

UK Serviced Apartment Report

Q4 2013



SUMMARY

■ Serviced apartments are finally evolving as a recognised sector in the UK.

■ Private equity funds have entered the market largely through the creation of new owner-operated brands.

■ Future expansion will result in greater variety in aparthotel offering, providing more consumer choice.

■ Entrance of private equity has been accompanied by a movement towards C1 (hotel) consent. This will help legitimise the sector.

■ Revenue per available apartment (RevPAA) grew 12.7% in London in Q2 exceeding the 5.4% growth in RevPAR reported for hotels (rolling 12-month basis).

■ Year to date transaction volumes total £123.5m and are expected to hit £200m by the year end.

■ Prime yields in London are in the region of 5.75% to 6%. Prime regional yields are 7.5% to 8%.

■ The entrance of private equity funds and level of committed resources means that the expansion of the sector will be significant.

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“With some serious money being committed to the sector the potential for growth looks set to be finally realised.”

Tim Stoyale, Savills Hotels
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→ **2013, the year serviced apartments evolved**

- This year will mark the point that serviced apartments evolved as a recognised sector in the UK.
- To date it has been formed of a blend of corporate housing (standard housing provided for short stays with no services), serviced apartments (short stay housing with services) and aparthotels (more akin to hotels with kitchenettes). The latter of which has limited branding recognition in the UK compared with traditional hotels.
- The aspiration of serviced apartment operators to develop their own branded offerings, noted in last year's report, looks set to be realised with the entrance of private equity funds.
- One such example is Go Native's tie up with the Palmer Capital backed developer Danescroft. The JV will see Danescroft secure and redevelop sites with Go Native taking on the units through either a lease or management agreement.
- For others it will mean the creation of new owner-operated brands as with Oaktree Capital's £300m allocation to the newly established CLSA to develop a portfolio of serviced apartment operations across the UK.
- Other new entrants include Starboard Hotels, Hanover Securities and Bridgepoint Ventures JV, Urban Villa concept.
- This future expansion will result in greater variety in aparthotel offering.

As the segment matures we expect to see greater consumer choice in terms of unit size, amenity and service provision.

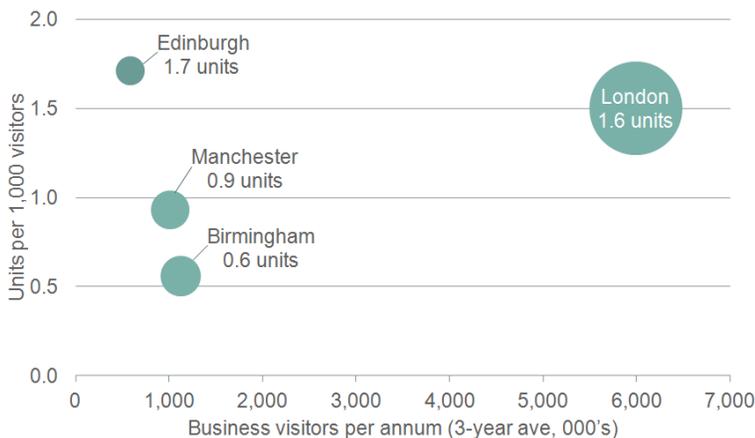
- The corporate guest segment, particularly from overseas, will continue to be the primary target. However, the real 'trick' will be the ability to access the shorter trip (under 13 nights) corporate visitor segment.
- Overseas business visitors to the UK totalled 6.5m in 2012, with those staying between four to 13 nights (medium term stay) accounting for 1.9m trips. While hotels and standard aparthotel concepts can no doubt adequately meet the requirements for those staying less than four nights. For those staying longer serviced apartments are more attractive.
- Hotels do not offer the option to 'cook in', whereas some current aparthotel brands do not necessarily offer the space and full kitchen facilities to make a longer stay truly comfortable. This leaves the corporate housing option but its lack of branding and absence of standardisation of product raises concerns for end users.
- The demand from the short to medium stay business segment is already being recognised by several existing operators and new entrants. In some cases operators are splitting larger units, traditionally more attractive to the longer staying guest, into one bed and studio apartments. Whereas new concepts are offering more spacious 'studios' than traditionally associated with aparthotels.

■ It is likely to be this extra space, offered at rates in line with the hotel market, that will be an important differentiator for the medium stay (four to 13 night) business traveller. Without it there may not be enough of a pull to attract them out of hotels.

