UK Commercial – 2020

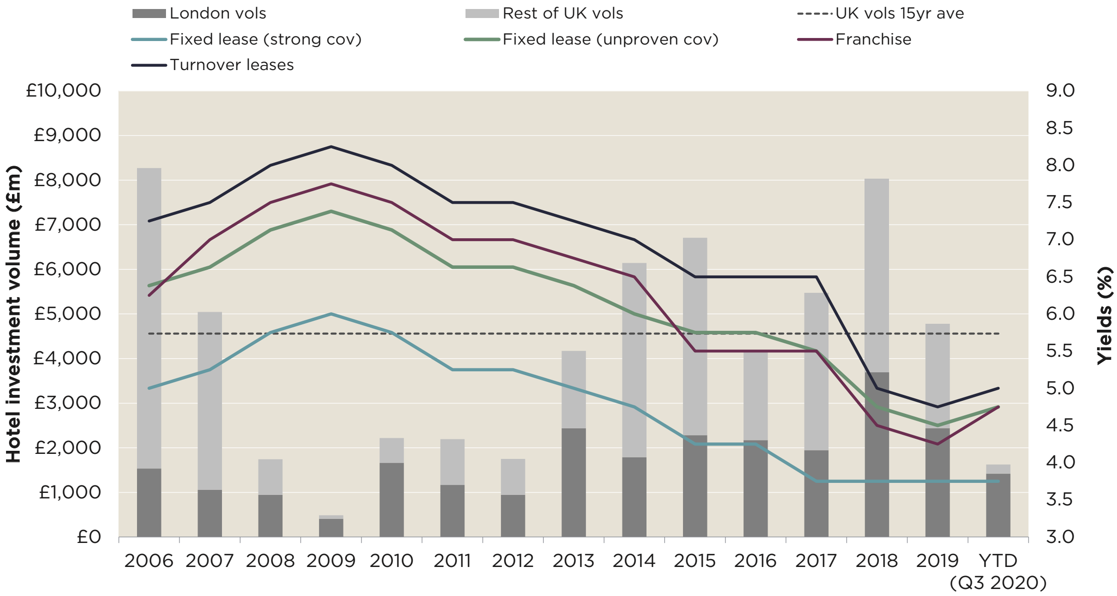
SPOTLIGHT
Savills Research

# UK Hotel Investment Report


- Regions lead the recovery
- Investment volumes slow
- Attractive pricing sparks new interest

> **“While year-to-date investment volumes have been dominated by London, total deal count in regional UK has climbed significantly since the easing of lockdown.”**

**Year-to-date UK hotel investment volumes** demonstrate the retrenchment to London, whilst yields have moved out in light of the current headwinds.




**Source** Savills Research

Year-to-date (Q3 2020) hotel investment volumes totalled £1.63bn, a decrease of -54.4% compared to the same period in 2019.

# Hotel investment: the long-term view

Despite immediate headwinds facing hotels, the underlying fundamentals of the sector continue to support longer-term investment opportunities.

**Hotel investment volumes have suffered due to Covid-19, but interest levels remain relatively robust.**
In line with the wider commercial real estate market, the Covid-19 pandemic has triggered a significant waning in hotel transaction volumes in 2020. Hotel investment this year to date (January-September) reached £1.63 billion, down 54.4% compared to the same period in 2019 and comprised largely by deals completed/agreed pre-lockdown, in the first quarter.

Despite a significant fall compared to volumes witnessed over the previous three years, hotel investment volumes remain above that experienced during the height of the GFC period in 2009 (see chart above).

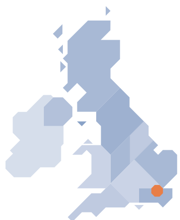
A major barrier to entry for some investors has been the difficulty in obtaining debt for hotel investment in light of the recent operational headwinds, effectively dragging transaction volumes since March. Nonetheless, interest levels from cash-rich investors has remained robust. International investors accounted for a 70.1% share of year-to-date transaction volumes, formed primarily by Israeli-backed Vivion Capital acquiring the Sanderson and St Martin's Lane hotels in January followed by Qatari-based investors acquiring The Ritz in March, with a combined volume nearing £1 billion.

In parallel with previous downturns, some investors have shifted focus towards quality trophy assets in London, despite the acknowledged slower performance recovery and difficulty travelling to the city for some international buyers. Key assets in ultra-prime locations are unlikely to experience such pronounced fluctuations in regards to capital value compared to the wider market. London has therefore accounted for an 87.3% share of total UK investment volumes so far in 2020.

