

UK Hotel Investment

Q4 2015



Hilton Newcastle Gateshead, sold on behalf of Aviva 2015

SUMMARY

■ Year to date transaction volumes total £5.7bn with year end expected to reach £8.5bn, exceeding the previous 2006 peak.

■ Portfolio transactions will continue to dominate going into 2016 albeit to a lesser extent than seen previously.

■ This should not generate any concerns for activity levels as we expect to see further break-ups of portfolios going forward.

■ Downward pressure on yields continue, exacerbated by lack of good quality stock.

■ Availability constraints in London and renewed confidence in the regional hotel markets are attracting new overseas investors into the regions.

■ Institutional appetite for hotels shows no signs of waning, as they look to 'new' brands and concepts to fulfill demand.

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“The UK is on course for a new record year for hotel transaction volumes.”

Rob Stapleton, Hotel Transactions
.....

→ Transaction volumes continue to rise

■ The new post recession peak recorded last year looks set to be surpassed with 2015 year end transaction volumes expected to hit £8.5bn, marginally exceeding the previous 2006 peak. Year to date volumes total £5.7bn.

■ Volumes over the first half of the year were already 76.8% up on the same period last year driven by a number of portfolio transactions. We expect activity levels will continue to increase over the final quarter of the year and could account for 30% of total 2015 volumes.

■ Regional transactions dominate UK volumes, representing 78.1% of UK activity. Portfolio deals have been driving this and we expect this to continue with c£1.6bn worth of portfolio deals expected to complete by the year end or during the early part of 2016.

■ Considering that there continues to be transactional activity between private equity houses suggests that there is still value in the platforms being traded. The key question is for how long this will continue.

■ This increase in activity is generating downward pressure on yields, which is being exacerbated by lack of good quality stock. In some cases we are seeing owners hold assets waiting for further yield compression. Across all hotel structures yields have come

in by an average of 63 basis points (bps) over the last 12 months with the greatest level of compression reported for franchise structures (see Table 1).

New overseas buyers in the regions

■ While the presence of overseas purchasers in the regions is nothing new, this year we have seen the entrance of new international investors into the regional market.

■ US private equity houses have been the dominant overseas buyer of UK hotels, accounting for 65% of regional hotel volumes to date this year. However, this is down on their 90% share of 2014 as activity by Asia Pacific and Middle Eastern investors picked up pace.

■ 2015 year to date acquisitions by Asia Pacific investors in the regions total £1bn. Key transactions include HK CTS Metropark Hotels acquisition of the Kew Green portfolio, Frasers Hospitality's purchase of the Malmaison Hotel du Vin Portfolio and CDL's recent acquisition of the Cambridge City Hotel.

■ Increased activity by overseas investors, other than those from the US, has been driven in part by availability constraints in London. Renewed confidence in the regional market helped by the improving operating landscape has also played a key role. This is highlighted by a number of country house hotel acquisitions by Asia Pacific investors this year. Last year there were none.

How 'mainstream' is hotel investment?

■ Hotel investment is increasingly being touted as mainstream due to rising activity by UK Institutions, which hit an all time high of £1.2bn last year.

■ However, in the context of wider ownership UK Institutions are not major owners even when you exclude owner-occupied stock. Examining just those hotels operated under a leasehold, management contract or franchise model, only 10.5% of hotel beds are institutionally owned.

■ The biggest barrier for entry for the UK institutions is stock availability as 80% of hotels are owner-occupied. The shift away from leased operational structures towards Management Contracts (MC) and Franchise Contracts, often with third-party management, is an additional barrier due to institutional investor preference for leased assets. For example, 93.2% of institutionally owned hotels are leasehold.

■ Despite these barriers, institutional appetite for hotels shows no signs of waning particularly in the face of continued inflows into UK institutional funds. As a result we have seen institutions look to 'new' brands and concepts in the hospitality space in order to fulfill demand. A recent example of this has been the acquisition of a number of serviced apartment/apart-hotel blocks. This is covered in more detail in the section on page 3.

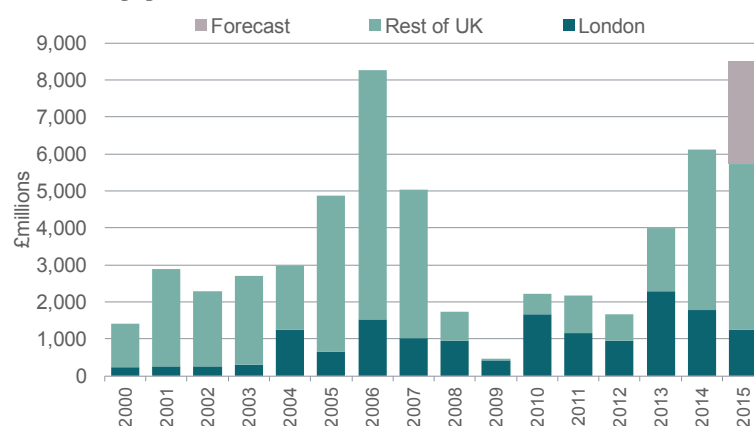
Travel budgets under downward pressure

■ Operational performance across the UK continues to improve with growth in the regions outpacing London. While the outlook remains positive, there are potential headwinds that could impact performance, particularly in certain sections of the hotel market.

