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The Global Corporate Advisor

The Corporate Finance newsletter of Crowe Horwath International



Welcome to the November issue of The Global Corporate Advisor.

The first article is about the potential of the global industrial waste management services market, which is expected to rise to \$750.09 billion in 2020 at a CAGR of 10%. Despite high bargaining power of buyers and intense competition, this fragmented sector can provide opportunities for acquisitions as a way to fast-track growth for entrepreneurial businesses.

The second article in this edition has a special focus on various aspects of due diligence in hotel transactions. While the process is important for any transaction, hotels as an asset class have unique characteristics, thus requiring specialised attention

from legal and commercial specialists in the sector. The feature examines complexities in transactions of single assets or a portfolio of hotel assets, with both domestic and cross-border buyers.

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Contact Us

The GCA team is here to respond to your needs relating to M&A transaction support, valuations and advisory services. If there is a topic you would like us to cover in future issues of the GCA newsletter, don't hesitate to contact Peter Varley, Chairman of GCA, at peter.varley@crowecw.co.uk. Alternatively, please contact your local GCA team member to discuss your ideas.

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The \$4 billion Australian Industrial Waste Management Market – a Hazardous M&A Environment?

By Rob Dando, Sydney

It's no surprise that a growing population, ever more dependent on industrial solutions, with greater environmental awareness and safety regulations, leads to increased amounts of industrial waste. High bargaining power of buyers and intense competition may suggest this market is not the best to be investing in. But as with other fragmented growth industries, this might not be the case.

Market forecast

The global industrial waste management services market is set for a period of stellar growth, (Frost and Sullivan) with revenue expected to rise to \$750.09 billion in 2020 from \$387.40 billion in 2013, a compound annual growth rate (CAGR) of circa 10%. InsideWaste estimates that Australia's industrial and hazardous waste market is approximately AUD \$4billion in size and is poised for future growth.

High bargaining power of buyers

It's widely known that commodity prices are declining, which naturally puts margins of major resource companies under pressure. Resource and oil and gas companies such as BHP, Rio, Chevron, Woodside, Fortescue and Glencore, are large industrial waste producers and are aware of the operational and PR risks of not complying with strict environmental regulations. Therefore demand for industrial waste services remains at high levels. However, given the pressures these groups are facing it is no wonder they have been pushing their waste management providers to reduce their prices.

These large industrial waste producers can use their market position and size to demand discounts up to 15-20% and better contractual terms. The trend is also to move away from a sole waste management provider and to put certain components in the waste management value chain out to tender.

Intense competition

Approximately half of the market is represented by a small percentage of companies, including household names such as Transpacific Industries/Cleanaway (TPI), JJ Richards, Suez (formerly Sita), Veolia, Remondis and Toxfree. Aside from these large groups, there are hundreds of smaller companies, ranging from local general waste management companies, battery breaking facility operators, mercury waste recyclers and specialised industrial waste management services, to power generation industries.

As listed companies are required to disclose financial information, we get an insight to the state of the industry. For example, although TPI has a relatively stable business regarding household waste and the traditional landfill business, its declining share price can be largely explained by the market forces mentioned above. French listed multinationals Veolia and Suez and the German privately held Remondis all indicate that they too are facing headwinds. An example of a more specialised group that has invested in recent times and has proven ability to innovate is Toxfree, which, in turn, has been impacted less by these market dynamics.

The opportunity

The above commentary may suggest that it's not the best environment to invest in, sell or buy an industrial waste management business. However, we disagree, and in a market that is still fragmented, the current slowdown will most likely be a temporary hiccup.

The industry needs to look through the commodity cycle. When prices increase, pressure from clients will drop and the one-stop shop or integrated solutions, in combination with sustainable ways of doing business, will prevail over low-cost options. Margin compression will alleviate and the companies that were able to navigate through the troughs will be well positioned to benefit in the medium- to long-term.

Focus, long-term investment, know-how, people and the development of innovative proprietary technologies will pay for themselves. Acquisitions could fast track growth, but as always, we advise people or businesses to be selective and act at the right time. It takes entrepreneurial courage and vision, but no doubt the key players will step into the M&A arena when the market picks up.

