P2P: Are There any More Public-to-Private Deals Left?

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Hanover, Macdonald and Jarvis were announced as public-to-private ('P2P') transactions in the European hotel sector in 2003; Pandox, Queens Moat Houses (QMH) and Gresham followed in 2004. Are more European hotel chains likely to go private in 2005? What are the alternatives to P2Ps for investors and owners? And how will the rest of the listed hotel companies in Europe react to improved hotel trading conditions and increasing investor appetite for hotel real estate?

The climate in the equity markets in Europe currently supports the P2P route for hotel companies, as, in any case, most of them continuously trade at a discount to net asset value (NAV), based on their real underlying asset values. However, P2P transactions have become more expensive on the whole and impediments to P2Ps in form of concentrated share ownership and heavily geared balance sheets mitigate against transactions. Nevertheless, more P2P transactions are likely to happen in Europe, even if not for the same reasons and not with the same deal logic as in the past.

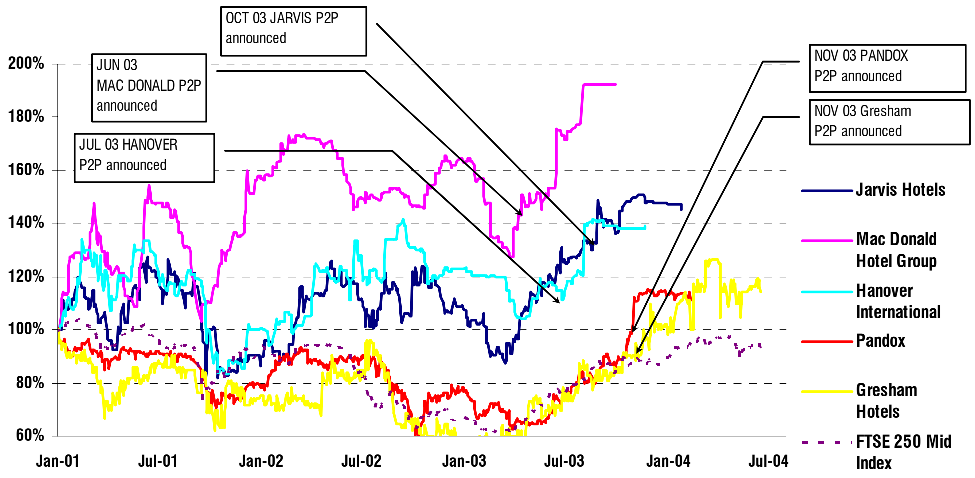
P2Ps will include corporate development prospects for target companies and in all likelihood strong private equity backing. The time when investors could take a big stake in a company at a discount to NAV above 40% and buy out the rest of the shareholders at relatively low premiums (below 20% in 2003 and 2004) is over. 'Straightforward', obvious targets parting with the equity market have seen share prices increase by roughly 60% in the case of almost every potential P2P candidate since early 2003, making transactions more expensive and squeezing IRRs for investors.

What made P2Ps work in the past?

Equity markets had ignored the underlying asset values of hotel companies during the Internet boom at the end of the 1990s and the beginning of the new millennium. Shares in hotel companies were not valued to their full potential; however, P2Ps would still have been too costly, due to high enterprise value entry multiples and the large share premiums that would have had to be paid on the share price. After 11 September 2001 the hotel sector fell out of favour. Hotel shares became affordable and the premiums shareholders were expecting were lowered, due to a lack of upside seen at the time.

When buying shares in hotel companies in 2002 and 2003 investors did not have to pay the market value for property. Now that properties are being put on the market, owners (of private and public companies) achieve the value of the properties. Ironically, when the share price of many hotel companies (those announcing asset disposals) shot up over the last 12 months, it suggested in part that equity markets value the assets of hotel companies only when they are sold.

