

The Failure of Queens Moat House I

Abstract

Queens Moat House Hotels grew rapidly in the second half of the 1980s to become one of the UK's largest hotel groups. Growth was achieved through acquisitions funded by frequent equity and loan issues. In March 1993, the group breached its borrowing covenants, and its bankers took effective control, appointing new management. This case charts the history of QMH up to that point.

This case was prepared by Chris Higson and Tom Ryan with the assistance of Christine Holly. The case study was prepared from publicly available information as a basis for class discussion rather than to illustrate either the effective or ineffective handling of an administrative situation.

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Introduction

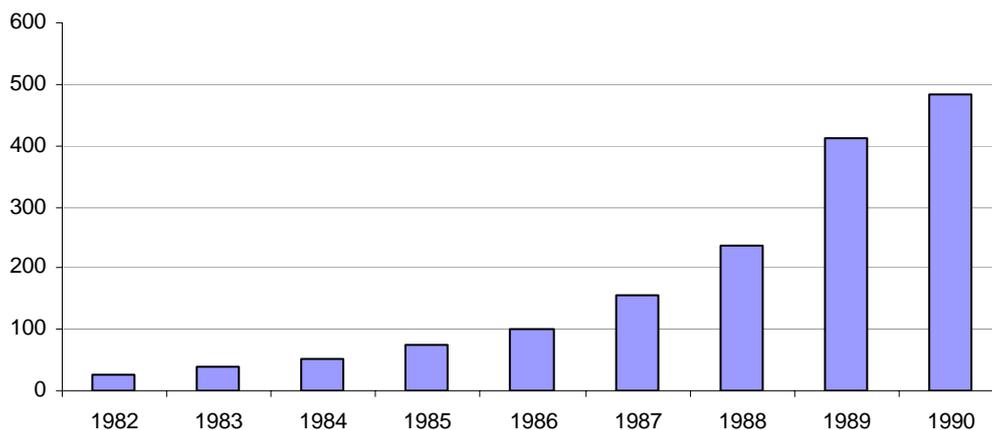
Queens Moat House Hotels was created in the early 1970s by John Bairstow. Its growth accelerated during the second half of the 1980s through a series of acquisitions funded by rights issues and debt [see Table 1]. During that time, QMH more than doubled to 10,000 the number of its UK rooms and acquired a further 10,000 bedrooms in continental Europe. In its first financial report to employees (issued in April 1989) Queens Moat's summarised the company's key objectives:

- to provide quality services to its customers in the business travel market
- to attract and retain managers of the highest calibre and to allow expert hoteliers considerable autonomy in running their hotels profitably and successfully
- to continue its high rate of growth in sales and profit and achieve consistent increases in profits and assets per share
- to maintain and upgrade its hotels on a continuous basis
- to expand as an international hotelier ... by acquisitions and building
- to operate a small efficient central organisation with careful management and financial controls

Bairstow was born in 1930, the son of a successful real estate agent. He joined his father's business, Bairstow Eves, and a year later became a partner. He then moved to set up a new sales office on the outskirts of north-east London. By the early 1980s, Bairstow Eves, with 33 sales offices and some 300 employees, was among the largest residential estate agencies in the South-East of England. In 1981 it handled the sales of over 7,000 homes with a value in excess of £200m, generating gross income of £4.7m, and pre-tax profits of £697,000.

In 1982, Bairstow Eves became the first estate agent to be floated on the London Stock Exchange when it offered for subscription 47 per cent of the issued capital to raise £2.9m. This allowed the company to acquire other agencies, through a combination of cash and/or shares, with the objective of establishing a network of sales offices throughout the country. A series of acquisitions in the following years increased the number of sales outlets to 137, while pre-tax profits rose to £7m in 1985. In June 1986 Mann & Co. PLC acquired Bairstow Eves in a deal which valued Bairstow Eves at £77m. Thereafter John Bairstow was able to devote all of his energies to building QMH.