■ The recent strengthening in Sterling against the Euro could pose issues in terms of overseas visitor numbers, or more notably average spend.

■ The majority of overseas visitors to the UK come from the Eurozone and while tourist arrivals from the region remain robust, travel budgets are potentially under downward pressure. On a rolling 12-month basis overseas

GRAPH 1 **UK hotel transaction volumes forecast to total £8.5 billion by year end**



Graph source: Savills

TABLE 1

Typical yields by operational structure

Structure	2014 yield	2015 yield
Franchise	6.5% to 10.0%	5.5% to 8.5%
Turnover leases	7.0% to 8.0%	6.5% to 7.5%
Fixed lease (strong covenant)	4.75% to 5.25% (50 basis point discount on similar product outside London)	4.25% to 5.0% (25-50 basis point discount on similar product outside London)
Fixed lease (unproven covenant)	6.0% to 8.0% depending on rent cover	5.75% to 7.5% depending on rent cover

Table source: Savills

visitor spend in the UK was down 1.7% in July (the latest published data) while visitor arrivals were up 3.1%. This is a continuation of a downward trend in spend first seen in February and which has corresponded with a strengthening in the Pound (see Graph 2).

■ With accommodation typically accounting for the bulk of travel budgets this decline in spend may impact operational performance in the full service hotel sector. Conversely for the budget sector it may feed positively into demand as visitors look for improved value.

■ The slowdown in the Chinese economy could generate additional concerns. Mainland Chinese tourists form a relatively small proportion of total overseas visitors to the UK, so in that sense the UK hotel market is perhaps more insulated than other markets such as Paris where Chinese

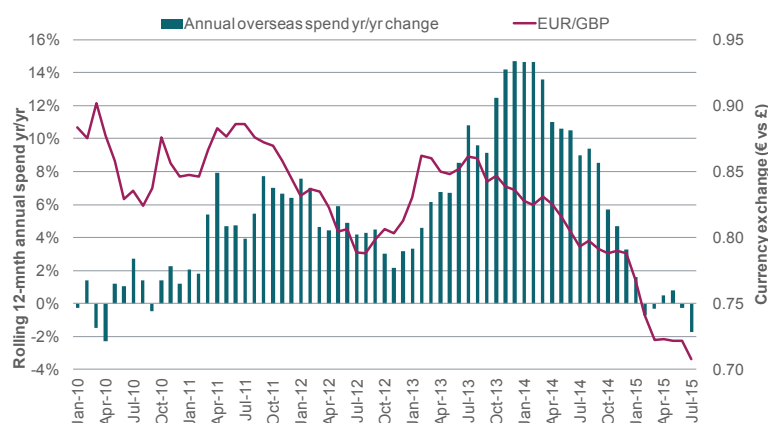
visitors account for a far larger share. However, the wider impact that the China slowdown may have on economies in the wider Asia Pacific region, and even globally, could temper global travel.

■ Current forecasts for the Global economy remain positive and we expect the effects of the €/£ exchange rate will be mitigated by the strengthening dollar which could lure an increasing number of American visitors to the UK. We have already seen a 4.3% year-on-year increase in arrivals from North America in Q1, the highest annual increase since Q1 2012

How much of a threat is Airbnb?

■ Much has been written on Airbnb's potential impact on the hotel market. While there is a need for a level 'playing field' in that the same regulations levied against the

GRAPH 2

Strengthening Pound creating downward pressure on travel spend

Graph source: ONS; Oanda

Serviced Apartments**Emerging as a branded sub-sector of the wider hotel market**

■ The serviced apartment sector, or extended stay, is emerging from its relatively 'grey' market origins in the UK into a branded sub-sector of the wider hotel market.

■ This is being aided in part by the expansion of purpose built stock by operators and by private equity investment houses. The most notable example of this is the £300m allocation by Oaktree Capital to the sector through what is now known as the SACO group.

■ The most telling sign that some level of confidence in the sector is gathering pace is the acquisition of a number of properties by UK Institutions.

■ Last year Savills Investment Management acquired a serviced apartment block in Manchester leased to SACO for c£9.5m reflecting a yield in the region of 6.6%. The same year LaSalle Investment Management purchased a similar block in Deptford leased to Staycity for approximately £9.6m.