Graph 1 – P2P Hotel Transactions Share Price Movements (Index) 2001-04



Source: Datastream, HVS International Research

Exit routes for transacted P2P deals have included the piecemeal sales of Hanover, Jarvis and QMH properties (Whitehall non-core assets), whereas we consider that the owners of Jarvis and QMH will try to improve profitability before they sell more assets. A full takeover by a large hotel chain could be an option too. Capona (the new owner of Pandox) put one of its properties on the market in 2004; however, it continues to implement Pandox's strategy as an asset-managing hotel owner. Macdonald's and Gresham's portfolios are being further developed too, with future potential for an IPO of Macdonald. A future independent listing of Gresham seems unlikely due to its limited size.

By looking at the economic environment hotel companies found themselves in and how owners, operators and investors proceeded with structuring deals, we can see specific trends in hotel P2Ps. Graph 1 gives a general overview of how share prices reacted to the events proceeding the completion of the most prominent P2P transactions in 2003 and 2004.

1. Equity markets ignored underlying asset values in hotel companies.

2. Hotel stocks were undervalued after 11 September 2001.

3. Owners, managers and investors achieved arbitrage of resilient hotel asset values.

4. Longevity of hotel assets allows for several exit strategies.

It also seems that investors re-engineered hotel P2P transactions in 2003 and 2004 using similar pricing metrics. Cash flow multiples and transaction prices per room are broadly the same for all four P2P deals set out in Table 1. Whilst similar cash flow multiples reassure the seller of the sanctity of the deal, the similarity between the price per room and the transaction price is likely to be a coincidence, given the heterogeneous nature of the portfolios. These buyout offers for shareholders in P2Ps were announced in 2003 and it took about four to five months to complete the deals from announcement to delisting.

Generally, P2P transactions and M&A deals in the hospitality sector are driven mainly by hotel trading cycles, as P2P transaction prices and hotel values are heavily dependent on the profitability of hotels. Because the exit from a hotel P2P or M&A deal often includes the portfolio or piecemeal sale of hotel assets, the hotel real estate cycles and, hence, future prices for assets are crucial. The interest rate levels and availability of funding for the industry are influential as well.

Table 2 – Key Ratios and Transaction Multiples of Four Hotel Companies Delisted in 2003/04 (£ 000s)[1]

	PANDOX AB	JARVIS HOTELS	MACDONALD HOTELS AND RESORTS	HANOVER INTERNATIONAL	AVERAGE
Net Asset Value	149,665	273,799	116,518	75,182	153,791
Offer announced	November 2003	October 2003	June 2003	July 2003	
Date of delisting	19/02/2004	04/02/2004	01/10/2003	24/10/2003	
Premium for shareholders	8.8%	5.5%	21.8%	15.2%	12.8%
Price of transaction	268,000	218,420	597,640	97,150	295,303
Cash flow multiple of offer	9.0	9.7	8.7	8.9	9.1
Price per room	22.5	22.3	25.6	22.6	23.2
EV / EBITDA	13.0	7.1	7.9	9.6	9.5

Source: HVS International Research

Valuations derived for single assets in European cities between 2001 and 2003, the period in which the P2P transactions were structured, declined on average by 7.6%, depending on hotel market fundamentals. Some markets saw hotel assets drop in value by more than 15% (for example, London, Warsaw, Amsterdam) while others increased by 10% or more (Milan, Moscow) as demonstrated by the HVS Hotel Valuation Index in Table 3. In 2004 Europe saw an overall appreciation of assets (3.2%).

Compared to major European equity markets, however, the values of hotel assets transacted during this period remained resilient.

Volatility and meagre returns on equity market between 2001 and 2003 in the USA (-1.8%)[2] and Europe (-27.7%)[3] led to significantly increased interest in alternative asset classes, including hotels. During the same period, capital remained relatively cheap as interest rates were low in Europe (3.75%) and the USA (1.0%).

