IHG Checks In On… Capital Allocation, Funding Arrangements and Financing Costs

20 February 2024

A fireside chat with Michael Glover, IHG Group CFO, and Hailey Laverty, VP Group Treasurer, hosted by Stuart Ford, VP Head of Investor Relations.

- Hello, I'm Stuart Ford, VP and Head of Investor Relations at IHG Hotels & Resorts. Welcome to IHG Checks In On… A series of mini teach-ins aimed at investors, analysts and other stakeholders looking to learn more about IHG. This is a series of videos, webinars and fireside chats which will dive deeper into how IHG operates and drives shareholder value.
- In our last episode, we looked at IHG's Luxury & Lifestyle portfolio of 6 brands which are growing particularly strongly and drive leading positions. That higher fee per key segment represents 14% of IHG's system size and 22% of our pipeline, and has doubled as a share of the portfolio mix from five years earlier.
- In the episode before that, we looked at IHG's System Fund: what it is, how it works, and why it is so effective, as well as how it forms a core part of the hotel owner value proposition and the enterprise platform that we provide.
- But today's episode is all about capital allocation, and we will be delving into how IHG uses the cash that the business generates, and how this links to the dividends we pay to shareholders and the potential to return additional capital to shareholders if that capital is surplus. We will also take a closer look at the funding arrangements that IHG has and the financing costs that the business bears.
- To do this, I'm joined by Michael Glover, IHG's Group Chief Financial Officer, and Hailey Laverty, Vice President and Group Treasurer.
- So, let's kick off.
- First then, on capital allocation, which is all about how IHG determines the right mix of its financial resources, with the goal of enabling growth opportunities for the benefit of all stakeholders and maximizing the returns for the owners of the company.
- Michael, can you set out for the audience how the Board approaches capital allocation?

Michael Glover, Group CFO (MG)

- Thanks Stuart, and I'm delighted to be here and talking about these topics.
- It's also great to be out at one of our hotels, in this case the fantastic Crowne Plaza Gerrards Cross.
- So, when we think about capital allocation, we start from a point of balancing the efficiency and the strength of the balance sheet.
- We want IHG to maintain what's known as an investment grade credit rating – for those who are unfamiliar with this, credit ratings are an independent evaluation of our ability to meet the obligations of the debt financing that we have. Currently, we have ratings with S&P and Moody's, two leading credit rating agencies, and I'm pleased to say IHG has always maintained an investment grade credit rating. This speaks volumes to the confidence these agencies have in our ability to service our debt.
- As I'll perhaps come on to, given our strong cash conversion profile, as well as the general resiliency of our business model, IHG maintained its investment grade credit rating even through the global pandemic, which was, of course, a period where our revenues, profits and cash flows significantly reduced. But as seen from our financial results for 2023, we are back to well above 2019 levels on all of these measures.

- So, when we look at wanting to be investment grade, a key metric to achieving that is our financial leverage ratio – how much debt the business has as a multiple of the profit that is generated, which gives an indication of the ability to service that debt.
- We have a target range of net debt to EBITDA of 2.5 times to 3 times. Our net debt is the gross debt obligations we have to banks and bondholders, less the cash and other short term investments that we hold. And EBITDA is a profit metric with the 'E', of course, standing for 'earnings' – before interest, tax, depreciation and amortisation.
- As a starting point, this ratio gives a good indication of the investment capacity available to the business from the cash we have generated.
- If there's surplus capacity, then we can look to return capital to shareholders.

SF

- OK, so before we get into how the Board looks at the options for the cash that's generated, Hailey can you remind us of IHG's track record in terms of the leverage ratio?

Hailey Laverty, VP Group Treasurer (HL)

- Sure. So the 2.5 to 3 times target range has effectively been consistent over a significant period, and presented in this way since 2018.
- Prior to that, the target range was 2 to 2.5 times, however the introduction of IFRS16 meant that the treatment of liabilities related to leases changed.
- This new accounting treatment meant that our reported net debt increased slightly and as a result we increased our target range to 2.5 to 3 times.
- Our target range has always been consistent with being an investment grade credit rating, and as Michael said, we've always maintained that.
- Our leverage has typically been in that range, though on a number of occasions, leverage at a specific balance sheet date was beneath the bottom of the range, particularly in the longer history of IHG when we were receiving sizeable proceeds from selling hotel assets.
- When those situations happened in the past, IHG had the capacity to return surplus capital to shareholders, which then subsequently increased the leverage back up into the target range.
- The impact of the Covid pandemic meant that our leverage – like virtually all companies in 2020 – went much higher.
- But by the end of 2021, our leverage was already back down to 3 times – the top end of the Board's stated target range. And, with the further rapid recovery of profitability, IHG's leverage was beneath the target range at both the end of 2022 and 2023.

