

Rating Methodology - Hotel Industry

[In supersession of “Rating Methodology – Hotel Industry” issued in [July 2018](#)]

Industry Overview

In India, the hotel industry is fragmented with many local and international players operating across different hotel segments. The industry is driven by macroeconomic factors like the prospects of the Indian tourism industry (which, in turn, is dependent on the overall economy and disposable incomes), competitiveness of Indian tourism, business and leisure travel, foreign tourist arrivals (FTAs), popularizing trend of meetings, incentives, conferences, and exhibitions (MICE). India is ranked 40th in the overall list of “world's attractive destinations” as per The Travel & Tourism Competitiveness Report 2017, published by World Economic Forum.

In CARE's view, the risk profile associated with the hotel industry is relatively higher as compared with other industries primarily on account of high capital cost, coupled with long gestation period, highly cyclical nature of the hotel industry and high degree of competition in the industry.

Rating Methodology

CARE Ratings has a detailed methodology for rating of companies belonging to the manufacturing / service sector. This methodology attempts to point out factors, over and above, those mentioned in the broad methodology, which are considered while analysing the companies belonging to the hotel sector. CARE's rating methodology identifies five key rating considerations that drive credit rating of the hotels companies:

- Promoters/management analysis
- Business risk analysis
- Industry risk analysis
- Financial risk analysis
- Risk associated with ongoing/upcoming projects

Promoters/Management Analysis

- **Reputation & experience of the promoter**

Experience and market image of the promoters are given utmost importance, while evaluating management competency and quality. CARE Ratings assesses management's ability to run business efficiently, while addressing inherent business risk associated with hotel operations and undertake judicious expansion activities. The evaluation also focuses on management's operating and financial track record under different business cycles and in the light of increasing competitive business environment.

- **Financial strength and commitment of the promoter :**

Considering the capital-intensive nature of hotel business, a company with financially strong promoters enjoys an advantage over others as its ability to infuse and/or raise funds in a timely manner is crucial. Furthermore, the strong group presence/parentage would result in enhanced financial flexibility. The rating methodology for hotel companies also lays considerable stress on commitment of the promoters not only in the form of initial equity infusion but their ability to continuously support during the initial years of operations and their active involvement in the operations of the company.

Hotel projects have long gestation period as construction of a premium hotel takes upto three to four years while stabilization of operations may take another two to three years. The company may also need external financial support for debt servicing till the time its operations get stabilized. CARE Ratings evaluates the financial position of the promoters, and their ability and willingness to extend such support, including their ability to effectively manage cost and time overruns that the project may be exposed to.

Business Risk Analysis

- **Evaluation of business model**

Hotels can be owned/leased, franchised or managed. A healthy mix of revenue from different business models would be favourable from a credit perspective. Selection of business model may depend on how experienced and financially equipped a promoter is to independently own and operate a hotel under one's own brand. Under 'self-owned' and 'managed' model, CARE evaluates

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capital cost per room and means of finance. From a credit perspective, a hotel with a lower capital cost per room and judiciously funded with higher proportion of equity is better placed compared with others.

Mix use projects

In the recent past there has been trend of hotel projects with real estate being integral part of the hotel property and therefore the company's revenue stream comprise of cash flow from real estate and hotel segment. In such cases, the cash flow and profitability of the company is being analysed separately for real estate and hotel segment.

- **Brand strength**

CARE favourably views hotels operated under renowned and established brand as it helps in higher visitation leading to better revenue visibility and maintaining market share even in increasing competitive scenario. Operational risk is lower in hotels operated by a renowned hotel chain vis-à-vis hotels operated by a hotel operator/owner with no prior experience in operating hotels.

- **Hotel segments**

The industry is composed of three sub-segments viz luxury/upscale segment; mid-scale segment and economy/budget segment. Revenue per available room (RevPAR) of luxury/upscale segment is more vulnerable to cyclicity vis-à-vis RevPAR of mid-scale and economy hotels. However, during high demand, the luxury/upscale segment has higher pricing flexibility as compared with mid-scale and economy hotels. While analyzing hotel companies, CARE Ratings examines their presence in various sub-segments. Companies with presence in multiple sub-segments have higher business stability. As they cater to different customer segments across various price points, they enjoy larger customer base.

- **Scale, diversification and coverage**

While assigning the rating, CARE Ratings considers scale of business operations in terms of room inventory and geographic coverage of the company i.e. the company's presence in the number of cities in India and overseas. In CARE's view, diversification and scale are important rating considerations since they provide revenue stability and lead to economies of scale in business operations, marketing and distribution. Therefore, CARE views companies with geographical

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diversification with large number of properties more favourably as compared to companies with single property.

- **Operational performance**

RevPAR is a derivation of average room rate (ARR) and Occupancy levels, which are, in turn, dependent on many factors like location, demand-supply dynamics, brand, sub-segment, economic scenario and others. For an operational hotel, CARE Ratings evaluates movement in RevPAR in the past and ability of a hotel to charge ARR at a premium over industry ARR without compromising on occupancy levels. CARE also evaluates the mix of revenue from room rent vis-à-vis food and beverage (F&B) /banqueting and their interdependence.

