#inittogether –

Will We See Structural Change in Lease Agreements?

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Before the global pandemic, hospitality development was one of the big asset classes in the bull-market. It was driven by low interest rate expectations combined with more than competitive leases. Strong guarantees from operators made the investment seemingly riskless. The agreements were leaning heavily in favour of asset owners. All this was caused by high asset prices, rising development costs, and probably overrated expectations from both sides, pushing operators close to their absolute limits.

But the first thing we realised during the first, second, and unfortunately partially third lockdowns is that being overoptimistic was not in our best interest. The most significant learning was that lease agreements greatly favouring asset owners were not the key to success under these circumstances. Operators could not uphold their initial commitments as revenues declined significantly and the seemingly secure agreement became much riskier from one day to the next.

Probably one of the most apparent findings in this situation was that we need to discuss new forms of what a partnership means, in good and bad times. Currently, both operators and owners are showing great understanding for the challenges faced by their counterparts and this needs to continue.

But what can we do to make this happen?

When it comes to lease agreements, we have seen a dramatic change in key commercial terms for most projects. Only strategically important projects in excellent locations were able to withstand that and still achieve terms similar to pre-Covid levels.

- Lease Levels

Many experts said that fixed lease levels were at their upper limit before the global pandemic but otherwise most projects would not have been feasible. In recent months, we have experienced a substantial shift towards variable lease agreements. Operators aim to balance the risk/reward between lessee and lessor, shifting risk to asset owners. Usually, these variable lease agreements offer a small/medium-sized fixed lease with a substantial variable component.

- Ramp-Up Period

The longer, the better – we are currently facing many uncertainties making it hard to predict how tourism will be in 12-24 months, and operators do not wish to take this risk. Where typically lease stabilisation is reached in the third operating year, we have seen this being extended until year four or five. Projects now nearing their opening date bear the highest risks, while new development projects, planned to start operating in say three years, are much more sought after by operators as well as investors.

- Lease Guarantees

One of the most influential factors were guarantees from operators which have developed negatively. A couple of months ago, lease guarantees from 12 to 18 months were the norm. Nowadays, lessees are only willing to offer bank or insurance guarantees of six to nine months.

What does this mean for future projects?

The biggest challenge project developers are facing is financing. A more cautious stance towards hospitality assets from most financing institutions require more securities than ever – this, however, conflicts with the trend towards variable leases, lengthening ramp-up periods and lower lease guarantees. Over the short term, owners will most likely need to put more equity into the project or look for other financing partners/models.

The second challenging aspect is the future interest rate expectations. Even before the pandemic with a bull-market, profit margins for project developers were shrinking. Forced by generally high asset prices and continuously soaring construction costs, fixed lease levels needed to be very high. Currently, observing that neither asset prices nor construction costs have fallen, paired with higher interest rate expectations, the only variable determining the project's feasibility is still the lease level.

We expect that as soon as markets start to normalise, financing institutions will rethink their current position on hospitality assets, and interest rates will also normalise in the months to come.

We need to rethink!

Hospitality-operators were delivering lease payments to property owners who saw it as a commercial investment without even dealing with the hospitality asset in detail. But operators also made use of it and did not want owners to interfere in their business, nor did they report how they were doing in good times.

The goal to success is transparency and a willingness to share both the upside and downside.

Over the short term, the market remains challenging, and operators struggle to avoid large losses. This situation should not be borne only by the operator. Short term lease waivers or reductions, combined with governmental support, should help lessees survive the crisis. Deferrals only serve to postpone the pain, and in a true partnership, all parties should earn profits in the long term.

Therefore, transparency needs to be given to the owner.

Hospitality operators should be willing to share insights with asset owners and also present, amongst others, their full profit and loss statements. This open-book policy should be maintained over the whole business relationship. Open communication, even past profits, helps owners understand the full impact of the crisis and addresses whether a long-term lease reduction is necessary. An assessment solely of the current status does not present the whole picture.

In the coming weeks and months, a lot of uncertainty remains. Switching to a partially or fully variable lease model is vital. For owners and operators, the ultimate goal should be to work together to keep operations going and avoid bankruptcy. Both parties should agree on a fair share of positive cash flow and, optimally, on a pre-defined profit share percentage.

Surviving the recovery period and slowly going back to normal, profit sharing should remain and benefit owners and operators in the long term. Pre-Covid variable leases tended to be the cherry on the top, but this could change and become more of a norm. If owners and operators agree to share the downside of the last months, then the upside should also be substantial, if cash flows permit. The opportunity exists to recover lost lease payments and even potentially surpassing them. In addition to a financially viable fixed lease, a revenue/profit share model, with full transparency, could be established to benefit both parties in good and bad years.

We are currently in a phase where owners, operators, financing institutions, investors and consumers must live with many uncertainties. But we genuinely believe that even after severe financial shocks we can recover even stronger. People will release pent-up demand and the economy will rebound. Maybe we are even at the beginning of the #roaring20s.

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