Hotel Industry

Stress Levels Rising, Investments Stalled

Special Report

No Signs of Revival: India Ratings & Research (Ind-Ra) expects hotel companies to continue to face muted revenue growth, stagnated profitability and elevated credit risk in FY15 driven by lower demand growth and supply-side pressures. Newer properties are likely to face higher stress due to an elongated stabilisation period. Also, companies facing highly leveraged balance sheets are cutting back on their expansion plans and selling existing assets to pare off debt. The industry is unlikely to witness fresh large-scale investor and developer interest in the near term.

Weaker Performance of Premium[1] Hotels: According to Ind-Ra's analysis, revenue growth of premium hotel companies remained stagnant in FY13 and 9MFY14. This is because of declining growth rate of corporate travellers as companies continued to cut travel cost on lower profitability amid the ongoing economic slowdown. The demand slowdown has put pressure on occupancy and average room rate (ARRs) across major cities limiting the ability of hotel companies to pass on an increase in input costs, impacting their EBITDA margins negatively.

High Stress on New Properties: With demand slowdown, the time taken for newer hotels to improve occupancy level and ARRs has also increased. Thus, new properties are facing higher stress and are primarily dependent on sponsors to repay their debt.

Deteriorating Credit Metrics Leading to Asset Sales: According to Ind-Ra's analysis, credit metrics of hotel companies have showed a downward trend since FY08. There has been even sharper deterioration of credit metrics over FY11-FY13 with median interest coverage declining to 1.7x in FY13 (FY11: 3.8x) and debt/EBITDA increasing to 7.1x (2.5x). Hotel companies which have implemented aggressive debt-led capex in the past are finding it difficult to manage their overleveraged balance sheets and have thus resorted to assets sales.

Rise in Debt Restructuring: According to the corporate debt restructuring (CDR) cell, nine hotel companies received approvals for debt restructuring in FY13 (FY12: nil), amounting to an aggregate debt of INR46bn. The number of companies undergoing debt restructuring outside of the CDR mechanism might be even higher.

Cautious Approach on Capex: Incremental borrowing by hotel companies continued to decline in FY13, indicating both that investors are cautious and banks are selective in lending. Defaults by leading industry players have made investors and bankers jittery. This has led to stalling of projects worth around INR143bn over FY12-FY14 (80% of new projects announcement). The November 2013 notification by the Reserve Bank of India (RBI) to include specific hotel projects in the infrastructure sector is likely to help hotel companies have access to higher tenure loan and low-cost funds. However, this is unlikely to boost investment in the sector due to a weak demand environment and concerns regarding existing investments.

Slowdown in Foreign Tourists: Ind-Ra believes the growth in foreign tourist arrivals (FTAs) in India will remain muted in 2014. The number of incremental foreign tourist arrivals fell below 0.3 million in 2012 and 2013 (2011: 0.53 million; 2010: 0.61 million) reflecting the slowdown in global markets. According to the Ministry of Tourism, CAGR of FTAs declined to 5.3% over 2008-2013 from 14.1% over 2003-2008. However, an improvement in economic environment could lead to an increase in foreign corporate travellers in 2014.

[1] Premium segment hotels include five-star deluxe, five-star and four-star categories

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Non-premium Segment Better Placed: Ind-Ra's analysis indicates that non-premium and budget hotels' financial performance is likely to face relatively less cyclical stress in FY15. This is because non-premium hotels cater mostly to domestic travellers – a segment which has continued to show strong growth despite slowdown. Thus, the non-premium hotel segment is likely to witness higher investments due to the higher growth expectations.

Rupee Depreciation Positive: The rupee depreciation in 2013 (around 13%) has increased affordability of India as a tourist destination which is likely to help increase FTAs in an improved economic environment. It also translates into higher earnings for the tourism industry in rupee terms, as seen over 2011-2013 where foreign exchange earning in rupee term grew 36.4% yoy despite slower growth in FTAs.

Muted Outlook for FY15: Ind-Ra expects revenue growth of major hotel companies (5%-10%) to remain sluggish in the near term due to weak macro environment. Although inflationary pressures are likely to moderate in FY15, the agency does not expect margins of hotel sector companies to improve from the current levels (20%), as pressures on ARRs are likely to continue from new capacity additions. However, with major hotel companies slowing down capex, Ind-Ra estimates that their credit metrics will not deteriorate significantly.

