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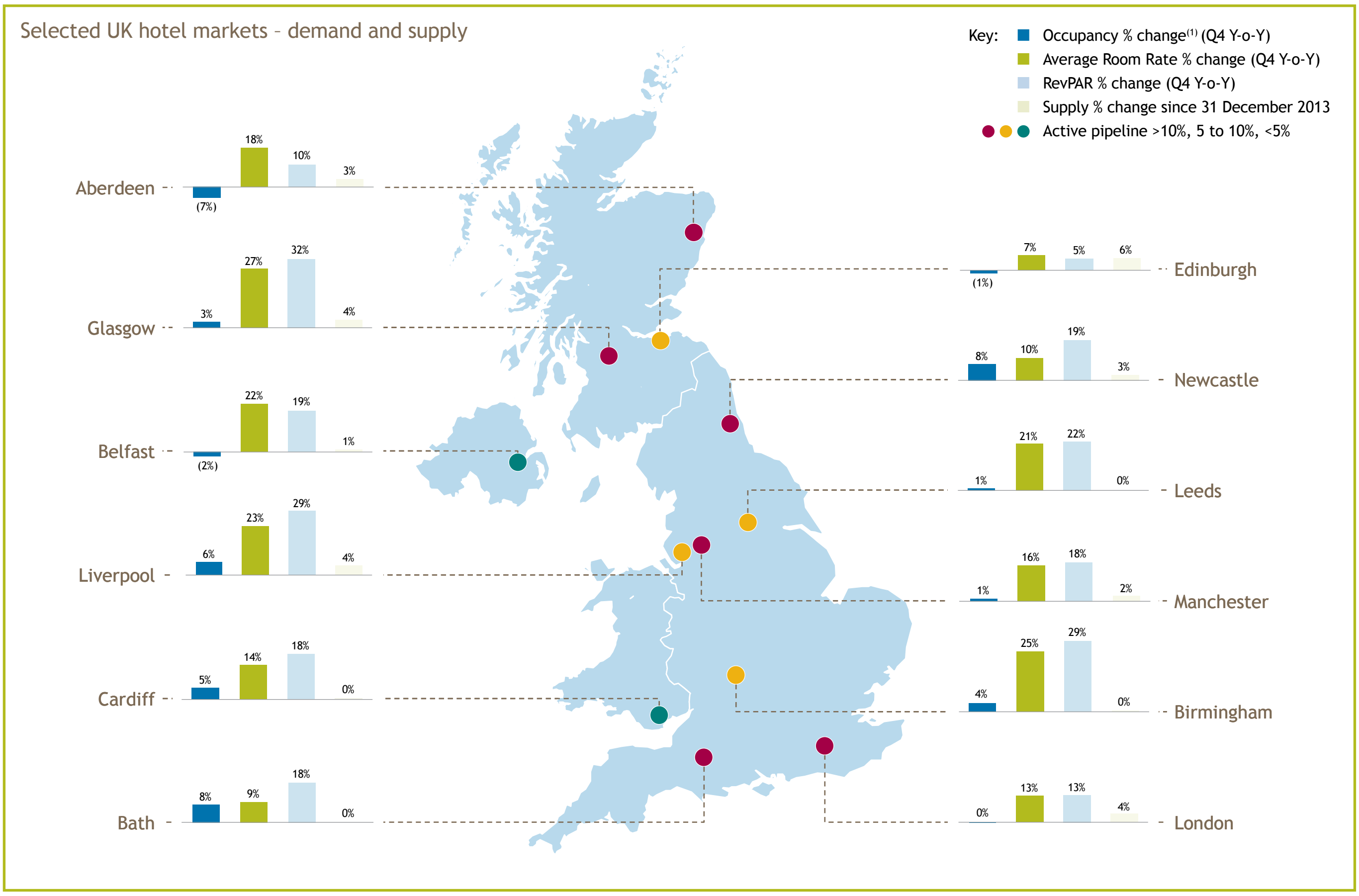
Hotel Bulletin: Q4 2014

This edition of the Hotel Bulletin reveals double-digit average RevPAR growth across the 12 cities reviewed. However, current occupancy and active pipeline trends reveal possible initial signs of market maturity. The large number of single asset deals that completed in Q4 contributed to 2014 recording the highest total transaction value since the downturn. This quarter's Focus outlines our trading expectations for 2015 and considers whether this year could be a good opportunity to sell.