Legitimisation through planning

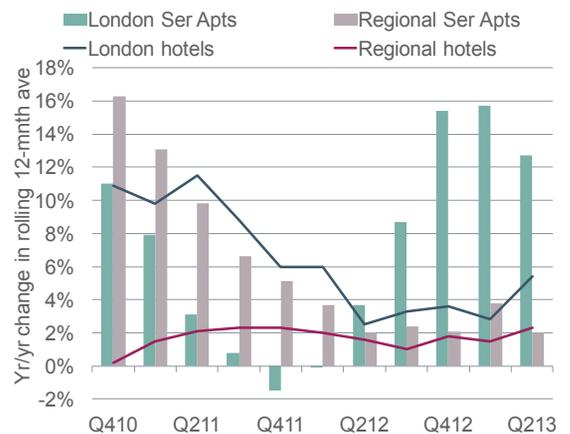
- The entrance of private equity funds has also been accompanied by a movement towards C1 (hotel) planning consent.
- Previous expansion was largely driven by the acquisition of standard residential (C3) units, typically part of larger residential blocks, through leases and/or management contracts.
- This has created barriers for some operators in terms of creating a visible branded product. In London this has posed a risk to operation as C3 properties cannot be let for periods of less than 90 days. If found in breach of this Local Planning Authorities (LPA) can issue enforcement notices requiring the operator to cease trading.
- Going forward, expansion through C1 development and/or acquisition will be the dominant trend. This will no doubt hasten an end to the 'grey' area the sector has sat in to date.
- The legitimisation of the sector through C1 designation and increased branding will be an important driver of attracting further investment.

GRAPH 1 **UK city supply comparison**



Note: size of bubble reflects number of overnight business visitors per annum
Graph source: Savills; AMPM; ONS

GRAPH 2 **London leading RevPAA growth**



Graph source: Savills; Hot Stats; ASAP

Room for expansion in the regional cities?

■ Our examination of Central London serviced apartment supply, relative to business visitors, highlighted that it was undersupplied compared to other global cities such as New York and Hong Kong. Per 1,000 business visitors London has 1.6 serviced apartments compared to 5.7 and 5.3 in New York and Hong Kong respectively, suggesting there is room for further expansion.

■ When you look at key regional cities, supply per 1,000 business visitors is even more constrained with Birmingham having the lowest relative supply of 0.6 units.

■ This would suggest that there is room for further growth in these markets. However, some caution should be exercised in those cities already well supplied for hotels as the depth of the medium to longer stay business visitor segment is likely to be shallower than seen in London.

■ For example, across the three regional cities examined, domestic business visitors dominate, accounting for on average, 72% of total business visitors. In London it is 51%. Considering that domestic business visitors tend to stay for an average of two nights, the potential for expansion may be more restrained.

■ Having said this, there will be opportunities for branded operators to successfully access both the shorter stay business and leisure segments including relocations, which are

typically served by the private rental market.

Operational performance

■ Despite some softening in Central London occupancy during 2012, rates ended the year 16.9% up with a 15.4% growth in RevPAA (revenue per available apartment).

■ On a rolling 12-month basis, RevPAA growth hit 16% this year (graph 2) far exceeding that seen in the hotel market where RevPAR growth has averaged 4.1% over the same period.

■ In contrast to 2012, the first half of this year has seen occupancy improve but the growth in rates slow. Q2 saw occupancy increase by 1.3 percentage points year-on-year with a 3.6% growth in rates, down on the 8.1% reported the previous quarter and resulting in a deceleration in rolling 12-month RevPAA growth.

■ We expect this trend to continue as operators look to balance occupancy with the continued upward trend in rates. However, RevPAA is unlikely to dip below the long term annual average of 7% growth.

■ Regional performance was less exuberant in comparison but with improvements in occupancy, Q2 RevPAA (on a rolling 12-month basis) was up 2% in line with hotels.

Expert view

James Bradley, Savills Hotel Valuation, highlights his key themes

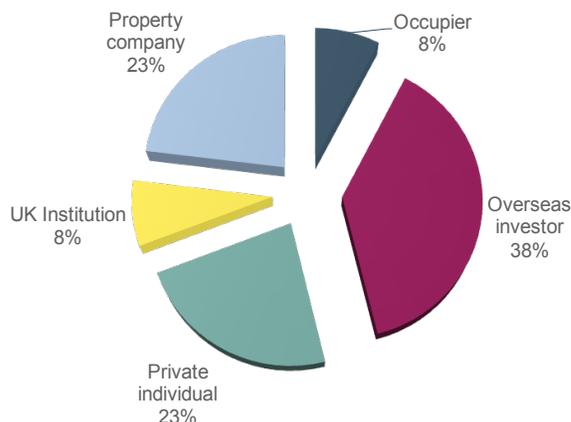
■ Strong trading fundamentals and a range of operational models are underpinning the evolution of the serviced apartment sector. Investor and lender interest is growing and potential for growth is strong.