SF

- That's great, thanks Hailey.
- So Michael, can you pick back up and explain how the Board evaluates the choices it has with the cash that is generated and the balance sheet capacity of IHG?

MG

- So, the Board's perspectives have not changed on the uses for the cash that we generate.
- We describe three priorities, in very clear order.
- First, we invest in the business in order to optimise growth, and that's the primary driver of shareholder value creation over the long term.

- So, we use the cash that we generate to invest in capital expenditure or occasionally in M&A, where in the past we've acquired some brands over the years such as Kimpton, Regent and Six Senses, and we've also invested in building new brands like avid, Atwell, voco, Vignette and our most recent brand launch, Garner.
- Second, from the cash that we generate, we want to fund a sustainably growing dividend. IHG has a really strong track record of dividend growth. From the demerger in 2003, the ordinary dividend has grown at a CAGR of 11%. It was briefly held flat during the 2008 and 2009 recession, and like most businesses we temporarily suspended dividend payments during Covid. But, we were quick in being able to restore it at the end of 2021 and we have grown it at 10% in 2022 and 2023.
- The third priority – and I emphasise again that these priorities are in order – is that, if there's surplus capital, which is where there is cash generation or leverage capacity that we don't have a need for in the business to drive a better return, then that surplus capacity gets returned to shareholders.
- So, those are the Board's priorities for the cash that we generate – first, invest to optimise growth; second, fund a sustainably growing ordinary dividend; and third, return surplus capital to shareholders.

SF

- Thanks Michael. I want to come back to IHG's track record of generating cash, but before that, Hailey can you set out what the profile of capital returns to shareholders has looked like?

HL

- Sure.
- So, there's the two streams that Michael has talked about.
- In terms of the ordinary dividend, if you go back to IHG's first year as a demerged company in 2003, there were dividends of just under 14 pence paid – we were, or course, still reporting in Sterling then. But, for comparison, this was equivalent to just shy of 24 cents.
- Fast forward 20 years, and the proposed final dividend in respect of 2023 takes the total dividend for the year to 152.3 cents, which is more than six times bigger.
- The dividend grew on average 11% through to 2019, and then it has grown at 10% a year since resuming dividend payments after Covid.
- Cumulatively, IHG has paid to shareholders $3bn in ordinary dividends since 2003, with the growth in the ordinary dividend reflecting the growth in IHG's earnings and our capacity to fund these shareholder returns after investing in the business.
- The second stream is the return of surplus capital.
- Over the last 20 years, IHG has returned an additional $12.4bn through a combination of special dividends and share buybacks.
- So special dividends were often used when there were cash proceeds received from the sale of a hotel property.
- But we are now all the way through that journey, as the business is fully asset light and typically doesn't own hotels outright anymore.
- Share buybacks were also used 6 times between 2004 and 2014 and then most recently in 2022 and 2023.
- So, when you add up all these distributions, over $15bn has been returned to shareholders.

SF

- So Michael, most recently, IHG has been using share buybacks. Can you talk us through that choice of buybacks versus special dividends a little more?

MG

- Sure. Well first, I'd say that in the past, when hotel assets were being sold, these were irregular and lumpy cash receipts, so using a special dividend was arguably the most appropriate vehicle to return those special inflows.
- Second, I'd say that to a large degree, IHG is agnostic between the two choices. The financial effect of the two is fundamentally identical for IHG. The same amount of cash goes out the business, whether that is paid to buy shares or paid out as a special dividend. When you buy back shares, your share count reduces. When you pay a large special dividend, it normally comes with a share consolidation to reduce the share count in the same way. Therefore, the accretion to earnings per share is the same in both cases.
- So the choice comes down to a number of other factors.
- First, if the inflow is special, then there's logic to using a special dividend.
- Second, there can be situations where major shareholders can have their own preference – if they want more income from their investments they may lean towards special dividends, or alternatively, they may place a greater value on the choice of actively participating in the buyback or not, rather than having to automatically receive an additional dividend.
- Over time, what's been seen is buybacks becoming much more common. Buybacks were always historically preferred by US investors. But they have now also become the norm in the UK and Europe.
- In the last two years, over half of the FTSE 100 companies have conducted share buyback programmes.
- In comparison, less than 10 have paid special dividends. And of those few that have, most of those companies have also undertaken buybacks, and so special dividends tended to be for very specific reasons.
- So why have buybacks become the prevalent option for returning surplus capital? Well for IHG, most of our large shareholders have expressed buybacks as their preference. That goes back to it being a mechanism which gives shareholders the choice of whether to crystallise an investment return or not. But for us as the company, a buyback programme is simple to manage and to do so over an extended period of time, and that also means it is flexible to market conditions or if other opportunities come up.

