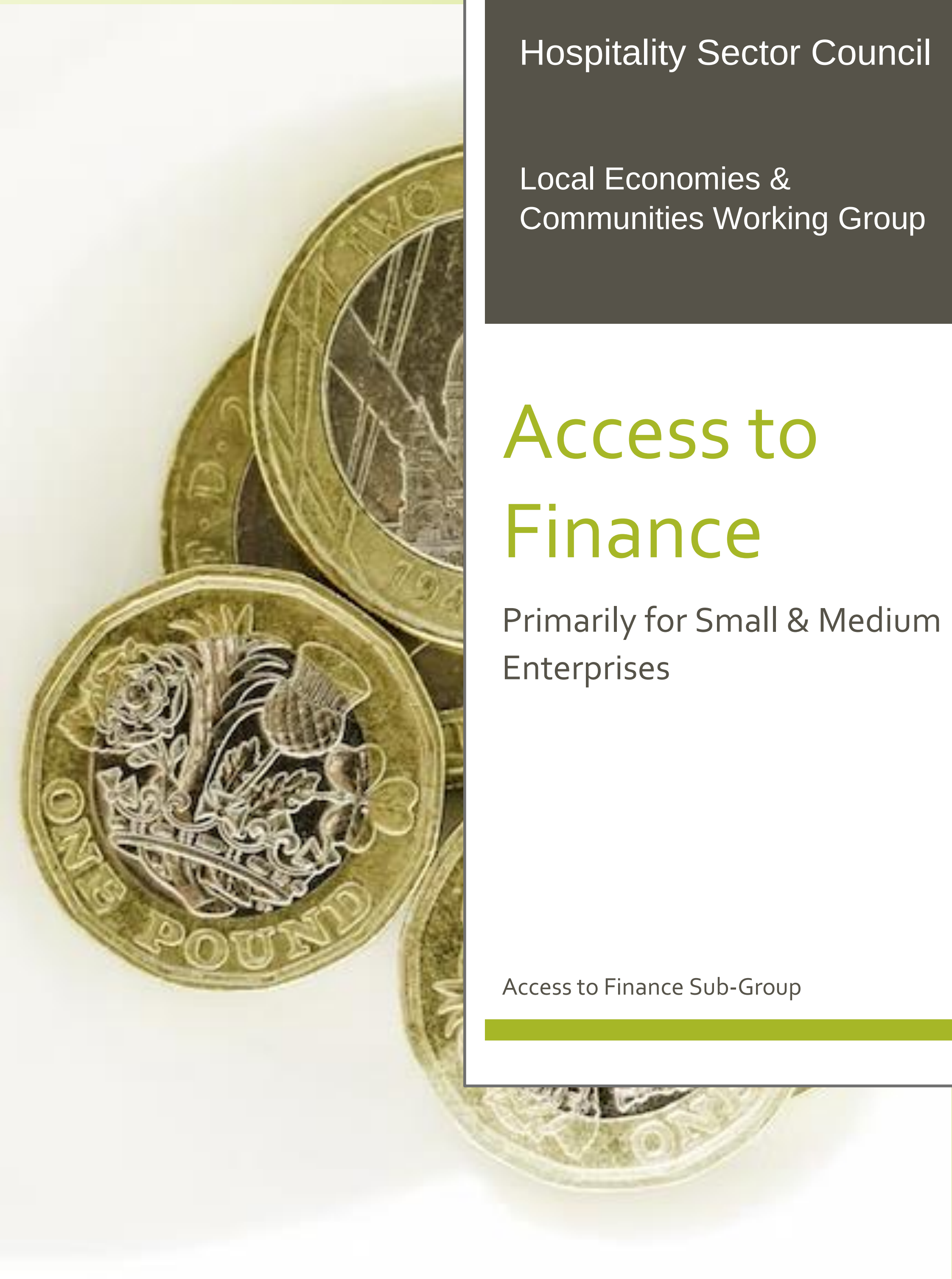
November 2022

Hospitality Sector Council

Local Economies & Communities Working Group

Access to Finance

Primarily for Small & Medium Enterprises



Access to Finance Sub-Group

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1. Executive Summary

The Hospitality sector has suffered significant financial damage over the last two years through the impact of pandemic related restrictions, closures and uncertainty. The impact being high levels of pandemic specific debts, minimal cash reserves and high levels of vacancies due to uncertainty in the sector & loss of overseas workers, all leading to minimal resilience.

