NOVEMBER 2017 | RESTAURANTS, HOSPITALITY & LEISURE

Q3 2017 Hotel Bulletin: softening RevPAR growth has yet to stifle a bumper quarter for transactions

In Q3 2017, RevPAR growth slowed down in eight of the 12 cities we reviewed in the Hotel Bulletin, and four of those cities recorded a decline. Despite weaker trading metrics, the total transaction value exceeded £1 billion for a second consecutive quarter. In this edition's focus, we analyse hotel cost pressures and the resulting profitability challenges for hoteliers.

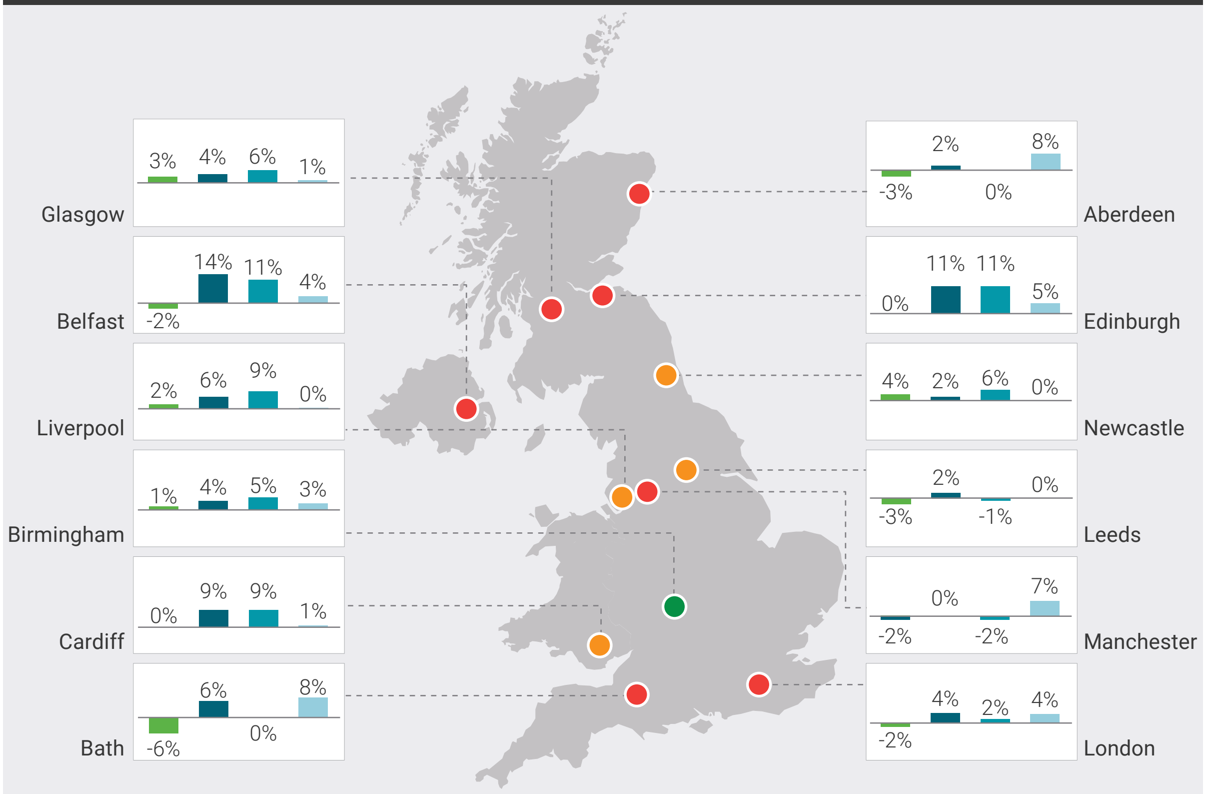
DEMAND

STR's Q3 2017 demand data demonstrates that RevPAR growth was more muted compared to previous quarters. Only two cities—Belfast and Edinburgh—achieved double-digit growth. In fact, average RevPAR growth in Q3 2017 was 5%, the lowest level since Q1 2016 (when we exclude Aberdeen's impact). Amid a lower-growth environment, global political uncertainty, and an increasing threat of terror, RevPAR growth for the 12 cities we examined has averaged 6% over the past 20 quarters. That vastly outpaces UK GDP growth, which has averaged below 1% in the same period,[1] demonstrating how robust the UK hotel market is.

Top performers Belfast and Edinburgh achieved 11% RevPAR growth in Q3 2017, as these popular UK tourism destinations continued to benefit from more visitors taking advantage of the weaker pound.

[1] Office for National Statistics

FIGURE 1: SELECTED UK HOTEL MARKETS – DEMAND AND SUPPLY



- Occupancy percentage change (Q3 YoY)
- Average room rate percentage change (Q3 YoY)
- RevPAR percentage change (Q3 YoY)
- Supply percentage change since 30 September 2015
- ●●● Active pipeline >10%, 5 to 10%, <5%

Notes: Q3 covers the three months to the end of September | Q3 YoY compares the average of Q3 2017 to the average of Q3 2016 | Supply and pipeline analysis relate to numbers of hotel bedrooms | 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

Belfast recorded double-digit RevPAR growth for a fifth consecutive quarter. Although below recent 20%+ levels of growth, these statistics are impressive given strong comparators in Q3 2016 (17% growth). The city is well-placed to build on this success, as Lonely Planet recently named Belfast and the Giant's Causeway coast the best region to visit in 2018.[2]

Over the last five years, there has been an upsurge in tourism in Edinburgh, with visitor numbers increasing by over half a million to 3.85 million over this period.[3] Some analysts have questioned whether the city has the infrastructure to cope with increased demand[4] which, at least in the short term, is probably a nice problem for hoteliers to have.

