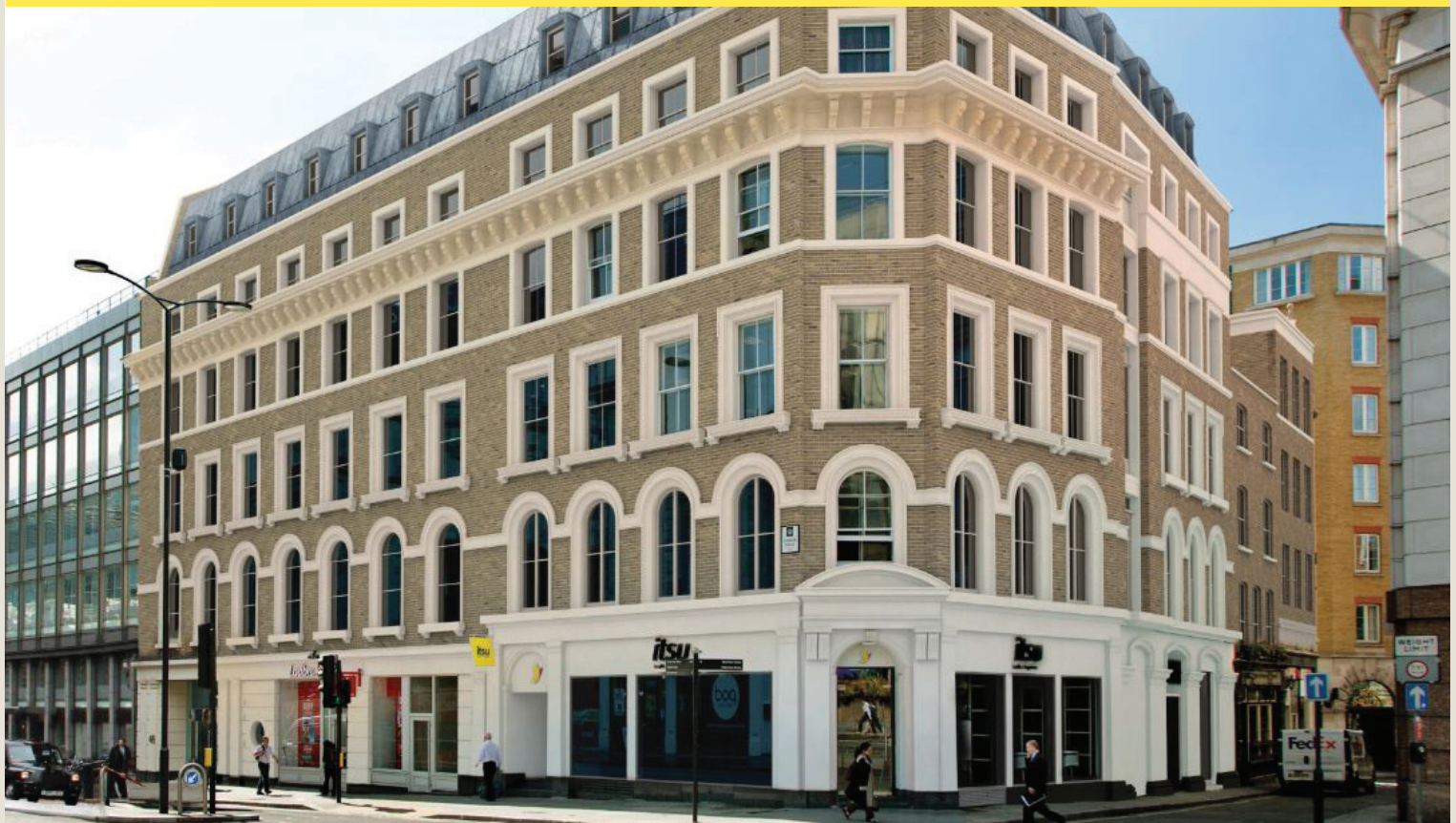


UK Serviced Apartment Report

Q4 2014



The Cannon, City of London - operator search by Savills 2014

SUMMARY

- Categorisation of the sector along operator and brand lines remains difficult. Greater branding in the sector is likely to resolve this boosting consumer and investor confidence.
- Adoption of Clause 34 as part of the Deregulation Bill is unlikely to have a significant impact.
- Expansion in the regional cities is picking up pace driven by the Aparthotel brands.
- London remains the primary focus for expansion with approximately 1,700 units in the development pipeline.
- Year-to-date, the regions have outperformed London in terms of occupancy and rate growth.
- Lack of institutional grade stock continues to limit transaction activity.
- Acquisition of the Adagio Whitechapel site will provide the best indication to date of prime yields in the sector. We expect this will be in line with that seen for hotels.

