Going private – why it's so appealing

Competition is red hot. The spectacular growth seen in Private Equity investment over the past decade reached record levels in 2006, and there is continued growth in the volume and size of Private Equity funds.

No wonder it is a favourite topic among tourism, hospitality and leisure market analysts. Here, we consider why this sector is so attractive to Private Equity investors; we look at recent acquisition activity and question whether the current level of activity will continue.

Unique opportunities for growth

Even though the tourism, hospitality and leisure industry is cyclical and vulnerable to external factors such as terrorist attacks and political upheaval the performance of the sector has proved amazingly resilient over the past few years, and confidence remains high.

Private Equity has dominated the top ten leisure sector deals across Europe during the first nine months of 2006 – accounting for six out of the top seven transactions.

European deals overview

Steady cash flows and typically asset-backed businesses make this an exciting sector for Private Equity investors. Many areas of the tourism and leisure industry are still relatively fragmented, offering 'buy and build' consolidation opportunities. Banks are keen to finance add-ons, so Private Equity firms can profit from relatively high gearing.

The hotel sector is a great example of successful Private Equity interest. In 2005, 40% of European hotel deals involved Private Equity groups, compared to just 1% five years earlier. Today, every time a hotel deal comes onto the market, property funds and private equity firms fall over themselves to sign the contract. Clearly, private investors, looking for businesses with potential in an expanding market, are maximising the opportunities in this high-growth sector.

Table 1 – 2006 Top 10 announced deals in the European leisure sector

Announced date	Bidder Company	Target Company	Deal value €m
April 2006	EQT Partners & Macquarie Bank	Select Service Partner	2,628
June 2006	Uberior Investments plc	De Vere Group Plc	1,406
August 2006	Dubai International Capital	Travelodge Hotels Limited	991
January 2006	BC Partners	Hyatt Regency SA	941
September 2006	Apax Partners and Permira	Sisal SpA	900
June 2006	The Carlyle Group and Vista Desarrollo SA	Turmed SLU	900
June 2006	GI Partners	Punch Taverns PLC (290 Spirit pubs)	832
September 2006	Genting International Public Limited Company	Stanley Leisure plc	817
March 2006	Masampe Holding BV	Codere SA	743
July 2006	Mitchells & Butlers plc	Whitbread plc (239 pub restaurant sites)	728

Source: Mergermarket

More transactions

If we look first at the UK, the diverse leisure sector has proven to be a strong magnet for Private Equity. Since 2002, around 10% of Private Equity transactions in UK companies have been in the leisure sector.

The size of Private Equity leisure deals in the UK are gradually increasing, rising from €210 million, in 2004, to €270 million the following year and €290 million in the first three-quarters of 2006, when some 22 leisure-related deals have transacted.

Recent successes included EQT's €2.6 billion acquisition of Select Service Partner and Creative Host Services from Compass, and Dubai International Capital's €0.9 billion acquisition of Travelodge from Permira.

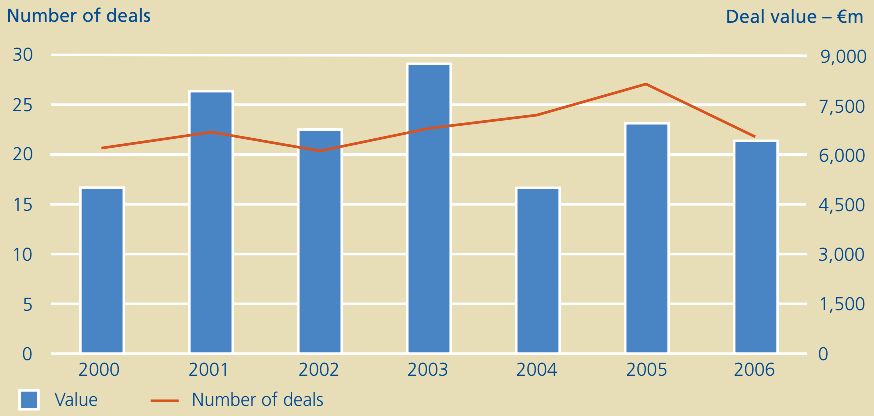
Growth patterns are similar across mainland Europe, albeit from a considerably lower base. In 2005, there were 23 deals valued at around €9 billion, up from 10 deals worth €2 billion the previous year. Much of the growth in average deal size was driven by Cinven and BC Partners €4.3 billion move for Amadeus Global Travel Distribution and Starwood Capital Group's €2.6 billion takeover of Groupe Taittinger and Société du Louvre.

More money

Although scrutiny from several regulatory bodies is increasing and many analysts are predicting a slowdown in Private Equity merger and acquisitions, record aggregate funds are still being raised.