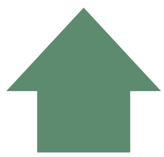
Elsewhere in the market, investors are keeping a keen eye on well-located value-add opportunities for properties with development potential to increase their longer-term income profile. As a result, we've seen some assets achieve higher than their pre-Covid guide price. For example, Savills sold SoHostel in London's Soho in excess of £30 million in August, more than 5% above the pre-Covid guide price after a fiercely contested bidding process. Located adjacent to Tottenham Court Road's new Crossrail entrance, the property provides the new owners with development and trading upside potential to drive further value.

**Strong recovery is driving investment across key UK staycation markets.**
While investment volumes have been dominated by London, total deal count outside of London has climbed dramatically since the easing of lockdown, in line with the strong recovery displayed across key UK staycation markets. Robust operational performance is expected for the foreseeable future in light of the ongoing restrictions limiting international travel, with reports of high levels of domestic bookings next summer already in some locations. As a result, interest levels from private investors for coastal and country hotels have surged, with Savills receiving multiple offers above guide price on well-situated regional assets.

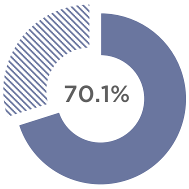
This has also encouraged future funding support for hotel development opportunities across key UK regional destinations. For example, Dalata and Topland recently entered into an agreement to develop a new 221-room



London has accounted for an 87.3% share of YTD 2020 investment volumes, totalling £1.42bn.



Strong recovery across staycation markets has triggered high investor interest levels, with offers exceeding guide pricing.




Overseas investors have accounted for a 70.1% share of YTD 2020 investment volumes, totalling £1.14 billion.

Maldron Hotel in staycation hotspot Brighton, emphasising longer-term investor confidence in UK's booming staycation market.

**Yield reversal experienced in 2020.**
In terms of pricing, while very little transactional evidence makes yield movements difficult to ascertain, current sentiment suggests that prime hotel yields have experienced an outward shift across most operating structures. Yields on franchise and turnover terms are expected to have seen a 50 basis points (bps) and 25bps softening respectively, off the back of the record lows recorded in 2019. Prime yields on a leased basis remain unchanged compared to pre-Covid levels at 3.75% in accordance with ongoing but selective interest for leased assets in core locations with best-in-class covenants and a sensible rental tone.

Further hotel yield softening can be expected across some non-core markets going forward, driven by ongoing subdued trading performance. However this could generate further investor interest, with well-positioned buyers particularly acquisitive given the attractive pricing on offer.

As a result, a number of investors have announced closing on new funds looking to deploy capital into the challenged sector as an opportunistic play. UK-based Schroders for example, recently announced a new €425 million pan-European hotel fund, with the objective of capitalising on attractive hotel and leisure opportunities across key Western European markets.

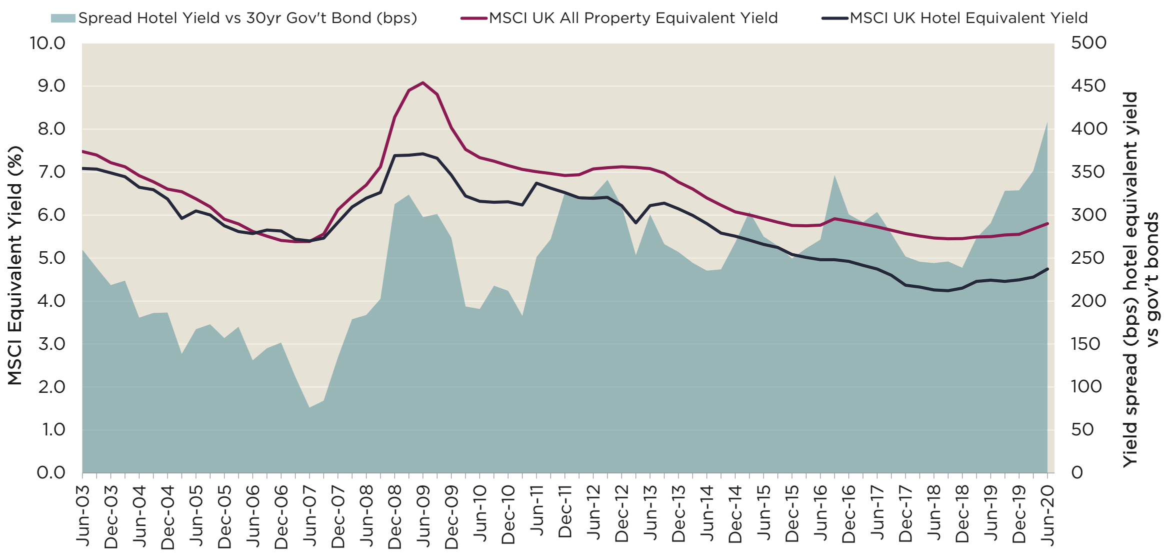
**How does the hotel sector fare against other investment options?**
The spread between hotel equivalent yields and government bonds is at an all-time high of 408bps as of Q2 2020, far outstripping the 15 year average of 248bps according to MSCI (see chart below). This spread has widened in recent months in light of the subdued interest rates coupled with a slight outward movement in hotel equivalent yields. While at a glance this might look particularly attractive for hotel investment, the risk element should be considered. Akin with previous recessions, many investors are veering on the side of caution, seeking the long-term security and ease of the buy/sell factors that support government bonds. That being said, well-positioned investors with strong cash reserves may look to commercial real estate as a move to improve their long-term income profile, and as a hedge against a potentially inflationary environment in the UK post-Brexit.