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 “Further brand development will be vital to improving investor and lender confidence in the sector”

James Bradley, Savills Hotels

➔ **Categorisation remains difficult**

■ Last year's key message was the legitimisation of the sector through planning via expansion with purpose built stock with a hotel (C1) consent. Thus allowing for stays of one night.

■ This trend continues, helped in part by the continued growth of international hotel owned brands in the UK.

■ This shift towards C1 development however, has not resulted in a clear categorisation of the sector along brand and/or operator lines.

■ Figure 1 tries to categorise a sample of operators/brands into the two primary subsectors; traditional Serviced Apartments and Aparthotels. A definition of these along with Corporate Housing is detailed in the table below figure 1.

■ For some operators/brands there is no definitive categorisation as they trade across several subsectors, with the location and property dictating

the offer. This largely reflects the opportunistic nature of the sector's expansion historically and, in some cases, providers' varied client base.

■ For example, a number of operators offer relocation and corporate housing services for those on longer stays. As a result demand remains for traditional residential property.

■ Yet, the drive to build greater economies of scale and tap into the short-medium stay business market, plus leisure segment, is leading some traditional Serviced Apartment operators to develop their own aparthotel type offering.

■ As a result operators are dealing with a relatively varied property portfolio. This may lead to greater brand development in the sector as operators look to categorise their offer.

■ Greater brand clarity would not only be beneficial from a consumer perspective, but would also offer greater clarity to investors/developers and lenders. Hotel brands and their

associated property requirements, in particular the budget brands, have provided investors/developers with a clear understanding of the offer aiding confidence in the proposition.

■ While some of the international Aparthotel brands have relatively defined property requirements, this is not universal across the sector. In those cases where branding is less developed, investors and lenders may need to focus on the property fundamentals of a particular asset rather than just the brand.

Proposed deregulation of the 90 day rule - is it a threat?

■ The focus on C1 expansion to legitimise the sector was in response to the fact that, historically, the bulk of stock was made up of standard residential with a C3 designation. In London this meant units could not be 'legally' let for periods of less than three months under the 90 day rule, unless they were in receipt of a daily letting license.

FIGURE 1 **Serviced Apartment brand and operator segment classification sample**



	Corporate Housing	Serviced Apartments	Aparthotels
Unit type	Units are identical to traditional residential flats; comprised of dedicated blocks or single units part of larger residential blocks.	Units tend to be similar to traditional residential flats; comprised of dedicated blocks or single units part of larger residential blocks.	Studios and small 1-bed apartments typically with a small kitchenette; part of dedicated purpose built blocks.
Services	Potentially concierge; weekly cleaning.	Concierge; may have a reception (24hr or part-time); weekly/daily cleaning.	24-hour reception; may have limited services such as cafe/bar; weekly/daily cleaning.
Typical stay	Appeals to longer length stays.	Appeals to short (1 night) through to longer stays.	Tends to appeal to short stays.

Table source: Savills

■ Operators did not always conform to this rule and if caught by the Local Planning Authority would vacate the property. This generated some operational uncertainty and in turn reduced investor confidence.

■ Operation with C1 consented property has helped to resolve this issue. However, Clause 34 of the proposed Deregulation Bill has raised concerns. An overview of the Bill can be found in the box opposite.

■ The issue is that deregulation could 'legalise' a huge swathe of London residential property for nightly stays, generating significant competition for C1 operations. As residential operations would be liable for the less onerous Council Tax, whereas C1 providers are required to pay Business Rates, would also put them at an unfair advantage.

■ The Association of Serviced Apartment Providers (ASAP) responded to the Bill welcoming the review of the legislation but highlighted the need to consider the safety and welfare of the guest in any deregulated market.