Table 1 QMH's Turnover (in £m)



The growth of Queens Moat

In 1968 Bairstow had recognised that executives visiting the Ford Motor Co. plant near his home needed a business hotel. He borrowed £47,000 to convert his home into an eighteen-bedroom commercial hotel named the Brentwood Moat House. In September 1972 Bairstow sold the Moat House Group (now comprising four hotels) to the quoted Queens Moat Hotels (renamed Queens Moat House Hotels) for £1.08m in shares, creating a group with twenty hotels. Bairstow bought another 8 per cent of the company and was appointed chairman. His objectives were to strengthen the group's balance sheet, upgrade its hotel portfolio and realise its property potential. By early 1974 Queens Moat Houses was attracting investor attention. The Sunday Times (26/8/74) explained "the spice in the situation stems from Bairstow's background in property".

In January 1982, Queens Moat Houses bought County Hotels for £30m. County was a chain of 26 provincial (i.e. outside London) hotels located in commercial areas and with a high three-star or four-star rating. They contained 1,915 bedrooms and were independently valued at £35.25m. The initial deal announcement left unanswered the question of how it would be financed, since the £30m price tag was more than twice the existing QMH market capitalisation. Directors requested that the shares be suspended until this was resolved. A month later, QMH announced (FT February 25, 1982) that it planned to finance the deal through a mixture of bank borrowings (most of which had a 15 year term), an underwritten rights issue of 41.6m shares at 27p to ordinary and convertible loan stock holders and an issue of ordinary shares to the vendor. The deal more than doubled the size of QMH, effectively launching it as a national chain. By the end of the next year, QMH was the sixth largest hotel group in the UK with 55 hotels and 4,432 bedrooms.

In December 1986, Queens Moat purchased the Dutch Bilderberg chain of 12 hotels with 910 bedrooms. The transaction cost £15.5m, of which £1.66m was paid in cash. The balance was paid in the form of a vendor placing under which 22.5m ordinary shares were issued to the vendor and immediately sold on its behalf by QMH's broker.

The 1987 acquisitions and rights issue

In August 1987 Queens Moat entered into conditional agreements to purchase two continental hotel groups, Globana and Crest, for £73.83m and £73.75m respectively. Globana comprised eight hotels located in Germany, with 1,706 bedrooms. Two of the hotels were financed by way of lease purchase, the outstanding obligations for which, totalling DM43m, were undertaken by the group. The properties were valued on an 'open market, existing use' basis at DM220m (£73.83m at the prevailing exchange rate of DM2.98/£1) by Weatherall Green & Smith, Chartered Surveyors. They described the basis of valuation:

"The properties have been valued ... in accordance with the recommendations [of] the Royal Institution of Chartered Surveyors. The properties fall into the category of property which normally changes hands in the open market as a continuing and fully operational business and they have been valued as such to include tenant's fixtures and fittings, plant and machinery, and assuming the retention of existing staff, and with the benefit of current and future bookings. ... We have been provided with copies of the recent management accounts and we have made enquiries regarding the future anticipated level of trading in respect of each hotel. Our valuations have regard to the future trading potential that is likely to be expected of new management taking over the existing businesses at the valuation date."

Crest comprised 16 hotels in Germany, Holland and Belgium with a total of 1,722 bedrooms. All were of a three-star or four-star standard. The hotels were valued on an open market existing use basis at £73.75m by Weatherall Green & Smith. To partially fund the acquisitions, the company made a rights issue. On December 7, 1987 QMH announced the acquisition of property development and construction group Taylor Williams Holdings, established in 1959. While continuing its existing business, Taylor Williams would examine and, where possible, exploit surplus assets within the QMH portfolio.

In October 1987 Queens Moat announced the completion of a £300m multi-option facility, which allowed the company to borrow in a choice of currencies and to match its overseas assets with borrowings in local currencies. Less than a year later, the facility was increased to £400m. At this time QMH attracted some criticism for its adoption of aggressive accounting policies. Queens Moat revalued its fixed assets on an annual basis and reflected those valuations in the Group balance sheet. The directors considered that, since properties were maintained to the highest possible standards, the lives of the assets were so long and their residual values were so high that it was inappropriate to charge depreciation.