SF

- So, can we go back to remind the audience about IHG's cash flow characteristics, and how that has an important bearing on if there's surplus capital?

MG

- That's a very important point in all of this.
- IHG has an asset light business model and is highly cash generative.
- So what does that mean? Being asset light means that we don't need to invest large amounts of capital to grow our business. We've gone from an estate of 3,300 hotels 20 years ago to over 6,300 hotels today, without needing to fund construction of those assets. So, our capital expenditure needs are low in comparison to the financial scale of our business, and low in comparison to many other industries.

- As the business grows, we also don't have to invest large amounts of working capital. Many other businesses have to pay out significant amounts of cost up front, and then receive their revenue or fees further down the line – which in some industries can be years down the line – but that's not the case for IHG's business model.
- A key metric relating to this is cash conversion is that IHG typically converts more than 100% of its profits into free cash flow – that's the cash flow definition before discretionary investment choices like paying dividends, share buybacks or doing M&A.
- So, in short, we generate strong cash flows, and typically much of that is surplus and therefore can be returned to shareholders.
- This is an inherent attraction of IHG's business model to many investors. We can deliver attractive levels of growth in revenues and profits, and that profit turns into cash which can be regularly returned to shareholders.

SF

- Thanks Michael. Turning back to Hailey for this one - we generate cash, but IHG has significant amounts of debt. Why is this, and can you tell us more about that debt?

HL

- That's right, and that's very normal.
- The strength of our business model, track record and the outlook for IHG and our industry means we are able to have debt commitments at attractive rates of interest.
- This goes back to our target leverage, which is to have net debt that is 2.5 to 3 times the level of EBITDA profitability, and our investment grade credit rating, which gives lenders confidence in our ability to repay the debt and interest payments.
- A parallel here is similar to how individuals can have a mortgage, relative to their income levels.
- so, the debt that IHG predominantly has is bonds that we issue on publicly traded debt markets.
- We currently have 6 bonds outstanding, with maturities – that's the date that we need to repay it by – spread fairly evenly between later this year and the end of 2029.
- We last raised a bond in November 2023, and that was for general corporate purposes which will include using the proceeds to repay one of our other bonds that matures in October of this year.
- Our blended cost of debt is 3.7% and it is the strength of our balance sheet which means we can optimise our capital structure through the mix of lower cost debt and the higher cost of equity which is reflected in the rates of return that shareholders expect and which ultimately sets the share price.

SF

- And we've recently changed the currency mix of some of our debt?

HL

- Yes. Historically, all of our bonds were either issued in Sterling, or issued in Euros that we then swapped into Sterling. Whilst US dollars became our presentational reporting currency in 2008, Sterling is still the functional currency of our UK companies from an accounting point of view.
- So we swapped the most recent bond we issued into US dollars, and we have effectively hedged another 1 billion dollars of our Sterling debt.
- So, of our reported net debt at 31 December 2023 of 2.3 billion dollars, around 1.2 billion of that is actually in dollars after those swaps, and the other 1.1 billion dollars is actually in Sterling.

- This is what gives rise to a translational FX exposure on our net debt, and because Sterling weakened against the US dollar by going from 1.20 at the end of 2022 to 1.27 at the end of 2023, this drove an adverse foreign exchange impact which increased our net debt by 105 million dollars as at 31 December 2023.
- However, in recent months, by swapping some of our debt into US dollars, we have reduced the exposure and volatility of our net debt to currency movements going forwards, however the absolute impact will still depend on changes in FX rates.
- If we swapped all of our remaining UK sterling debt into US dollars, we could end up with a significant translational FX impact that goes through the Group's income statement. You can only do what's called 'net investment hedge accounting' and take the FX impact reserves, if you have corresponding assets in the same currency. IHG has some US dollar assets, but we are an asset light business and therefore we would not be able to use net investment hedge accounting for all of our debt.
- But in recent months, we have been working hard to put in place new structures so that we can have an increased proportion of debt in US dollars, which has reduced the balance sheet translational exposure, and not created any income statement exposure.

