IHG Checks In On: The System Fund

Hello and welcome to "IHG Checks In On…", a series of mini teach-ins aimed at investors, analysts and other stakeholders who want to get to know IHG better. This will be a series of short videos, webinars, 'fireside chats' and other materials where we will take a deeper dive into how IHG operates and drives value.

This episode of "IHG Checks In On…" is all about the System Fund. We are checking in on what the System Fund is, how it works, and why it is so effective for our owners.

The System Fund is a core part of IHG's hotel owner value proposition. By collecting and utilising fees from all the hotels that are part of IHG's system, IHG drives incremental demand to hotels along with operating efficiencies and cost savings. This is done through how we carry out marketing and sales activities, how we provide the Guest Reservation System, how we deliver direct bookings through our channels, how we run the loyalty programme 'IHG One Rewards', and so much more on behalf of all our hotel owners, collectively.

It's called the System Fund because all hotels in IHG's system – that's over 6,000 hotels globally – contribute to and benefit from this singular fund. The System Fund should be thought of as funds which IHG collects and spends on the behalf of owners, doing so in a way that drives scale benefits and leverages the skills, capabilities and investments that are being made collectively for all IHG hotels, system-wide.

The framework on which the System Fund is administered is defined within the System Fund Letter, a commitment between IHG and the IHG Owners Association. Key principles of this agreement include:

- …that the IHG Owners Association has a general oversight role, with the right to provide "advice and counsel" on System Fund investments, though IHG retains final decision-making authority;
- …which revenues comprise the System Fund, as well as the parameters for reasonable cost allocation of corporate expenses; and
- … the agreed upon procedures relating to third party audits to ensure that IHG is fairly administering the System Fund.

The obligations of the System Fund are also written into all hotel franchise and management agreements.

So, what are the benefits of the System Fund?

It is all about the scale, skills and capabilities of individual hotels coming together as part of one global system and enterprise platform. For example, the software and technology which underpins the guest experience – from reservations systems to revenue management, from the mobile app to the loyalty programme – doesn't come cheap. Developing a best-in-class tool, like IHG's Guest Reservation System has cost hundreds of millions of dollars of investment – something which would be out of reach for an independent hotel, or even a small to medium size group. By being part of IHG's system, hotel owners gain the advantage from having access to these leading-edge technologies, ensuring that they maintain a competitive edge.

It doesn't stop at technology either. Ever seen an advertisement such as IHG's 'Guest How You Guest' campaign on television? Or how about a billboard in an airport showcasing one of our brands? The spend for this marketing would have been funded through the System Fund. Being part of the System Fund means that owners are benefitting from marketing budgets that are magnitudes bigger than owners would be capable of generating individually, further enabling them to capture demand and revenue into their hotel.

So how is the System Fund… funded? The two core revenue streams are:

- IHG One Rewards assessments, and;
- Marketing and Reservations assessments – also sometimes referred to as Services Contribution.

…both of these we're going to look at in detail. Aside from these, there are also other performance-based fee streams, including travel agent commissions and revenue management for hire - but to keep things simple, we've included these within marketing and reservations fees in the chart.

Revenue coming into the System Fund totalled over one-point-two billion dollars $1,217m in 2022. Deployment of this revenue is planned so that, over time, the System Fund is breakeven on a cash flow basis. However, due to the revenue recognition implications of IFRS15, the System Fund usually results in an accounting loss on IHG's P&L each year while ever there is a growing loyalty programme, and we'll come back to why this is later when we look at the administration of IHG One Rewards.

First, let's take a look and marketing and reservations assessments.

Generally, all hotels in IHG's system – whether franchised, managed, or leased managed – pay marketing and reservations assessments into the System Fund. These assessment fees are generally levied as a percentage of hotel rooms revenue, and are recognised as those revenues occur.

IHG hotels typically pay around 3% of total rooms revenue as marketing and reservations assessments into the System Fund.

Hotel owners usually pay these assessments to IHG on a monthly basis, therefore cash generation is closely aligned to revenue recognition.

