

UK Hotel Investment



Transaction volumes top £6.6bn • Portfolio deals dominate • Robust operational performance

Resilience in the face of Brexit is the key feature of the UK hotel market as we head into 2019.

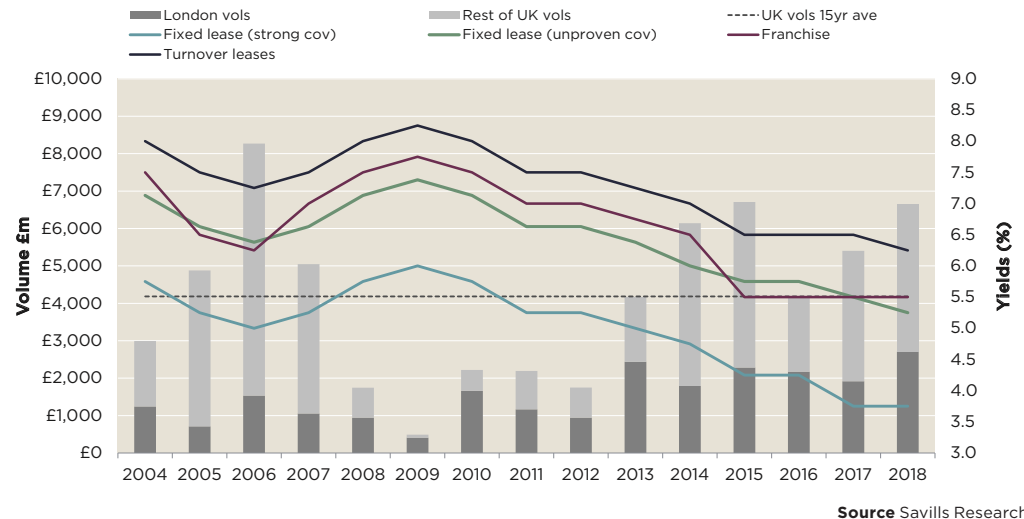
Transaction volumes increased 25.2% to total £6.6bn in 2018 supported by continued overseas investor appetite. This is likely to continue over 2019, particularly for its tourist markets, as whether the UK is in the EU or not will do little to dent its appeal to international tourists. Structural shifts in consumer spending, with a shift towards 'experience' activities such as holidays, will also support demand and in turn operational performance in the face of rising supply. However, going forward, we may see these shifts shape guest preferences when it comes to branding and type of offer.

This year we will also see more investors move up the risk curve in 2019 on the hunt for higher yielding opportunities. As a result we are likely to see a more diverse range of buyers in the management contract space and in the less mature subsectors such as serviced apartments and hostels.

An increasing number of retail to hotel conversions will also emerge this year. While this is in response to the structural shifts in retailing, which is driving retail vacancy, these conversions have the potential to provide a sense of place, supporting the retail that remains.

While the sector drivers remain robust, margin challenges will continue this year. The real change from 2018 will be its influence on investor preferences, to the benefit of operators and subsectors that enjoy higher margins.

Transaction volumes and prime yield Year-end 2018 volumes topped 2017 totals and exceeded the 15-year average by 59%. This continued investor appetite has resulted in the marginal hardening of yields.



Source Savills Research

Hotel investment volumes grow

Overseas investors continued to dominate transaction activity in 2018, driven by a number of large portfolio deals.

2018 was a particularly buoyant year in terms of transaction activity with volumes totalling £6.6bn, exceeding the 2017 total by 25.2%.

Much of this growth was driven by an increase in portfolio deals which totalled £3.5bn, 2.3 times the 2017 total and representing 53.3% of total volumes. This was the third consecutive year of volume growth.

Despite the Brexit uncertainty overseas investors continued to be the most active, in particular those from Europe and Middle East, highlighting their continued confidence in the UK hotel market. Acquisitions by this group reached £3.4bn in 2018, 22.5% up on 2017 and the second highest annual figure after the 2015 peak of £4.3bn. Almost 70% of this 2018 total was accounted for by

portfolios. These included Israeli investors Vivion Capital Partners acquiring the 20-asset Holiday Inn and Crowne Plaza portfolio from Apollo Global Management for £742m, with French investors, Covivio, acquiring the Principle Hayley portfolio for a reported £847m.

