Rating Methodology for Hotel Companies*

Indonesia is one of the strongest emerging market countries and rich of tourism destinations throughout the archipelago. The popularity of Indonesia as a tourist destination has been increasing year after year. In the decade 2002-2012, travel and tourism industry's contribution to the country's GDP grew at compounded annual growth rate (CAGR) of 13.4%, (Source: Indonesia Hotel Watch 2014). Meanwhile, according to the World Travel and Tourism Council (WTTC), the direct contribution of travel and tourism in 2013 was Rp 281.6bn, constituting about 3.1% of the GDP and growing by 8.4% over 2012. This is the largest growth recorded within G20 countries. The year or year (yoy) growth is estimated to be 8.1% in 2014, higher than the expected GDP growth rate of 5.0-5.1%.

Further, Indonesian destinations figured among the top 25 tourism destinations and top 25 beaches in Asia in the 2014 travelers' survey by TripAdvisor. Continued increase in visits from the ASEAN neighbors, increasing disposable income of the population and expanding air transport network so integral to the inter-island transport have been the major catalysts for the growth of tourism in the country. The number of foreign tourist arrivals stood at 8.5 million by end of November 2014, a growth of 7.3% on yoy basis. These statistics indicate that the growth of tourism in Indonesia has remained steady, despite the medium term global slowdown, which had also trickled down to major domestic sectors.

Higher proportion of domestic tourists has also continued to ensure steady growth of tourism sector in Indonesia. Consequently, the demand for hotel rooms has been increasing. This is being supported by medium-term expansionary plans by some international hotel service companies such as Accor, Starwood, IHG, Swiss-Belhotel International and Archipelago International as well as the local operators such as Tauzia Hotel Management, Kagum Hotels and Santika Indonesia Hotels. According to HVS Research, between 2009 and 2013, the country witnessed the opening of 538 classified establishments with a cumulative count of 52,716 rooms leading up to a CAGR of approximately 9.5%. Moreover, the investment in hotels and restaurants has increased by more than 200% since 2011. With the above facts and the strong intention of the government to develop the tourism sector in the years ahead, the prospect for hotel industry should be boosted.

The major players in the industry depend primarily on their luxury properties in key metro cities for revenues and profits. However for the last couple of years, a move to expand product offerings across cities and price points has been under way. The developments of the low cost hotels or often called budget hotels have also begun in recent years; the reason being the smaller required area of only 850-2,200 m2, the lower construction and operational costs and the shorter break-even point vis-a-vis a five-star hotel of up to 8-10 years. As per Indonesian hotel association's PHRI, about 40% of the new properties comprise budget hotels including under Amaris, Favehotel, Ibis Budget, POP! Hotel,Tune and Whiz brands.

However, the hotel industry is prone to cyclicality with prospects being driven by overall economic growth, room additions relative to demand, and general outlook for business and leisure travel. The fact that the industry is capital intensive with high operating leverage increases its vulnerability to cyclical trends. The industry also remains vulnerable to exogenous factors like geo-political crisis and disease outbreak, which can affect the extent of travel and hence the occupancy rates of hotel properties.

ICRA Indonesia's rating methodology for hotel companies involves an assessment of both industry and company specific factors. ICRA Indonesia also evaluates the company's track record in managing downturns, as well as the company's financial position so as to ascertain the adequacy of its cash flows in the light of its debt servicing obligations.

Industry Risks

Vulnerability to economic cycles and event risk

The revenues of hotel companies are vulnerable to economic cycles and to the impact of "event risks". Growth in demand for hotel rooms generally bears a strong correlation to economic growth; in fact it is often one of the leading indicators of an economy's prospects. Typically, during an economic downturn, the volume of both business and leisure travel slows, resulting in declining Revenue per available room (RevPar = Average Room Rate (ARR) X Occupancy) and hence total revenues. Similarly, unforeseen events like terrorist attacks and epidemics can cause a significant decline in leisure and business traffic. The companies following an asset light strategy (through management contract/franchisee) are in general better placed to deal with the financial impact of downturns in the industry.