Table 3 – HVS Hotel Valuation Index 2001-04 – Percentage Change in Hotel Values

	2001	2002	2003	2004	CAG 1993-04	CAG 2001-04
Moscow	22.6	13.2	8.7	**21.7**	n/a	14.4
Prague	-0.5	-4.3	1.6	**17.7**	n/a	4.6
Istanbul	-10.0	-19.5	-9.5	**16.9**	2.1	-5.2
London	-12.7	-5.0	-5.9	**11.9**	6.3	0.0
Munich	5.1	-7.3	-8.1	**11.7**	n/a	-1.7
Edinburgh	-5.3	3.3	-3.4	**9.4**	n/a	3.0
Budapest	-1.2	-2.8	-13.6	**7.9**	n/a	-3.2
Birmingham	-1.4	2.5	-4.2	**7.7**	n/a	1.9
Manchester	3.1	0.7	-5.7	**7.5**	n/a	0.7
Athens	-2.9	5.9	-2.8	**6.7**	4.6	3.2
Zürich	4.0	-7.1	-5.5	**6.2**	n/a	-2.3
Rome	-3.1	-1.8	-1.9	**4.7**	5.5	0.3
Paris	-6.4	4.4	-7.2	**4.3**	2.1	0.3
Europe	**-1.9**	**-1.5**	**-4.2**	**3.2**	**3.7**	**-0.9**
Brussels	-4.2	-7.7	-4.0	**3.1**	2.6	-3.0
Lisbon	-0.1	-1.9	-4.0	**2.6**	2.4	-1.1
Dublin	-8.5	-1.6	1.9	**2.3**	n/a	0.8
Stockholm	-10.5	-5.5	-6.5	**1.9**	5.5	-3.4
Berlin	3.8	1.5	-2.9	**1.0**	2.7	-0.1
Vienna	0.1	-1.4	6.4	**0.8**	1.1	1.9
Hamburg	-9.1	3.7	-0.2	**0.5**	n/a	1.3
Amsterdam	-6.5	-5.5	-4.9	**-0.3**	6.6	-3.6
Copenhagen	-6.2	-3.0	-8.3	**-3.1**	3.5	-4.8
Milan	6.6	3.8	-0.4	**-3.3**	n/a	0.0
Frankfurt	6.4	-6.6	-2.0	**-3.7**	1.2	-4.1
Geneva	10.4	3.8	-7.9	**-8.4**	2.6	-4.3
Barcelona	-1.5	1.4	-5.5	**-8.5**	7.4	-4.3
Madrid	-2.6	2.4	-5.7	**-10.9**	3.3	-4.9
Warsaw	-2.0	-15.2	-10.9	**-13.4**	n/a	-13.2

Source: HVS International

[1] Enterprise value (EV) calculated as market value of equity (net operating profit after tax (NOPAT) x price earnings ratio (PER) last operating year) + book value of long-term debt
[2] Dow Jones Index, Negative capital gain between 1.1.2001 and 31.12.2003
[3] FTSE 100 Index, Negative capital gain between 1.1.2001 and 31.12.2003

So what were the real drivers of P2Ps?

Clearly the discount to NAV of a target company was the main driver for P2P deals during 2003 and 2004. The Jarvis and Hanover P2Ps realised a discount of approximately 60% to NAV based on adjusted company asset valuations (Table 4). While Macdonald traded at a lower discount to NAV (approximately 20%) and Pandox at a premium to NAV (40%), this was acceptable due to differences in the deal logic between each transaction. Macdonald, as a private equity-backed management buyout (MBO), was done for corporate development opportunities and management incentivisation, while Pandox can be described as a transparent, lower-risk refinancing deal because virtually all of the company's hotels are on long-term leases.

Nevertheless, there were other important factors that made P2Ps lucrative for investors:

- **Real asset values based on up-to-date valuations were superior to company (balance sheet) valuations;**
- **Timing was crucial as hotel trading cycles were thought to be on their way up with hotel values expected to rise (which was priced into values);**
- **Asset ownership in all companies was high.**

Jarvis's properties were stated at cost in the books and the market value approximation of the assets plus the debt, resulting in market enterprise value (MEV) of the company, was therefore higher than the implied enterprise value. The same is true for Macdonald and Hanover. The discount MEV to enterprise value shows the approximate investor arbitrage for the transactions.