CARE also evaluates diversity in guest profile and revenue stream for a hotel company.

- **Location analysis**

The location of the property portfolio is important in determining the volatility and relative level of a hotel's earnings. The strategic location of a property near a place of interest/commercial area helps attract more and repeat customers and is viewed positively. At the same time, competing properties in the vicinity would tend to exert pressure on pricing.

Proximity to commercial hub/airport/leisure destination and related seasonality: Properties located in leisure destinations are likely to have significant seasonality in occupancies and ARR and high gestation period. Similarly, the chains with a higher dependence on foreign travellers are likely to be affected more severely during extraordinary events like economic slowdown, terrorist attack and other events. Location at 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.

CARE Ratings also evaluates demand-supply dynamics, acceptability of particular category/product (luxury/upscale/mid-scale/economy) and RevPAR/F&B/banqueting potential at a given hotel location. The analysis of various factors, as mentioned above, is primarily aimed at determining the quantum and stability of the company's future operational cash flows in relation to debt servicing requirements. CARE Ratings undertakes detailed financial risk analysis, which includes an assessment of business model & performance and its impact on financial performance and cash flows.

Financial Parameters

- **Revenues & Profitability**

In the case of a hotel company, degree of stability to revenues and profits is of high importance. Healthy sales and profitability are a direct derivation of higher RevPAR. Higher RevPAR indicates strong market positioning of the hotel, whereas, healthy profitability reflects ability to generate cash accruals to support business operations and fund ongoing expansion, if any. Furthermore, higher proportion of revenue from banquets/conferences and management/franchisee fees also improve profitability.

- **Leverage and Debt Servicing**

Extent of leveraging determines the possible level of stress on operational cash flows, particularly in cyclical downturns. High leverage reduces financial flexibility of a hotel company, thereby, its fund-raising ability in case of any future capex plans. CARE Ratings evaluates total debt position vis-à-vis level of gross cash accruals to ascertain the adequacy of its cash flows to service debt repayment obligations. Furthermore, while evaluating future cash flows, capex requirement (usually for new properties and renovation of existing properties) and its funding pattern are also factored in.

During economic downturns, the companies with lower financial leverage may be able to withstand some moderate weakening in operational performance due to relatively lower debt servicing requirement and high degree of financial flexibility.

- **Repayment structure**

Hotels with longer repayment structure are expected to have better liquidity position. The hotel industry is highly capital intensive with long gestation period and recovery period. Therefore the repayment structure is critical in the assessment of liquidity position and the credit rating of the company.

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Industry Risk

CARE's analysis of industry risk focuses on the prospects of the industry and the competitive factors affecting the industry. The demand-supply dynamics is an important consideration from the rating perspective. Some of the factors analyzed include existing demand & supply, key demand drivers, expected economic growth, expected supply addition, new demand attractions and leisure/business destination to arrive at location specific outlook. The hotel industry is cyclical in nature as the demand for hotel rooms varies with the business cycle. CARE's ratings aim to be stable across seasons and economic cycles and are a reflection of long-term fundamentals. The hotel industry is also exposed to event risk such as terrorism, epidemic diseases and natural disasters. CARE Ratings considers the company's diversification (across geographies and segments) and financial flexibility as primary mitigating factors against such risks.

CARE Ratings also takes into account the economy-wide factors which have a bearing on the hotel industry such as movement in global as well as domestic travelers, economic/business growth trends, government policies and initiatives, socio/political environment of the country, among other factors.

Project Risk

Some additional factors are accounted for while rating companies that are in the project stage or are undergoing expansion. CARE Ratings considers the management's past track record of executing projects with a judicious mix of debt and equity components and without any cost/time overruns as a critical success factor. The facilities being offered, the competitive positioning, relative cost structure, cost per room, funding sources, debt structure of the project and accessibility of various sources of funding is assessed. The hotel industry is cyclical and projects have a long gestation period, hence, the timing of setting up a new hotel or expansion is of critical importance for any company.

While examining new/expansion plans CARE Ratings evaluates the rationale of the project, its strategic importance in the company's business plan, marketing-cum-management tie-up and the magnitude of the project vis-à-vis the net worth/asset size of the company. CARE Ratings also evaluates the location demand-supply situation at time of project completion and analyses its impact on the company's financials and future cash flows. In case of inorganic growth, CARE Ratings analyses the cost of acquisition vis-à-vis benefits of synergies. While examining an ongoing project, CARE Ratings examines

the stage of approvals, licences, governmental clearances agreements with contractors and consultants and their impact on the possibility of time and cost overrun.

Conclusion

The rating outcome is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. CARE Ratings analyses each of the above factors and their linkages to arrive at the overall assessment of credit quality by taking into account the industry's cyclicity. While the methodology encompasses comprehensive technical, financial, commercial, economic, and management analysis, the credit rating analysis is ultimately an overall assessment of all aspects of the issuer focussed on assessing timely debt servicing ability of the issuer.

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