Horwath HTL

Hotel, Tourism and Leisure *Celebrating 100 years*

Consolidation within the hotel industry: Global vs. local perspective

Horwath HTL Croatia
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FOREWORD

Croatia is becoming more and more aligned with major international tourism trends. Like most other countries in the region, Croatia is experiencing and benefitting from, increased tourism growth and demand. Another significant trend that is making its way into the market is an appetite for mergers and acquisitions within the hotel industry.

The process of consolidation has intensified over the last couple of years, when major industry players 'woke up' after several decades of almost complete market inaction. This has additional significance as many other industries are struggling to grow or even maintain current levels post financial crisis. Tourism-related business performance however continues to experience constant growth, thus creating an attractive segment for investors.

The fact is that the Croatia hotel industry is still highly consolidated: 3 of the leading ownership groups control almost half of the total hotel, resort and camping sites capacities in the country.

Globally, the trend is similar: mid November this year Marriott International announced its acquisition of Starwood Hotels & Resorts through a 12,2 billion US$ cash and share transaction, one of the largest of its kind ever seen in the industry. The transaction includes the whole brand and real estate portfolio, as well as management and franchise agreements. So why is this happening, what effect will it have on the market and what lessons can be learned for a developing country like Croatia?

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REASONS BEHIND INDUSTRY CONSOLIDATION

In modern, rapidly changing global markets, the motives behind consolidation within the hotel industry are both strategic and economic

Croatia is now part of the global trend for consolidation, although several decades after it became popular. In mature markets such as the US, the trend dates back from the 1980s and 90's, when international investors first showed an appetite for acquiring well-known hotel chains. At the time, the main reason behind the acquisition of established hotel brands was business and geographic diversification, expansion of product portfolios, as well as rationalization through corporate restructuring.

Currently, large hotel portfolio transactions generally take place in order to achieve strategic leverage and economies of scale. On top of that, the effects of market dispersion, entry into new market segments through different brands and concepts, and simply gaining access to loyalty databases can also serve as a strong motive for consolidation.

On an operational level, there are other compelling incentives for scale. One important motive for consolidation is the need to provide a more effective response to the challenges associated with the position of online travel agencies (OTAs) as key distribution channels for hotels, and the impact they have on the bottom-line.

When it comes to maturity level of the hotel industry, the Southeast Europe region is still lagging behind the more developed western markets. Hence, the main motive behind the consolidation is different.

The consolidation of several major players in the Croatian and regional hotel markets is conditioned primarily by the desire to 'put the flag' on attractive destinations, and the acquisition of assets with low initial value. The assets can then be built up into an attractive portfolio, increasing their market share. In Croatia, there has been evidence of growth in value following the consolidation process, partly since they manage to achieve substantial cost savings through restructuring and optimization of business processes. Restructuring of the company has the aim of increased productivity, while the increased scale affords stronger negotiating power with distributors. Both factors are used to achieve increased profits through efficiency.

Globalisation plays a large part in the entry of major international players into the M&A activity in Croatia, and companies listed on stock exchange will eventually start to follow principles such as 'eat or be eaten' or 'big is beautiful '.

A GLOBAL M&A PERSPECTIVE: MARRIOTT - STARWOOD

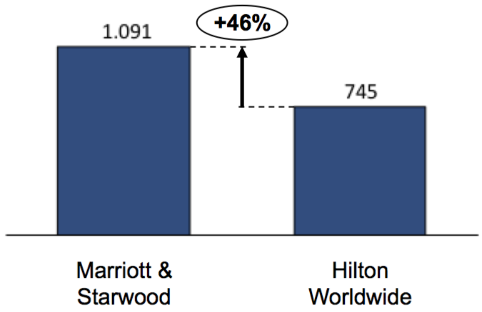
The Recent takeover of Starwood Hotels & Resorts by Marriot International, valued at 12,2 billion US$, is the largest transaction of its kind in the hotel industry since 2007. The result is a single hotel company, the largest one in the world, with a portfolio of over 5,600 hotels and 1.1 million hotel rooms that generates yearly revenue close to 20 billion $. The Total number of guests enrolled in its loyalty programmes (Marriot Rewards, The Ritz-Carlton Rewards, Starwood Preferred Guest) is estimated at 75 million. The question is, what advantages does size bring a company that owns or leases only 2% out of the total accommodation capacities under its management?

