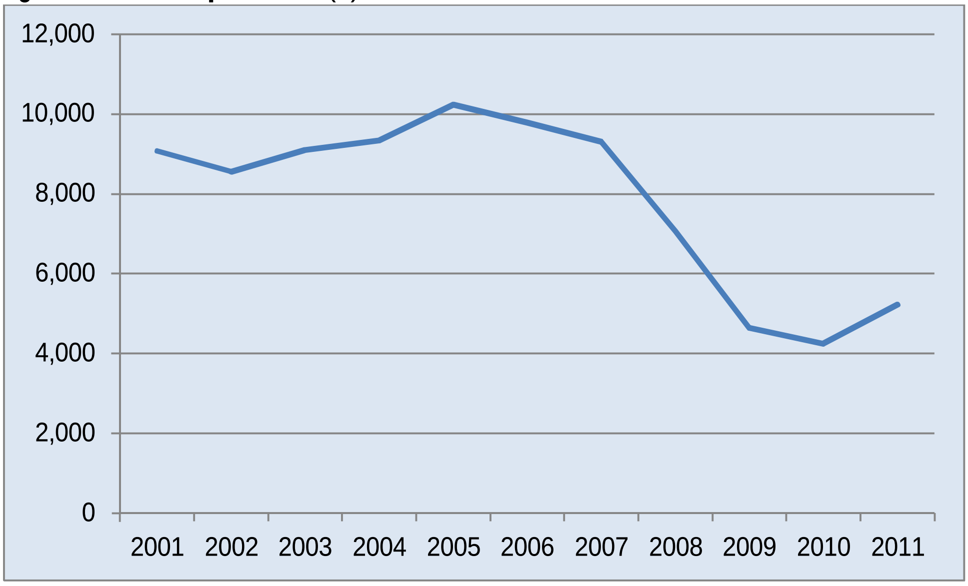
Figure 3.4 shows the average profit per room in the Irish hotel sector over the period 2001-2011.[14] Profit is measured before tax, depreciation, bank loan interest or rent where relevant. This measure of profits (EBITDA) is employed because it provides an estimate of the cash flow available to service debt on the sector's long-term assets.

Profit per room trended up during the first half of the last decade, in line with overall inflation in the economy, from €9,067 in 2001 to a peak of €10,238 in 2005. Profit per room edged down over the next two years, but remained above the average for the period 2001-2007 of €9,340 per room.

The onset of the financial and economic crisis saw a dramatic deterioration in profitability, with profit per room plummeting over the 2008-2010 period to hit a low of €4,239 in 2010. Last year appears to have been a turning point for hotel profitability, with profit per room rebounding 23 per cent from its 2010 level to €5,220 per room. However, this increase in reported profit per room may reflect a lack of spending by distressed hotels on marketing and refurbishment rather than a true improvement in underlying profitability.

[14] Data on earnings are drawn from the results of the Crowe Horwath Annual Irish Hotel Survey. The survey covers key issues in Ireland's hospitality sector including hotel performance, room occupancy, average daily rate, profit before tax and receiverships. For details, see: www.crowehorwath.net/ie/

Figure 3.4: Profit per room (€)



Source: Ireland and Northern Ireland Hotel Industry Survey, various editions.

As shown in Table 3.1 below, the fall in profit per room since 2007 has resulted from a sharp drop in total revenue per room. Over the period 2007-2011, total revenue per room declined 30 per cent. The industry responded to the downturn by driving down costs. Indeed, the increase in profit per room recorded in 2011 resulted entirely from additional cost-cutting achieved by the industry of about €1,000 per room.

Table 3.1: Profits, revenues and costs per room (€, unless stated)

	2005	2006	2007	2008	2009	2010	2011
Profit	10,238	9,786	9,308	7,056	4,650	4,239	5,220
Total Revenue	57,640	59,107	59,968	55,116	44,798	41,702	41,693
Total Costs	47,402	49,321	50,660	48,060	40,148	37,463	36,473
Profit rate (%)	17.8	16.6	15.5	12.8	10.4	10.2	12.5

Source: Ireland and Northern Ireland Hotel Industry Survey, various editions.

Nonetheless, because fixed and quasi-fixed costs make up a significant portion of hotels' total expenses, the large fall in activity since 2007 has been accompanied by a decline in the average profit rate from 15.5 per cent in 2007 to 12.5 per cent in 2011.