■ At this stage, it would appear that Clause 34 will be adopted without amendment. We suspect, however, that it will be restricted to owner-occupiers in order to support the sharing economy initiative rather than being available to commercial landlords, thus mitigating the potential risk to the sector. Although we will have to wait and see if and how the Clause is utilised.

Expansion outside London picks up

■ The constrained supply in the regional cities, relative to their overnight corporate market, looks set to be resolved.

■ Graph 1 details the percentage increase in stock across a number of UK cities expected by the end of 2017.

■ Birmingham leads with a 65.7% increase, reflecting growth off a low base with c370 new units to be added to the current stock of 600. This is closely followed by Aberdeen, whose oil industry is attracting developers and operators.

■ Unlike London where stock growth is being driven by a relatively wide variety of operators, in the regional cities it is the Aparthotel brands that are the most active.

■ Union Hanover's Urban Villa concept leads with just over 400 units in two proposed schemes in Aberdeen and Portsmouth. This is followed by Staycity with their planned Birmingham and Edinburgh properties. Adagio are delivering c250 units across the same two cities. Roomzzz is expected to deliver over 280 units across four regional cities.

■ The difficulty of securing sites at the 'right' price for large purpose built development in London has meant regional expansion, particularly for new international entrants, has been the initial route to developing scale in the UK. For example, Accor's Adagio brand and IHG's Staybridge

Deregulation Bill

London's 90-day rule under review

■ The Deregulation Bill was introduced to the House of Commons in January 2014. The purpose of the Bill is to remove or reduce burdens on businesses, civil society, individuals, public sector bodies and the taxpayer.

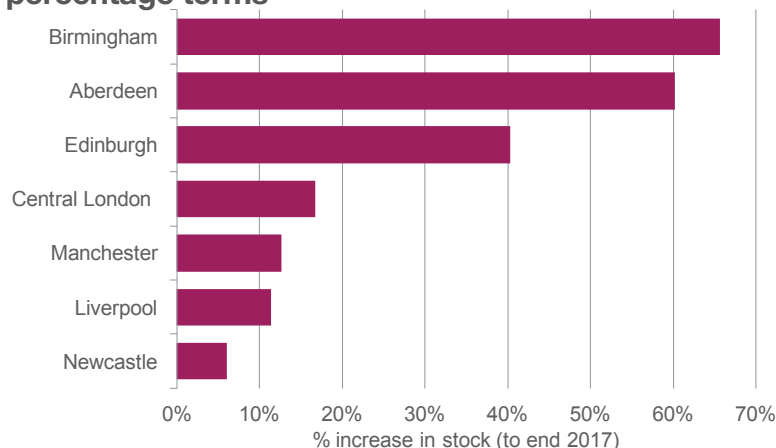
■ Clause 34 of the Bill will provide the Secretary of State the power to relax restrictions, known as the 90 day rule, related to the short-term letting of residential property in Greater London subject to it not being deemed as a material change of use.

■ The 90 day rule (section 25 of the Greater London Council Act 1973) was implemented to protect London's housing, to the benefit of permanent residents, from the conversion to short-term lets. A short-term let was deemed a stay of less than 90 days. Holiday home-swap websites and use of Airbnb, amongst others, led to calls to relax the rule.

■ Adoption of the Bill will not necessarily mean all residential property can be let for periods of less than 90 days. Clause 34 provides the Secretary of State the power to amend section 25 setting out circumstances in which the use of residential property as temporary accommodation does not involve a material change of planning use. The new clause will also allow the Secretary of State or the local authority to exclude particular residential premises and particular areas from any relaxation of section 25.

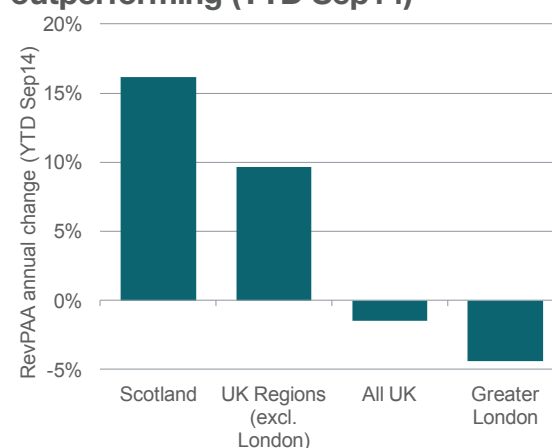
■ As a result we suspect that the relaxation of the rule will be restricted to owner-occupiers and is unlikely to be available to commercial landlords.