Key Issues

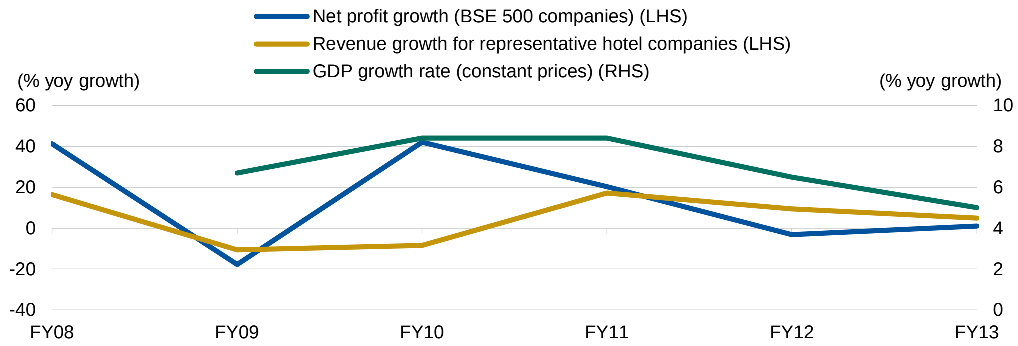
Subdued Revenue Growth on Lower Corporate Profitability

Revenue growth of hotel companies deteriorated in FY13 on the back of corporates cutting travel budget due to lower profits, a fall in incremental FTAs and over-supply in certain markets. Companies saw aggregate revenue growth of 5% yoy in FY13 (FY12: up to 9.4%).

In 9MFY14 too, revenue growth remained muted due to weak macro environment with India's gross domestic product (GDP) growing at a five-year low rate of 5% in FY13 (FY14 advance estimates: 4.9%). Apart from that, a lower demand environment coupled with over capacity has stressed occupancy and ARRs across India. Industry estimates indicate that ARRs have declined by 5%-10% yoy across major cities in the country in 9MFY14, while occupancies have shown a mixed trend.

Figure 1

Corporate Proftability Closely Related With Sector Performance



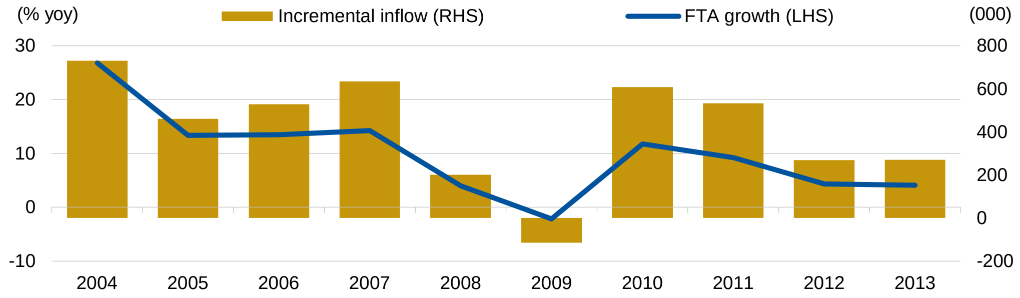
Source: Ind-Ra, Ace Equity, RBI

Premium Hotels more Stressed than Budget Hotels

According to the Federation of Hotel & Restaurant Associations of India's (FHRAI) survey 2012-2013, business travellers comprised 58.2% of total hotel guests over 2012-2013. However, in the premium segment, more than two-thirds of guests are business travellers or foreign tourists. Therefore, the slowdown in business and foreign travellers, coupled with the over-supply in this segment, has severely impacted premium hotel companies.