Investor appetite is set to remain in 2019 with overseas buyers continuing to dominate. However, with fewer portfolios likely to come to the market we may see a slight softening in volume terms with deal count holding.

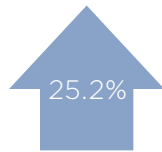
UK institutions looking to management contracts in the pursuit of higher yields

An emerging trend has been the acquisition of hotels on management contracts by UK

Institutions. Leased assets, particularly those with strong covenants and typically favoured by this buyer group, have seen significant yield compression over the last five years with indicative prime yields now in the region of 3.50-4.00%.

The hunt for higher yielding assets has already resulted in a growing interest in leased assets with weaker covenants. This has now shifted into the management contract space helped by the fact that prime indicative yields are in the region of 150bps higher than those leased on strong covenants. L&G, for example, bought the Hampton by Hilton Stansted Airport hotel in October 2017, with Blackrock acquiring the Hilton Garden Inn Birmingham Airport in September 2018.

👉 Overseas investors have contributed to the lion's share of portfolio transactions in 2018, totalling £2.4bn. 🐾



25.2%
Increase in total UK transaction volumes in 2018.

The size of the management contract space (in terms of deal count) is relatively constrained, representing only 6.5% of transactions in 2018. Whereas, leased transactions accounted for a 24.2% share of transactions over the same period. With a broadening buyer pool however, this share will increase improving the range of opportunities available for investors.

The appeal of management contract acquisitions is not just confined to pricing, the ability to benefit from strong operational performance and asset management is an added attraction. But, it does mean more exposure to operational risk, costs and increased complexities due to employee liability.

Despite these relative risks we expect UK Institutions will look to take on additional operational risk in 2019. Yet, it will require much greater deal scrutiny in terms of the asset itself, cashflow and local market dynamics. More importantly it will require working with credible operational partners.

The return of the regions

London is, understandably, the largest city market in the UK with transaction volumes of £2.7bn in 2018, exceeding the previous 2013 peak by 10.2%. However, its share of the wider UK market has been softening over the last 5 years due to pricing and availability constraints. Regional volume share was 59.3% in 2018, 3.7% above the 15 year average. While a significant share of this is attributed to portfolio deals, we have also seen significant growth in single asset acquisitions across a number of regional cities.

Investor shift towards leaner business models

This diversification is not just a geographical trend. Acquisitions across grade and subsector has also improved. In 2007 the market was dominated by four and five-star transactions. Last year, while four-star accounted for a sizeable 32%, budget hotels represented 28.1%, up from 11.2% in 2007, and serviced apartments 12% of transaction volumes (albeit this was largely determined by the £360m attributed to UK

assets within the SACO portfolio acquired by Brookfield, the most substantial serviced apartment deal in the UK to date).

This diversification partly reflects the increased availability of stock within these sectors, for example 51% of new stock delivered over the last 10 years has been budget. In the case of the budget sector, it has also been supported by strong investor appetite for leased assets that are more prevalent in this segment.

This trend may also reflect an emerging investor preference for leaner business models in the face of mounting margin pressures.

The big issue for hoteliers over the last 18 months was shrinking margins due to rising costs, largely in response to the introduction of the living wage in 2016, and in London the Business Rates revaluation that came into effect in April 2017. Going forward these margin pressures are likely to intensify in response to staff availability constraints after the UK exits the EU.

