# Consolidation in the U.S. Hospitality Industry

## The urge to merge

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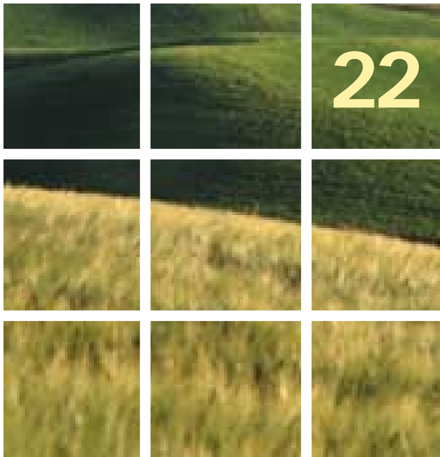


### The global M&A boom

By all accounts, businesses in many industries are exhibiting a tremendous urge to merge in a number of economies around the world. General merger and acquisition (M&A) activity skyrocketed to over $1 trillion last year. Nearly two thirds of this activity took place in the US, a $650 billion total that was nearly twice the last peak in volume back in the 1980's. And of the US total, six "mega" deals topped $10 billion each, representing one quarter of the activity. Big companies are clearly getting bigger—but are they getting better ?

Robust pricing in the stock market has clearly played an important role in the resurgence of M&A in the US providing acquirers with a premium-priced currency with which to pay for acquisitions. And while the public market has received a great deal of attention of late, the private market is by no means a sideshow. Acquisitions of private companies were reportedly up 84 percent last year, suggesting that there is more to the M&A boom than meets the eye. But how are these trends playing out in the hospitality industry?

### Hotel industry M&A

In the 1980's we saw some large-scale acquisitions of hospitality companies including amongst others, Hilton International, Inter-Continental, Westin, Holiday Inns, Motel 6 and Omni. In each of these cases, international buyers acquired established, branded companies driven by a variety of motivations including brand acquisition, business and geographic diversification, product extension and rationalization.

Today, the big transactions appear to involve acquisitions designed for strategic fit and economies of scale. Over the last year or so, we have seen a steady stream of sizable hotel company transactions—Granada/Forte ($6b); Doubletree/Red Lion ($1b); Marriott/Rennaissance ($1b); Starwood/Prisa-HEI ($440m); Patriot/Carefree/CalJockey ($400M)—a total of close to $9 billion. And in discussion, Hilton's quest to acquire ITT Corporation ($10 b), Patriot American's reported interest in Carnival Hotels and Wyndham ($1b plus) and the possible sale of Westin Hotels ($1.5b).

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With improved management, a balanced supply-demand relationship, low inflation and a super-charged stock market, it is not surprising that we are seeing a flurry of hospitality industry M&A deals. But unlike the debt-financed acquisitions of the 1980's, financing risk

is mitigated this time by the use of stock rather than debt. For the seller who is paid in the stock of the acquiring company, there is however the attendant risk associated with the ebbs and flows of the stock market's inevitable cycle. Lengthy "lock-out" periods that preclude the sale of such stock for a certain period of time increase the risk for a seller and has the potential for substantially reducing the price particularly for those transactions completed at the market's peak.

With the occasional exception, today's buyers tend to be large corporate enterprises looking for strategic fit and friendly transactions as opposed to the hostile deals that corporate raiders and leveraged buyout firms initiated in the 1980's. Back then, raiders and acquirers looked for financial gain through restructuring and reengineering whereas in this cycle the motivations have clearly changed.

In most industries that are consolidating, pricing is either flat or declining and there is therefore a need to become bigger in order to drive down costs and gain market share—but price increases in the hotel industry have been strong in recent years suggesting an attraction for newcomers. Such new entrants may, however, have difficulty finding their way in an industry destined for more consolidation.

A classical driver to consolidation in other industries—vertical integration producing end-to-end solutions for customers—doesn't appear to be a factor in the hospitality industry. It was tried before—with the United Airlines—Hilton International—Hertz Rent a Car combination—a structure that at the time was characterized as "ahead of its time". But perhaps it was destined from the start for the industry's history books. Confirming a decade later that there is still little investor sentiment for such vertical combinations, they are nowhere to be seen in the current consolidation cycle.

The traditional arguments in favor of consolidation—the power of linked-up businesses, reduced costs and enlarged distribution networks—are supplemented in this latest round of activity by a growing sense that the globalization of the world economy requires that the big need to become bigger in order to survive. Acquire or be acquired / eat or be eaten are visions that come to mind.

In the early 1990's when the hospitality industry was losing money, there was significant pressure to reduce costs. Reengineering and restructuring of companies was not uncommon but such initiatives did little to increase revenues or market share. But with trimmed-down overhead, the industry was all set to benefit from the inevitable upswing that was to follow as demand growth far outstripped the increase in supply. The big upturn in the US, however, appears to be close to having run its course and as it does there are pressures to build profits using other means—thus the desire to acquire what cannot be quickly built whether it be buildings, revenues or profits.

