

UK Hotel Investment

Q4 2016



Imperial Hotel, Torquay, sold by Savills to Brownsword Hotels

SUMMARY

■ UK transaction volumes over the first nine months of the year total just over £3.1bn. We expect year end volumes will be above the 10 year average.

■ While we were anticipating volumes to be down on 2015 levels, activity for the first nine months of this year remains 12.4% above the long term average.

■ The regional hotel market has maintained its appeal post Brexit helped by continued strong operational performance. We identify our top 10 regional markets going forward.

■ UK Property Companies have been the most active to date this year, but there has been renewed activity by overseas purchasers following Brexit and subsequent currency fluctuations.

■ Prime yields continue to hold with marginal compression for fixed income assets with strong covenants, reflecting renewed appetite for these types of opportunities in the wake of the EU Referendum result.

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“Deal activity, in terms of number of transactions, held up on the lead up and after the Brexit result pointing to continued investor confidence.”

Martin Rogers, Hotel Transactions
.....

→ Transaction volumes remain above long term average

2015 was a peak year with transaction volumes reaching £8.1bn, just 2.2% off the previous 2006 peak. The large number of portfolio deals seen last year, accounting for 58.7% of total volumes, was the primary driver of this volume high. As a result we were always anticipating 2016 volumes to be more subdued.

Volumes over the first nine months of 2016 total just over £3.1bn. London accounted for 52.0% of volumes, marginally above the long term average, although this is skewed by the fewer regional portfolio deals that have taken place. While volumes are 39.1% lower than the same point last year, it is 12.4% above the long term 10 year average of £2.8bn pointing to continued resilience and growing maturity in the market. This relative resilience is apparent when you examine deal count.

Deal count, on a rolling monthly basis, as of June was in fact on a par with that seen at the same point in 2015 and far outperformed the 10 year average (see Graph 2). This is more reassuring considering this parity was achieved in the same month as the Referendum on EU membership. This points to a high degree of investor confidence in the face of negative newsflow regarding the potential impacts of Brexit before the vote.

The vote to leave to the EU, and the impact it had on investor confidence,

has seen deal activity on a rolling monthly basis start to trail 2015 levels. However, activity remains very much ahead of the 10 year average.

No retrenchment to London

Investor confidence, on the whole, has softened in the wake of the Brexit vote. Previously this level of uncertainty may have resulted in a retrenchment to London, this has not been the case over the last two months. Rather the 'flight to safety' is being determined by income security rather than geography alone.

For example, regional deal activity picked up in August, a historically quiet month, with 14 deals completing, compared to five in July. An additional 13 deals were recorded for September. The same level of bounce-back in deals was not seen in London although this has been heavily constrained by the restricted availability of stock.

The continued appeal of the regional hotel market post the Brexit vote, has been aided by relatively strong operational performance over the last three years. Growth in revenue per available room (RevPAR) over this period has averaged 7.4% per annum, helped by relatively constrained levels of new supply. London over the same period has seen RevPAR growth average 1.9% per annum. This relative outperformance has continued into 2016 with year to date RevPAR growth of 3.0% for the regional markets.

Going forward, there are a number of regional markets that we think could

continue to report strong growth. The box opposite provides more detail on these drivers and what we consider to be potential performance growth markets.

The focus on income security is apparent in the pre-brexit prices that have been agreed on certain budget branded hotels. These assets are typically let on 20 year plus, inflation linked, leases with strong covenants. For example, Savills acquired a Travelodge in London's Liverpool Street on behalf of a client in July, post the Brexit vote, for £42.0m reflecting a yield of 4.84%.

The appetite for leased assets, and the growing appetite for income security is reflected in the fact that leased deals accounted for the largest proportion of transaction volumes over the first nine months of 2016. In 2015 they only accounted for 12.0% of volumes.