As noted in our 2018 report, the potential halt of free movement into the UK could

Average value per key



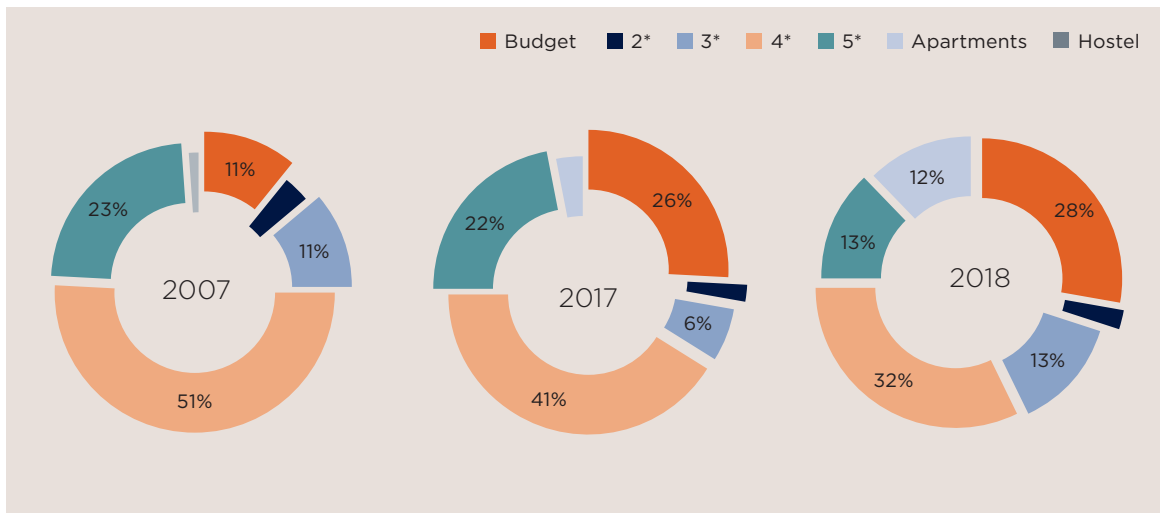
£350,513
London 2018
average value per key



£104,047
Regional UK 2018
average value per key

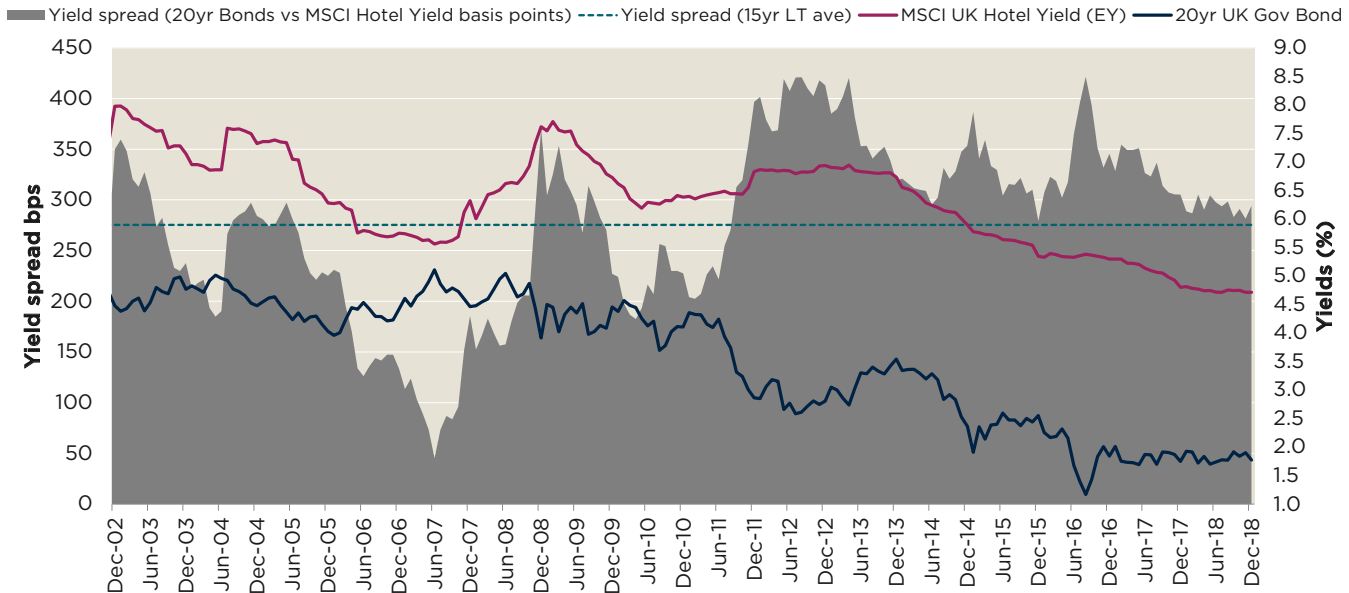
59.3%
Share of total UK investment volumes attributed to regional hotels in 2018.