There are several key issues at play here, some purely financial, some operational. For Marriott, Starwood on the face of it does not seem to have a huge benefit on market segmentation. With the exception of the W brand, Marriott is arguably already far better represented that Starwood so why do the deal? The first argument, is with Starwood very publically in play, if Marriott didn't do the deal, one of their competitors would have. Any CEO is expected to deliver growth, regardless of how that is achieved. Secondly, the drop in share price played into Marriott's hands, as the deal was done mostly with Marriott stock, which Marriott had been systematically buying back making the deal relatively cheap.

Operationally, hotel companies have an easier time negotiating with online travel agencies (OTA's), through scale. In the situation where OTAs take out great percentage of total bookings in the industry, and websites with room price comparisons (metasearchers) provide limited opportunities for price increases, the hotel industry is trying to find strategic leverage. Consolidation and scale is one of the key tools in this fight. Additionally, Airbnb and other proponents of the 'shared economy' who's global room portfolio exceeds that one of Marriott and Starwood combined will only become more of a risk.

The Newly formed company manages almost 50% more rooms than the runner up, the second largest hotel company in the world, Hilton Worldwide.

Portfolio comparison: Marriott & Starwood vs Hilton Worldwide (hotel rooms, in thousands)



Source: Hilton Worldwide Investor Presentation, November 2015., Horwath HTL analysis

Although the takeover came as a surprise, Marriott has been very active in corporate acquisitions. In the last few years, Marriott took over companies such as Gaylord Hotels (210 million US$ in 2012) and the Canadian hotel group delta Hotels and Resorts (130 million US$ in 2015) as well as AC Hotel in Spain and Protea in South Africa.

Other major hotel companies are following the same trend: this year InterContinental Hotel Group acquired Kimpton Hotels for 430 million US$, while Accor is currently in the process of negotiation for a takeover of Canada based hotel group FRHI, owner of hotel brands Fairmont, Raffless and Swisshotels. Still, these are dwarfed by the last huge deal in 2007, when private equity firm Blackstone acquired Hilton for 26 Billion US$.