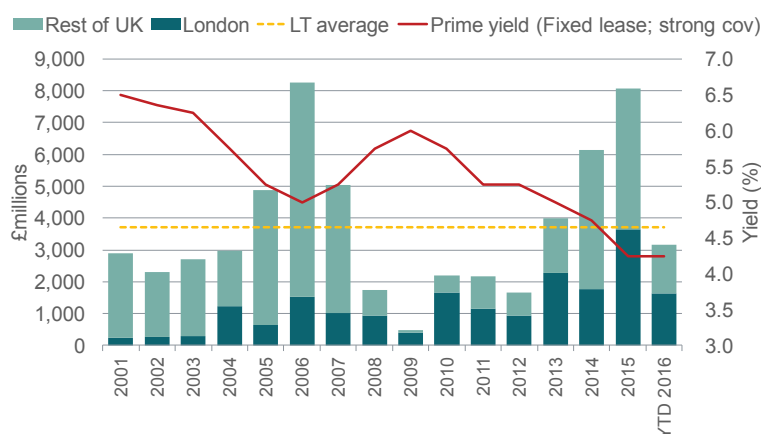
The biggest buyers of leased assets remain the Institutional Funds. To date, acquisition volumes of fixed income assets by this group total £328.5m. While institutional appetite for these types of assets remains, availability is significantly constrained. These availability constraints has meant we have seen some funds look beyond traditional budget hotels, which have historically dominated institutional activity. For example, Schroder's UK Real Estate Fund acquired Staycity Hayes, a leased Serviced Apartment property for £32.4m.

International buyers making a come back

Overseas investors have dominated acquisition activity since 2012, accounting for 71.6% of volumes in 2015 alone due to a number of portfolio acquisitions by US Private Equity houses. Over the first half of this year, however, their activity levels were more subdued. More constrained activity levels by this group has meant that the most active purchasers over the first nine months of 2016 have been UK property companies.

These buyers have accounted for 34.6% of total transaction volumes spending just over £1bn. This is already in excess of the £655.3m they spent in 2015, although over half of this is attributed to the c.£550m sale of the Atlas Portfolio by Hudson Advisors to London & Regional Properties.

GRAPH 1
Transaction volumes and prime yield



Graph source: Savills

TABLE 1
Typical yields by operational structure

Structure	2015 yield	2016 yield
Franchise	5.5% to 8.5%	5.5% to 8.5%
Turnover leases	6.5% to 7.5%	6.5% to 7.5% (50-75 basis point discount for similar product outside London)
Fixed lease (strong covenant)	4.25% to 5.0% (25-50 basis point discount for similar product outside London)	4.25% to 4.75% (25-50 basis point discount for similar product outside London)
Fixed lease (unproven covenant)	5.75% to 7.5% depending on rent cover	5.75% to 7.5% (50-75 basis point discount for similar product outside London)

Note: Upto 100 basis point discount for properties outside London. Reflects the real estate play typically associated with London acquisitions.

Table source: Savills

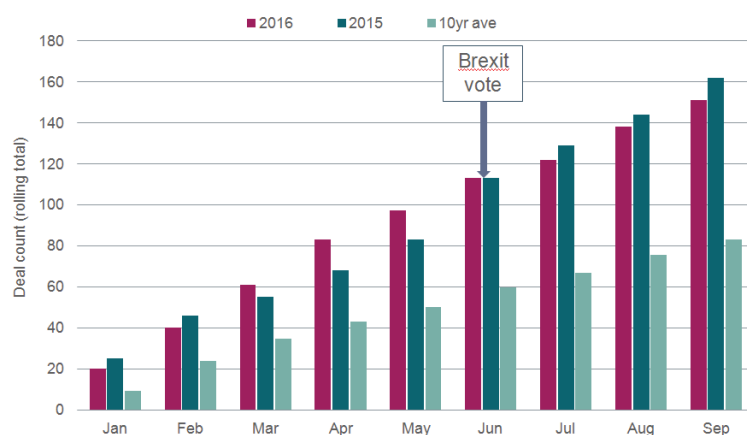
Private individuals have also become more active over the course of 2016 with transaction volumes almost double that of year end 2015 levels, at £340.4m. For these buyers the widening yield spread between interest rates, bonds (risk free rate) and property has enhanced the attractiveness of the asset class. This has been more pronounced in the country house hotel and high street retail markets due to the smaller lot sizes available.

Despite their more subdued activity levels, overseas investors were still the second biggest buyers of UK hotels as of September. This group have spent a total of £803.9m to date, representing a share of 26.3%. However, just under half of this is attributed to a single deal - the £350m purchase of the former War Office by the Hinduja Group

and Obrascón Huarte Lain, for hotel redevelopment.