■ Naturally the yields attached to these transactions reflect a relatively higher risk profile compared to similar hotels due to the covenant attached to operators in this space.

■ Having said this, institutional investors are becoming increasingly comfortable with the underlying operational fundamentals of the sector. For example, in London serviced apartment operational performance has tracked, and in some cases even outperformed, that for hotels. Add to this the potential for greater operational returns due to the lower service levels associated with the sector, and the sector is proving increasingly attractive.

■ The willingness of operators to take leases in order to secure sites in key markets is also aiding interest. The diversification potential away from branded budget hotels, which have tended to dominate institutional holdings, should also help boost increased transaction activity.

■ Expansion of the sector, as seen in the early days of the budget hotel sector, will continue to be driven by owner-occupiers. However, as branded stock expansion picks up pace and the sector becomes more entrenched with consumers there will be increasing opportunities for investors to enter the sector.

hotel sector are applied in some shape or form against the informal accommodation sector, it is perhaps not the threat it was first considered to be. Or at least not currently a significant threat to the London hotel market.

■ In terms of its penetration of residential supply London has one of the lowest rates when compared to other key tourist markets at 0.5%. Paris has one of the highest estimated at 2.4% (see Graph 3).

■ This would suggest that London's hotel market is perhaps more insulated from the effects of Airbnb than other cities. It has been reported that Paris' hotel market is already feeling the effects of its relatively higher proportional supply of Airbnb units. This has perhaps been exacerbated by the fact that Paris' city centre is more residential than that of London meaning that more supply comes into direct competition with hotels than is the case in London.

■ According to a recent note from Citibank, global Airbnb supply is forecast to expand 1% per annum over the next five years. However, listing growth in London and other major European cities is slowing, pointing to some maturity in these markets.

■ This, coupled with the findings from a number of US studies that found that approximately 40% of Airbnb supply was existing 'commercial' stock suggesting that it is purely seeking more efficient distribution channels, points to it having a relatively minimal future impact on the wider London hotel market.

■ Having said that, its lower price point suggests that its impact is magnified as you move down the price tiers pointing to more significant impacts on the budget traveller sector (budget hotels and serviced apartments, hostels) particularly in those

peripheral locations where Airbnb supply is more prevalent.

■ While its direct impact on operational performance in London and the UK is as yet unknown, where it may also have an impact is on OTA's (online travel agency) due to its lower commission and simpler technological interface.

2016 outlook

■ Overseas visitor numbers are likely to remain robust for the remainder of 2015 although we may see some softening over the remainder of this year and into the early part of 2016 due to the strength of Sterling.

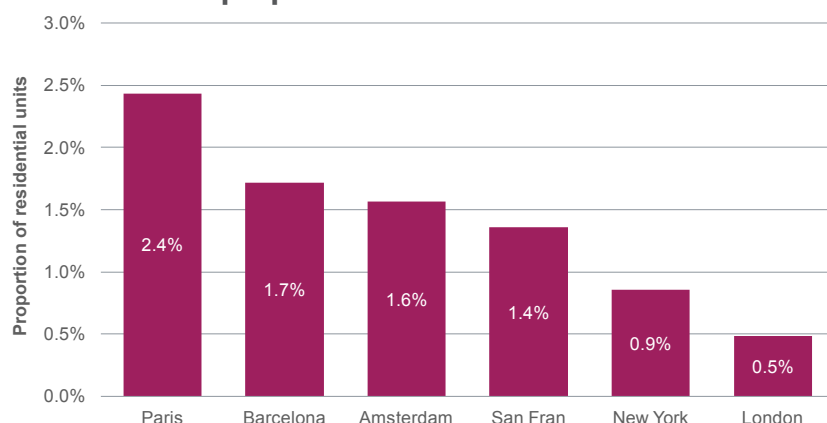
■ We expect operational performance to continue to report positive growth albeit the recent resurgence in regional performance is expected to slow with PwC forecasting a 4.2% growth in RevPAR for 2016. This is down on the 6.3% uplift forecast for this year.

■ This should not generate any concerns in terms of transaction activity as we expect to see further break-up of portfolios acquired by private equity groups over the last four years.

■ Portfolio transactions will continue to dominate activity in the UK albeit to a lesser extent than seen over the last few years as private equity houses shift their attention towards other European countries.

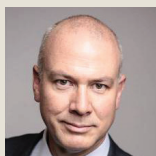
■ The downward pressure on yields will continue over the remainder of the year and into 2016. However, with yields at or close to their pre-recession peak further downward shifts will be more constrained. ■

GRAPH 3
Airbnb stock as proportion of residential stock



Graph source: Savills; Inside Airbnb; OECD; Citibank

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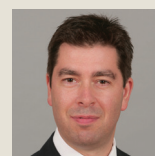
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