■ Our serviced apartment valuation index shows a return to 2006/07 values; further growth is of course dependent on a number of macro and market specific factors, but key considerations when approaching valuation of serviced apartments, and their potential impact on value, include:

- Is there a sustainable approach to profitable operation; the importance of affordable rents and efficient management agreements.
- Continued and targeted strategies for increased brand awareness and marketing systems.
- Renovation to provide a higher number of studios/ one-beds. Whilst this does not suit every model, it can offer enhanced medium term returns in the right locations.
- The corporate market is still key for the sector, but the effective targeting of leisure guests during quieter periods is increasingly important.

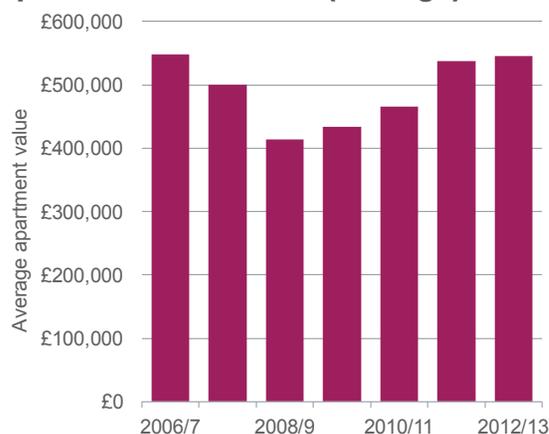
■ From a valuation perspective, it is important that we fully engage with new concepts and refined strategies but retain the basics of valuation for such assets: an in depth understanding of market demand, a robust cash-flow and (an ever increasing pool of) relevant comparables.

GRAPH 3 Investment transactions by purchaser type (last 3 years; number of deals)



Graph source: Savills; Property Data

GRAPH 4 Prime Central London serviced apartment unit values (average)



Graph source: Savills

→ **Investment market remains shallow**

■ Despite a number of 'prime' assets coming to the market this year, the dearth of stand alone blocks with the appropriate consent means that investment activity remains highly constrained.

■ Investment volumes totalled £218m last year, 59% up on 2011. This year volumes to date total £123.5m, all in London. We expect year end volumes to hit close to £200m.

■ As seen in the wider London property market, investment activity has been dominated by overseas investors over the last three years (graph 3). As the sector develops, and as investable stock expands, interest from the UK institutions should improve.

■ Savills value and transact, on average, over £400m worth of serviced apartments annually. From this we have been able to build an index of average serviced apartment values. Due to the nature of properties valued, this index represents average prime values. For London, which is the more robust index, prime values currently average c£545,000, bringing it back in line with its 2006/7 peak of £548,000.

■ Prime yields in London are in the region of 5.75% to 6% having come in by c.50 basis points (bps) since March 2012. Regional prime yields are 7.5% to 8%.

■ In some instances transaction yields will be lower than this as properties, particularly in certain parts of London, will be purchased based on the underlying residential value.

■ Going forward we expect further upward momentum in values, with an associated downward shift in yields, as demand for assets intensifies in line with the entrance of new brands and investors.

■ New entrants are largely having to develop, primarily through office conversions, in order to expand their portfolio of standalone stock. Ascott's purchase of The Cavendish Hotel last year for future conversion into serviced apartments may mean we see similar acquisitions.

■ The commitment and focussed approach from operators and investors to expand purpose built stock means that the sector is set to see significant expansion over the next five years. ■

OUTLOOK

Serviced apartments to finally become a recognised sector in the UK

■ Future expansion will result in greater variety of aparthotel offering.

■ Expansion through C1 development and/or acquisition will be the dominant trend. This will hasten an end to the 'grey' area the sector has sat in to date.

■ There would appear to be room for further growth in London and key regional cities. However, the scope for expansion outside London may be mitigated by its shallower medium to longer stay business visitor segment.

■ RevPAA growth is likely to slow into 2014 as operators balance occupancy with further increases in rates. It is unlikely to dip below its long term annual average of 7%.

■ We expect year end transaction volumes to hit close to £200m.

■ There is likely to be further upward momentum in values, with an associated downward shift in yields, as demand for assets deepens.

■ The entrance of private equity funds into the sector, and their level of committed resources, means that the expansion of purpose built stock will be significant.

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Savills plc

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ASAP

The Association of Serviced Apartment Providers (ASAP) was first established in 2002. ASAP represents all the main serviced apartment operators in the UK, who in turn manage and control in excess of 10,000 units across the UK & Ireland. The Association is the primary body representing the collective interests of all parties involved in the provision of serviced apartment accommodation across the UK. For further information please go to www.theasap.org.uk

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