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Due Diligence for Hotel Transactions

By Vijay Thacker, Mumbai

Hotels are a class of asset subject to trading in good times and bad, for different reasons. Transactions may be for single assets or for a portfolio of hotel assets, with buyers being national or cross-border in terms of their funding sources and business organization.

Due diligence is a key element of any acquisition, and hotel transactions are no different; the need and scope for due diligence must recognize the basic characteristics of a hotel, which are –

- It's a capital intensive yet highly perishable asset hosting global buyers,
- sourced through multiple channels and with individual needs and expectations,
- creating a large number of retail transactions serviced by trained staff with varied backgrounds,
- using goods and services from multiple local and cross-border vendors.

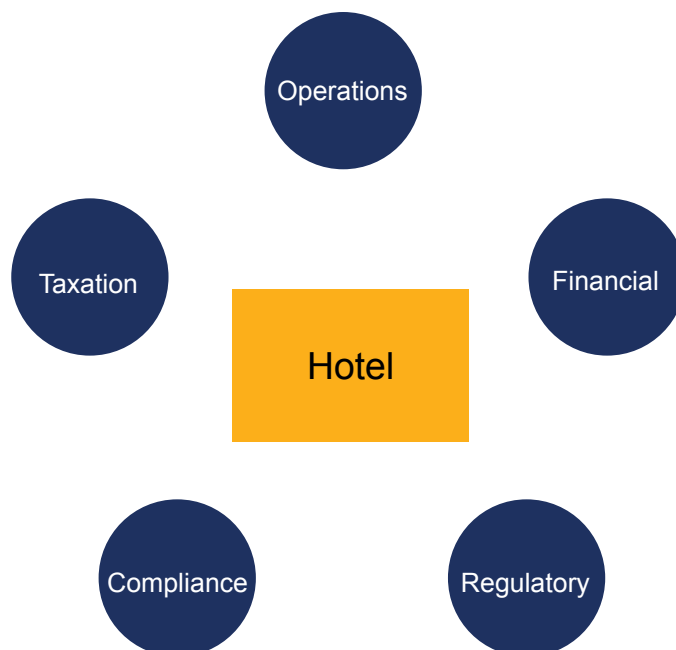
The buyer class is typically very organized in its approach to the transaction (there have undoubtedly been exceptions, even for some high profile transactions, where sheer emotion or inexplicable strategy has overtaken business justification and due care). On the other hand, the seller class still carries a reasonable share of family owners or owners that lack adequate structure and organization; the benefits of adequate pre-sale due diligence are under-recognized by several sellers who tend to treat the hotel as a real estate asset with additional (often exaggerated) value-creating elements.

In this article, certain key elements of a hotel due diligence are examined for the benefit of hotel buyers and sellers. The degree of complexity will vary depending on the nature, positioning,

scale and operating arrangements for the target. The article does not cover the due diligence aspects relevant for acquisition of a hotel management company – the business elements and due diligence issues therein are indeed a separate subject.

The skills required for these elements are different and may likely require multiple teams that carry relevant expertise and knowledge. For example, several of these matters are outside the typical scope of a financial due diligence consultant. Fortunately, our team of Crowe Horwath Global Corporate Advisors combines with experienced global consultants from Horwath HTL, to provide a formidable combination of sector expertise and cross-border due diligence skills and capabilities.

Figure 1. A comprehensive hotel due diligence exercise would comprise each of the elements depicted below.



Operational aspects

Hotels are preferably bought as operating assets, though there have been transactions where the hotel is transacted while it is closed for reasons of financial distress or otherwise.

From an operating viewpoint, matters to be reviewed include:

- the competitive positioning and situation of the hotel,
- its ability to improve rates, occupancies and non-room revenues, together with the factors that may help achieve that (investment, branding an independent hotel, change of brand, management contract, change of operator, marketing arrangements, etc),

- cost improvement needs and possibilities, or external limitations on cost improvement,
- physical condition of the asset, covering guest areas and service areas – and the investments needed to get these up to competitive speed,
- operating impact of long-term contracts and commitments, collective bargaining agreements, expected changes in indirect tax or other regulatory aspects – for example, impending prohibition on sale of liquor in certain jurisdictions, and
- the ability of the hotel to provide targeted EBITDA levels that will enable private equity (PE) investors to achieve their exit within a defined period.