Figure 2

Decline in Incremental Foregin Tourist Inflows

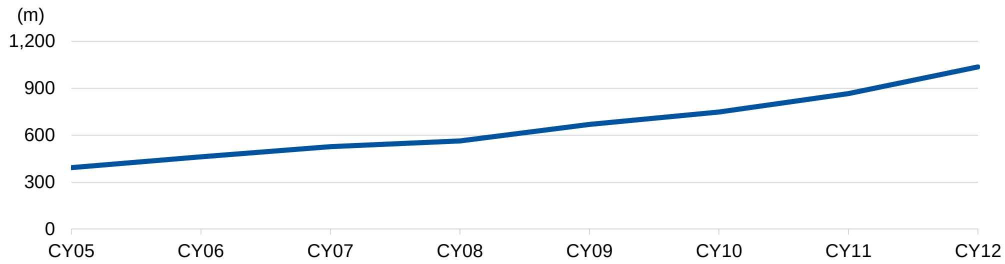


Source: Ministry of Tourism
2008-2009 were impacted by Mumbai Terror Strike

Ind-Ra believes non-premium hotels with their lower cost structure will continue to fare better than premium hotel chains in the current environment. In addition, this segment has also benefited from strong growth in price conscious domestic travellers which account for over 75% of the total guest in such hotels. The better prospects of non-premium/budget segment, coupled with a relative shortage of supply of such hotels, are likely to result in higher investment in this segment.

Figure 3

Domestic Tourist Visits
Pimary driver of leisure demand



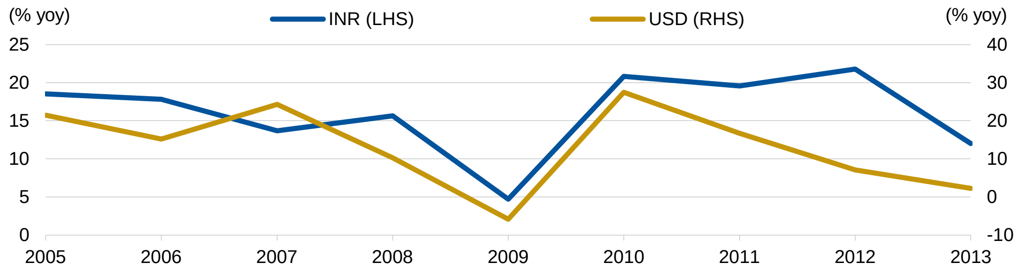
Source: Ministrv of Tourism

Rupee Depreciation Could Aid Industry Growth

The significant rupee depreciation in 2013 (around 13%) would benefit the hotel industry. A weaker rupee makes India a more affordable destination and is likely to increase FTAs. It also translates into higher earnings for the tourism industry in rupee terms, as seen over 2011-2013 where foreign exchange earning in rupee term grew 36.4% yoy despite slower growth in FTAs. Also, rupee depreciation makes outbound travel more expensive for Indians, who may opt for domestic travel.

Figure 4

Revenue Receipt from Tourism



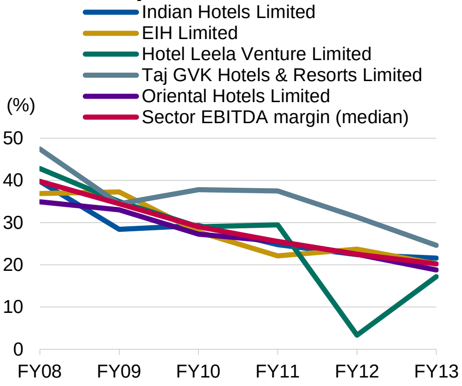
Source: Ministry of Tourism

Inflationary Pressures Hurting Margins

Ind-Ra's analysis indicates that profitability of hotel companies declined by 100bp-300bp in FY13 primarily due to inflationary pressures, mainly higher food and fuel costs, and an inability of companies to pass on such pressures due to weak demand. However, wage costs which were the primary reason for margin contraction over FY08-FY12 remained largely flat (as % of sales) over FY12-FY13. The declining trend in EBITDA margins has continued in 9MFY14 as well.