Are there reasons to delist European hotel companies based on P2P criteria? If so, which European hotel companies are likely to go/be taken private?

Virtually all listed hotel companies considered[4] have different strategic and financial ground rules when evaluated closely. However, some similarities are noticeable once the transactions are grouped by geographical region (Table 5).

Table 4 – Key Ratios and Transaction Multiples and Discounts to NAV and MEV (£ 000s) [5]

	PANDOX AB	JARVIS HOTELS	MACDONALD HOTELS AND RESORTS	HANOVER INTERNATIONAL	AVERAGE
Rooms	8,729	7,142	6,127	1,638	5,909
Hotels	45	69	86	15	54
Reporting period ending	31/12/2003	29/03/2003	30/09/2002	31/12/2002	31/12/2002
SALES	45,707	162,393	91,364	31,206	82,667
EBITDA	33,766	34,366	25,586	8,096	25,453
Net profit after tax (NOPAT)	12,921	10,211	11,507	1,181	8,955
Net book value (fixed assets)	384,666	395,236	196,718	118,469	273,772
Assets last valued	continously valued	in books at cost	02 - 1996	partly every 5 years	
Market value approximation (MVA)	384,666	474,283	236,062	130,316	306,332
Long term debt	235,001	121,437	80,200	43,287	119,981
Net asset value (NAV)	149,665	273,799	116,518	75,182	153,791
Discount NAV to MCap	-40.1%	52.9%	-4.6%	57.2%	16.4%
Discount MVA to MCap	-40.1%	63.4%	21.8%	63.1%	27.1%
Implied equity value	204,516	122,724	121,822	34,822	120,971
EV / Equity multiple	2.1	2.0	1.7	2.2	2.0
TM / EBITDA	12.8	8.2	9.3	9.9	10.1
MEV / EBITDA	18.4	17.3	12.4	21.4	16.7
Discount MEV to EV	29.1%	59.0%	36.1%	55.0%	43.5%

Source: HVS International

[4] Hilton and Accor have not been included in this analysis as both listed companies are not pure hotel businesses but run other business with a significant contribution to their earnings.

[5] MEV calculated as market value approximation of assets plus long-term debt (book value). Transaction multiple (TM) is the sum paid by investors for the shares before delisting plus long-term debt (book value)

From an analysis of all publicly listed companies:

- **Discount to NAV in the UK companies studied is high across the board;**
- **Discount to NAV in continental European companies is relatively low across the board.**
- **EV/EBITDA[6] multiples are similar across the board for UK and European small caps[7];**
- **Return on capital employed (ROCE) and return on equity (ROE) are on average lower in the UK than in Europe;**
- **Share ownership is generally concentrated more in central and northern Europe than in the UK.**

Table 5 – Grouping of Listed Hotel Companies

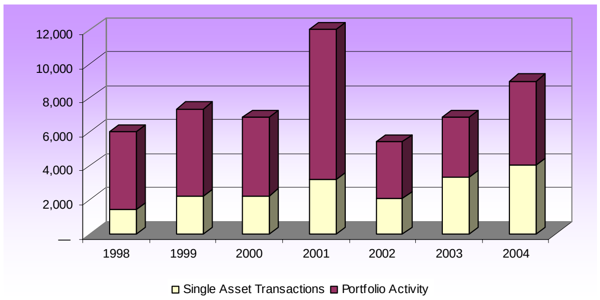
UK Hotel Groups	Jurys Doyle Hotel Group De Vere Group
Large International Operators	Millennium & Copthorne Intercontinental Hotels Group
Central European Operators	NH Hoteles Sol Melia Societe De Louvre Jolly Hotels
Northern & Eastern European Operators	Orbis Capona Danubius Hotels Group

Source: HVS International Research

The long-term appreciation of real estate values in the UK is a major driver for the delisting of hotel companies. Even though London hotel property values saw a sharp decline between 2001 and 2003 (-23.6%), when the considered P2P transactions were structured, the HVI shows a compound annual growth rate of 6.3% since 1993 (European average 3.7%). By valuing all UK and all European hotel companies with a traditionally recognisable EV/EBITDA multiple, similar values are derived for both sets of companies within their respective groups, suggesting that equity markets value hotel operations across the UK and Europe consistently and that EBITDA levels correlate with the size of the company.

