

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

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A fireside chat with Michael Glover, IHG Group CFO, and Stuart Ford, SVP Head of Investor Relations

Stuart Ford, SVP, Head of Investor Relations (SF)

- Hello, I'm Stuart Ford, SVP 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.
- 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.
- This is a topic that we've looked at before, but given it's central to IHG's growth algorithm, and given we have announced another share buyback – the fourth year in a row – this time for 900 million dollars, we wanted to talk back through it with Michael Glover, IHG's Chief Financial Officer.
- Before we get started, to note for you that in previous episodes of 'IHG Checks In On...', we've covered a bunch of topics, from primers on our System Fund and Luxury & Lifestyle portfolio, all the way through to a deep dive on the NOVUM Hospitality agreement signed last year.
- Just as a further 'advert' for IHG's additional briefings for investors and analysts, I'd note that alongside our 2024 full year results reporting, there's an additional presentation with Catherine Dolton, IHG's Chief Sustainability Officer, in which she gives the latest update on Carbon & Energy - a key area of our 'Journey to Tomorrow' responsible business plan.
- But back to today's episode, which is all about capital allocation, and we will be delving into how IHG uses the cash we generate, and how that links to the dividends we pay and the potential to return additional surplus capital to shareholders. We will also take a closer look at the funding arrangements that IHG has and the financing costs that the business bears.
- And, to do this, I'm joined by Michael Glover, IHG's Group Chief Financial Officer.
- So, let's kick off!
- Good morning Michael!

Michael Glover, Group CFO (MG)

- Morning to you, Stuart, and I'm delighted to be here and talking about these topics.

SF

- OK, first then, on capital allocation, which is all about how IHG determines the right mix of its financial resources in order to enable growth opportunities for the benefit of all stakeholders, and maximise the returns for the owners of the company.
- Michael, can you set out for the audience how the Board approaches capital allocation?

MG

- 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. We currently 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.

- A key metric in maintaining our investment grade rating 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 debt capacity to reach our target range, 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, let me remind the audience of IHG’s track record in terms of the leverage ratio.
- So the 2.5 to 3 times target range has effectively been consistent 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.
- That new accounting treatment meant that reported net debt increased slightly, and as a result IHG increased its target range to 2.5 to 3 times. On the chart we’ve hopefully got up on screen for the audience, we are showing the target range as the shaded area.
- Our target range has always been consistent with maintaining an investment grade credit rating, and as you just said Michael, we’ve always done just that.
- Our leverage has typically been in or around 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 the company was receiving sizeable proceeds from selling hotel assets.
- You can see on the chart, in years such as 2013 and 2015, that IHG had the capacity to return surplus capital to shareholders, which then subsequently increased leverage back up into the target range.
- So the blue line on the chart is that actual reported leverage, and the orange line is where leverage was on a pro forma basis, taking into account the subsequent capital returns that IHG put in place.
- What the chart also shows is the impact of the Covid pandemic which 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 the end of 2022, 2023 and 2024 as well.
- 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 that IHG has?

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.
- We use the cash that we generate to invest in capital expenditure or occasionally in M&A, where we’ve acquired brands such as Kimpton, Regent and Six Senses in recent years. We’ve also invested in creating new brands like avid, Atwell, voco, Vignette and our most recent launch, Garner. We might come back to this point, but alongside announcing our 2024 full year results, we also announced the acquisition of the Ruby brand, and so that has an interplay with how we think about capital allocation, specifically in 2025.