Figure 5

EBITDA Margin of Representative Hotel Companies

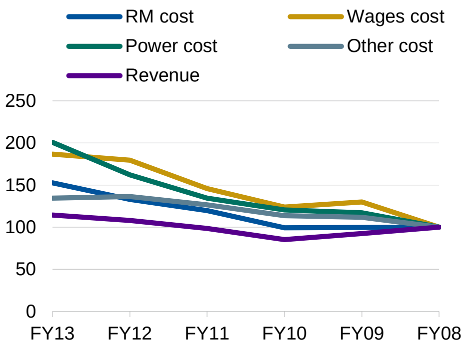


Source: Ind-Ra, BSE India

Figure 6

Revenue and Cost Trends in the Sector

(Indexed to FY08 costs and revenue)



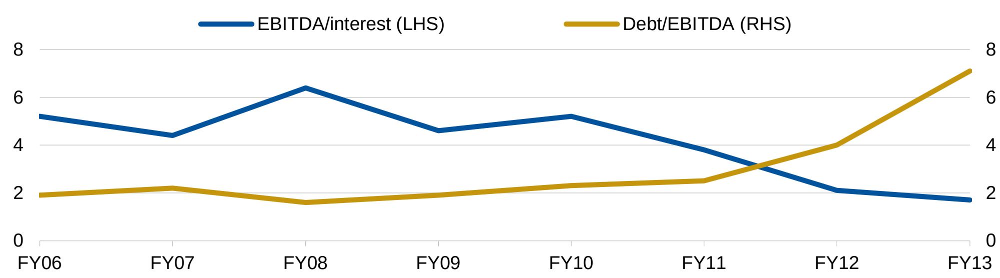
Source: Ind-Ra, Ace Equity

Sharp Deterioration in Credit Metrics

According to Ind-Ra's analysis, credit metrics of major hotel companies have continued to deteriorate since FY08 due to muted revenue growth and a decline in profitability. Median interest coverage deteriorated to 1.7x in FY13 from 5.2x FY08 and debt/EBITDA to 7.1x from 1.6x. Although incremental borrowing has declined, many companies are finding it difficult to manage their overleveraged balance sheets.

Figure 7

Credit Metrics Have Deteriorated



Source: Ind-Ra, Ace Equity

Rise in Debt Restructuring Indication of Stress in the Sector

The increasing number of approved CDR cases in the hotel sector indicates the severe stress among sector companies. Also, a large number of restructuring cases are handled outside CDR through bilateral agreements between banks and companies.

Credit Metrics Unlikely to Deteriorate Further; Asset Sales to Pare Off Debt

Ind-Ra estimates that credit metrics of major hotel companies are unlikely to deteriorate from current levels with major hotel companies slowing down capex and shelving the already announced projects. This is also supported by the fact that several hotel companies have announced assets sales to pare off existing debts and are looking to consolidate current operations. However, due to the weak macroeconomic environment, the initial stabilisation period for new hotels has increased, thus impacting their debt servicing ability.

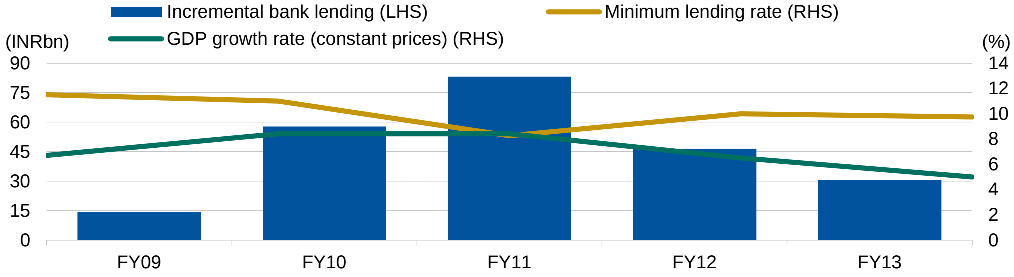
Investment Outlook

Significant Decline in Incremental Lending

Borrowings by hotel companies continued to decline in FY13 with incremental lending to the sector dropping to INR31bn, almost two-thirds of FY11 levels. This in an indication of companies turning cautious as well as of selective lending by banks to corporates. Capex plans have been put on hold given the already stretched balance sheets and the poor performance of new properties. Ind-Ra expects this trend to continue in the near term as the overall economic scenario remains muted. Over April 2013-February 2014, incremental lending to the sector stood at INR38bn, but remained well below the peak recorded in FY11 (INR84bn).