From the seller's viewpoint, pre-sale due diligence may help stress the beneficial impact of recent renovation spends, unused entitlements and taxation benefits, among others.

Financial aspects

Similar to every meaningful due diligence, the financial aspect of a hotel's due diligence would remain focussed on EBITDA and adjustments to EBITDA. Familiarity with the Uniform System of Accounting for Hotels is critical to be able to meaningfully assess the hotel unit financial statements – these can actually yield insight which a normal financial statement may not provide.

Review aspects relating to earlier reported EBITDA would mainly relate to one-time or significant spends on renovations and refurbishments, one-time costs for changes in brands or management companies, costs for implementing changes in brand standards or to meet regulatory needs (say for fire and life safety), income streams from one-off transactions that are typically associated with creating financing flows while creating potential future service

obligations, costs arising from collective bargaining agreements, changes in allocation and treatment of service charges, among others.

Proforma adjustments arise from one-time transactions towards renovation spend or brand change, spends for compliance with significant new brand standards or regulatory needs. Income transactions arising out of use of the asset for financing purposes could give rise to adjustments to reflect a stable state EBITDA levels. Adjustments could also arise from inadequate inventory valuations or the likely costs and impact of a brand change (current chain affiliation to a new chain, or independent hotel to a chain affiliation or vice versa) post transaction. Adjustments may arise for missing fixed assets or inventories. Often, the depreciation rates adopted for assets are lower than required with reference to the real useful life of the asset, creating the need for 'retained earnings' adjustments. The creation and utilisation of a Replacement Reserve or Furniture, Fixtures & Equipment (FF&E) Reserve also gives rise to proforma adjustments.

Generally Accepted Accounting Principles (GAAP) related adjustments are required on two counts:

- for the differences in accounting treatment between Uniform System of Accounts and local GAAP, and
- for differences between the GAAP applicable in the country where the hotel is situated and the home country GAAP reporting needs of an overseas buyer. GAAP difference adjustments will also arise upon portfolio consolidation where hotels are located in different GAAP jurisdictions.

From a seller's viewpoint, aspects such as substantial circulation inventory (in a situation where sizeable recent inventory purchases have been accounted to consumption), and value of artwork and artefacts are matters that are often missed in creating and presenting the

value proposition to potential buyers. Future EBITDA may be impacted by matters such as collective bargaining agreements, time/profit based scaling of management fees, plans for hiring or retrenching expatriate staff and the potential costs and impact of participation in or separation from (as the case may be) shared or cluster services.

Regulatory aspects

As a real estate asset, regulatory aspects are relevant from the viewpoint of ensuring that the title, entitlements, corporate and other structures are proper and supportable for an investment. Equally, it is important to examine the regulatory scenario in the context of the buyer's plans for the asset or portfolio – thus, if there are refinancing plans through a condominium sale, or timeshare, or hiving off certain hotels in the portfolio, or a rejig of some mixed use components being acquired as a composite deal, then is all of this possible under the regulatory framework governing the hotel or the portfolio?

Cross-border transactions, or portfolios with hotels in multiple countries, will invite examination of investment along with funding options and structures, regulatory possibilities for asset segregation and disposal, where the assets include non-hotel assets that may not be germane to the buyer's interests or investment mandate.

A thorough legal due diligence could spread to other aspects as well, including evaluation of the management contract – several of these matters link back to commercial matters and buyers are well-advised to associate a commercial specialist, such as Horwath HTL, with the legal specialists.

Compliance aspects

Compliance aspects would cover both corporate and unit level compliance. The latter comprises a mix of owner-related responsibilities and operator/unit related responsibilities.

At the unit level, hotels may be subject to several regulations covering matters such as:

- operating licenses for the hotel as a whole and for several individual elements within the hotel
- labor and labor benefits
- expatriate employment
- foreign currency collection, handling and usage
- guest registration and reporting
- data protection and data security
- fire and life safety

It is good to ensure that the requisite compliance mechanisms are in place and working; that all licenses are available and in good order – you don't want your bar license pulled from under your feet, nor do you want any hidden challenges for compliance, which could lead to unexpected investments or even temporary closure.