For the first nine months of 2006, €300 billion was raised globally compared to €250 billion for the whole of 2005. These record levels of fund raising are driven by the recent emergence of the mega buy-out funds, including the $15.6 billion

Chart 1 – Private equity UK leisure transactions



Source: Centre for Management Buy-out Research (CMBOR)

(€12.3 billion) raised by Blackstone Capital Partners, which created the world's largest Private Equity fund.

There was also the $15 billion (€12 billion) raised by both Kolberg Kravis Roberts & Company (KKR) and Texas Pacific Group (TPG); €11.1 billion by Permira and €6.5 billion by Cinven.

Lenders are also making senior debt available on ratios considerably higher than historically offered. This, coupled with the increasing levels of available equity, has intensified bidder competition amongst Private Equity investors themselves, and with other private investors (property and hedge funds).

More competition

More aggressive competition and larger transactions have resulted in two trends. Firstly, Private Equity funds are clubbing together to reduce risks and circumvent investment limits from one fund on any particular asset. Private Equity investors typically expect a return of 20% – 25%, but the increase in competition and hence prices is increasing the risk on exit multiples.

One example of a consortium bid was the acquisition in 2005 by a consortium comprising Lehman Brothers, Realstar and the Government of Singapore (LRG) of 73 UK Hotels from IHG for 9.3 times Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA).

Secondly, the increasing use of auctions – More and more deals across the UK and mainland Europe are going to auction, often attracting in excess of 30 first round bids.

This move towards auctions and controlled sales give sellers more say in the transaction process, and limits the amount of pre-transaction planning in which a buyer can engage. Private Equity firms are rapidly becoming adept in open auctions. In the UK market, Private Equity was successful in 74% of auctions in 2005, compared with only 30% in 2001.

A recent study by Deloitte also revealed that the superior transaction execution of Private Equity bidders has enabled them to frequently knock out the corporate competition.

If they are to truly compete with the Private Equity sector, corporate buyers now need to update their skills in the buyers' marketplace and deliver shareholder value, or they could ultimately become targets for private investors themselves.

Playing for time

Private Equity investors are now looking for opportunities with a strong headline exit, and the gaming industry ticks all the boxes.

Operators of bingo and casino establishments, for instance, are asset-based, with non-elastic customer demand, and are very cash generative. There is also a significant amount of deregulation taking place, particularly in the UK.

In 2005, Permira acquired a 33% stake in the Gala Group (valuing the business at circa £1.9 billion). Leading the way in 2006 was the acquisition by BC Partners of 51.57% of Hyatt Regency Hotels & Tourism from its majority shareholder Hellenic Casinos Company. Headquartered in Athens, Hyatt Regency Hotels & Tourism is the leading operator of casinos in southeastern Europe with casinos in Athens, Thessaloniki and Tirana.

Despite the proposed smoking ban, the bingo sector, where a high proportion of customers are smokers, has seen continued interest by Private Equity investors – Buckingham (Alchemy Partners LLP), Mayfair Gaming, and Thomas Holdings LLC (Hermes Private Equity).

Hotel market heats up

The hotel industry has seen unprecedented levels of transactional activity in the past five years. In 2005, European volumes were up 57% – at €15.7 billion – year on year. We expect 2006 levels will be almost as impressive at circa 20% up on the previous high in 2001.

With hotels offering a yield of around 6%, compared to the sub 5% through offices, retail and other forms of property, it's not surprising that hotels have become more attractive to buyers. Separating hotel ownership from operations has been a clear trend in the hotel industry in recent years with opco / propco splits and sale and leasebacks or sale and managebacks driving many of the recent transactions.

Further structuring opportunities and expected earnings growth are proving attractive to Private Equity firms, who, keen to unlock the value in an industry supported by strong fundamentals, have pounced on this sector. Private Equity groups have taken a stake in around 35% – 40% of hotel deals across Europe in the last couple of years – an amazing leap since 1998 when it was less than 20% and the year 2000 when it was just 1%.

The major Private Equity acquisitions in the European hotel sector in 2005 included Starwood Capital's acquisition of Louvre Hotels as part of the wider acquisition of Groupe Taittinger and the acquisition by Starwood Capital and Lehman Brothers of the Le Meridien hotel chain. 2006 has to date included the acquisition of 24 InterContinental Hotels across Europe (comprising a mix of Crowne Plaza Hotels & Resorts, Holiday Inn Hotels and Express by Holiday Inn Hotels brands); 6 Principal Hotels being acquired by Permira; and Blackstone's purchase of 8 hotels across Europe previously owned by Hospitality Europe B.V.