The 1988 and 1989 rights issues

In October 1988 Queens Moat agreed to pay UK brewer Bass £96m for seven hotels in West Germany. The deal was to be partly financed by a 1-for-6 rights issue at 85p per share. In August 1989, Queens Moat announced it had embarked on an investment programme, which would increase the number of bedrooms through acquisitions (1,033 rooms), extensions to existing hotels (391 rooms) and new hotels (855 rooms). The estimated cost of the programme was £194m. Earlier that year Queens Moat had acquired 6 hotels in the UK (valued at £85m), and two hotels in the Netherlands (valued at Dfl40m (£11.6m)). This coincided with a rights issue to raise approximately £141m. Bairstow explained that the company was raising equity rather than debt because the UK would account for most of its current £194m investment programme, and UK interest rates were too high. The influential Lex column noted (FT – August 17, 1989):

"The institutions accepted Queens Moat's third rights issue in two years with alacrity and not merely because of the depth of the 19 per cent discount at which it was priced. A more flattering reason why yesterday's £141m call caused no unrest was the good use to which the hotel group has put the proceeds of the previous two: to fund growth in Europe and the UK. That its share price performance since 1984 has outshone other hoteliers is no surprise, given its 29.9 per cent compound annual growth in earnings per share... Only two clouds loom on the horizon: the high prices of UK hotels, such as the £110,000 per room Queens Moat paid for Nottingham's Savoy, and the relative scarcity of medium-sized European chains available for purchase."

In early October 1989, Queens Moat announced that 95.1 per cent of the rights had been taken up, and the remainder had been sold in the market at a premium.

In 1982 Norfolk Capital, a rival hotel chain, had decided to reduce its dependence on the volatile tourist market by focusing on upmarket accommodation for business travellers. It implemented this strategy through a series of disposals, acquisitions and refurbishments. By 1987 Norfolk's earnings appeared to justify the high prospective multiple it had long shown on the stock exchange, but in the following two years, the share price under-performed the FT All Share Index by almost 30 per cent. By the end of 1989, the share price was supported more by asset backing and bid hopes than earnings expectations.

Balmoral International, a private company led by three hoteliers, gradually built a stake in Norfolk Capital, rising to 13 per cent in 1989. It then launched a bid to elect three of its directors to the Norfolk board and to manage the company on a five-year contract. In response QMH launched a hostile £176m all-share bid for Norfolk, offering 2 of its shares for every 5 of Norfolk's (FT January 26, 1990). QMH shares closed the day down 5 at 106p, while the FT Ordinary Share Index rose 6.9 to 1835.5. QMH's share price had outperformed Norfolk's since 1987 by around 60 percent, as shown by Exhibit 1.

Balmoral promptly abandoned its plans, leaving Norfolk to make its own defence, which hinged on its high net asset value of 47.7p compared to the 42p value offered by QMH. A month later, QMH announced that it controlled 52.94 per cent of Norfolk Capital's shares and declared its bid unconditional (FT February 27, 1990).