Demand-supply outlook

The demand-supply outlook for each major market that a hotel company operates in is an important consideration from the rating perspective. Demand estimation for current and prospective markets of the company is done by analyzing various factors such as overall economic growth, market specific dynamics including ability to attract new investments (entailing business travel) or its popularity as a leisure destination. Apart from the existing supply of hotel rooms in a particular market, ICRA Indonesia also takes into consideration ongoing and planned hotel projects to determine the likely room supply relative to demand, and the resultant impact on occupancy, ARRs and RevPar.

Operating Risks

Scale & diversification—geography, brands, revenue streams

Scale, ARRs & market share can be used as proxy for a hotel company's brand and market position. Scale can also augment ability to establish brands across geographies, which in turn increases ability to attract and retain visitors, ability to add capacities especially in difficult financing environment and ability to attract partnerships through franchisee & management contract routes. Scale also helps in achieving cost economies in operations as well as in marketing & distribution.

In the case of a hotel company, diversification by geography, market segments and revenue streams are important rating considerations since they provide a degree of stability to revenues and profits. Internationally, some of the larger hotel companies have achieved geographical diversification by having properties not only across cities, but across countries as well.

Brand segmentation is also considered to provide diversity as a hotel company with multiple brands can appeal to a larger customer base by offering properties covering price points across varied customer budgets and preferences, across business, corporate groups and leisure segments.

Hotel properties can be owned or franchised/managed by the company. Owned properties imply high capital investments and operating leverage. On the other hand, managed or franchised properties enable a company to rapidly scale up and enhance revenues without having to make large capital investments. Franchised or managed properties are however feasible only once the hotel company has established a strong brand name and management expertise. ICRA Indonesia also takes into consideration the relationship of the hotel company with its franchisees and the hotel owners whose properties it manages to ascertain the long-term viability of such relationships and the stability of revenues from these sources.

Diversity of revenue streams on the basis of guest profile—mix of foreign versus domestic guests, dependence on airline crew, and corporate versus free individual travelers—is also evaluated while rating a hotel company. These segments display quite different characteristics at various points in time and can impact the revenues of a hotel company in different ways. For example, a higher dependence on airline crew is likely to result in lower ARRs for a hotel company, although it provides stability to occupancies, which could be particularly beneficial during slack seasons. Properties located in leisure destinations are likely to have significant seasonality in occupancies and ARR. Similarly, chains with a higher dependence on foreign travelers are likely to be affected more severely during extraordinary events like terrorist attack or epidemics like Severe Acute Respiratory Syndrome (SARS).

In assessing a hotel company, ICRA Indonesia also evaluates the mix of revenue from rooms vis-à-vis food & beverages (F&B). While all hotels will have revenue streams from these sources, the proportion of such revenues from each stream could vary depending on the focus that an individual hotel decides to place on it. ICRA Indonesia notes that retail revenue streams—those originating from, say, restaurants or banquet services-- have, in the past, displayed more resilience compared to revenues from room occupancy. Further, over the last few years, the larger hotel companies are seeking to diversify into specialized or niche products like wildlife or spa tourism as customers are looking to newer options and becoming increasingly discerning. Rental income from retail space, convention centre also can add to revenue diversity. ICRA Indonesia analyses the impact of such initiatives on the company’s revenue streams and brand pull.

Quality and location of property portfolio

The quality and location of a property portfolio are important in determining the relative level and volatility of a hotel company’s earnings. Portfolios with properties in gateway cities, key business centers and popular leisure destinations may provide some buffer during periods of economic slowdowns as occupancies may not decline as sharply. The strategic location of a property near a place of interest, commercial area, etc. also helps attract more and repeat customers. Quality of property is also important, not only to attract customers, but also to create brand strength. Room (occupancy) market share in key markets is a widely used indicator of brand strength.

Investment in renovation

Regular hotel renovation is one of the key drivers of competitive advantage in the hotel industry with an ability to influence market share and guest profile. It is important for a hotel company to continually invest in renovation/up-gradation to maintain the contemporary look and feel. Although such expenditure can impact profitability in the short to medium term, ICRA Indonesia is of the view that the benefits of renovation accrue over a period, enabling the hotel company maintain its competitive position.