Fragile hospitality businesses started their recovery early in 2022 as pandemic restrictions were removed fully in late February following Omicron and Plan B measures. Initial revenues for many recovered strongly but were hampered by ongoing high vacancy levels reducing trading capacity. Post covid inflationary increases in goods had begun to impact businesses with over 5% rises in January rising rapidly to over 9% in April squeezing profitability. Escalating energy prices quickly followed with further levels of inflationary costs through the summer meaning the majority of hospitality businesses need to trade at 120% of pre-pandemic levels to stand still, rendering 1 in 3 unable to make a profit (BII,UKH & BBPA trade body survey).

Access to finance is key to support short term liquidity requirements, site improvements, technology investments, increasing trading space or to finance new site acquisitions. In February 2022 only 20% of BII members (predominantly operating single pubs) were considering additional finance, this reduced to 12% by June. Of those seeking finance 2 in 3 were not successful via any route, Only 5% have been successful using their current bank and only 16% have been successful with a new or additional bank. The group noted many anecdotal examples of traditional high street banks not lending to hospitality businesses due to perceived risk with many still having significant debt overhang from the pandemic and repayment costs increasing as rates rise.

Feedback has also been received indicating that the Government's new Recovery Loan Scheme (RLS) is markedly less generous than the CBILS and BBLS schemes it replaced, meaning banks are less keen to lend to SMEs through it. Under RLS the Government no longer pays the first 12 months interest on behalf of businesses, nor the lender's fees, while interest rates for borrowers have also risen.

The group considered that a number of factors must be addressed to stimulate essential investment in the hospitality sector and in particular with SMEs;

1. Improve trading conditions and certainty through Government support to improve business confidence to plan long term recoveries including investment.
    - Key measures proposed by Hospitality Recovery Group
2. New Government backed loans with criteria in line with initial BBLS and CBILS
3. Government backed restructuring of existing loan agreement to a long-term basis
4. Government and sector best practice guides to accessing finance through high street and challenger banks through strengthened business cases

The majority of our sector's SMEs remain resistant to further debt with the current trading uncertainty, and this will endure until more stable conditions occur in the medium term without recovery support.

2. Financial Realities for SME hospitality businesses

The compound impact of the following key issues has left many hospitality businesses in a fragile position;

- Full trading commenced March 2022 after 2 years restrictions & closures
- Christmas and Summer trading heavily compromised for two years preventing any resilience being built
- Average pandemic debts for independent pubs at £40k (BII data)
- Minimal cash reserves, 1 in 3 no reserves (UKH, BBPA & BII data)
- High vacancy rate leading to reduced trading capacity
- Escalating inflationary costs throughout the business
- Material increases in energy costs
- Cooling consumer confidence reducing frequency and value of visits

As hospitality businesses head into the final quarter of 2022 the realities are stark.

2.1. Business Failure

The **CGA/Alix Partners Hospitality Market Monitor** published in October 2022 highlighted a growing failure level.

'It has been a tough third quarter for the hospitality sector, and our Hospitality Market Monitor data shows Britain has seen a ***net decline of 2,230 licensed premises between June and September 2022.*** *This is equivalent to 24 net closures every day, or one an hour.'*

In additional insolvency numbers are also beginning to rise as indicated by data shared by **audit, tax, and advisory firm Mazars** in July 2022.

*'**The number of hospitality company insolvencies has risen by 59% over the past year** amid spiralling cost pressures. Figures from the Insolvency Service showed 2,156 pubs, bars and restaurants went insolvent in the 12 months until the end of July, compared to 1,354 the year before. There were 216 insolvencies of hospitality businesses in July this year, up from 158 in June. Overall Mazars showed a 72% increase in the number of overall UK company insolvencies in the past year, with 20,512 businesses shutting down.'*

It is clear that the fragility inherent in SME hospitality businesses is starting to result in higher failure with significant numbers forecast for January 2023 without Government support and certainty for the next twelve months. This is being reflected in banks willingness to lend to hospitality SMEs.