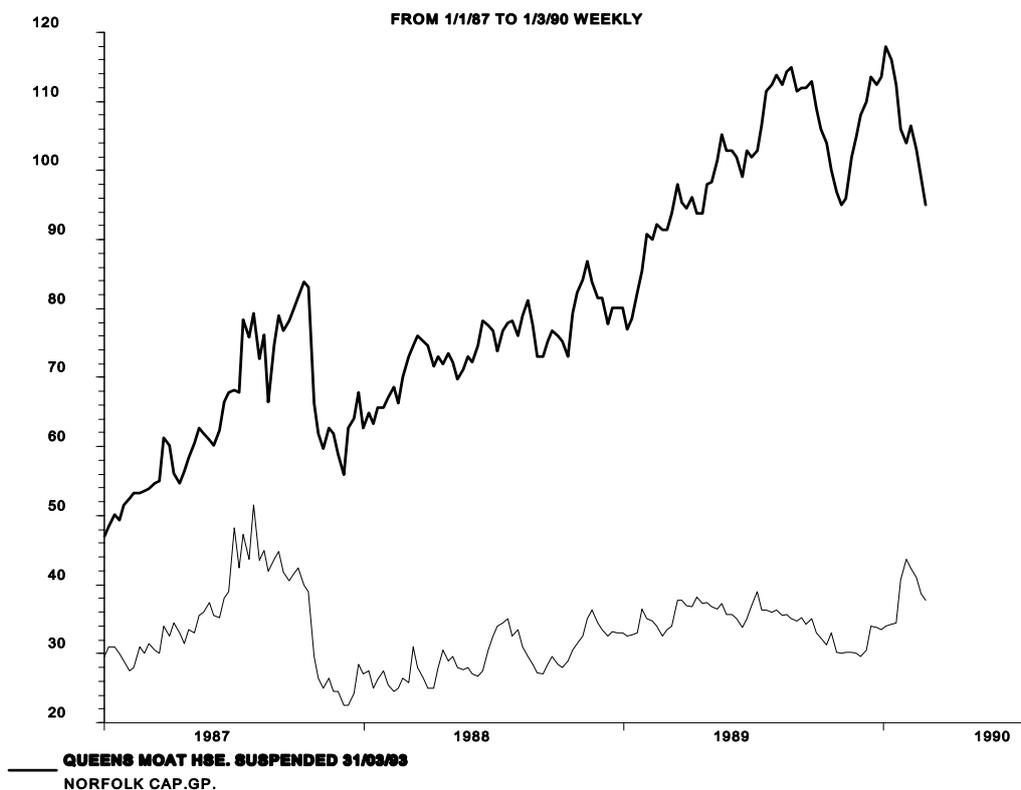
Queens Moat finally achieved a long sought entree to the French market in August 1990 when it announced (Financial Times – August 16, 1990) that it had agreed to pay an initial £30m for a 48 per cent stake in H.I. Management, with an option to buy the remaining shares for a maximum of £48m cash by April 1993. H.I. Management owned 8 three-star and four-star hotels in France and two hotels in Belgium. The average cost per room was £70,000, compared with the £99,000 average prevailing in the UK.

Queens Moat issued a financial report to employees in April 1989. The report emphasised that:

"It has always been our policy to buy properties rather than rent them. Although it is more expensive in the short term to buy, in the long run it gives us much greater security and stability."

One indicator of the frequency with which QMH issued equity over the years 1986-92 is the increase in its issued shares from 164.5m in 1986, 369.2m in 1987, 445.4m in 1988, 727.0m in 1989, 889.6m in 1990, 898.0m in 1991 and 924.3m in 1992.

Exhibit 1 Share price performance – QMH and Norfolk



Source: Datastream

Governance and financial control

By early 1991, the structure of the group had become extremely complicated, with nearly 200 subsidiaries.

A key factor in implementing the group's objectives was the hotel manager incentive scheme, which by 1987 was in use at half of the group's UK hotels, especially the smaller hotels with stable business levels. The scheme was later applied to certain of the continental hotels. The 'incentive manager' agreed to pay a pre-determined fee to QMH for the coming year. He or she then ran the hotel independently, keeping any profits and bearing any losses for that year. Each participating 'incentive manager', who was self-employed, provided QMH with audited turnover accounts. They then negotiated likely growth for the next year. Queens Moat set a fee based on its estimate of the hotel's return on turnover. 'Incentive managers' were responsible for and bore the cost of the physical maintenance of their hotels, but capital spending, where approved, was funded by Queens Moat, which owned the asset. The manager had to repay the investment over five to ten years, in addition to the normal licence fee. The scheme was started in 1975 to guarantee cash flow to satisfy its bankers. Queens Moat found that it was working well as a management system and claimed that the scheme allowed the group to operate with a very lean central staff and to concentrate its management resources on its hotels where the incentive scheme was felt to be inappropriate.

Queens Moat was managed by a board consisting of eight executive and six non-executive directors. In 1989, the company appointed two new non-executive directors, David Howell and John Gale. Howell had held a number of governmental and parliamentary offices during his 25 years as a Member of Parliament. He was Chairman of the House of Commons Foreign Affairs Committee and the UK Japan 2000 Group. Gale had just retired as Senior Executive Vice President, Chief Administration Officer and a Director of NatWest Bank U.S.A. and NatWest Bancorp. At December 31, 1990 the executive directors held just under 2 per cent of the share capital, while the non-executives held just under 0.4 per cent. Bairstow owned 8.2 million QMH shares.

Queens Moat's auditor was Bird Luckin, an 18 partner firm with two offices in the UK, which had no other client quoted on the Stock Exchange.