Investment in branding and marketing

Branding and marketing strengths are critical success factors for any hotel company. ICRA Indonesia therefore evaluates the hotel company’s investment in advertising and brand building, as reflected by its ability to command premium pricing, maintain customer loyalty, and secure attractive management contracts. Sometimes, instead of investing in building their own brands, companies could tie up with foreign brands to attract customers. Similarly, strong corporate relationships ensure bulk bookings, thus providing some degree of stability to revenues, while strong loyalty programs that reward customers for frequent stay help in retaining customers. It is also important for a hotel company to have strong reservation systems and sales force so that it can tap a larger customer base.

Financial Risks

The financial strength is important as a stronger balance sheet with low financial risks allows a company to tide over downturns much better than leveraged companies. Companies with a stronger balance sheet are also usually in a better position to grow through establishment of new properties. ICRA Indonesia also factors in the rated entity's plans of acquiring or setting up new properties and the means of financing the same in analyzing the financial risks of a hotel company.

Profitability

Healthy profitability indicates ability to generate cash flows to support ongoing expenses as well as generate surplus for future investments. Weak profitability is often an indicator of a weak market position (combination of weak ARR and low occupancy rates). Higher proportion of management fees also supports profitability. Profitability from other segments like F&B however needs to be looked into separately – while higher F&B revenues supports a stronger earnings profile, typically it leads to lower operating margin due to higher proportion of raw material expenditures. The profitability indicators however undergo significant variations depending on locations. Demand-supply mismatch although temporary is likely to have a significant impact on profitability. Also, being a cyclical industry, profitability undergoes significant variations across the economic cycle.

Leverage, debt service indicators and management policy

Higher leverage can significantly increase the financial stress during cyclical downturns and can also limit the managements' flexibility in pursuing its policies of investments and growth. ICRA Indonesia ascertains the adequacy of its cash flows vis-à-vis its debt repayment obligations, besides its capital investment requirements. The key contributors to revenues, such as increase in room inventory, likely movement in occupancy, room rates and state of economy, determine the future direction of revenues. An evaluation of debt repayments, if any, also captures the off-balance-sheet obligations of the company, besides its financial commitments to subsidiaries/group companies for servicing their debt obligations, etc.

While determining future cash flows, due importance is also given to the company's policy on renovation and capital expenditure for new properties, as also the means of funding the same. During economic slowdowns, profitability and cash flows come under pressure. However these stress periods also result in lower land prices, general financial distress and weak funding environment, often a conducive environment to pursue opportunities for in-organic and organic growth. The management's policy of conserving capital during upturns can often come handy during these periods of downturns. ICRA Indonesia also evaluates the management's risk appetite to incorporate likely future investments and funding plans for the same, which is incorporated to build various stress scenarios in its cash flows.

Promoters/Management Quality

All debt ratings necessarily incorporate an assessment of the quality of the issuer's management, as well as the strengths/weaknesses arising from the issuer's being a part of a "group". Also of importance are the issuer's likely cash outflows arising from the possible need to support other group entities, in case the issuer is among the stronger entities within the group. Usually, a detailed discussion is held with the management of the issuer to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the issuer's industry. Some of the other points assessed are:

- Experience of the promoter/management in the line of business concerned
- Commitment of the promoter/management to the line of business concerned
- Attitude of the promoter/management to risk taking and containment
- The issuer's policies on leveraging, interest risks and currency risks
- The issuer's plans on new projects, acquisitions, expansion, etc.
- Strength of the other companies belonging to the same group as the issuer

- o The ability and willingness of the group to support the issuer through measures such as capital infusion, if required.

Conclusion

ICRA Indonesia's rating methodology for hotel companies look at both the qualitative factors that will have an impact on its future cash flows, as well as the quantitative factors like existing financial strength and adequacy of cash flow in relation to debt servicing obligations. Given the nature of the industry, particular attention is paid on the ability of a company to manage cyclical downturns and the company's approach towards investments and growth.

* Adopted and modified from ICRA Limited's Rating Methodology - the Hotel Industry