2.2. Debt levels and vulnerability

Many hospitality SMEs firms weathered the impact of the pandemic by taking on debt and this is considered to make firms more vulnerable to future economic shocks which can undermine their ability to service this debt. The interest coverage ratio (ICR) is a debt and profitability ratio used to determine how easily a company can pay interest on its outstanding debt. The interest coverage ratio is calculated by dividing a company's earnings before interest and taxes (EBIT) by its interest expense during a given period. Clearly for hospitality SMEs in the current trading environment this creates a real challenge in raising further finance as this key metric is used for risk.

Outstanding bank lending to small businesses in the hospitality sector has fallen by more than £ 1.4bn since the end of CBILS and BBLS loans schemes, dropping to £14.61bn in April 2022, down from £16.08bn in March 2021*, highlighted by **Hazlewoods, Chartered Accountants and Business Advisers.**

"With the cost of living crisis eating into consumers' discretionary spending, banks have been less willing to lend to pubs, bars, restaurants and hotels given their perceived higher risk of default. Some lenders have reduced their lending to the leisure sector following two years that have weakened it significantly through the combined effects of spiralling inflation and repeated closures through lockdown.

*Rebecca Copping, associate partner at Hazlewoods says: "**Banks are really starting to back away from lending to hospitality businesses. Without financial support from lenders, some pubs, restaurants and hotels are really going to struggle**. With a cost of living crisis weakening consumer spending, securing bank lending at viable rates is no easy task for hospitality businesses at the moment."*

The **Bank of England's Financial Stability Report, July 2022**, recognised the issues for SMEs

'UK small and medium-sized enterprises (SMEs) have more debt than they did before the Covid pandemic. However, the vast majority of new debt was issued at relatively low rates that tended to be fixed for six years or longer.

SMEs make up a relatively small share of total corporate debt (less than 20%), but around half of UK employment. Over the course of the pandemic, they acquired substantially more debt – while larger businesses' outstanding debt was broadly flat, total outstanding SME debt increased by over 20% between end-2019 and end-2021. However, the vast majority of new SME debt was issued at relatively low interest rates via government-guaranteed loan schemes. These loans are on fixed rates (the majority of which had fixed-rate terms of six years or longer) and include greater repayment flexibility than typical SME loans.

Rising interest rates and falling SME cash buffers are nevertheless likely to contribute to stress for a number of SMEs. The share of SMEs with insufficient cash to cover seven days of turnover was 34% in 2019. SME liquidity positions improved over the pandemic, in part reflecting precautionary borrowing, and the share fell to 21%. Liquidity positions have since deteriorated, and the equivalent share stood at 31% in February, likely largely reflecting the impact of public health measures introduced in the early part of the year to contain the spread of the Omicron Covid variant, as well as the repayment of loan scheme debt.'

This position was also reflected in the **British Institute of Innkeeping (BII) members summer trading survey in June 2022,** 81% of respondents were single pub operators.

- **70% have debt (excluding mortgages)**
- **1/3 have up to £30k, 40% have up to £50k, 1 in 4 have debts between £30-£100k**
- **30% have no cash reserves in their business**

3. Banks approach to investment in hospitality

The group has received a significant number of specific examples from across the sector from those seeking investment that traditional banks are either unwilling to lend or that their lending criteria does not support the majority of hospitality cases. This is reinforced by the BII members survey, June 2022;

- **Only 12% are seeking further investment, down from 20% in Feb 2022**
- **Those seeking investment 2 in 3 have not been successful**
- Only 5% successful with current bank
- 16% successful with new or additional bank

Direct feedback from a high street bank has indicated that whilst they are still lending to hospitality the lending criteria have strengthened significantly around certainty of the business case, evidenced business demand etc. All of which are increasingly more difficult to achieve for the majority of hospitality operators with the current trading uncertainty.

A recent example from an established successful multiple operator with no debt seeking finance for major refurbishments encountered a very cautious approach from all the high street banks. Most **will not lend to above a 50% loan to value (LTV) and want extensive evidence of strong cash generation and EBITDA to ensure it is serviced**. Clearly many operators seeking additional finance do not have freehold assets which makes the likelihood of success considerably less.

It is expected with rising interest rates and ongoing sector trading challenges that the likelihood of successful bank lending for hospitality SMEs will worsen.

4. Government backed loans

The Government provided access to loan support through the pandemic predominantly via the Bounce Back Loan Scheme (BBLS) and Coronavirus Business Interruption Loan Scheme (CBILS). Both schemes provided favourable terms and were heavily used by hospitality businesses for both supporting liquidity and supporting small site improvements. The Government has since withdrawn both products and introduced the Recovery Loan Scheme (RLS) which is currently due to operate until 30th June 2024.