Underlying the drop in total revenue per room since 2007 has been a fall in both revenues derived directly from accommodation sales and ancillary revenues. As shown in Table 3.2, revenue per room from accommodation sales (RevPAR) has dropped markedly over recent year as a result of two factors.

- First, the average room rate achieved has fallen from €97.69 in 2007 to €72.67 in 2011, marking a decline of nearly 26 per cent. Hoteliers have cut room rates in an attempt to maintain sales volume.
- Despite the reduction in average room rates, occupancy rates have declined from close to 70 per cent in 2007 to 61.4 per cent in 2011.

The combination of lower room rates and lower occupancy rates has depressed revenues.

Table 3.2: Determinants of revenue per room (€)

	2005	2006	2007	2008	2009	2010	2011
RevPAR	65.61	68.12	68.06	56.04	46.22	43.89	44.62
Achieved room rate	95.22	97.58	97.69	88.25	77.81	73.51	72.67
Occupancy rate	68.9	69.8	69.7	63.5	59.4	59.7	61.4

Source: Ireland and Northern Ireland Hotel Industry Survey, various editions.

Notwithstanding the improvement in profits last year, the radical shift in the financial condition of the sector over the past decade is clear: Compared with 2001, debt per room in 2011 had more than doubled, while profit per room had almost halved. To put it another way, annual profit per room in 2001 was equivalent to 18 per cent of outstanding debt per room; by 2011 that figure had slumped to less than 5 per cent.

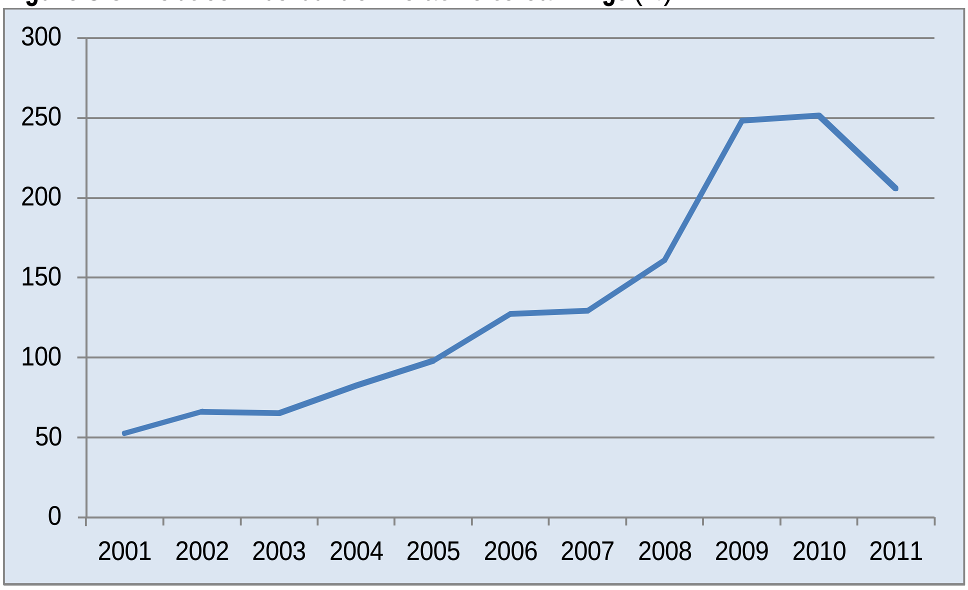
3.4 Sustainability of Debt

The very high level of indebtedness of the hotel sector by historical standards raises questions about the sustainability of this debt. Of course, the amount of debt per room is only one factor in assessing debt sustainability. The hotel sector's income prospects, interest rates and the average maturity of the debt also matter for the assessment of whether the level of debt appears sustainable.

Although there are many ways to try to assess debt sustainability, an intuitively appealing and widely used approach is to examine the burden of servicing debt in the hotel sector. The debt service burden is composed of interest payments and principal repayment obligations. Using this approach, the level of indebtedness is usually considered unsustainable if the debt service burden exceeds earnings (EBITDA).

Figure 3.5 shows the debt service burden relative to earnings for the Irish hotel sector.

Figure 3.5: Debt service burden relative to earnings (%)



Source: Author's calculations.

As reliable data on the debt service burden in the hotel sector are not available, the burden is estimated assuming an interest rate of 5 per cent and a principal repayment term of 15 years.[15]

The data in Figure 3.5 suggest that the amount of debt in the hotel sector has been at unsustainable levels (that is, the burden of servicing debt has been greater than 100 per cent of profits) since 2006. In 2011, the ratio of the debt burden to earnings stood at a clearly unsustainable level of 206 per cent. Moreover, for higher assumed interest rates, the debt burden is even more unsustainable.