Source: AM:PM, HotStats

Notes: Q4 covers the three months to the end of December
Q4 Y-o-Y compares the average of Q4 2014 to the average of Q4 2013
Supply and pipeline analysis relate to numbers of hotel bedrooms
(1) Occupancy percentage change represents actual rather than absolute percentage change
Active pipeline refers to hotel bedrooms with an opening date in the next three years

Our thoughts for the year ahead

Graeme Smith, Zolfo Cooper

Current rate trends suggest there are robust supply and demand conditions in the main UK cities. This bodes well for the year ahead, especially with support from lower energy costs. Development pipeline has now responded though which could be a test towards the end of the year and into 2016. With these factors at play it could be that 2015 represents a high water mark for valuation multiples.

Russell Kett, HVS

The strong performance by UK hotels in 2014 should have resulted in improved bottom lines and hotel values. These should be sustained through 2015 and potentially beyond, as the UK hotel sector is expected to remain attractive to investors. The outcome of the General Election in May could provide an additional stimulus to investors' confidence.

Alan Gordon, AM:PM

2015 looks set to be another good vintage, but some fundamental gaps between the winners and losers are likely to widen further as the current cycle progresses. Major metropolitan markets look best placed, albeit a few may experience some indigestion until new supply growth settles down. Many smaller independents will continue to face serious challenges against larger and increasingly branded competitors.

Demand

Once again, Glasgow tops performance league

In Q4 2014 all of the cities reviewed in this bulletin recorded RevPAR growth. On average, Q4 RevPAR increased by 19% year-on-year.

In a continuation of an emerging trend, regional cities' growth exceeded London in Q4. An average RevPAR growth of 20% in the 11 regional cities reviewed overshadowed London's, still impressive, 13% growth. London occupancy levels stagnated for a third consecutive quarter but this was more than offset by continued material improvement in average room rates, which increased by 13% in Q4 2014.

The top performer this quarter was Glasgow, where RevPAR increased by 32% compared with Q4 2013. Glasgow has benefited from hosting numerous high profile events including the Liberal Democrat party conference in October, the MTV Europe Music Awards in November and the 2014 Sports Personality of the Year awards in December.

Birmingham's RevPAR increased by 29% in Q4 2014. In 2014, the number of tourists visiting the city increased by 32% over the previous year, which bolstered leisure demand in this traditionally corporate focussed city. Liverpool's RevPAR also grew by 29% in Q4 as the city hosted Champions League matches in Q4 for the first time since 2009.

Edinburgh recorded the lowest RevPAR growth in Q4 (5%). It is likely that performance was impacted by Glasgow hosting so many high profile events. For the second consecutive quarter, Aberdeen found itself towards the bottom of the 12 cities reviewed. Since June 2014, the price of oil has decreased by approximately 50%. Although the impact on demand is not yet fully known, severe price volatility is likely to cause uncertainty among both corporate clients and hotel investors. Developers and operators alike will be watching closely to see how activity levels in the North Sea change in response to this price fall.

Hotel market buoyant in 2014

2014 has been a stellar year for demand performance in the UK hotel market. In absolute terms, all but three of the cities reviewed in this bulletin have now surpassed pre-downturn RevPAR levels. Only Belfast, Birmingham and Newcastle are marginally short of this goal. There were an unprecedented number of high-profile events in 2014, including the Grand Départ of the Tour de France and the Commonwealth Games. Hoteliers capitalised on the sustained high occupancy levels to push rates up during these events, which undoubtedly promoted bottom line performance.