As marketing and reservations fees are linked to hotel room revenues, System Fund income from these sources can fluctuate with industry hotel performance. Usually, this means these fees increase year-on-year, given hotel RevPARs generally increase under normal macro-economic conditions, and because the number of hotels in IHG's system also typically grows.

However, there have been rare situations when sudden, unanticipated shortfalls have formed in marketing and reservation assessments. For example, all non-loyalty related assessments received from hotels totalled just over one billion dollars $1.03bn in 2019, and dropped by over 50% to 490 million dollars a year later due to the Covid-19 pandemic. There was a spending plan initially in place for 2020 assuming similar receipts to the prior year, and therefore IHG's teams had to quickly adapt and reprioritise when unexpected circumstances meant this was no longer the case. This is an extreme example, but careful planning and forecasting of assessments by IHG underpins the effective utilisation of the System Fund resources, and ensures that the Fund is always breakeven on a cash flow basis over time.

> In accounting terms, this is relatively simple on both sides of the equation. Let's take the example of a guest paying $1,000 dollars to stay in one of our hotels, and for simplicity, ignore all other fees and assessments. With marketing and reservations assessments typically being 3% of gross rooms revenue, the hotel will recognise a $30 payable to IHG's System Fund, while IHG's System Fund will recognise a $30 receivable. Each of these entries will then be reversed when the hotel owner pays their monthly fees and assessments to IHG to go into the System Fund.

Let's now look at the recognition of revenue relating to our loyalty programme, IHG One Rewards.

Under its franchise and management contracts, IHG's System Fund is entitled to receive assessments from hotels when an IHG One Rewards 'earning stay' occurs. The assessment is based on the total qualifying hotel revenue from IHG One Rewards members, and is an assessment fee paid to the System Fund typically at 4.75% of the hotel bill. In exchange for these assessments, IHG is required to administer the IHG One Rewards programme and arrange for the provision of future benefits to members who are redeeming points. When an IHG One Rewards member redeems points for a hotel stay, the hotel where the redemption – or 'burning stay' – occurs is paid a reimbursement.

All assessments and expenses relating to the IHG One Rewards loyalty programme are recognised within the System Fund, where they are allocated between points and Milestone Rewards benefits based on their respective stand-alone selling prices.

We will come back to the how redemptions of IHG One Rewards points work in a little while.

But first, let's look at how the System Fund spends the assessments it receives.

As mentioned, advertising spend, whether it be digital, television or radio, is funded through the System Fund. In 2022 alone, the System Fund spent more than $400m on external vendors, covering activities such as global, regional and localised marketing, and the potential for this to grow will increase as more and more hotels join IHG's system and contribute more and more marketing and reservations assessments.

But it doesn't stop there – any activities which relate directly or indirectly to sales, marketing, reservations and brand management are paid for via the System Fund. This spend can take many forms, including public relations, market research, promotions, and other related activities.

So what <u>isn't</u> included? Investment in the initial establishment of new brands is financed by IHG directly, rather than by the System Fund, as are activities relating to protecting the intellectual property rights of IHG's brands. Similarly, costs associated with developing and marketing IHG's franchise offering to prospective hotel owners – as opposed to advertising the brands to guests – are also excluded.

Advertising and marketing costs therefore have to be appropriately allocated to the System Fund. This is also the case with staff costs. The System Fund itself doesn't employ staff – instead, employee costs are allocated in proportion to their support of the relevant System Fund activities. As well as salaries, other related expenses, like travel expenditure, and corresponding business support costs, such as finance, human resources and legal, are allocated in this way. The System Fund spent just over $340m on direct staff costs in 2022.

What about investment spend, such capital expenditure?

All System Fund capital expenditure is initially paid for by IHG. Depreciation and amortisation is then recorded as a System Fund expense, reducing the capacity to spend in other areas and therefore enabling IHG to recover the cost of the asset. This is a further reflection of how the System Fund is breakeven on a cash flow basis over the longer term. Capital investments on behalf of the System Fund would include spend on the Guest Reservation System, investment in the loyalty programme, or technology which directly benefits our brands and owners. In the same way as with day-to-day income statement expenditure, IHG's hotel owners are benefiting from the scale, skills and capabilities of how investment is carried out on their behalf across capital investments that are being leveraged across more than 6,000 hotels in the system.