For comparison, according to the European Central Bank, the average debt burden-to-earnings ratio across the non-financial corporate sector in the euro area has fluctuated within a range of between 60-80 per cent over the past decade.[16]

To service a debt level of €113,250 per room in 2011, earnings per room of at least €10,750 would be required. That level of profit per room would exceed the peak level of profit per room of €10,238 recorded in 2005 at the height of the boom. To achieve that level of profitability in, say, five years would require profit per room to grow at an annual rate of more than 15 per cent per year. Such a rate of growth seems implausible.

Growth Scenarios

Table 3.3 explores the sustainability of debt per room under different scenarios about growth in profit per room over the next five years. For example, assuming an annual growth rate in profit per room of 5 per cent over the period 2012-2016, profit per room would reach €6,662 by 2016. Such a level of profit could sustain, at a maximum, a level of debt per room of €70,200. To lower the debt overhang to that sustainable level from the current level of debt would require a reduction in debt of 38 per cent.

This reduction in debt could result from the injection of new equity into the sector (if the newly invested funds are used to pay down debt), from the write down of debt by lenders, or from a combination of these two actions.

Table 3.3: Debt sustainability under different scenarios (€ per room, unless stated)

Growth rate in profit p.a. (%)	Profit in 2016	Maximum sustainable debt	Current debt	Restructuring required (%)
Zero	5,220	55,000	113,250	51.4
3	6,051	63,800	113,250	43.7
5	6,662	70,200	113,250	38.0
7	7,321	77,200	113,250	31.8
10	8,407	88,600	113,250	21.8

Source: Author's calculations.

An implication of the gulf between the level of sustainable debt (based on expected profit) and the current amount of debt is that the hotel sector on aggregate is in negative equity (that is, debts exceed the market value of the sector's assets.)

[15] Similar assumptions about interest rates and debt repayment terms are contained in the analysis of hotel sector sustainability by Horwath Bastow Charleton (2011).
[16] "Corporate indebtedness in the euro area," ECB Monthly Bulletin, February 2012.

Industry sources suggest that hotels today are being offered for sale on the market for between 6-8 times annual profits (EDITDA). Using the figure for profit per room in 2011 of €5,220, this rule of thumb would place a market value on hotels of €31,320-€41,760 per room on average. This in turn implies negative equity to the tune of €71,490-€81,930 per room. This market-based approach would put the estimated total amount of negative equity in the Irish hotel industry at €4.2bn-€4.9bn.

The scale of this debt overhang in the hotel sector underscores the importance of attracting new equity into the sector and reducing debt to restore financial strength to the industry.

Even if zero growth in profit per room over the foreseeable future is assumed, the offer prices for hotels on the market translates into annual yields which are high by historical standards. If profit per room is expected to rise, then even higher yields are currently on offer. For example, if profit growth of 3 per cent per annum is assumed, then hotels are being offered at yields of between 15-20 per cent.[17]

The question arises as to why, with relatively high yields on offer, transaction volumes are so low.[18] For sure, the required rate of return on equity investment in the hotel sector is high, given the risks to the Irish economy, the property market and the tourism industry. Notwithstanding the risks, the projected rate of return implied by current offer prices is probably not far from levels that make investment in hotels attractive.

It seems that it is not so much the offer prices for hotels that are deterring buyers, but rather the lack of finance to fund purchases. As mentioned earlier, hotel owners in Ireland are heavily dependent of banks for finance – and given the ongoing deleveraging in the banking sector, bank credit to fund purchases of hotels is almost certainly in very scarce supply.

Tellingly, industry analysts report that what transactions have taken place recently outside of urban areas primarily involved cash buyers.[19]

In summary, three key lessons can be drawn from the analysis in this chapter.

- The hotel sector as whole is generating an operating surplus and therefore can sustain a certain level of debt.
- The current level of indebtedness in the hotel sector is not sustainable and balance sheets will need to be restructured to increase equity and reduce debt.
- Transaction volumes in the market for hotels are substantially lower than might be expected given the yields on offer and mostly involve cash buyers. This suggests that access to finance is a problem for prospective buyers.