Hazlewoods, chartered accountants and business advisers, concluded that the Government's new **Recovery Loan Scheme (RLS) is markedly less generous than the CBILS and BBLS schemes it replaced**, meaning banks are less keen to lend to SMEs through it. Under RLS the Government no longer pays the first 12 months interest on behalf of businesses, nor the lender's fees, while interest rates for borrowers have also risen.

'Under the RLS the Government guarantee to a lender is only 70% of the amount loaned to a business, making them significantly higher-risk for banks to write than under the 100% Government-guaranteed CBILS and BBLS schemes.

Copping added: "The Recovery Loans Scheme that has replaced CBILS and BBLS is much less attractive for banks – that has impacted the level of risk they are willing to take."

"SMEs planning for the end of their CBILS and BBLS loan terms may find that they struggle to refinance their debts at rates that work for them."

Whilst the continuation of a Government backed loan scheme is greatly appreciated, the terms need to be reviewed to ensure the associated lenders can meet the requirements of the hospitality sector.

5. Recommendations

The core recommendations for the access to finance group as are in four key areas.

5.1. Hospitality Recovery Support

For many hospitality businesses their recovery has not started through the impact of escalating costs of doing business with high inflation, material energy cost increases and colling consumer demand.

This month the **ONS reported more than a third of British pubs and restaurants have shortened their trading hours over the last three months to keep a lid on soaring energy costs**. N Some 6% of pubs, cafes and restaurants had decided to close an extra two days a week, 7% were open one day less, while 21% had reduced opening hours but not the number of days they were open. Reduced opening times were far more common in the hospitality sector than in other parts of the British economy, where just 7% of businesses reported this.

This is clearly being seen in trading with tourism and recreation experiencing the fastest fall in output of any UK business sector last month, according to the **Lloyds Bank UK Recovery Tracker**. Output in the sector, which includes pubs, hotels and restaurants, declined at the fastest pace since February 2021, when the UK was last in lockdown, with a tracker score of 36.3 in September, according to the. Any reading below 50 indicates contraction. The drop was caused by demand falling for a fourth consecutive month – to a tracker score of 38.5 last month – as consumers reined in spending amid rising inflation.

A recent joint trade body survey (**BII, UKH, BBPA and Hospitality Ulster**) revealed that a **third of hospitality businesses are at risk of failure through soaring costs.** We have had specific feedback that lenders are asking for detailed information on energy bills as they have stated concern that the Government support will not protect the businesses as expected and is material concern on profitability.

The Hospitality Recovery Group has made a number of key recommendations to provide confidence and certainty for hospitality operators to trade through a recovery and unleash investment. This will be critical for many SME hospitality operators who are resistant of taking more debt, although investment is critical, until they have great certainty.

5.2. New Government backed loan

The current Recovery Loan Scheme does not reflect the realities of the hospitality sector at this time and the applied conditions are too onerous for many. We recommend the development of a specific Government backed loan for hospitality businesses recognising the underlying nature of their finances. Hospitality businesses, unlike many sectors, can bounce back rapidly with support. Outline terms should mirror the conditions of the BBL and CBILs, particularly long-term pay back and flexibility. This can also provide more support for lending banks allowing them to apply hospitality specific criteria.

5.3. Government backed restructuring of existing loan agreements to a long-term basis

Many hospitality businesses, particularly SMEs, have Government loans and also deferred HMRC payments. The loans and the ability to service them is a significant factor is gaining additional finance. We recommend a hospitality sector specific scheme to restructure these loans on to a long-term payment scheme of over 10 years with a fixed/low interest rates applied. This would have a material impact on the interest coverage ratio (ICR) and view from bank lenders on risk. This restructure could also include deferred HMRC payments. The benefits to Government are two-fold; higher likelihood of repayment as businesses do not fail and supports hospitality businesses invest at the heart of their communities once more.

5.4. Government and sector best practice guides to accessing finance

An identified barrier to accessing finance is the strength and quality of business cases supporting the investment. There is an opportunity to provide a sector best practice guide, including specific case studies, supported by the trade bodies, Government and high street banks. As this is an open to all initiative, we would be seeking Government funded support with creating a programme to include assets and accredited training as appropriate.