Taxation aspects

Hotels are often subject to sizeable direct and indirect taxation. The taxation aspects of a due diligence must cover three elements:

- direct tax
- withholding tax
- indirect tax

The capital intensive nature of a hotel asset creates depreciation allowances and needs around refurbishment, replacement and asset renewal. Debt taken to finance hotels creates sizeable interest costs. Hotels often have operating profit at unit levels but book and tax losses at consolidated corporate reporting level, particularly in the initial years. Thus, it is important to understand tax issues surrounding various asset related allowances, renewal and refurbishment expenses, timeshare sales and other arrangements that

have created funding against long-term service obligations. It is also important to understand the tax impact of carried forward tax losses upon acquisition and sale of hotel assets – the seller should not ignore the monetary value of tax credits and losses being handed over to the buyer.

Tax withholding compliances are an important compliance aspect, dealing with:

- payroll taxes and costs,
- expenses and payments to contractors and consultants, both local and cross-border; and
- local or cross-border payments for franchise/management company fees and reimbursements.

Indirect tax matters are related to credits and cost offset or refunds on input purchases and services, besides any compliance matters related to the operations.

Some special elements

In this section, we examine some special elements related to hotel transactions – these are by no means a comprehensive statement of such elements, but are only indicative of the type of issues that may arise.

- **Stand-alone hotels v/s hotel portfolio/chain:** The scope of work for a portfolio of hotels is wider than the scope for a stand-alone target hotel; while this may seem obvious, the aspect of inter-relationships between hotels comprised in a portfolio is much larger than just the aspect of covering multiple hotels in a portfolio.

For example, the operational aspects and their impact on EBITDA for each hotel (and therefore the valuation of key individual assets within the portfolio) get more complicated when the target is a hotel chain that also owns hotels in addition to managing its owned and third party hotels. Similarly, if hotels within the portfolio are managed by different

chains then the evaluation becomes more elaborate as one works to understand chain-related issues and synergies (or lack of these).

- **Full service v/s limited service:**

Hotels that are big format hotels, with full service capability, large banqueting and multiple F&B outlets will carry greater elements of due diligence evaluation as compared to select service or limited service hotels. The former need much deeper evaluation from an operational standpoint with potential impact on EBITDA adjustments on account of age, inefficiency, renewal/renovation need, re-branding, and similar issues applicable for different services and segments within the hotel. It is very likely that renovation and refurbishment programs for a large format hotel have been done in phases so that several different segments of such a hotel may need varied degree of investment or improvement, which is likely to be done in phases.

- **Mixed-use projects:** Hotels are increasingly associated with mixed-use projects. This may create short-term or long-term service and revenue implications that need careful examination. For example, a hotel associated with a branded residences project may have revenue opportunities and service obligations under a rental pool or condominium arrangement; the buyer may enter at a stage when real estate profits and cash flows have been taken and enjoyed by the seller, leaving limited benefits and limited or larger obligations for the buyer. As part of a mixed use project, the hotel may have shared facilities, utilities or even parking spaces, which may have worked efficiently when the hotel and other mixed use components were under common control. However, after the acquisition of the hotel by a new buyer it is important to understand the operational control on the shared services, certainty and quality of service, service pricing implications and need for any independent or additional back-up investments.

■ **Chain-affiliated hotels:** The subject hotels may enjoy franchise or management arrangements with one or more hotel chains. It is important to assess and understand such arrangements in terms of remainder period, renewal or break options, break costs, contract terms in terms of fee arrangement, owner's ability to guide or approve operating budgets, control over hidden costs

and performance-related termination obligations, among other aspects. Each of these factors will have different implications depending upon whether there is value attached to the brand and chain, or whether the contracts can be terminated – the inability to terminate contracts may restrict the universe of potential buyers as competing hotel chains are eliminated.

Hotels are fun to stay at, mostly. They are harder to run. They can be even harder to yield investment returns, particularly for investors with shorter-term hold interest. Patience is key and thorough due diligence, like in all businesses, is very beneficial. An attractive asset must be the genesis of a transaction interest; it mustn't be the cause for circumventing sound business processes.

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