Compared to other commercial real estate sectors, UK hotel equivalent yields have remained the lowest on average since Q1 2012 within the MSCI database, in line with continued investor appetite for long-term secure income. Despite marginal shrinking in Q2 2020, the spread between UK hotel equivalent yields and the all property average remains sizeable, at 106bps. However, further hotel yield softening could provide comparatively attractive pricing within some markets.

While the immediate operational headwinds in the hotel market will be a cause for concern for some investors, the longer-term outlook for the sector continues to bode well for prime assets and development opportunities whilst we expect distressed sales to drive investment volumes as we move into 2021. In addition, further currency play post-Brexit continues to entice international buyers seeking relatively well-priced hotel assets.

> "A number of investors have announced closing on new funds looking to deploy capital into the challenged sector as an opportunistic play."

**Hotel yield spread to government bonds and the all property average** highlights the continued security in long-term hotel investment despite the immediate headwinds.




**Source** Savills Research, MSCI, Oxford Economics

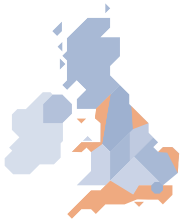
## Could reinvention of space open opportunities?

**In light of the current consumer environment, the hotel market is in temporary oversupply across some locations, however there are a number of options for hotel owners in terms of dormant or underused properties.**

**Short-term redefinition of space has provided interim cash-flow for some operators, whether that be in the form of alternative workspace for individuals/ companies, pop-up restaurant space or healthcare response centres.**

**More permanent renovations could provide hotel owners with a longer-term solution. The typical configuration of hotel properties bodes well for change of use to other sectors such as healthcare, multi-family or student housing.**

**This also works in both directions, with areas of strong hotel demand being a more attractive long-term option for owners of vacant/underutilised retail or office space. This has brought about hotel development opportunities across the UK. For example, two historic department store properties in Edinburgh have been earmarked for mixed-use developments each including hotel assets. This trend is likely to continue given the headwinds facing sectors like retail, which could leave vast pockets of vacancy across well-situated locations.**



Key coastal staycation markets have experienced a significant bounce in occupancy rates, with Plymouth, Bournemouth and Brighton recording over 90% across periods of August.

# Where's leading the recovery in the hotel market?

Domestic leisure-led locations are experiencing the immediate recovery in performance while larger urban centres continue to be hindered by an absence in corporate and international demand.

**Covid-19 shocked the hotel market but strong domestic demand has sparked a recovery.**
The Covid-19 crisis has adversely impacted the wider UK hotel sector, with the vast majority of hotels being forced to close for over three months between late March and July. The easing of lockdown measures and reopening of hospitality from 4 July triggered a phased return to business for some hotel groups while others remained closed, utilising the Government Job Retention Scheme until higher levels of occupancy could be achieved. As of early September, under 10% of hotel stock still remained closed across the UK, according to STR.

Based on the furlough scheme winding down in October and business rates holiday coming to an end in March, some hotel groups could be forced to streamline their business. Further insolvencies are also widely anticipated as businesses begin reabsorbing their full payroll costs at a time when revenues remain subdued.

Nonetheless, we have started to witness some very positive developments regarding recovery in certain markets. Continued limitations in regards to international travel with the ongoing risk of quarantine, coupled with pent-up demand to travel since lockdown has propelled the domestic staycation holiday market in recent months.

Domestic holiday trips in the UK increased 4.4% year-on-year in 2019, totalling 60.5 million. In the same year, UK visits abroad reached over 73 million, making the UK the second largest outbound source market in Europe after Germany. What this suggests is that the gap left by international tourists could in part be filled by heightened domestic demand while international restrictions last, supporting UK holiday hotspots.