If you'd like to know more about the accounting treatment for capital expenditure, click here.

The System Fund is run on a cash-flow neutral basis over time. However, timing differences mean that on a short-term basis, there may be temporary cash flow surpluses and deficits – often this is driven by loyalty, but it can also be as a result of capital expenditure.

> Let's take a look at an example to explain why this is.
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> In most years, System Fund capital expenditure has averaged somewhere between \$30m-\$40m. When steady state spend was at this level, corresponding depreciation and amortisation charges were at a similar level, and therefore the cash flow impact of capital expenditure was broadly neutral to IHG. IHG would make capital investments on behalf of the System Fund totalling \$30m-\$40m and would receive similar levels of cash back from the System Fund, refunding the previous capital investments.
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> However, there have been instances where higher levels of capital spend were required on behalf of the System Fund, with a key example being the investment in the Guest Reservation System. This project required approximately \$300m of spend over several years, and therefore the upfront cash investment required from IHG during this period far exceeded the cash IHG recuperated from the depreciation and amortisation of previous spend. Therefore, System Fund capital expenditure was cash flow negative to IHG. However, after the GRS project was completed, System Fund spend returned to normal historic levels, but depreciation and amortisation was elevated due to the spend on GRS. This meant that IHG was recuperating more cash from refunded System Fund expenditure than it was spending on new capital investments.
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> Over time, System Fund capital expenditure is neutral on a cash flow basis to IHG. The initial investment made on behalf of the System Fund gets fully refunded via depreciation and amortisation payments. However, due to the 'lumpiness' of spend, there may be times when a short-term capital expenditure net inflow or outflow occurs.

Let's return to how the System Fund is responsible for the IHG One Rewards loyalty programme, and what happens when a guest redeems their loyalty points, and how the hotel at which they are staying is reimbursed via the System Fund.

Core to why, following the implementation of IFRS15, the System Fund is likely to report an accounting deficit while ever the loyalty programme is growing, is the accounting treatment regarding deferred income recognition.

When an assessment is received by the System Fund, it is deferred in full on IHG's balance sheet until the guest redeems the points or receives the benefits promised from their Milestone Reward (for example utilises their annual Club Lounge membership or confirmable suite upgrade). When the points and benefits are redeemed, the System Fund recognises revenue according to the number of points and benefits redeemed, as well as a cost equal to the expense of reimbursing the hotel for the guest stay, which is also recorded ad a reduction to net revenue.

So, the growth in the IHG One Rewards programme means that, although assessments are received from hotels up front when a member earns points, more revenue is deferred each year than is recognised in the System Fund P&L. This can lead to accounting losses in the System Fund each year as the deferred revenue balance grows.

> When a guest redeems points or other benefits at a franchised or managed hotel, or exchanges points for airmiles or another third-party benefit, IHG is acting as agent for that hotel or third party. This is because IHG is not principally responsible for providing the hotel stay or any other award to the guest. For instance, if a guest exchanged a point for airmiles and booked a flight which was then cancelled, IHG would not be responsible. The revenue recognised when points and benefits are redeemed is therefore recorded net of the cost of reimbursing the hotel for the stay or the provision of the related benefit.
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> If points and benefits are redeemed at an IHG owned or leased hotel (of which there are only 16 out of more than 6,000 hotels in our system), the reimbursement is an intercompany transaction, which will be eliminated.
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> When determining the allocation and recognition of revenue, 'breakage' is considered, which is an estimate of the number of points and/or benefits that will never be redeemed. On an annual basis, the Group engages an external actuary to assist with this estimate. Breakage adjustments increase/decrease the deferred revenue balance, with a corresponding change in System Fund revenue for the year.
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> The deferred revenue balance replaces the points liability that was recognised prior to introduction of IFRS15. It includes 'margin' to the System Fund over and above the cost of reimbursing the hotel which is only recognised when points or other benefits are redeemed. This 'margin' covers the System Fund's expenses of running the programme which are expensed as incurred.

Lets take a look at an example:

Step 1. A guest stays at an IHG hotel and pays $1,000 for their stay. IHG will invoice the hotel a loyalty assessment of $47.50, and the guest will receive IHG One Rewards points (Illustratively 4,250) and also earns a fraction of a milestone benefit.