Lower levels of ROCE before tax in UK hotel companies (before the latest disposals of assets[8]) are a result of generally higher asset values in UK hotel companies, which is due to higher and more recent valuations and the higher proportion of owned properties. The UK average for owned hotels within a portfolio is about 60%, as opposed to approximately 30% in central Europe and northern Europe. This is consistent with lower asset turnover[9] levels in the UK (average 0.3) as opposed to central Europe (average 0.6). Obviously this comparison will change as more hotel companies divest themselves of real estate. Transaction activity in 2004 increased considerably, as indicated in Graph 6.

Graph 6 – Total Hotel Investment Volumes 1998-04 (€)



Source: HVS International Research

Ownership of shares in UK companies is on average less concentrated, which enables investors to gain a larger share more easily than they could in some companies in central and northern Europe, where members of the founder's family or long-term shareholders own approximately 30% of the shares, and

[6] EV/EBITDA (Enterprise value divided by earnings before interest taxes depreciation and amortisation
[7] Company with a market capitalisation below £1 bn (definition varies)
[8] All UK hotel companies considered in our analysis have sold or put assets on the market in 2004 and early 2005. Furthermore Sol Melia and Jolly have sold properties.
[9] Calculated by dividing total revenues by total assets (book value)

therefore the company, and make all of the important decisions. The takeover or P2P of such a company may result in the deal falling apart as the concentrated ownership enjoys more bargaining power. Other factors to consider include protectionism of family assets or corporate empires, nationalism, managerial hubris or pride, which results in non-rational economical behaviour.

So what does this mean for listed hotel companies in Europe?

By applying a set of key drivers for investors and operators of the already delisted companies to listed companies through a discriminant analysis[10] we derive an *a priori* classification of firms that technically fulfil the conditions for a P2P transaction and a score for the most important financial drivers[11]. This exercise results in a preliminary selection of possible candidates, although further investigation into the individual companies should be made.

- **Jurys Doyle, Millennium & Copthorne (M&C), Jolly and Danubius fulfil the technical conditions for a P2P**

The main financial drivers for a P2P are the discount to NAV (higher than 30%) and the ability to generate operating cash flow (to repay debt). Other important drivers that determine the attractiveness of a hotel company for a P2P are ROCE before tax, Debt/ equity ratio, Freehold ownership of hotels and Enterprise Value/rooms.

The feasibility of a P2P for this selection of companies, which fulfil the main financial criteria, depends largely on the following.

- **The willingness of the owners to participate in such a transaction12;**
- **The strategic fit (valuation leverage) of the target companies with the buyers;**
- **The financing available for the deal.**

These should be the main elements to a deal to counteract increasing share prices and, hence, deteriorating discounts to NAV.

P2P – Outlook and Exit Routes

- **Changed economic environment makes 'straightforward' P2Ps less attractive to investors;**
- **Concentrated share ownership or lack of discount to NAV is the greatest impediment to P2P;**
- **Availability of asset portfolios, equity funds and debt financing;**
- **A number of feasible alternatives to P2Ps are available.**

A future P2P, moving slowly up the hotel trading and economic cycle, is unlikely to be made just for the discount to NAV. Entry barriers to P2Ps for remaining target companies have risen on all fronts: share prices have increased, ownership is more concentrated, interest rates are higher and trading of hotel companies has improved. All this suggests that 'straightforward' deals are more expensive and returns for investors are reduced. What remains are the availability of funds for real estate investment, hotel companies divesting their real estate assets, and sufficient availability of debt.