[17] These calculations are based on the Gordon growth model, which relates the price of an asset to future cash flows, assuming that these cash flows grow at a constant rate in perpetuity.
[18] The CBRE's Irish Commercial Property Market Outlook reports 8 Irish hotel transactions in 2011, up from 3 in 2010 and 2 in 2009. This compares with a peak of 32 transactions in 2006.
[19] The reliance on cash buyers seems to be a feature of the property market more generally. According to the media reports, cash buyers accounted for half of all residential property purchases in the first six months of this year (Sunday Business Post, 7 October 2012).

Chapter 4: Initiatives to Support Equity Investment in Hotels

4.1 Introduction

The rapid build-up of debt in the Irish hotel sector during the boom times and the subsequent downturn in tourism have left many hotels in a weakened financial condition. There are a large number of bank-owned hotels in the hands of receivers. Prospective buyers of bank-owned hotels need to be able to finance the purchase.

Many other hotels are undercapitalised and require the restructuring of their balance sheets and injection of new equity investment to survive and prosper.

International investors are reportedly showing interest in buying larger hotels in urban areas, especially in Dublin and potentially in Cork and Galway. These investors can obtain finance from conventional sources.

Smaller hotels outside urban areas, however, are unlikely to attract overseas investors. Realistically, only domestic residents will be bidding for these hotels.

Outside of the bank-owned hotels, there are many viable hotels in need of equity investment to bolster their balance sheets. Domestic sources of equity capital will be essential to the restructuring and restoration of financial sustainability to these hotels.

At the best of times, some viable SMEs find it difficult to gain access to risk capital due to well-known structural market failures. These market failures stem from imperfect or asymmetric information between finance providers and SMEs. The economic and financial crisis has exacerbated these structural problems, resulting in a widening of the so-called "equity gap" experienced by SMEs.

The most obvious candidates to provide new equity to small- and medium-sized hotels are hoteliers with strong track records in operating hotels and with access to finance. However, given the dramatic decline in net wealth of many individuals and the marked tightening of banks' lending standards since the credit crunch began, few established hoteliers are in a financial position to buy hotels or provide additional equity to hotels.

If receivers are to find buyers at acceptable prices for bank-owned hotels, prospective buyers will need access to equity capital. The sharp drop over the past few years in offer prices for hotels should be attracting bidders. However, the market mechanism for the supply of equity finance to hotels is not functioning. Potential buyers are unable to raise equity capital, even for the purchase of hotels with reasonable prospects for profitability and growth.

It is common in international hotel markets for hotels to be purchased and refinanced at a later stage. The ability to source refinancing allows the market to function and sales transactions of distressed hotels to flow. Provision of equity finance schemes will accelerate the rehabilitation of the industry and lead to companies paying corporation taxes and participating in a normal economy.

Similarly, access to external finance to recapitalise overleveraged but viable hotels is severely restricted.

To address these structural issues, policy initiatives are needed to create a framework to increase the availability of equity capital to the hotel industry.

4.2 Existing Equity Support Schemes

Policymakers in Ireland and at the European level have long recognised the challenges that SMEs face in accessing equity finance and have sought to address these difficulties with a range of equity support schemes.

- **Employment and Investment Incentive Scheme** (EIIS). The EIIS has replaced the Business Expansion Scheme. Under the EIIS, qualifying investors can avail of a tax deduction for the cost of investing equity in certain businesses. In order for the relief to apply, the business must use the funds invested to either increase the number of employees or increase the amount of expenditure by the business on research and development. The business must be a micro-sized enterprise or a SME. Unlike the BES, the EIIS is open to businesses in a wide range of sectors. However, hotels cannot qualify for the EIIS.

- **Development Capital Fund**. Enterprise Ireland's new €50m Development Capital Fund works together with fund managers to invest risk capital of between €2m and €10m into established investee companies. Eligible sectors include manufacturing, technology and high growth trading services companies in Ireland.

- **Innovation Fund Ireland**. This fund was created to increase the availability of risk capital for early stage and high-growth companies. Enterprise Ireland and the National Pension Reserve Fund have each made available €125m to invest in international venture capital funds that invest in Irish companies.

- **European Investment Bank and European Investment Fund**. The EU financial institutions, the European Investment Bank (EIB) and European Investment Fund (EIF) invest in venture capital funds and offer loans, equity and guarantees to the SME sector via a range of programmes. The EU's new Programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises (COSME) will run from 2014-2020 with a budget of €2.5bn. COSME seeks to facilitate access to finance for SMEs.