Financial distress

Events in 1991

By early 1991, Queens Moat was the UK's third largest hotelier, ranking behind Trusthouse Forte and Mount Charlotte in terms of the number of hotel rooms. In 1990/91, the UK hotel industry experienced a major slump, following the buoyant 1980s. Occupancy rates plummeted in the face of higher interest rates and fewer American visitors, deterred by the weak US\$ and the Gulf crisis. The industry reached its lowest point in early 1991, when occupancy rates as low as 20 per cent were reported. Britain's top two hotel chains felt the impact. Mount Charlotte announced flat profits despite a 55 per cent increase in turnover due to the 1990 acquisition of Thistle Hotels, while Trusthouse Forte pre-tax profits for the year to January 1991 fell by 27 per cent to £190m. But QMH announced in 1990 pre-tax profits up from £62m to £94m (including a £10m contribution from Norfolk Capital from March 1990), on turnover up from £409m to £485m.

In January 1991, QMH announced that it had concluded a deal to sell five hotels and two office properties to the Bank of Scotland for £66m. QMH was granted a 30 year lease with a buy-back option at the end of five years. The transaction guaranteed the Bank of Scotland rent increases of 7 per cent per annum, 'which seems to equate to a gross internal rate of return of about 13 per cent (Financial Times, January 16, 1991). The FT reported (January 16, 1991) that 'the properties had been chosen for their relative newness, which enables the company to avoid heavy capital gains taxes'. Bairstow commented that the deal was a good opportunity to reduce gearing (from 61 per cent to 57 per cent), while the buy-back option allowed it to retain control of the properties.

In May 1991 Queens Moat announced that it proposed to issue up to 188,850,972 new 7.5 per cent (net) convertible preference shares at par, payable in full on acceptance. These shares would be offered by way of rights to holders of ordinary shares and existing preference shares. The rights issue, fully underwritten by Charterhouse, was on the basis of 1 new convertible preference share for every five ordinary shares and 5 new convertible preference shares for every 11 existing convertible preference shares. Shareholders were advised that earlier in 1991 three hotels with a total of 236 bedrooms had been bought in the UK, Germany and Holland for a total consideration of £16m. Negotiations were at an advanced stage to purchase a company with leasehold interests and a management contract in five hotels in Austria and two in western Germany with a total of 910 bedrooms. That company also had interests as a franchiser in hotels in Austria, Czechoslovakia, Hungary and Yugoslavia. Queens Moat was also negotiating to purchase two further hotels in the UK at a total cost of £45m.

Queens Moat shares closed 1.5p down at 86p in response to the announcement of the rights issue. The next day, Lex (Financial Times, May 30 1991) summarised the dilemma facing investors:

"Queens Moat has weathered the recession in the hotel business better than most, chiefly because of its diversification into Europe. But as yesterday's £184m rights issue demonstrates, aggressive expansion has its costs. The market has been subjected to a blizzard of Queens Moat paper over the past decade: the issue is its seventh since 1980, not counting last year's paper acquisition of Norfolk Capital. ...The natural assumption is that the money is to be spent on buying yet more hotels. The group's market value stands at a 30 per cent discount to the net value of its assets, which consist of hotels at current value. Thus, having handed over their money, investors can expect to see 30 per cent of it if promptly vanish. To institutional investors who could equally well buy Queens Moat hotels through sale and leaseback, this might seem an expensive procedure. ...The question is where the company's finances go from here. Some £45m of the proceeds are already earmarked for further expansion in Europe and Queens Moat will want to buy the outstanding 51 per cent in its French associate HI Management. On the assumption that the rapid earnings growth of the 1980s is now over, the time may be approaching when the company can no longer count on shareholders to fund its progress."

In late July Queens Moat announced that just 42.5 per cent of the rights issue had been taken up.

Events in 1992/93

Despite the downturn in the UK hotel market, QMH continued to report strong results, surprising its struggling rivals. For 1991, Queens Moat announced pre-tax profits of £90.4m (1990 – £94.1m) on sales up from £484.5m to £543.3m. The interim results to June 1992 showed pre-tax profits up from £36.2m to £38.1m, fuelling analyst projections of full year profits of up to £95m. Despite the strong profit performance, the 1992 interim balance sheet indicated that total debt had increased to £790m, focusing investor attention on the continuing negative cash flows reported by QMH. Analysts became concerned that the company might breach borrowing covenants. These worries triggered a selling wave that drove the share price down from 70p before the results announcement to 27 1/2p by mid-September 1992. The share price performance from 1982 to 1991 and from 1991 to 1993 is shown as Exhibits 2a and 2b. QMH was stunned by the market reaction and hired investor relations firm Frew MacMaster to launch a round of meetings with investors. The concerns of the shareholders focused on the choice of auditors and the structure of the board, including the non-executive directors.