The assessment is allocated between points and milestone benefits, taking into account expected breakage (the proportion of points and benefits awarded not expected to be redeemed) and, in the case of milestone benefits only, the expected benefit election expected to be made (meaning the choice the guest is ultimately expected to make between the different milestone benefits on offer).

The hotel pays the assessment to the System Fund on a monthly basis in the same manner as paying other assessments (such as Marketing & Reservations). So it is at this point when cash inflows relating to growth of IHG One Rewards is received by the System Fund.

Step 2. IHG System Fund incurs an admin cost for running the programme (for illustrative purposes, $5).

Step 3. The guest redeems the entire value earned (i.e. 4,250 points) for a subsequent stay at a hotel, utilising their selected milestone benefit in full during the stay.

NB: some milestone benefits, such as suite upgrades and lounge access, provide benefit over a specified period of time: revenue would be recognised in line with the provision of the underlying service to the IHG One Rewards member i.e., over that period of time.

Step 4. The System Fund reimburses the hotel $42.50 via a reduction to the System Fund assessments invoice.

This is therefore in essence the timing delay of when the cash ‘outflow’ occurs. IHG receives cash at Step 1 and incurs an overhead cost, however it is not until Step 3, when the guest redeems their points (which could be months later) when the revenue is recognised and there is a cash “outflow” to the owner (though this outflow is more likely to be netted off against newer IHG One Rewards assessments.)

Let’s return to consider the overall impact of the System Fund on the presentation of IHG’s financial results.

Since the adoption of IFRS15 for the 2018 financial year, revenue and cost for the System Fund has been included on IHG's statutory Group Income Statement. This has therefore been a relatively new accounting change, and before this, System Fund income and expenses were deferred to the balance sheet, and not as part IHG's Group Income Statement.

The growth in the IHG One Rewards programme means that although assessments are received from hotels up front when a member earns points, more revenue is deferred each year than is recognised in the System Fund. This can lead to accounting losses in the System Fund each year as the deferred revenue balance grows which do not necessarily reflect the Fund's cash position and the Group's capacity to invest.

In 2022, the reported System Fund loss increased by $94m to $105m, reflecting accelerated investments in consumer marketing, loyalty and direct channels, largely driven by the transformation of the Group's loyalty programme and its growth.

Within IHG's cash flow statement for 2022, working capital movements included $108m of cash inflow related to deferred revenue, driven primarily by the loyalty programme.

The System Fund result included in IHG's Group Income Statement is excluded from reporting disclosures relating to Operating Profit from Reportable Segments. Therefore, System Fund losses, as a result of the implementation of IFRS15, do not impact the interpretation of our performance. Similarly, these losses are also excluded from credit rating agency assessments and therefore do not impact the decision-making process for returning capital to our shareholders. Practically speaking, IHG's business operations, its cash profitability, leverage workings, nor its financing arrangements or assessment changed in any way as a result of the implementation of IFRS15.

In summary:

- The System Fund is managed for the benefit of hotels in the IHG system and their third-party owners, who pay contributions into it, with the objective of driving incremental revenues and profits for those hotels and their owners. On a financial basis for IHG itself, it is managed so that it generates neither a surplus nor a deficit over the longer term.

- Given the significant scale of the System Fund, IHG can make substantial investments in marketing brands, creating a leading loyalty programme and in powerful technology, thereby further strengthening the IHG enterprise platform.

- By collecting and utilising System Fund fees on behalf of over 6,000 hotel globally, IHG is driving scale benefits and leveraging substantial skills, capabilities and investments such as in its Guest Reservation System and the IHG One Rewards loyalty programme collectively for all its hotel owners, system-wide.

We hope you've enjoyed this edition of IHG Checks In On… and look forward to have you joining us on for other topics in our series of mini teach-ins aimed at investors, analysts and other stakeholders who want to get to know IHG better and take a deeper dive into how IHG operates and drives value.

In the meanwhile, if you have any further questions on anything in this series, don't hesitate to get in touch with IHG's Investor Relations team.