The importance of increased provision of equity capital for investment in SMEs is reflected in a commitment in the Government's Action Plan for Jobs 2012 to:

> *"Review the equity investment landscape in Ireland with a view to introducing actionable steps (enterprise supports, tax, etc.) to support equity investment in productive firms."*

At the same time, the EU's new Programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises (COSME) emphasises the need for a special effort to promote the development of SMEs in the tourism sector. The European Commission's proposal paper for COSME states:

"Particular attention will be given to improve the competitiveness of enterprises in the tourism sector to implement the new competencies of the Union provided for the in the Lisbon Treaty, the reason being the significant contribution of the sector to the Union's GDP and the high proportion of SMEs active in this sector."

Improving the competitiveness and sustainability of the tourism sector in Ireland requires the restoration of a strong equity capital base to the hotel industry. But the existing schemes to attract new equity investment into SMEs are not applicable to hotels. This means that policy initiatives are needed to support equity investment in hotels.

Any new scheme to address the market failures affecting hotels raising finance must respect certain principles:

- It must be cost-effective from an Exchequer perspective.
- Equity financing must be provided on a strictly commercial basis.
- It must be targeted at correcting an identified market failure. This means that the scheme must apply to equity investment in existing small- and medium-sized hotels, not to newly constructed hotels, large hotels in urban areas or so-called "trophy" hotels.
- Hotels in receipt of new equity must be viable and have sustainable balance sheets. In particular, balance sheets that are stressed with debt overhangs must be restructured prior to injection of fresh capital. In addition, the scheme should not be used to prop up non-viable hotels.

4.3 Proposed New Equity Support Schemes

This report outlines three new Government initiatives that could, if implemented, improve access to equity finance to hotels.

- Extend the Employment and Investment Incentive Scheme.
- Hotel Restructuring Fund.
- Qualifying Investor Funds for Hotels.

Illustrative examples showing how these schemes could in principle achieve financial sustainability in the hotel sector are also provided.

Extend the Employment and Investment Incentive Scheme

The Employment and Investment Incentive Scheme (EIIS) could be extended to include restructured hotels.

Under an extended EIIS, qualifying investors could avail of a tax deduction for the cost of investing in restructured hotels. This deduction could be at the standard tax rate, not the higher rate currently available under the EIIS for other investments. The purpose of the scheme would be to provide reimbursable equity capital to prospective buyers of restructured hotels and current owners of viable undercapitalised hotels.

The scheme could work as follows:

1. A promoter sets up a new company with the sole objective of operating a hotel.

2. The company issues ordinary shares to qualifying individuals who invest in the company. These individuals could qualify for EIIS relief at the standard tax rate.
3. The promoter uses the equity capital raised by the company and probably other funds (such as a bank loan, possibly including vendor financing) to buy a restructured hotel or to strengthen the equity position of a hotel.
4. The investors could sell their EIIS shares after five years to realise a return.

Qualifying investors

- Investors in hotels qualify for EIIS relief if they subscribe for eligible shares in a qualifying company. Eligible shares must be ordinary shares and must be issued on or before 31 December 2014.
- The minimum investment that a qualifying individual can make is €250 per year and the maximum amount qualifying for relief is €150,000 per qualifying investor per year.
- Tax relief is given at the standard rate of tax by means of a deduction from the qualifying investor's total income.
- The investor must not dispose of the shares before five years after the shares are issued, otherwise he or she will not be entitled to relief in respect of those shares.

Qualifying companies

In order for a company's shares to qualify for the relief, several conditions must be satisfied.

- The company must have as its sole purpose the operation a hotel in the State.
- The construction of the hotel purchased by the company must have been completed before 31 December 2010.
- The maximum amount that a company can raise through the issue of eligible shares during its lifetime is €2 million.

Illustrative Example

Consider a restructured hotel with annual profits (EBITDA) of €100,000. The hotel is owned by a bank and on offer for €700,000. The hotel is purchased and €50,000 in cash is injected into the business using €300,000 raised by issuing EIIS shares and a five-year bank loan of €450,000. The loan carries an interest rate of 5%.

In Year 1, €50,000 is spent on renovations. Investors claim €60,000 in EIIS tax relief. The hotel performs well and EBITDA grows at a rate of 5 per cent per year. At the end of Year 5, investors sell their shares, earning a rate of return of 20 per cent per annum. The shares are redeemed using a new loan (that is, refinancing) and accumulated cash flow.[20]

[20] The refinancing at the end of Year 5 would have to respect new norms regarding loan-to-value ratios.