By November, QMH concluded that UK profits would be below budget, and guided market expectations down to the £80-85m range. The company's market capitalisation was also being adjusted down: at the end of 1990, the market had valued QMH's equity at £774.3m, a year later it had fallen to £709.4m before collapsing to £415.8m at the end of 1992.

By this time, sterling had exited from the Exchange Rate Mechanism of the European Community and had depreciated substantially against the deutschmark... As a result, the sterling value of the company's foreign currency loans (under the DM multi-option facility) had jumped dramatically, forcing QMH to start renegotiations with its bankers. The combination of investor communication and action on debt levels comforted shareholders and the share price recovered to a high of 59p in early February 1993. This new confidence was dented, however, when the market heard that deputy chairman Martin Marcus had sold 1.1m shares at prices of 57p and 57 1/2p just before the close period leading up to the results announcement.

By late March 1993, QMH was assembling the accounts for the 1992 financial year. While Bird Luckin was the UK auditor, Coopers & Lybrand and Arthur Andersen were responsible for the audit of the continental operations. The combined earnings were some £20m short of the market expectation of £80m, a number critical to the resolution of the on-going negotiations with the company's bankers. Bairstow also decided that it would be inappropriate to recognise the £20m due from the German incentive manager scheme that had been signed in late 1992. This further reduced the profits, to around £40m. Finally, the profit forecast had assumed 'audit adjustments' such as the capitalisation of interest, expected to contribute £20m to profits. (Financial Times – November 11, 1993).

Breach of covenants

Bairstow knew that the firm was in breach of its borrowing covenants. He advised the situation to the group's banks on March 31 1993, just 7 days ahead of the scheduled date for the announcement of the 1992 results. At the banks' request, accountants Grant Thornton were appointed to investigate the group's financial position. A standstill agreement was reached whereby "the group's banking facilities were capped at the amounts outstanding at March 31, 1993, payments of certain interest were deferred and strict limits were imposed on capital expenditure by the group" (Chairman's Statement, 1992 Annual Report). The company's shares were suspended from listing on the London Stock Exchange from that date at 47 1/2p. In early April, they also appointed two consultants to run the business: Andrew Coppell and Andrew Le Poidevin.

Grant Thornton presented their report to the banks on May 27, leading to the extension of the standstill agreement until October 31 to allow Queens Moat to prepare a medium-term strategic plan. The crisis prompted the appointment of new advisers and managers. Coopers & Lybrand replaced Bird Luckin as the firm's auditors and Morgan Grenfell were appointed financial advisers in May. On July 2, Andrew Coppell was appointed Chief Executive. Stanley Metcalfe, 61, formerly chairman of food manufacturer Ranks Hovis McDougal PLC, was appointed non-executive Chairman. Andrew Le Poidevin was appointed Finance Director. In the three months following the presentation of the Grant Thornton report, all the previous directors, other than non-executives John Gale and David Howell, resigned.

The second largest loss in history

On October 29, 1993 the Group finally released its results for the year ended 31 December 1992. These showed losses before taxation of £1,040m on a turnover of £384.m, the second largest loss ever recorded by a UK company. Exceptional losses amounted to £939m of this total, including £803.9m arising from the reduction below historical cost in the value of the group's properties since 31 December 1991. As a result of the losses, the consolidated balance sheet showed net liabilities of £388.9m. The Group's properties had been valued by Weatherall Green & Smith at £2.0bn at December 1991 and that valuation had been incorporated in the balance sheet. In May 1993, Weatherall Green & Smith presented draft valuations as at December 31, 1992 (£1.86bn) and March 31, 1993 (£1.35bn). The board then replaced Weatherall Green & Smith with Jones Lang Wootton who valued the properties as at December 31, 1992 at £861m. The difference in valuation from two reputable firms of surveyors has never been fully explained.