Hotel investment volumes by grade Budget hotels and serviced apartments have considerably increased their market share of investment volumes.



Source Savills Research *Note - excludes mixed grade portfolio transactions

Hotel yield spread to Government Bonds Stock market uncertainty has placed downward pressure on Bond yields, widening the risk free rate to hotels.



Source Savills Research; MSCI; BoE

reduce access to labour for a sector where 34.1% of staff are EU nationals (BHA 2017 survey). Staffing constraints are already apparent in vacancy with the latest data from ONS (November 2018) pointing to a 4.1% vacancy rate in the accommodation and food services sector, the highest of any subsector classified by ONS, and exceeding the all sector average of 2.8%. This is now starting to feed into wage costs, placing further pressure on margins. For example, CV-Library revealed that advertised salaries for jobs in the hospitality sector grew 7.1% over 2018, the second highest of any sector.

Shift towards leaner business models

Margin pressures have already led operators to improve efficiencies across their businesses. We expect it will also lead to greater investor focus on those parts of the market, and operators, that can deliver enhanced margins particularly where assets are being purchased on management contracts.

This will further support investment into the serviced

apartment, budget and hostel subsectors as they tend to enjoy higher margins. Serviced apartments, for example, typically operate with margins of 50-70% as opposed to an equivalent hotel which can be between 10-20% lower.

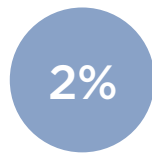
Could recent stock market uncertainty further support current pricing?

2018 saw yield hardening in some parts of the market with Prime indicative yields for leased assets on unproven covenants and those on turnover leases hardening by 25 basis points (bps), driven by growing investor appetite for higher yielding assets. Prime indicative yields for institutional leased assets on strong covenants, which are the lowest, continued to hold at their 2017 level last year. On certain selective deals, however, there have been some record yields recorded.

Downward pressure on prime yields across the board largely dissipated over the second half of 2018. Some of this was in response to rising Bond yields, shrinking the spread to property yields, due

to a strong run in the equities market. However, stock market uncertainty towards the latter end of 2018 has seen a ‘flight’ to more secure assets such as Government Bonds and Gold, with Bond yields now under downward pressure as a result. A trend that is set to continue going into 2019 due to slowing global growth.

This recent compression has marginally opened up the yield spread to UK hotels, which remains above the long term average of 275 basis points (bps). While this increasing spread will help to support current pricing, rising investor appetite for ‘income security’ in the face of slowing Global growth and volatility in the equities market could enhance the appeal of property as part of a wider portfolio strategy in 2019. With hotels enjoying strong demand fundamentals it is likely to benefit from increased property allocations, potentially leading to further yield hardening in some parts of the market.



UK hotel average annual stock growth over preceding five years against the 1.3% forecast through to end of 2023.

Resilience in the face of Brexit

How well placed is the UK hotel market to weather any potential Brexit related headwinds?

UK Real Estate has been facing a number of challenges of late largely focused around Brexit and structural shifts in regards to consumer behaviour and use of technology. For some sectors, such as logistics, this has thrown up opportunities. For hotels the positive implications of some of these shifts have been somewhat under the radar.

Whether the UK is in the EU or not will have little bearing on its appeal as a tourist destination, highlighted by the boost in tourist arrivals due to the weakening in the Pound immediately after the EU Referendum result. This tourist appeal is expected to continue beyond the UK exiting the EU in March 2019 with international arrivals forecast to increase 12.7% to 44.2 million by 2030. This will support operational performance, particularly in those key gateways cities that attract significant numbers of international tourists. For example, London is forecast to see a 12.5% growth in arrivals to 22.3 million by 2030. However, this expansion is likely to throw up regulatory challenges in terms of maintaining a sustainable balance between local resident and visitor need (see opposite).