Purchase price	700,000					
EIIS investors	300,000					
Loan	450,000	Loan-to-value = 64%				
	Year 1	Year 2	Year 3	Year 4	Year 5	
Opening cash	50,000					
EBITDA	100,000	105,000	110,250	115,763	121,551	
Debt service	(101,905)	(101,905)	(101,905)	(101,905)	(101,905)	
Renovations	(50,000)					
Net cash flow	(1,905)	3,095	8,345	13,858	19,646	
Accumulated net cash flow						43,040
New loan		Loan-to-value = 65%				549, 519
Shares redeemed						592,559
Investors' return on equity						20%

It is important to note that without the EIIS tax relief, the investors' return on equity falls to 15 per cent. It is not clear that a return on equity of 15 per cent would be sufficient to attract private investors, given the considerable risks involved. The tax relief element of this scheme would be important to incentivise investors who are no longer investing in the Irish economy.

From the Exchequer's perspective, extending the EIIS to restructured hotels could in the short term lower receipts from income tax. However, the strengthening of the sector's financial condition and profitability would be expected to boost corporation tax receipts. In addition, VAT receipts might be expected to rise as a result of increased spending on renovation and refurbishment.

Hotel Restructuring Fund

The National Pension Reserve Fund (NPRF) was established in 2001 to help the State to fund welfare and public sector pensions from 2025 onwards. At the end of June 2012, the NPRF had assets valued at €5.8 billion in its discretionary funds and €8.1 billion of directed investments in Irish bank shares.

Box 4.1: National Pensions Reserve Fund

The National Pensions Reserve Fund (NPRF) was established in 2001 to contribute to the financing of Ireland's social welfare and public service pensions from 2025 onwards. The Fund is controlled by the National Pensions Reserve Fund Commission.

The Commission's statutory investment policy requires that the Fund be invested so as to secure the optimal total financial return provided the level of risk is acceptable to the Commission. The Commission is also required to make investments in credit institutions, as directed by the Minister for Finance. The NPRF, therefore, has two parts – the Discretionary Portfolio and the Directed Investments.

The Discretionary Portfolio (the Fund excluding the public policy investments in Allied Irish Banks and Bank of Ireland) was valued at €5.8 billion at 30 June 2012.

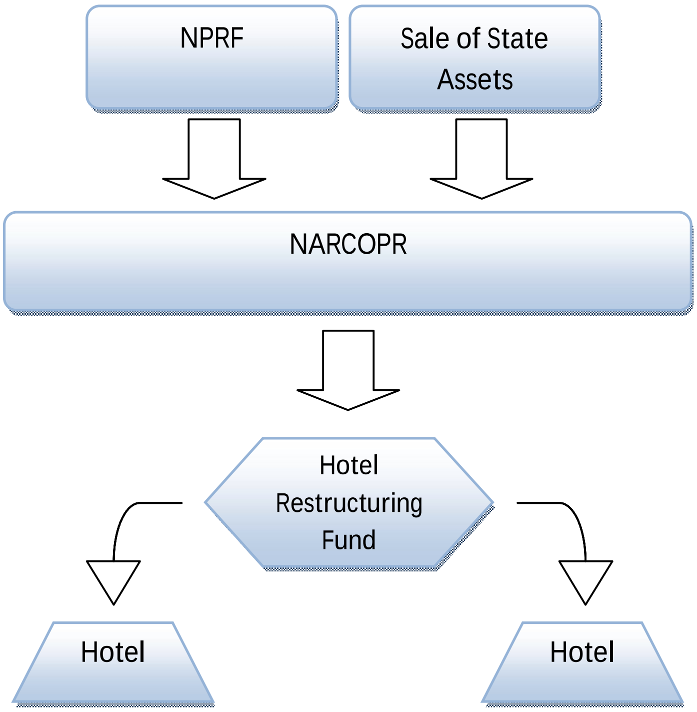
Since the Fund's inception in 2001, the Discretionary Portfolio has recorded an annualised return of

3.5 per cent per annum.

The Discretionary Portfolio Asset Allocation as of June 2012 was composed of €2.3 billion in quoted equities (including €463 million in Emerging Markets equity); €1.2 billion in financial assets (including €346 million in euro area corporate bonds and €771 in cash); €2 billion in alternative assets (including €757 million in private equity); and €224 million in equity options.