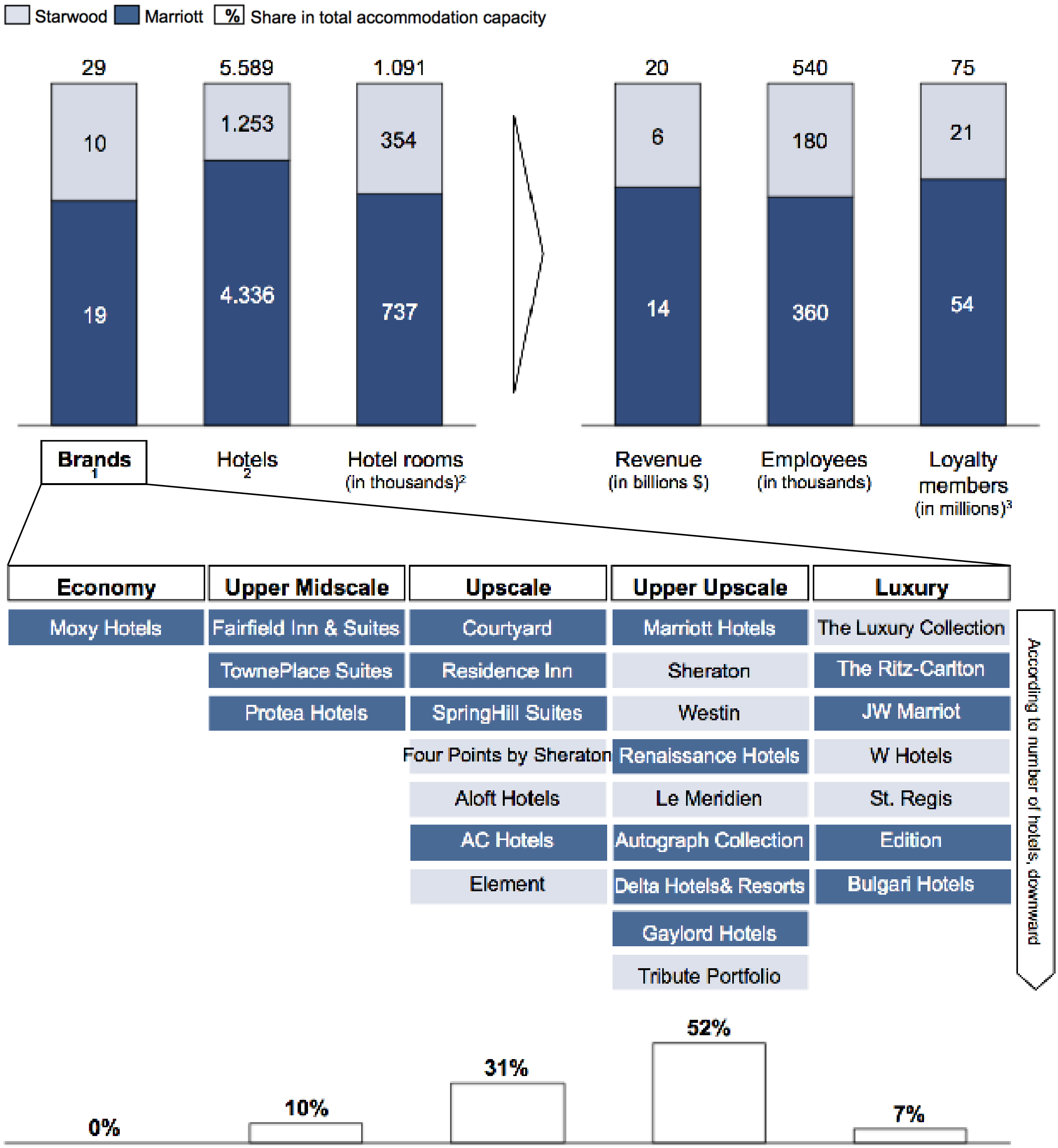
The consolidation game is happening in the OTA business as well: this year alone Expedia took over Orbitz, Travelocity and 'home-sharing' website HomeAway, while Priceline acquired OpenTable, Kayak and Buuteeq.

As the CEO of Marriott International, Arne M. Sorenson said officially, the main reasons behind this transaction are creating a corporate synergy through rationalization of corporate functions, eventually resulting in a higher level of efficiency. The strengthening of their competitive power through marketing activities, joint loyalty program, unification of technological platforms, stronger powers of negotiation, as well as the possibility to transfer the cost of new technology development (ranging from user apps to BI platforms) across the larger portfolio.

Due to its size and complexity, it is announced that the process of consolidation among two companies will last the whole year, with cost of consolidation expected to be quite substantial. Still, Marriott managed to buy Starwood under the market price, with the plan to continue Starwood's plan of selling their real estate portfolio for about 2 billion US$.

Still, it is not easy to say if and when there will be any brand consolidation. Both companies together manage a total of 29 hotel brands, with several serious overlaps of brand promise and positioning. It is certain that there will not be any quick or radical cuts in terms of brand restructuring, and that the whole process of brand consolidation is seen more as a mid-term activity. The possibility of brand conversion in several destinations where the current brand is under performing is always an option, but it is a process that will take into consideration hotel owners and their desire, as well as strict management and franchise contracts.

Results of consolidation: Marriott International and Starwood Hotels & Resorts



Source: Marriott International 2014 Annual Report, Starwood Hotels & Resorts 2014 Annual Report, Marriott Investor Fact Book, Starwood Hotels & Resorts Q3 2105 Results, Horwath HTL analysis
1) Including Marriott Executive Apartments i Marriott Vacation Club
2) As of 30th Semptember, 2015
3) Including Marriott Rewards, The Ritz-Calton Rewards and Starwood Preferred Guest programs