The lesson for acquirers of hospitality companies is that they need to be cautious in assuming a big benefit from cost cutting, employee productivity improvements and the like since for many enterprises, these kinds of initiatives have long been in place.

### Consolidators

While major hospitality companies tend to dominate the industry's landscape, there are also a large number of small businesses that need to be considered in any review of the trend toward consolidation.

In certain other industries, where there are a large number of small players, consolidators have been rolling up small firms into larger ones that have professional management, can wield marketing power and possibly launch a brand. While we do not see much evidence of this in the hospitality industry currently, it would not be surprising to see one or two consolidators emerge backed either by private or public capital to take advantage of an increasingly challenging industry context. And for small private

firms that cannot presently compete for capital in order to grow, the prospect of an exit strategy into today's hot public financial markets may be hard to resist.

For medium-sized companies (in the so-called "mid-market"), the challenge of finding one's way is especially acute in this environment. Mid-market companies may be large enough to compete at the margin but not big enough to be taken seriously by the capital markets. And it is the capital markets that are beginning to take a very influential role in shaping the industry's future and its move towards greater consolidation. Gone are the days when all of the industry's real estate was financed privately by local commercial banks, insurance companies and private investors.

Today, the securitization of real estate in the US, while still involving only a small fraction of the total inventory of hospitality real estate, is rapidly changing the financing dynamic of the industry. And for Wall Street and its advisors, big is beautiful—in fact the bigger the better. As to capital markets advisors—they too are an evolving breed—whereas the 1980's encouraged quick fixes and the immediacy of the deal at the moment, the late 1990's suggests a new article of faith amongst those who are counseling hospitality enterprises through the shoals of consolidation—long term relationships that breed trust.

Timing, of course, is everything and when times are good as they are in the US today, with steady economic growth, low inflation, low unemployment and a hot stock market, it is hardly surprising that we have seen the big run-up in M&A volume over the past year.

The issue facing many players in this market is how long it will last and what would prompt the current activity to slow down or come to a halt. Rising interest rates driven by fears of inflation in an over-heated economy would certainly be one contributor. In fact the recent up-tick in the US discount rate seems to have very modestly dampened some of the enthusiasm in what was otherwise a frothy stock market. If stock prices moderate, then the high-valued currency of today's public market companies will not buy as much as it has over the last year.

As has been well-documented elsewhere, hotel REITs have been particularly active in the property acquisition market, where they represent approximately 75 percent of large hotel deals (that is those in excess of $10 million). For a few key REIT players (notably Starwood and Patriot American), the action has also involved acquisitions of existing hospitality companies. The acquisition by REITs of Carefree Resorts, HEI Hotels and now the possibility of deals involving Wyndham Hotels and Carnival Hotels, all suggests a coming of age for REITs as they continue to grow and consolidate some of the existing players in the business.

The REITs unlike most of their c-corp cousins in the public marketplace, will need, however, to develop a branding strategy that can connect the marketing of their typically diverse portfolios. But brand value comes from a well-integrated and consistent product line—something that might elude those who have looked at each property acquisition on its own merits as opposed to developing a homogeneous portfolio. The challenge of brand development for companies with a real estate focus (REITs) may therefore moderate some of the benefits of consolidation unless it involves companies with existing brands that can be built upon.

As consolidation continues apace in the US marketplace, the specter of governmental policy occasionally comes to the fore, although the present US administration, with a few exceptions, appears particularly quiescent to the current wave of consolidation throughout industry.

Antitrust regulations designed to preclude dominance of an industry by a single enterprise have been on the books for years but are only occasional considerations for consolidators in most industries. In the hospitality industry, it is hard to envision much to be concerned about, although many do believe that the sector will eventually be dominated by a small grouping of multi-national, multi-branded hospitality companies.

While the prospective benefits of mergers have been enumerated previously, it is worth pausing to take note of some recent evidence that suggests that some of these benefits can be quite elusive. In fact, a recent study indicated that approximately one half of merged entities under-performed their industry rivals following the merger, this attributed partially to the difficulty of integrating different corporate cultures and management styles. And while there is little to suggest that we should expect any better performance in the hospitality industry but there is clearly plenty that today's hospitality industry consolidators can do to mitigate this risk.

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For many executives on the buy-side of a major company acquisition, the strategic and financial aspects of the deal are paramount. Less attention is typically paid to planning the process of integrating the companies following the merger—it is often left to others who may not have been bought into the plan or been a part of it.

The key is therefore to ensure that before CEO's become wound up in the enthusiasm of "The Deal", they pause and involve the people who will be responsible for making the merger/acquisition work following the transaction. These are the people that must review the work that needs to be accomplished in integrating the differing cultures and organizational structures, develop a plan, a timetable and a cost and report back to the top as the transaction is engineered and brought to a close.

Of course to senior managers and their advisors, secrecy and speed are often drivers that preclude this approach but to those who look back on the damage that can be wrought in a large-scale merging of business enterprises, the old adage "haste makes waste" must surely come to mind.

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