- Second, from the cash 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 percent. It was briefly held flat during the 2008 and 2009 recession, and like most businesses we temporarily suspended the dividend payments during Covid. But, we were quick in being able to resume it at the end of 2021 and we have grown it at 10 percent in each of 2022, 2023 and 2024.
- 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 immediately need for growth investment, then we look to make incremental returns to our shareholders beyond the ordinary dividend.
- 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, I'm going to pull up some other charts so the audience can see the profile of the capital returns to shareholders that you just explained.
- 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 in that year – IHG was still reporting in Sterling then. But, for comparison, it was equivalent to just shy of 24 cents.
- Fast forward 21 years, and the proposed final dividend in respect of 2024 takes the total dividend for the year to 167.6 cents, which is seven times bigger.
- As you said Michael, the dividend grew on average 11 percent through to 2019, and then it has grown at 10 percent a year since resuming dividend payments after Covid.
- Cumulatively, IHG has paid \$3.3bn to shareholders 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.
- Far in excess of this, though, has been the return of surplus capital.
- The left chart on this next slide shows how IHG has returned an additional \$13.2bn through a combination of special dividends and share buybacks to reach total shareholder returns of \$16.5bn.
- And on the right chart, you can see the split between the sources of those returns.
- Further back in IHG's past, special dividends were often used when there were cash proceeds received from asset disposals when IHG still had some hotel properties to sell, and that was a source of almost \$8bn.
- But as a business, we are now all the way through that journey - IHG is essentially fully asset light as we don't own hotels outright anymore. In fact, on the figures we just reported for the end of 2024, IHG had a total estate of over 6,600 hotels, and just 16 of those – that's one-six – were asset heavy, which are the few hotels where IHG ourselves are leasing the property. The journey of unlocking asset value was completed many years ago, in fact way before my time of arriving at IHG!
- Back on that journey though, share buybacks were used 5 times between 2004 and 2014 and then more recently they've been used in each of 2022, 2023 and 2024.
- So, when you add up all those additional capital returns, it's over \$13bn that has been returned to shareholders on top of the dividend payments.
- And here's one more chart which is a table from our annual report, which runs down the different programmes over IHG's track record. On the table, the shaded ones are the buybacks.
- 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, IHG would receive irregular and lumpy cash receipts, so using a special dividend was arguably the most appropriate vehicle to return those variable 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 of the business, whether that is paid to buy shares or is 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 effectively the same way as a buyback. 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 have their own preference – if they want more yield 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 the additional dividend.
- Over time, we have seen buybacks become much more common. Historically, returning capital in this manner was generally more preferred by US investors. But they have now also become the norm in the UK and Europe.
- In the last three years, more than 60 of the FTSE100 companies conducted share buyback programmes. In fact, almost half of the FTSE100 conducted one in 2024, so this is not just a post-Covid thing. 38 of these companies have done a programme in each of the last 3 years, of which IHG is included.
- In comparison, only 11 FTSE100 companies have paid special dividends in recent years. 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. And then for us as the company, a buyback programme is simple to manage, and it can be executed over an extended period of time, which means it's flexible to market conditions and can be adjusted if opportunities come up.

SF

- So Michael, let me just cover off another chart, which shows the types of returns but just over the last three years.
- Here, the audience can see the \$2.8bn that has been returned to shareholders cumulatively through 2022 to 2024.
- \$700m of that is through ordinary dividends, which have been growing at 10 percent a year.
- And just over \$2bn has been through the aggregate of the \$500m share buyback in 2022, the \$750m in 2023 and then last year's \$800m programme.
- So Michael, 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 which 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 around 3,000 hotels 20-odd years ago to over 6,600 hotels today, without needing to fund construction for those thousands of assets. 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 – and in some industries it 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 – you are going to put up the chart on this for the audience, right?

SF

- It'll be up on screen for them now...

MG

- OK, so the point about cash conversion is that IHG typically converts around 100 percent of its profit – our adjusted earnings metric, to be precise – into free cash flow. That's the cash flow definition before discretionary investment choices like paying dividends, share buybacks or doing other types of discretionary investments such as acquisitions.
- 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. It enables us to deliver attractive levels of growth in revenues and profits, which in turn efficiently converts into cash, and that cash can then be regularly returned to shareholders.

SF

- OK, so lots of cash being generated.
- This bar chart shows IHG's earnings - they're the orange bars, and the free cash flow generated – the blue bars. The blue free cash flow bars are typically similar to, and sometimes above the orange earnings bars, hence the conversion ratio of profit into cash is 100 percent or greater. And that's demonstrated too by showing the conversion percentage line which is measured against the right-hand axis of the chart.
- So if IHG's generating all that cash Michael – and the chart shows that over the last decade cumulatively the business has generated over \$5bn of free cash flow – then why does IHG also have significant amounts of debt?

MG

- That's right, we have debt, 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.
- By not exceeding this level, lenders have confidence in our ability to meet our interest payments and our debt repayments.
- We've talked in past conversations that the simple 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 we need to repay them by – spread fairly evenly between later this year and September of 2031.
- We last raised a bond in September 2024, and that was for general corporate purposes which included using the proceeds to repay one of our earlier bonds that matured in October last year.
- Our blended cost of debt is just over 4 percent, 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.
- A share buyback programme – or a special dividend when combined with a share consolidation – reduces levels of higher cost equity in a business's capital structure and replaces it with cheaper to service debt financing.
- This goes back to the basic mortgage example – the rate of return that a bank requires is lower because their loan is secured on the property and they are receiving a regular stream of interest payments. The rate of return that an equity investor would require to finance your house is higher, as they take the risk that their investment could go down as well as up, whereas mortgage lenders should get the full value of their loan back, and equity investors aren't guaranteed to receive a regular income stream either.