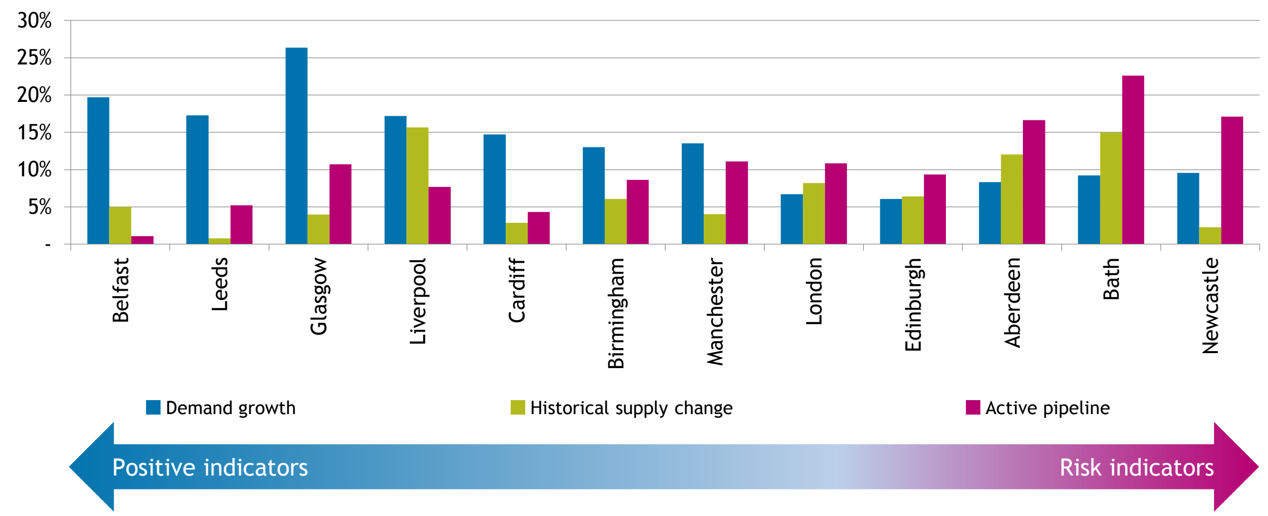
Whilst trading performance is very strong overall, there are initial signs of performance maturity. Occupancy growth is beginning to plateau, albeit against strong comparators. As discussed later in this bulletin, increased competition from new supply may make rate growth more challenging towards the end of the year and into 2016. For now though, hoteliers are enjoying pricing power once again after a long wait.

Investment indicators

Although high-level demand and supply metrics alone will never fully inform an investment decision, the graph below highlights demand and supply data for cities that may attract, or concern, investors.

The interaction of demand growth, historical supply and active pipeline are considered. Demand growth has been calculated as the average RevPAR growth for the last four quarters to provide an indication of recent demand trends. Historical supply has been calculated as the increase in rooms in the last two years in order to allow for an appropriate amount of time to contextualise recent trading performance. Active pipeline has been included in the analysis to provide an insight of each city's hotel market in forthcoming years. Only bedrooms with confirmed opening dates are included.

Investment indicators



Source: AM:PM, HotStats

Notes: Demand growth calculated as the average quarterly RevPAR change for the last four quarters
Historical supply change calculated as the change in hotel bedrooms between December 2012 and 2014
Active pipeline calculated as the active pipeline as a percentage of current supply
The shading of the arrow reflects positive (blue) or risk (red) indicators

Supply and pipeline

Leisure operators continue to add hotel sites

In the graph below (left), we compare the proportion of current supply (inner circle) and active pipeline (outer circle) in the UK market by sector. Budget hotels continue to dominate both supply and active pipeline with 34% and 47% of the total population respectively.

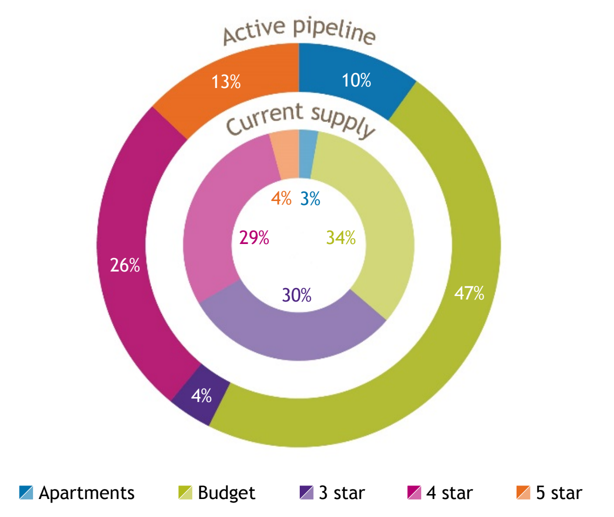
In the first three quarters of 2014, Travelodge opened 506 bedrooms. Q4 2014 is notable for its absence of Travelodge openings. The brand has a healthy pipeline with over 1,400 bedrooms (17 hotels) set to open in 2015.