The log jam in the market for hotels creates an opportunity for the NPRF to invest money in solid investment assets on a strictly commercial basis. In doing so, the NPRF would not only be aiming for higher returns, but would also be giving a boost to an important indigenous export industry.

A proportion of existing NPRF discretionary funds, as well as some of the proceeds from the sale of State assets, could be invested in a new state-owned National Restructuring Corporation (NARCORP).[21] The main objective of NARCOPR would be to increase the availability of equity capital to restructured SMEs. NARCOPR could be a division of a new state-owned Small Enterprise Bank.



Within NARCOPR, a dedicated Hotel Restructuring Fund (HRF) could target the hotel sector. NARCORP could commit €100 million to the HRF. These funds could be augmented by commitments from the European Investment Bank and/or private sector capital funds. The HRF could invest in

[21] NARCORP takes its name from a similar corporation, the National Development Corporation (NADCORP), established in 1986 "to assist in the creation of the maximum amount of viable employment in the State by way of equity investment on a commercial basis in companies." (Dáil Éireann Debates, NADCORP Investment Job Creation, 3 May, 1989). NADCORP's annual accounts show that the total number of companies in its portfolio was 52 with employment in excess of 1,800. The report also showed that investments made by NADCORP over the period 1986-1989 amounted to £18.4 million. The National Development Corporation Act, 1986 can be found at http://acts2.oireachtas.ie/zza5y1986.1.html

hotels that have undergone balance sheet restructuring and have reasonable prospects for profitability, growth and providing sustainable employment.

The private sector capital funds could be venture capital funds, business angle networks, private equity funds, or dedicated funds set up by banks. Through joint ventures with the private sector, the public and private sector could work together to restore an equity based to the hotel sector.

The HRF could work as follows:

1. A prospective buyer of a restructured hotel or the current owner of an undercapitalised hotel could apply to the HRF for equity finance. Applicants would have to meet certain criteria to be considered for financing.
2. Successful applicants could use the equity capital provided by the HRF and funds from a bank loan (possibly partially guaranteed by the HRF and/or the European Investment Bank) to buy or to improve the equity position of a restructured hotel.
3. In return for providing equity, the HRF could take part ownership of the hotel and would appoint directors to the board.
4. The successful applicant could buy out the HRF's equity stake gradually over a period of five years.

Investment criteria

A prospective buyer could submit an expression of interest to the Fund. Applications could be evaluated by an expert Hotel Restructuring Fund Committee. This Committee could work in cooperation with the Credit Review Office. The Committee could consider, among other things:

- Financial condition of the hotel, including the level of the debt on the balance sheet.
- Proposed business plan for the hotel.
- Track record and experience of the applicant.

Illustrative Example

Consider a restructured hotel with annual profits (EBITDA) of €300,000. The hotel is owned by a bank and on offer for €2,100,000. The hotel is purchased using €750,000 invested by the HRF and a 15-year bank loan of €1,350,000. The loan carries an interest rate of 5% and could be guaranteed by the HRF or the European Investment Bank. €60,000 is spent on renovations annually. The hotel performs well and EBITDA grows at a rate of 5 per cent per year.

Each year, the remaining available cash flow is used to redeem part of the HRF's investment. At the end of Year 5, a final repayment is made to the HRF, which has earned a rate of return of 17 per cent per annum. This payment is financed by a new loan and the outstanding balance of the original loan is refinanced.

Purchase price	2,100,000					
HR Fund	750,000					
Loan	1,350,000	Loan-to-value = 64%				
	Year 1	Year 2	Year 3	Year 4	Year 5	
EBITDA	300,000	315,000	330,750	347,288	364,652	
Debt service	(128,109)	(128,109)	(128,109)	(128,109)	(128,109)	
Renovations	(60,000)	(60,000)	(60,000)	(60,000)	(60,000)	
Repayment to HF Fund	(111,891)	(126,891)	(142,641)	(159,179)	(176,543)	
Outstanding Principal	1,287,984	1,222,797	1,154,274	1,082,244	1,006,530	0
Final repayment to HR Fund					654,134	
New loan		Loan-to-value = 65%				1,660,663
HR Fund's return on equity						17%

Qualifying Investor Funds for Hotels

In other countries, Real Estate Investment Trusts (REITs) play an important role in providing equity investment to the hotel industry. Although the legislation governing REITs differs from country to country, a Hotel REIT is typically a listed company that purchases hotels using equity capital raised from public offerings and bank loans. REITs are not permitted to operate the hotels that they acquire, but instead enter into lease agreements with outside parties such as hotel management companies.