SF

- Thanks Hailey. OK. So, we know what debt IHG is using and what currency it is in. Michael, you updated the market recently and guided that the Group's adjusted interest expense would be rising. It was an expense of 122 million dollars in 2022, we reported that it increased to 131 million in 2023, and you've guided that it would be between 155 million and 170 million in 2024. Can you talk us through that?**MG**
- That's correct.
- In terms of 2023, that rise in interest costs takes into account that our overall net debt was higher in 2023 than it was in 2022.
- There is also the new bond that we issued in November of 2023, so there is a month or so of having that new tranche of debt that is at a higher rate.
- And there is also an effect from the System Fund. Within our adjusted interest expense, we include an interest charge which IHG incurs because we sit on an accumulated balance of cash that is received in advance of when loyalty programme points are consumed further down the line. That is an interest expense to IHG, but an interest income to the System Fund which contributes to its overall capacity.
- The interest expense to the System Fund increased in 2023 due to an increase in the rate, which is driven by the SOFR rate, the standard benchmark rate for overnight lending.
- Therefore, the expense we paid to the System Fund was 44 million dollars in 2023, whereas it was only 16 million dollars in 2022.
- When we think about interest expense in 2024, it's about those same three drivers.
- First, net debt will be higher – we are returning a further 1 billion dollars to shareholders, which is the combination of the 800 million share buyback programme in 2024, together with our cash outflows for the ordinary dividend. But do remember that whilst net debt will be higher, we have said that we still expect to be around the bottom of our target leverage range of 2.5 to 3 times.
- Secondly, the blended borrowing cost will be higher. Our bonds, which are fixed, were at a blended borrowing rate of 3.1% through most of 2023. From the start of 2024, that is now 3.7% due to the recent issuance.
- It is these two drivers which lead to the overall expected increase in net interest expense.

- The third component is the System Fund interest. We expect the loyalty programme balances to continue increasing, reflecting both the success of the growing programme and our expanding system size. But we don't know what the benchmark interest rate will be. So, the expense could be a bit higher than 2023's 44 million dollars, or it could be lower if base rates start to come down later in the year. That's the predominant reason why we guide to a range.

SF

- Thanks Michael. And then to close, I just wanted to come back to the share buyback programme for 2024, and any further context around it that you wanted to share with the audience.

MICHAEL

- Sure.
- What I'd say is, IHG's business model is expected to continue its strong track record of generating substantial cash flows. This drives capacity to fully deliver our investment plans which underpin future growth, and provides funding for a sustainably growing ordinary dividend. Then – and only then, after those two priorities are met – it also enables capacity to routinely return surplus capital to our shareholders.
- As part of this, in 2022 we completed a 500 million dollar buyback. In 2023, a programme returned another 750 million dollars. And in 2024, we've announced a further buyback for 800 million dollars this year.
- The ability to regularly do share buybacks is a very common practice particularly for asset light business models such as ours.
- We will always look at alternatives – if there are opportunities to invest inside the business, or to do acquisitions - just as we've done in the past with brands such as Kimpton, Six Senses and Regent – then we will do those wherever and whenever they drive superior returns for our shareholders over the long term.
- So, I'd expect investors to see IHG's ability to return additional capital as a core part of our growth algorithm and investment case.
- Within our 2023 financial results, we set out a reminder of how we see our growth algorithm over the medium to long term:
    - High single digit fee growth through the combination of RevPAR growth and net system size growth.
    - Then those two fee drivers together enable 100-150 basis points of fee margin improvement a year on average.
    - We expect to keep converting 100% of earnings into cash flow.
    - And that cash will fund investment into the business to support growth, followed by growing the ordinary dividend.
    - But it is expected that there will be surplus capital that we can additionally return to shareholders, such as through annual share buyback programmes.
    - And bringing those all together, means that we see the opportunity to for compound growth in adjusted earnings per share of 12 to 15 percent annually over the medium to long term.

SF

- Thanks Michael, and thank you Hailey.
- Well, that wraps up another episode of IHG Checks In On…
- You'll find past editions on IHGplc.com, under the investors section of the website.
- That's also where you will find our full year results announcements and presentations, including the details of the $800 million share buyback programme for 2024.
- And you'll also find our webcast providing an update on IHG's strategic priorities, which accompanied the release of the 2023 full year results. Many thanks.

[[[END.]]]