Premier Inn has continued to increase its market share, with ten new openings (1,043 bedrooms) in the quarter. Pub groups are becoming increasingly active in the UK hotel market. J D Wetherspoon opened two hotels and Marstons Inns opened its first new hotel in Q4 2014.

Notable new openings and developments in the quarter include:

- Corbin & King, most famous for owning The Wolseley restaurant in Mayfair, opened the five star Beaumont Hotel near Grosvenor Square, converting a Grade II listed art deco property owned by Grosvenor Estates.
- Whitbread's first 163 bedroom hub by Premier Inn opened in Covent Garden. This high-tech ultra-budget hotel concept aims to capitalise on the popularity of similar brands such as CitizenM and Z Hotels.
- Starwood Hotels and Resorts has opened its second UK Aloft hotel, in Liverpool, indicating that the brand may eventually be gaining traction in the market after the last opening in 2011.
- Tune Hotels opened its second hotel outside London in Newcastle (104 bedrooms) and its fifth hotel in London in Canary Wharf (130 bedrooms). The Tune Hotel Canary Wharf is owned by RAAG Hotels, the JV between Francoli Limited and the Wellcome Trust.

UK current bedroom supply and active pipeline by grading



Source: AM:PM
Notes: Active pipeline includes developments with a confirmed opening date in the next three years
The budget category includes hostels, budget and two star hotels

Transactions

2014 total transaction value highest since downturn

Q4 transactions have contributed to 2014 total transaction values reaching pre-downturn levels. There has been a relatively balanced mix of single asset and portfolio transactions in Q4 2014. £0.4 billion of the total £1.1 billion of acquisitions this quarter was accounted for by single asset sales.

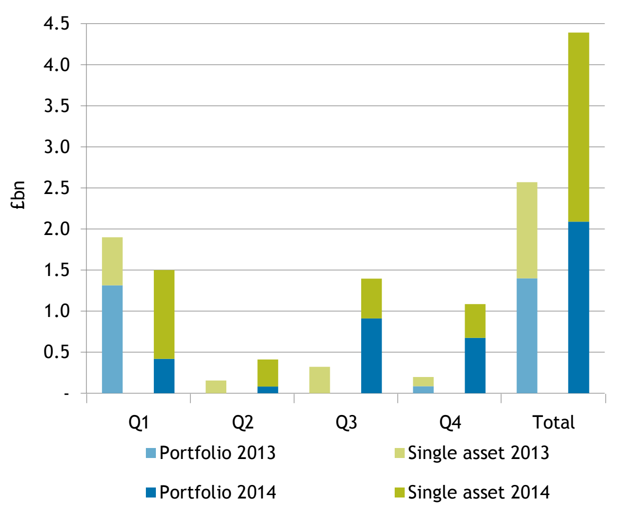
This situation is not expected to continue into the next quarter as already in 2015 there has been several portfolio transactions. These include Topland's acquisition of Feathers Group, Starwood Capital's acquisition of the Townhouse Collection and Lone Star's acquisition of Moorfield's legacy fund assets and the Jurys Inn portfolio. In addition, many portfolios are already being actively marketed, including Jupiter, Malmaison/Hotel du Vin Starwood non-core estate and LRG2

Valuations of hotels are increasing as a result of increasing profitability and demand for quality assets that is outstripping supply. While this trend is almost universal in larger regional city centres, there is scope for valuation increases in secondary and tertiary locations as investors are forced to look further afield for opportunities.

Notable transactions include:

- KSL Capital Partners acquired the 25 hotel De Vere Village Urban Resorts portfolio for a reported £480 million after a heavily contested auction process. The portfolio was initially marketed for a guide price of £450 million.
- Invesco purchased two Ibis and Novotel branded hotels located in Reading from Osborn Securities. The hotels formed part of the security on RBS's Project Achill loan portfolio sale.
- Ability Group acquired two Travelodge hotels and the Park Inn by Radisson in Peterborough in three single asset transactions. The group has continued to be active in 2015 through its recent purchase of the Park Inn by Radisson in Manchester city centre.