Ireland is one of the few advanced countries in the world not to have in place a REIT regime. Building up a meaningful REITs market in Ireland would require enacting the necessary legislation and time for the market to establish a good track record. As such, REITs are not a near-term solution to problem of a lack of equity capital in the hotel industry.

In contrast, Qualifying Investor Funds (QIFs) are investment structures that are well-established in Ireland. QIFs are aimed at sophisticated investors who meet minimum net worth and subscription tests. QIFs enjoy specific tax benefits. For example, non-Irish resident investors are not subject to any charge to Irish tax on the income or gains on the assets held by the fund.

A tax-efficient QIF-type structure especially designed for restructured hotels may be attractive to investors who do not wish to own hotels directly. The QIF could be launched by an investment house. The European Investment Bank could play a role in the scheme by providing guarantees of minimum return to the investors.

The QIF could work as follows:

1. QIF is launched.
2. A prospective buyer of a restructured hotel or the current owner of an undercapitalised hotel could apply to the QIF for equity finance. Applicants would have to meet certain criteria to be considered for financing.

3. QIF chooses projects to fund and attracts funds from investors on the basis on these projects.
4. European Investment Bank could provide guarantee of minimum return to the investors.
5. Successful applicants use the equity capital provided by the QIF as well as other funds to buy or to improve the equity position of a restructured hotel.
5. The successful applicant could buy out the QIF's equity stake after a period of five years.

An illustrative example showing how a QIF could work would be very similar to the examples provided earlier.

4.4 Orderly Reduction in Capacity

As shown in Chapter 3, the average reported occupancy rate was 61.4 per cent in 2011. A recent Fáilte Ireland report points to international research that suggests that an occupancy rate of 65 per cent is indicative of the rate that must be achieved if the hotel sector is to function on a commercially sustainable basis.[22] Given the report's projections of growth in spending by tourists to €6.2 billion by 2015 (from €5.3 billion in 2011) and the associated increase in demand for hotel nights, the report concludes that a reduction in capacity of around 7,000 rooms would be needed to return occupancy to sustainable levels.

Initiatives to increase the availability of equity capital to the hotel industry would promote an orderly reduction in capacity to sustainable levels. Faced with competition from hotels with stronger balance sheets, non-viable hotels that are not able to attract new equity investment will have to close.

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[22] "Recent Developments in the Hotel Sector & the Medium-Term Outlook," Fáilte Ireland, November 2010.

Chapter 5: Conclusions and Recommendations

The Irish hotel industry has been particularly hard hit by the economic and financial crisis. The drop in overseas visitor numbers and the negative effects of fiscal consolidation on consumer spending have depressed revenues and profits in the industry. Moreover, the severity of the ongoing recession has destroyed equity in the sector and undermined the industry's financial strength.

Hotels have a critical role to play in contributing to recovery in Ireland's tourism sector and in the wider economy. A high-quality stock of well-run hotels spread across the country attracts tourists from abroad and encourages Irish consumers to spend in the domestic market. Forecasts for growth in international tourist arrivals, along with the projected bottoming out of domestic consumer spending, underscore tourism's potential to be an engine for job creation across the country. A viable hotel industry has a key role to play if this potential is to be realised.

The Irish hotel industry is suffering from a significant debt overhang problem which is curbing recovery in the sector. The hotel sector as whole is generating an operating surplus and therefore can sustain a certain level of debt. The current level of indebtedness in the hotel sector is not sustainable and balance sheets will need to be restructured to increase equity and reduce debt.

New equity investment in hotels is therefore required if the sector is to survive and prosper. The scarcity of new equity finance in the current environment represents a market failure that is gumming up the recovery process in the hotel industry.

This report identifies what is required of Government to increase the availability of equity finance and facilitate an orderly restructuring of the hotel industry. Working together, the Government and the industry can restore financial sustainability to this critical sector.

Recommendations

- Employment and Investment Incentive Scheme could be extended to include restructured hotels, thereby providing incentives to private investors to inject equity into restructured hotels.

- Hotel Restructuring Fund could use funds from the National Pension Reserve Fund and the sale of state assets to invest in hotels that have reasonable prospects for profitability, growth and providing sustainable employment.

- Qualifying Investor Fund for hotels may be attractive to private investors, especially from abroad, who would like to invest in Irish hotels but do not wish to own hotels directly.