[10] Tests the correlation of key ratios and financial indicators between a set of delisted companies and a set of listed companies and predicts to which of the above sets a company should belong to.
[11] Variables used: discount to NAV, operating cash flow, ROCE before tax, debt/equity ratio, freehold ownership of assets, EV/rooms, EV/cash flow, total assets, EV/EBITDA, NOPAT
[12] All transacted hotel P2Ps, except the Hanover International transaction, were reached in agreement between shareholders and management

HVS considers that viable alternative scenarios for the short to medium-term are buyers such as private equity funds cooperating with management teams of small to medium-sized hotel chains to take a company private in order to develop a larger portfolio and enhance profitability and growth prospects for a single or two existing businesses. It will be challenging to structure deals just for the discount to NAV, even though hotel values are increasing again in many markets, as shown by the HVI.

Jurys Doyle, for example, has been approached by Precinct, the consortium that took Gresham Hotel Group private, and other bidders who already own hotels. Bids have so far been resisted by the owners and management, as they are said to have been too low. The owners of De Vere Group are said to be considering a break-up while the profitability of the company is improving. Asset disposals and improved trading conditions in both companies demand additional 'valuation leverage' to make a potential P2P pay off for investors.

The 80 hotels of the QMH portfolio across the UK, Germany and the Netherlands could be a complimentary management opportunity for emerging Pan-European chains like Sol Meliá, Barceló or Louvre Hotels. Non-core assets are being disposed of at the moment. NH Hoteles could be interested in managing the UK properties (with financing help from a private equity house), as it already has a foothold in Germany (Astron hotels) and the Netherlands (Krasnopolsky hotels). The portfolio could be complementary with a big selection of hotel companies; however, the assets and operations are being enhanced by the Whitehall fund (Goldman Sachs) and its partners before a trade sale to a private equity house or a listing via a property investment fund (PIF)[13] can take place.

Holiday Inn Victoria, London

Recently sold for €53 million (£35 million) to the Spanish hotel operator Hesperia Hoteles; its first hotel in the UK and the third Spanish operator to invest in London

Value creation for shareholders and satisfactory returns for P2P investors are achievable by realising economies of scale in a deal that brings together two or more companies and/or leveraging brands and transferring knowledge and capabilities. Furthermore, many portfolios have not been re-valued for years and do not demonstrate the real asset value of the company.

A private equity backed P2P of Jolly Hotels in Italy with the help of NH Hoteles, which already owns 20% of Jolly, could be an option to improve the market coverage for NH in Italy, where it is difficult to develop new hotels, and help bring operational benefits for Jolly at the same time. The deal between Marylebone Warwick Balfour's Malmaison and Hotel Du Vin is another example where two relatively small companies can bring together economies of scale and different capabilities (e.g. F&B competence, marketing, cross-selling) to develop a joint portfolio under the same ownership (even though it was not a P2P).

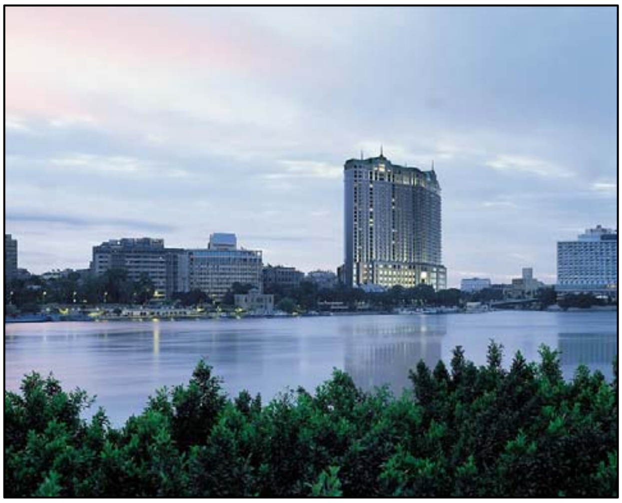
We have also seen the opposite scenario to a P2P demonstrated by Dawnay Shore Hotels. Dawnay Shore has listed a private equity backed MBO (Paramount Hotels) on the Alternative Investment Market, perhaps to

[13] PIFs or REITs are not yet available in the UK but may possibly be introduced in the course of 2005 and 2006. At present it is not certain whether hotels will be included as a valid asset class.

partially exit investors before the implementation of the proposed strategy is valued on the equity markets and a final exit route is followed. The sale of some hotels once valuations improve further is likely and another P2P during the next downturn in the hotel trading cycle is a strong possibility.