However, as in other sectors, Private Equity investors are facing increasing competition for hotels from other buyers, such as property investors and institutional investors, as well as from strategic partnerships which include joint venture entities comprising a mixture of buyer types. An example of a particularly active strategic partnership is HHR Euro CV, which comprises Jasmine Hotels – a subsidiary of the Government of Singapore Investment Corporation; Host Hotels – a US Real Estate Investment Trust – and Stichting Pension funds. This group joined together to acquire a portfolio of Starwood Hotels in Europe and the Hotel Arts in Barcelona.

Decreasing yields across the property sector as a whole coupled with increasing competition amongst bidders has driven up prices. Excepting 'trophy hotel assets' multiples 2-3 years ago were typically in the range of 8x to 12x EBITDA depending on location; upside potential etc. This contrasts with the EBITDA multiples currently being achieved which have generally been above 12x and as high as 20x in 2006.

Future exit strategies are likely to include further secondary buy-outs as well as some hotel companies or hotel investment vehicles listing on Alternative Investment Market (AIM) and Euronext, as an alternative to the main market.

The emergence of Real Estate Investment Trusts (REITs) is also likely to offer alternative exit routes for some investors. The French REITs, Fonciere des Murs, has already acquired 2 Accor portfolios and with the introduction of REITs in the UK in 2007, more hotel REITs are anticipated in the medium term.

Health warning

The Health and Fitness sector is an excellent example of how changing market demand and competition from alternative investors can impact investments and acquisitions. During the 1990s, when everyone wanted to belong to a gym, the health and fitness industry was on a roll. Joining fees were acceptably high as membership became a token of middle class aspirations, but rapid expansion by market newcomers slowed the sector down.

Private equity houses stepped in and acquired Holmes Place, Esporta Health Clubs, Fitness First and Cannons, among others, and these were all de-listed.
But even in private ownership, many clubs struggled to attract and retain members, especially as the number of high quality clubs and competition for dwindling numbers of fitness enthusiasts increased.

Consolidation was the obvious solution, and there has been a great deal of activity in 2006. Acquisitions of LivingWell Premier Health Clubs, Fitness Exchange, Dragons Health Clubs, and Next Generation Clubs, as well as the Virgin Active takeover at Holmes Place contributed to one of the busiest mergers and acquisitions (M&A) seasons the health club sector has seen.

Deloitte expects the market to stay buoyant as alternative investors start to circle the sector and Private Equity investors further consider their exit and consolidation plans for their health and fitness investments. Duke Street Capital has recently sold Esporta Health Clubs to Simon Halabi, the Syrian private investor for over £460 million (€678 million), seeing off bids from MidOcean Partners, Legal & General Ventures and Next Generation Clubs. Cannons, meanwhile, remains under strategic review.

Enduring appeal

We believe the leisure sector overall will continue to attract Private Equity investors, and that the betting and gaming and hotel sectors' will be the hot favourites. Especially as increases in disposable income means that leisure goods and services now make up close to 20% of household expenditure across Europe.

Alex Kyriakidis, Global Managing Partner, Tourism, Hospitality & Leisure of Deloitte sums up the appeal of the market so well. "This industry is appealing to Private Equity because its fundamentals are very robust. Global travel is set to increase from 1.5 billion to 2.3 billion by 2010, the silver segment is not only growing due to the ageing population, but living longer and spending on tourism, hospitality and leisure. In addition, the emerging middle classes in China, India and Central and Eastern Europe will provide the 'turbo charge' to the industry.

The betting and gaming sector is gearing up for a dynamic future. When the UK Gambling Act 2005 comes into play in the autumn of 2007, international competition is likely to intensify, and Gala Coral Group is among the UK players that will be interesting to watch over the next year.

The proposed introduction of a smoking ban across England could also impact investment in the betting and gaming market.

Initial findings in Scotland, where smoking has been banned already, suggests customers will drift away, however many operators expect business to return to historical levels. Deloitte's ongoing involvement in transactions in this sector supports this view, and as noted above, the smoking ban has not deterred private equity investors during the past year.

The hotel sector is also one to watch closely. A panel debate at the 2006 New York University International Hospitality Industry Conference was asked whether the wave of hotel merger and acquisitions had peaked. Several CEOs of leading hospitality companies suggested that we are "two to three innings into a nine inning game."

Although most of the mega deals in the hotel sector may have come and gone, we can expect to see plenty of smaller asset and portfolio moves while companies balance their portfolios and dispose of non-core properties. We anticipate more secondary buy-outs by Private Equity investors, but within a more competitive forum, comprising property investors and strategic partnerships.

Currently breaking news in the hotel sector are Blackstone's acquisition of the Interhotel Gruppe in Germany comprising 16 hotels; and the ongoing disposal of Scandic Hotels by Hilton which is generating significant Private Equity interest.

There is clearly plenty of life in the tourism, hospitality and leisure sector yet and the value and volume of deals will stay high for some time to come.

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