The Chairman's Statement explained the environment in which the new valuations had been prepared.

"In the UK and Continental Europe there was considerable hotel expansion in the late 1980s, fuelled by abundant availability of capital. Circumstances have changed materially over the past few years and the recent market place for hotels in the UK has been dominated by distress sale values... On the continent, the declining profitability has lagged the UK but the market place for hotels has shown similar adverse developments. It is this adverse context of declining profitability and limited purchasers' interest in hotels in which the valuation has been prepared."

At the same time, the adoption of more prudent accounting policies and the correction of errors also led it to a restatement of the 1991 results, reducing the 1991 £90.4m pre-tax profit to a loss of £56.33m. The remaining non-executive directors, David Howell and John Gale, resigned in early November following widespread criticism for their apparent ineffectiveness in controlling Bairstow and the executives. Bairstow remained unrepentant, commenting:

"When a company is run with an entrepreneurial flair, it is not the way accountants would run it... with everything done absolutely properly, and due diligence on every acquisition and disposal." (Financial Times, October 30, 1993)."

Exhibit 2a Share price performance – Feb 1982 to May 1991

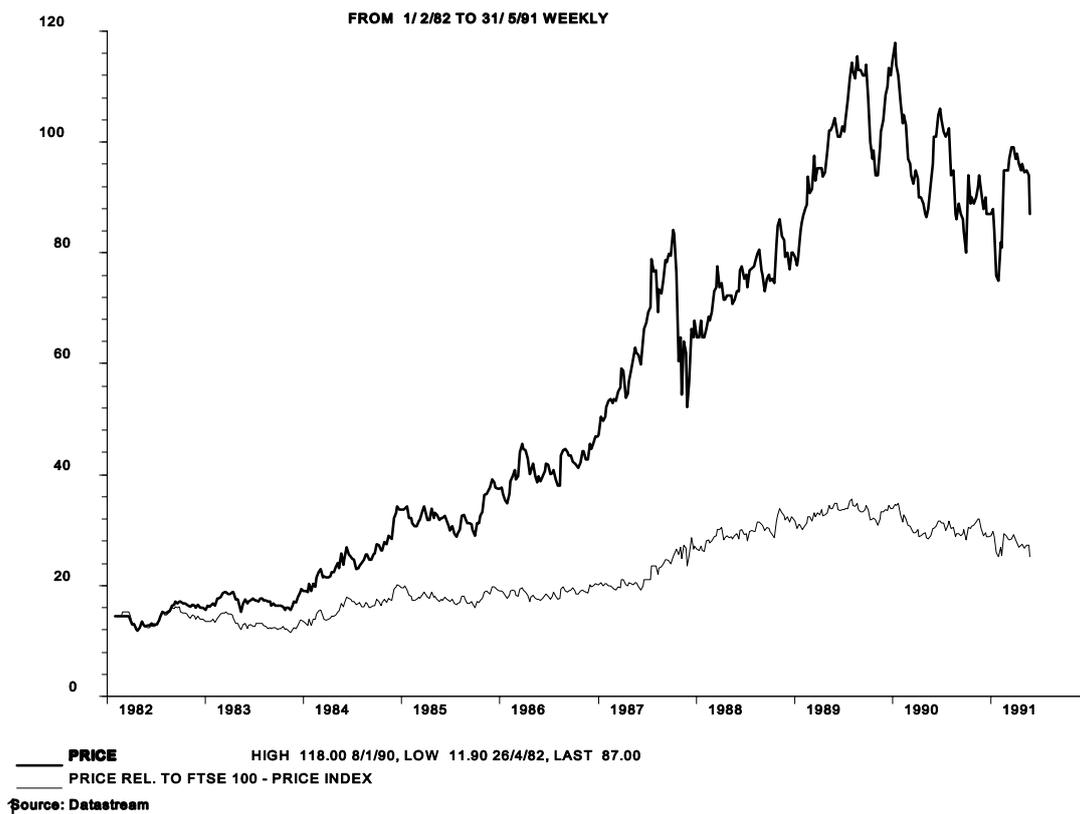


Exhibit 2b Share price performance – May 1991 to March 1993