Exit routes for the transacted P2Ps will be a combination of piecemeal asset sales to improve overall returns and repay a portion of the debt taken on to finance the P2P and will ultimately include larger corporate transactions, portfolio sales and the listing of hotel asset portfolios on equity markets (if PIFs become reality).

We consider IPOs to be a financing possibility for hotel companies in a specialised market with a history of growth, like Dawnay Shore Hotels or possibly Macdonald Hotels. A candidate in another market is Prince Al Waleed's Kingdom Hotel Investments.



Four Seasons Hotel, Cairo – Part of the 14-property strong US$2 billion Kingdom Hotel Investments portfolio

Other P2P considerations

- **Private equity houses prove to be better asset managers than hotel companies;**
- **Separation of bricks and brains drives up hotel values;**
- **Relationship management with owners becomes more important.**

The implications of the current events for the industry are far-reaching. As many hotel companies now see no value in owing properties they manage, more single assets and portfolios are put on the market.

The separation of ownership (bricks) from management (brains) becomes an even bigger concern for large management companies, since private equity houses have proved that they are better asset managers. This development takes away the main impetus for investors to take hotel companies private as the underlying real estate value of the company is much lower. The trend in separating bricks and brains should drive up the value of hotel properties and also support the listing of real estate portfolios.

Hotel operators have been able to retain their brands on hotels leased-back or managed-back. Relationship management with owners will, however, become more important as direct control over the assets slip away. Third party asset management will become more widely used by real estate owners to ensure profit and value maximisation.

In Conclusion…

We anticipate more P2Ps, but only with investors who possess increased valuation leverage based on the complimentary nature of seller and buyer and a 'good growth story' for investors. Without these prerequisites, required IRRs (usually in excess of 20%) may not be met. To put it simply: make sure assets reflect the real underlying value; add the market cap increase from 2003 and 2004 to the transaction price; value the deal with your special 'valuation leverage' and your strategic fit; and have an appropriate process in place to win over existing (concentrated) share owners.

Glossary of terms and abbreviations

Asset turnover	The amount of sales generated for every pound's (euro's) worth of assets
AV	Asset value
Cash flow multiples	Enterprise value of a company divided by its operating cash flow
Discount to MVA	Arbitrage between market value approximation of a company and its market capitalisation
Discount to NAV	Arbitrage between net asset value of a company and its market capitalisation
EBITDA	Earnings before interest, taxes, depreciation and amortisation
EPS	Earnings per share, the portion of a company's profit allocated to each outstanding share of common stock.
EV	Enterprise value, market capitalisation plus debt and preferred shares, minus cash and cash equivalents
EV/equity multiple	Enterprise value of a company divided by its shareholder equity
Implied equity value	Price earnings ratio multiplied by NOPAT
IPO	Initial public offering
IRR	Internal rate of return, the interest rate that makes net present value of all cash flow equal zero.
MEV	Market enterprise value, market value approximation of assets plus interest bearing debt
MVA	Market value approximation, book value plus estimated appreciation of assets
NAV	Net asset value, book value of assets less liabilities
NOPAT	Net operating profit after tax
P2P	Taking a public company into private ownership by buying a required threshold of company shares to subsequently buy all the shares
P/E ratio	Price earnings ratio, a valuation ratio of a company's current share price compared to its per-share earnings.
PIF	Property investment fund
Private equity	Equity capital made available to companies or investors, but not quoted on a stock market
REIT	Real estate investment trust
ROCE	Return on capital employed, ratio that indicates the efficiency and profitability of a company's capital investments
ROE	Return on equity, dividing net income by average shareholders' equity
TM	Transaction multiple, the sum paid by investors for the shares before delisting plus long-term debt (book value)
Transaction price	Total price paid by investors for company shares plus debt of the target company

About the Authors

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