Transactions by quarter



Source: HVS
Note: Only disclosed hotel transactions over £6 million included in this analysis

Focus on: the year ahead

2014 - a tough act to follow

2014 was an exceptional year for the UK hotel market. As the UK economy continues to recover we expect further improvement. However, as a result of such strong comparators, 2015 growth may be more subdued than the across-the-board double-digit levels enjoyed in 2014. In addition, new stock entering the market is likely to temper the rates that can be commanded by existing hoteliers in those markets.

A number of high profile events are planned for 2015. The Rugby World Cup and General Election should enhance performance across the country. However, due to the unprecedented number of events across the country in 2014, event driven RevPAR performance is likely to decline in comparison.

The recent drop in fuel prices is likely to positively impact hoteliers in general. The expected increase in disposable income will enable consumers to spend more money on hotels and leisure. In addition, fuel linked operational costs are likely to decrease. These improvements will undoubtedly bolster the bottom line.

Overall, we expect RevPAR growth in 2015, albeit it is likely to be at a smaller premium to macroeconomic growth than the double digit RevPAR growth recorded in 2014. Hoteliers who can control costs and fend off new entrants are likely to realise profitability growth beyond RevPAR increases as the positive benefits of operational leverage are experienced.

2015 - the year to sell?

Although demand is expected to grow, there are early signs that the market is beginning to mature. Certain investors may prefer to sell in a growing market rather than try to call the top. This is likely to be particularly relevant for investors who bought during the downturn and have already satisfied return requirements.

The graph opposite displays the total transaction volume and average quarterly RevPAR growth by year and demonstrates transaction volumes have increased in line with RevPAR growth. Factors such as the attractiveness of other asset classes will impact the level of transaction activity but this correlation suggests that investors are more reactive to growth than absolute RevPAR levels.

RevPAR growth continues to be strong which is consistent with the recent deals completed by experienced investors including Lone Star, KSL Capital and Topland. This indicates they believe that there is scope for further growth. Transaction activity in the second half of 2015 will be telling for the investor sentiment.

With 2015 profit growth likely to outstrip revenue growth, the challenge of outperforming strong comparables and interest rates at all-time lows, there is a real possibility that 2015 could represent a high water mark for valuation multiples.

As ever, the decision to sell will be made on a case-by-case basis and influenced by respective investment criteria as well as widespread market fundamentals.

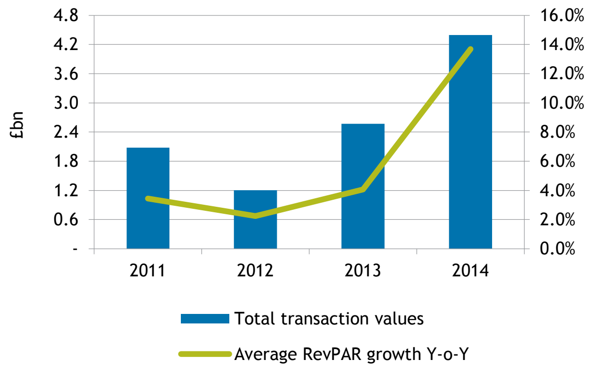
The rise and rise of third party operators

Recent transactions in the hotel operator market have resulted in management platforms with the scale and reputation to meet the latest quality criteria demanded by the brands. Owners are also attracted to third party operators due to their more flexible approach.

At the same time as this consolidation, the brands are becoming increasingly aware of the benefits of the franchise model. Using a franchise model allows brands to expand their footprint more quickly whilst limiting operational risk. Even luxury brands are beginning to trust their operations to third parties. For example, the Conrad London St James is operated by Splendid Hospitality Group.

In the UK, approximately 12% of hotels are franchised as opposed to the US where over 50% of hotels are franchised. As third party operators cement their reputations, we expect the gap between the US and Europe to narrow.

UK transaction value and average RevPAR growth



Source: HVS
Note: Only disclosed hotel transactions over £6 million included in analysis

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