Changing consumer behaviour also set to support demand

Changing consumer preferences for 'experiences', such as travel, will also support operational performance, driven both by international and domestic visitors.

UK households have increased spend on holiday accommodation abroad by 29.9% in real terms since 2009, with a similar trend seen across a number of European countries. This shift in spend is more marked when you consider that total household expenditure has declined 5.8% over the same period. Likewise, spend on 'staycation' accommodation in the UK has grown by 52.4% in real terms since 2009.

Those consumers driving this growth are the under 30's and over 50's. With millennials and Gen-Z consumers (largely those under 30) placing more onus on 'experiences', this is a trend that is likely to pick up pace over the coming years.

While there are a number of attractive operational drivers for UK hotels going forward, the sector does have its own unique headwinds that may be apparent at a submarket and geographical level. These include the development pipeline, softening corporate demand and shifting guest preferences when it comes to branding and type of offer.

Hotel stock due to grow 1.3% per annum through to 2023

From an operational perspective, one of key concerns is the volume of new stock coming to the market in 2019. According to STR, close to 23,000 new rooms

will be delivered across the UK in 2019 on the back of the 15,000 delivered in 2018. By December 2023 this will total an additional 46,400 new rooms. While this is sizeable, in growth terms it averages only 1.3% per annum, lagging the historical five year average of 2.0%.

This national picture, however, does mask significant pipeline variations across regional cities and grades.

London accounts for 32.1% of total new rooms forecast to be delivered by the close of 2023 (approximately 14,900 new rooms). While there may be some very localised and subsector absorption risks, we expect that where these do materialise they will be short-lived. This is reflected in the continued RevPAR growth reported in 2018 (year-end growth of 2.4% year-on-year) in the face of a 3.3% growth in stock, highlighting that overall demand continues to outpace supply.

It is in those regional cities set to see a significant increase in four-star supply that may be more exposed over the short term particularly in the face of softening corporate demand in response to the UK actually leaving the EU. In these cases resilience will be determined by the specifics of location, operator expertise and product differentiation.

Retail to hotel development opportunities emerge

The well documented challenges facing UK retailing is generating redevelopment and intensification opportunities both in-town and out-of-town, as retail vacancies increase and planning regulations relax. For example, planning consent was secured for the redevelopment of vacant retail and office space at Chester's Grosvenor Shopping Centre into a 94 room Premier Inn in 2018 with a similar scheme secured for the former BHS store on Princes Street, Edinburgh.

Apart from the obvious conversion benefits hotels can add value and a sense of 'place' to the remaining retail and town centre offer. Firstly, hotel guests can provide additional footfall. Secondly, integrated hotel amenities such as gyms, bars, restaurants, event space and co-working, not only for the use of hotel guests but also local residents and day visitors, can also provide an additional draw and vibrancy further enhancing footfall.

“London is expected to see levels of overseas arrivals grow by 12.5% between 2017 and 2030, to reach 22.3m.”

BALANCING LOCAL AND VISITOR NEED

The growth in overseas visitor arrivals has brought about challenges in terms of managing both the needs of local residents and tourists.

This is a key concern for a number of European tourist gateway cities, with many implementing hotel development and Airbnb controls to help mitigate the issue. Barcelona, for example, has effectively banned any future hotel development within the city centre as well as curbing Airbnb supply.

In London, we are starting to see similar policies put in place. From a development perspective some inner boroughs are refusing planning consent for hotels on the grounds of maintaining local resident amenities.

Westminster City Council (WCC) has taken this a step further with their new City Plan that may require all new hotel developments (including extensions) within Westminster's Central Activity Zone to ensure at least 35% of floorspace is allocated to on-site affordable housing. This will likely challenge viability, in some cases, within the zone. It does mean however, values and operational performance of existing properties will be more immune from future development. It may also open up new opportunities in surrounding areas and other boroughs.



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