Figure 8

Decline in Lending
Hotel, toursim and resturants



Source: Ind-Ra, RBI

Grant of Infrastructure Status Unlikely to Revive Investment

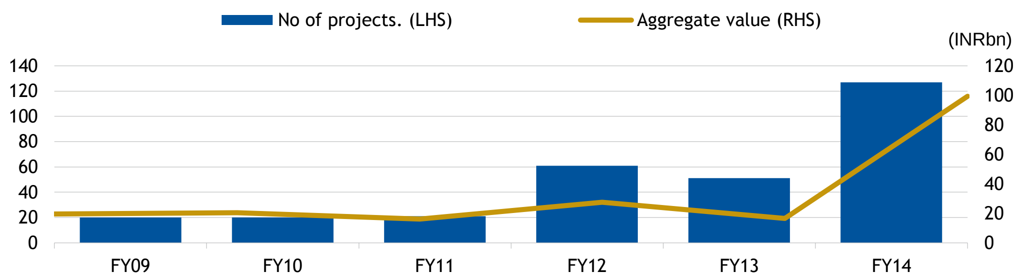
Ind-Ra believes that RBI's notification (November 2013) to include hotel projects under the infrastructure sector will fail to revive the investment in the sector. Under this, hotel projects costing over INR2bn (excluding land cost) across India and convention centres costing more than INR3bn are included under the infrastructure sector. Thus, these projects can now avail long-term loans as well as funding at lower cost. However, given the weak demand environment, it is unlikely to boost capex in the sector.

Increasing Number of Projects Being Shelved

According to Ind-Ra and industry reports, the current supply of organised hotels is around 100,000 rooms and an additional 85,000-90,000 are in pipeline. However, many hotel companies are delaying new projects and even shelving proposed plans (40%-50%) due to the prevailing economic downturn and increased stress levels. This is mainly due to 1) lower liquidity and rising financing costs 2) longer stabilisation periods along with a rise in construction and land costs making projects unviable and 3) delays in availing clearances for projects. Ind-Ra estimates 80% of the new projects announced (by value) have been stalled over FY12-FY14.

Figure 9

Increase in Number of Projects Being Stalled

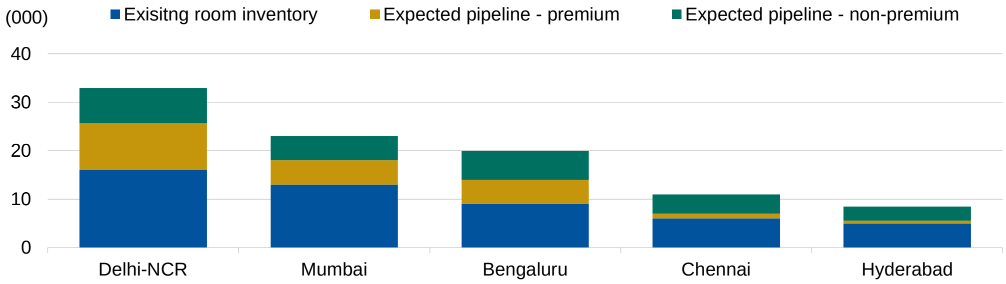


Source: Ind-Ra, CMIE

Among major regions, Delhi-NCR, Mumbai, Bengaluru, Chennai have a proposed pipeline which is likely to double the inventory of rooms in these cities over the next few years. Delhi-NCR has an oversupply of rooms (inventory of around 16,000 rooms) which has led to a decline in occupancy and ARRs over FY13-FY14. Thus, the performance of hotels in this region is likely to remain muted in the near term. However, Gurgaon, being a major business hub in NCR, is likely to witness a steady increase in demand. Also, Mumbai and Bengaluru, being major business centres, are best placed to absorb the additional supply.

Figure 10

Supply Pipeline in Major Cities



Source: FHRAI, Industry data, Ind-Ra

Change in Mix Towards Non-Premium Segment Hotels

The contribution of non-premium hotels to India's total room inventory has increased gradually and now accounts for over half of the total inventory. Due to robust demand from domestic leisure travellers in the past, major companies have now increased focus on this segment and thus the upcoming inventory would further be skewed towards these hotels.