SF

- OK, so we are financed partly by debt, and over the last couple of years you've been progressing with changing the currency mix of some of our debt?

MG

- Yes. Historically, all of our bonds were either issued in Sterling, or issued in Euros that we swapped into Sterling. Whilst US dollars became our presentational reporting currency way back in 2008, Sterling is still the functional currency of our UK legal entities from an accounting point of view.
- So we've swapped the two most recent bond issues into US dollars, and we have effectively hedged another 1 billion dollars of our Sterling debt.
- So, of our reported net debt at 31st December 2024 which was 2.8 billion dollars, 1.9 billion of that is actually in dollars after those swaps and net of cash we hold in dollars, then there's 1 billion dollars which is in Sterling, and then small amounts in other currencies.
- By swapping more of our debt into US dollars in the last couple of years, we have reduced the balance sheet translational exposure and the volatility of our net debt to currency movements.
- We do still have that net 1 billion dollars' worth of debt that is actually in Sterling. If we swapped all the Sterling debt into US dollars, we could end up with a significant translational FX impact that goes through the Group's income statement. A company can only do what's called 'net investment hedge accounting' and take the FX impact to reserves if the company has corresponding assets in the same currency. IHG has some US dollar assets, but we are an asset light business so we are not able to use 'net investment hedge accounting' for all of our debt.
- So over the last two years, we've worked hard to put in place new structures that have optimised a reduction in translational exposure and not created any income statement exposure.

SF

- OK. So, we know what debt IHG is using and what currency it is in. Michael, you updated the market with the FY24 results and guided that the Group's adjusted interest expense would be rising again in 2025. It was an expense of 131 million dollars in 2023, we reported that it increased to 165 million in 2024 - now you've guided that it will be between 190 million and 205 million in 2025. Can you talk us through that?

MG

- That's correct.
- In terms of what we've just reported for 2024, that rise in interest costs takes into account that our average net debt was higher in 2024 than it was in 2023. That was driven by the outflows of cash that we returned to our shareholders through the dividend payments and share buybacks.
- There was also the new bond that we just mentioned which was issued in September 2024 - this was at a higher rate than the bond we repaid in October of 2024. Its important to be clear that this change in rate reflects the broader macro conditions and base rates – IHG itself is the same investment grade credit rating.
- And there was 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 we receive in advance of when loyalty programme points are consumed. 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 2024 due to the higher System Fund balances that IHG was holding.
- Therefore, the expense we paid to the System Fund was 50 million dollars in 2024, whereas it was only 44 million dollars in 2023.
- When we think about interest expense in 2025, it's about those same three drivers.
- First, net debt will be higher – we are returning a further 1.1 billion dollars to shareholders, which is the combination of the 900 million dollar share buyback programme in 2025, together with our cash outflows for the ordinary dividend. But do remember that whilst net debt will be higher, we have said that we will 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 3.7 percent through most of 2024. From the start of 2025, that is now 4.2 percent 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 growing the 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 2024's 50 million dollars, or it could be lower if base rates come down later in the year. That's the predominant reason why we guide to a range at the start of the year.

SF

- Thanks Michael. And then to close, I just wanted to come back to the share buyback programme for 2025, and any further context around it that you wanted to share with the audience.

MG

- 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 sustainably growing the 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. Then in 2024 we did 800 million dollars. And now for 2025, we've announced a further buyback of 900 million dollars.
- 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.
- There's the case in point that at the same time as announcing the new 900 million dollar share buyback programme for 2025, we've also announced the acquisition of the Ruby brand for over 100 million dollars. We see a great opportunity to drive significant shareholder value from that acquisition.
- 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 2024 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 and net system size growth.
 - Fee margin improvement of 100-150 basis points a year on average.
 - We expect to keep converting around 100 percent of earnings into cash flow.
 - And that cash will fund investment in 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 together, it means that we see the opportunity for compound growth in adjusted earnings per share of 12 to 15 percent annually over the medium to long term.

SF

- Thanks Michael.
- Well, that wraps up another episode of IHG Checks In On...
- You'll find past episodes 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 \$900 million share buyback programme for 2025.

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