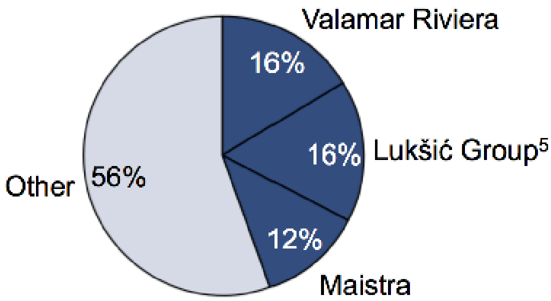
LOCAL PERSPECTIVE: A CROATIAN CASE

Current Croatian consolidation

In the Croatian hotel and tourism sector, the consolidation process has intensified recently, primaraly as a result of major transactions amongst the industry's leading players. Lukšić Group bought Adriatic Luxury Hotels and Istraturist. Liburnia Riviera Hotels took over Hoteli Cavtat and several other hotels in the region, but due to different management strategies the company split into two different entities. Valamar Riviera has integrated several companies under their portfolio (ownership and management companies), while Maistra took over the Hilton Imperial Dubrovnik.

Today Valamar Riviera, Lukšić Group and Maistra manage around 44% of the total commercial accommodation supply in Croatia4, while the top 10 companies/ownership groups manage around 65%. It is clear that Croatian hotel sector shows a high level of consolidation, with local and regional players leading the process since they understand the market.

3 of the leading ownership groups: share in overall accommodation capacities of Croatia[4]



Source: List of categorized properties, Ministry of tourism of the Republic of Croatia, Horwath HTL analysis
4) Only commercial capacities: hotels, resorts and camping sites
5) Including Plava Laguna, Adriatic Luxury Hotels and Istraturist

An interesting model of consolidation can be seen, where hotel management companies and ownership groups merge into one single entity (an example is Valamar Riviera). This process is mainly influenced by a higher level of efficiency achieved through rationalization of business functions, but at the same time is atypical when compared to global trends, where ownership and management functions are usually divided. However, in conditions where revenue growth is limited due to high seasonality, this strategy proves to be beneficiary for pumping up the bottom line.

What comes next?

Usually, the market puts focus on the transaction itself, but little thought is given to the process that follows. Croatia is a specific market with close to monopolistic market structures, where one or two hotel and tourism companies dominate one destination. Such conditions are rare now . Due to this kind of market condition, the risk of too little competition exists, compared to destinations where different management and ownership strategies coexist.

Due to that, the existing structure is suboptimal in the long term and can serve as a limitation to sustainable growth of business performance, as well as the overall industry development. However, in current market conditions with non-existing efficient destination management, the fact that accommodation capacities are in the hands of several companies can lead to stronger management strategies.

After the takeover it is reasonable to expect that the owners reallocate their resources into the process of portfolio branding. The portfolio should be based on diversification instead of a cost cutting strategy - cost cutting can bring results in the short term, but in the long run it might have a negative impact on quality, and indirectly lead to losing loyal guests.

Other major challenge that companies face in the post-consolidation period is assimilation of corporate cultures, which is something extremely important in the hotel and tourism industry, as it directly affects brand communication towards guests and impacts the overall experience.

Research has shown that companies that went through a consolidation process often achieve lower results when compared with competitors that did not go through a similar process. This can be explained as a result of difficulties two companies come upon when trying to integrate different corporate cultures and management styles into one coherent entity.

WHAT'S NEXT?

Despite the worldwide consolidation trend within the industry, the hotel market is still pretty fragmented and the degree of competition extremely high. Experts foresee the trend of mergers and acquisitions continuing among global hotel companies as a strategy to gain market share, create added value and assure higher degree of efficiency.

In terms of Croatia and the broader region, it is expected for the consolidation in hotel sector to continue. Still, in the mid-term it is reasonable to expect that it will be led by local and regional players, as they understand the market. In that context, consolidation within the hotel sector in Croatia should be seen as a cornerstone for future consolidation on a global level.

In the long term, along with the stability of tourist market and increased competitiveness of investment climate in Croatia, it is reasonable to expect a more open market for international investors. Those initiatives will probably be more greenfield-based investments, as those will not have any internal limitations and will allow professional, up-to-date development and efficient management

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Mirko started his career at Horwath HTL office in Barcelona as an Analyst. During that period he provided advisory services to global hotel companies and investment funds, covering the markets of Spain, Portugal and Andorra. After several successful projects, he moved to Horwath HTL office in Zagreb to become a Junior Consultant, advising Clients in both private and public sector in the SEE region.

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