GRAPH 1 **UK regional cities leading stock expansion in percentage terms**



Graph source: Savills; AMPM

GRAPH 2 **Scotland & regions RevPAA growth outperforming (YTD Sep14)**



Graph source: ASAP; STR Global

→ Suites both had their first sites outside London before securing locations in the Capital. However, the ability to secure London sites has been improving as developers and investors have become more familiar with the concept and its brands.

■ While the regional cities lead in percentage growth terms, London continues to dominate in quantum of new units. Approximately 1,700 new purpose built units are expected to be delivered in Central London by 2018 - a 16.7% increase on current stock levels.

■ Bucking the previous trend of entering the UK via the regional cities, Starwood Hotels & Resorts is expected to open their first UK Element branded property in London's Tobacco Dock in 2017.

■ The traditional Serviced Apartment operators will also be instrumental in driving stock levels in London, accounting for approximately 30% of the development pipeline, many with their own Aparthotel type offer.

Regions outperforming

■ Expansion in the Scottish markets of Aberdeen and Edinburgh is being supported by strong trading performance. Year-to-date Revenues Per Available Apartment (RevPAA) are up 16.2% in Scotland compared to the same period last year. The other UK regions have also reported strong RevPAA growth on the back of improving demand and uplift in nightly rates. However, this was not universal

across all cities particularly those that have recently seen a significant increase in stock.

■ Despite a strong growth in occupancy of 3.3%, exceeding the UK regions, year-to-date average daily rates in Greater London have fallen 7.4% compared to same period in 2013. As a result RevPAA is down 4.4%.

■ Central London is likely to have outperformed the Greater London average. Yet, the downward pressure on rates, as operators have looked to boost occupancy, has been a common theme. We expect that rate increases will return in the final quarter meaning that annual RevPAA growth for 2014 should remain in positive territory.

Build and they will invest

■ The sector still lacks institutional grade stock on any large scale. It is this that is limiting transaction activity. This is likely to improve over the next five to 10 years as more developers/investors deliver purpose built stock into the market.

■ This has made it difficult to identify an institutional yield. This may be resolved once the Adagio Whitechapel development site has been sold, which is on the market quoting 5.5% reflecting its location and strength of the Accor covenant. From an investor perspective, if this yield is achieved it would suggest greater alignment with hotels indicating strong investor confidence in the sector and its brands. ■

OUTLOOK

Investors no longer seeing the sector as distinct to hotels

■ Branding in the sector is expected to pick up pace as operators look to differentiate product across their portfolio. This will help boost consumer and investor confidence.

■ The adoption of Clause 34 as part of the Deregulation Bill is unlikely to have a significant impact. We expect that the Secretary of State will restrict its use to owner-occupiers and to certain areas in London and not make it available to commercial landlords.

■ Regional expansion by the Aparthotel brands is likely to slow after 2017 as they gain a foothold across primary cities. However, we expect some of the dedicated London operators will look to expand outside the Capital with their Aparthotel type product.

■ London will continue to be the main focus for operator expansion.

■ Investors/developers and lenders will become increasingly comfortable with the sector and are likely to see it as an extension of the hotel sector. However, this will be dependent on assets having a C1 consent.

■ This confidence in the sector is likely to be reflected in transaction yields. Location and strength of covenant will become the chief concerns over the property specifics of the asset. As a result we expect that prime yields are in the region of 5.5%.

Please contact us for further information



Tim Stoye
Head of Hotel Valuations
+44 (0)20 7409 8842
tstoye@savills.com



James Bradley
Hotel Valuations
+44 (0)20 7409 8771
jbradley@savills.com



Robert Stapleton
Hotel Transactions
+44 (0)20 7409 8029
rstapleton@savills.co



Oliver Heywood
Hotel Transactions
+44 (0)20 7409 9939
oheywood@savills.com



Marie Hickey
Research
+44 (0)20 3320 8288
mlhickey@savills.com

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