In terms of location, domestic travellers have opted for less densely populated regions, veering towards coastal and regional towns with the likes of Plymouth, Bournemouth and Brighton experiencing occupancy levels in excess of 90% over large periods of August, as reported by STR. This mimics historic trends, with the South West dominating in terms of total domestic holiday trips in 2019 (see chart below). The current demand shift to regional locations is verified further when looking at the spread in average daily rates (ADR) between London and regional UK, which shrunk from £96.4 in July 2019 to £20.9 in July 2020.

**City centres remain adversely impacted by the absence in corporate and international travel.**
The recovery profile of larger urban centres is expected to be more gradual, with regions such as London, South East and West Midlands exposed to both corporate and international demand. Latest WTTC forecasts suggest overseas visitor arrivals to the UK could fall 73% year-on-year in 2020. To put this into context, overseas arrivals accounted for a 64.7% share of total arrivals in London last year, compared to a 12.2% share in the South West.

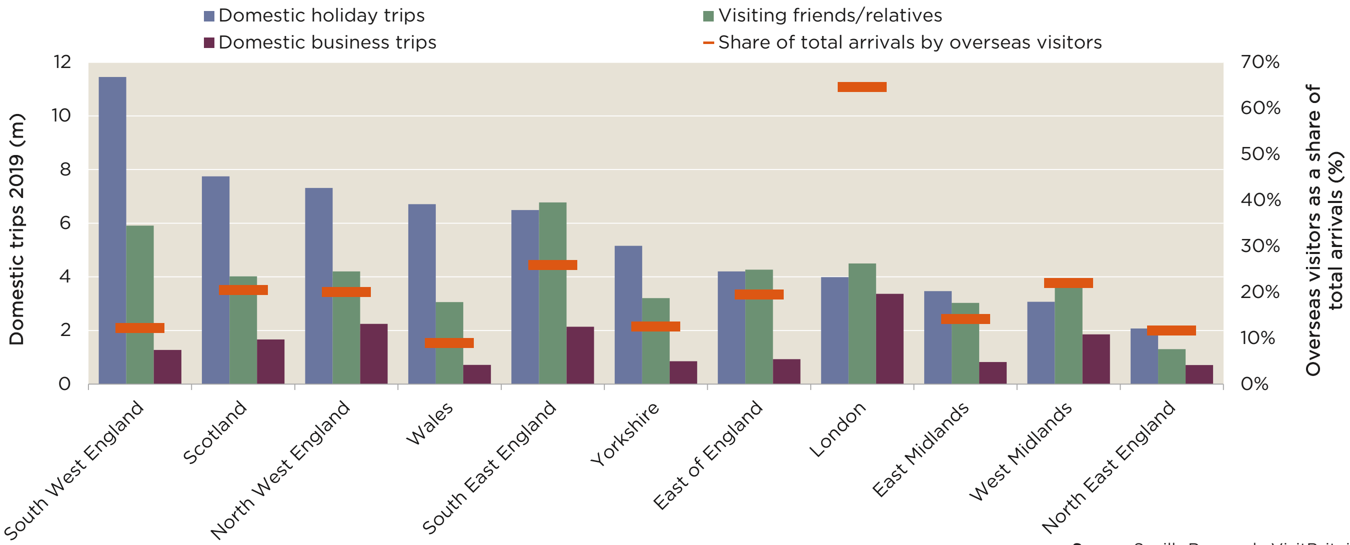
Corporate-reliant markets are expected to be amongst the slowest to recover, in line with companies scaling back work travel whilst conferences and events remain largely online. This could amplify headwinds within the full-service, conference-reliant segment over the medium-term.

**Outlook for 2021**
Akin to previous recessionary behaviour, we can expect the budget hotel segment to enjoy a quicker recovery due to both leisure and corporate travellers watching their wallet in the face of an economic downturn. What's more, a great deal of budget hotel supply is conveniently located with available parking, supporting social distancing. The budget segment also tends to have less room rate to lose, effectively meaning falls in ADR (and therefore RevPAR) may not be as severe on average.

Despite being historically dominated by corporate demand, the serviced apartment sector has increased its appeal to leisure travellers due to greater social distancing options in light of the typical self-contained unit layout, as well as a push towards more aparthotel product in recent years.

2021 is expected to be a very strong year in terms of recovery off the back of the unprecedented falls this year, with STR projecting London and regional UK occupancy rates could improve by 122% and 73% year-on-year respectively. However, full RevPAR recovery to the sector will likely be hindered due to a lagged pick up in ADR across larger markets in response to hotels dropping rates in the face of subdued demand. Most sources are in agreement that RevPAR will therefore not return to 2019 levels until 2023-2024 at the earliest, albeit with some markets expected to recovery quicker.

**Domestic tourism by region 2019** highlights the demand for holiday trips across UK regions while urban centres like London remain more exposed to corporate and international travel.




**Source** Savills Research, VisitBritain, ONS

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