Currency and strong pricing constrained deal activity by overseas buyers over the majority of 2016, although overall appetite remained strong. Following the vote to leave the EU, and subsequent currency fluctuations that saw the value of the Pound decline, acquisitions by overseas investors have picked up. Transaction volumes by this group have totalled £267.8m over the third quarter alone with the majority of buyers coming from Asia Pacific. Excluding the War Office deal, transaction volumes over the whole of the first half of 2016 totalled £186.0m. A good example of the catalyst effect of currency fluctuations on activity is the acquisition of the Travelodge Liverpool Street already cited, which

GRAPH 2
Rolling deal count



Graph source: Savills

Regional 'hot' towns

What markets set to provide best growth prospects

■ At the end of last year we released our list of the best hotel markets from an investment perspective. This took into account pricing (yield spread to previous 2006/7 peak) and the fundamental operational drivers going forward including forecast GDP growth, overnight visitor market, current stock and pipeline.

■ What the analysis highlighted was that it is not necessarily the obvious markets that offer the most attractive opportunities.

■ Nine months on, we have decided to update this analysis across 51 of the UK's largest hotel markets. However, this time we have excluded pricing and just focused on the fundamental operational drivers going forward.

■ The top 10 'hot' markets from this analysis are detailed in the table below. The universal feature of all those markets that made the top 10, bar Bristol, is that they are all sub-regional centres as no major regional cities featured. Although Cardiff, after Bristol, was the next highest ranking major city.

■ The real driver behind the top 10 is that they all have constrained levels of current, and future, bed supply relative to their overnight visitor market, plus strong GDP growth forecasts. For example, second placed Bristol has only 2.8 bds per 1,000 overnight visitors with this only expected to improve to 2.9 based on the known development pipeline, with GDP growth forecasts of 2.0% per annum through to the end of 2020. This constrained supply is apparent in its past operational performance with average RevPAR growth per annum of 12.0% between 2013 and 2015.

Rank	Hotel market
1	Oxford
2	Bristol
3	Winchester
4	Windsor
5	York
6	Brighton
7	Salisbury
8	Cambridge
9	Chester
10	Bath

Table source: Savills; AMPM; Oxford Economics; ONS

was purchased by the Hong Kong based YT Realty in the month immediately after the Brexit vote.

But, this renewed interest in the UK market is not just confined to London. We have seen overseas buyers acquire 12 properties in the regional markets, with seven of these post Brexit including the largest single purchase by this group year to date. This was the £38.6m purchase of the Hyatt Regency Birmingham by the Bin Otaiba Investment Group.

Prime yields continue to hold

This renewed appetite from overseas investors, coupled with the continued interest from UK institutions amongst other buyer groups, has largely maintained prime yields at their 2015 levels despite the decline in total transaction volumes (see Table 1).

Prime yields for fixed leases on strong covenants did come in marginally with a typical range of 4.25% to 4.75%, a compression on the 4.25% to 5.00% range noted for 2015 and reflects the renewed appetite for fixed income assets in the wake of the EU referendum result.

As was the case in 2015 the yield 'discount' continues with a typical yield spread of up to 100 basis points for properties on a similar lease structure outside London. This reflects the 'real estate' play offered by London acquisitions rather than a 'pure' hotel yield.

Post Brexit impact on spend and visitor numbers

The resilience of prime yields, despite lower transactional volumes, is a reflection of the

long term operational strength of the UK hotel market and its continued appeal as a international tourist destination.

London did experience a drag on operational performance at the start of the year on the back of the Paris terror attacks and subsequent weakening in international tourist arrivals.

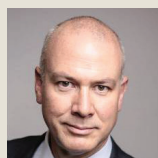
However, Brexit and the subsequent currency fluctuations enhanced the attractiveness of the UK to international tourists as it became a significantly cheaper destination. For example, in July overseas visitor arrivals increased 1.3% year-on-year following a -1.3% decline the preceding month. More telling was the 2.3% increase in spend compared to the preceding four months of annual declines. For London's hotels this resulted in a 3.8% increase in RevPAR year-on-year in the same month.

2017 outlook

We expect year end transaction volumes for 2016 will be above the long run average. The outlook for 2017 is less transparent due to the knock on economic effects the invoking of Article 50 could have on the market.

However, political and economic uncertainty in other European markets could enhance the UK's 'safe haven' status aiding transaction volumes. This is likely to be further enhanced by improving, or at least continued positive, operational growth. With the regions expected to see positive, albeit slowing, RevPAR growth of 2.3% over 2017. ■

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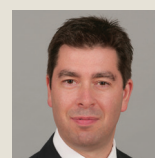
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