London recorded a 2% increase in RevPAR this quarter despite a decline in occupancy, caused by supply growth outpacing demand. However, the city did attract 5.5 million international visitors in Q2 2017 (a 10% increase on the same quarter last year). This included a 30% increase in visitors from North America,[5] likely attracted by a weaker pound against the dollar.

Aberdeen recorded an eleventh consecutive quarter of falling RevPAR, although the decline of "only" 1% suggests that the city may have, finally, hit the bottom. With oil prices increasing, there may be light at the end of the tunnel for Aberdeen's long-suffering hoteliers hoping for workers in the industry to return to the city. However, a significant active pipeline in the city (10% of current supply) is likely to continue causing concern.

This quarter's worst performer was Manchester, which recorded its first RevPAR decline (2%) since 2012. Manchester has traditionally been able to absorb significant amounts of new hotel bedroom supply with minimal impact on demand metrics. However, the fact that more than 1,200 bedrooms entered the market in the last 12 months (7% of current supply) suggests that, in the absence of an uptick in room night demand, Manchester's hotel market may be approaching saturation. With an extra 1,600 bedrooms (10% of current supply) due to open in the next three years, hoteliers should look to stand out from competitors to drive growth.

Bath recorded its first decline in RevPAR (less than 1%) since Q1 2013. But that small decline need not concern hoteliers, as it follows strong comparators in Q3 2016 in a traditionally robust leisure market.

[2] Lonely Planet
[3] The Scotsman
[4] The Times
[5] London & Partners

SUPPLY AND PIPELINE

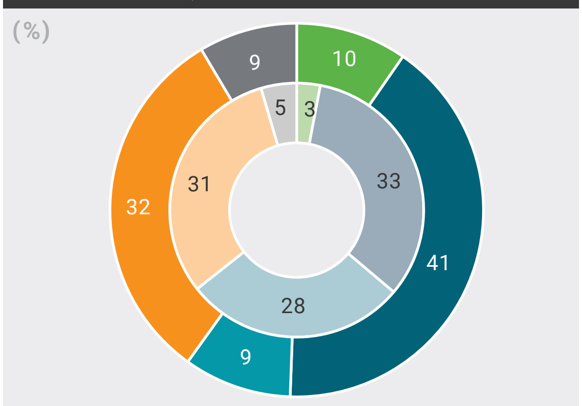
Figure 2 compares the proportion of current supply (inner circle) and active pipeline (outer circle) in the UK market by sector. Q3 2017 was another relatively slow quarter for openings, with just over 3,000 new bedrooms coming onto the market. By contrast, development activity is still strong—particularly in the serviced apartment and five-star segments.

There have been several serviced apartment openings and developments this quarter, with investors attracted by its lower operating cost model. In addition, fewer uniform sites can often be used for serviced apartments, which can increase site availability and lower overall development costs.

Notable new openings and developments this quarter include:

- The 339-bedroom hub London Westminster Abbey opened following a forward purchase by M&G Real Estate. The hotel is being leased to Premier Inn for a reported £4.2 million per annum.
- The 119-bedroom Titanic Hotel in Belfast's Titanic Quarter has opened with conference and banqueting facilities for up to 250 guests. Owners Harcourt Developments have plans for other hotel developments in the same area, including a 244-bedroom development in Hamilton Dock.
- Westminster City Council has approved plans to convert the US Embassy on Grosvenor Square into a 137-bedroom Rosewood Hotel. The proposed development will also feature a range of high quality shops and restaurants.

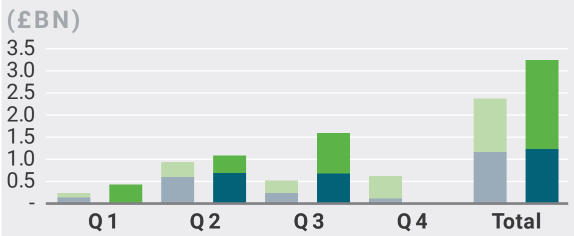
FIGURE 2: UK CURRENT BEDROOM SUPPLY (INNER CIRCLE) AND ACTIVE PIPELINE (OUTER CIRCLE) BY GRADING



Active pipeline (%) / Current supply (%): Apartments, Budget, 3 star, 4 star, 5 star

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

FIGURE 3: UK TRANSACTION VALUE



Portfolio 2016, Single asset 2016, Portfolio 2017, Single asset 2017

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

TRANSACTIONS

Transaction values in Q3 2017 totalled £1.6 billion, of which £1.0 billion related to single asset transactions (the highest since 2014). More than half the total value of single asset transactions consisted of one transaction: the sale of the Grosvenor House Hotel for a reported £600 million.

What's driving this upward trend in transaction values in recent quarters? It may be partially attributable to investors rushing to complete transactions before the effects of Brexit are felt. To date, the weaker pound has bolstered top-line performance in the UK hotel market, but some investors are likely to become increasingly wary of hotel assets as plateauing RevPAR growth is combined with the expected labour shortages and increasing costs following Brexit.

Notable transactions in Q3 2017 include:

- Henderson Park acquired two Hilton Metropole hotels located in London and Birmingham from Tonstate Group for £500 million. The two hotels will continue to be managed by Hilton under existing agreements.
- Ashkenazy Acquisition Corp. acquired the five-star, 494 bedroom Grosvenor House Hotel from administrators Deloitte for a reported £600 million. The property had been on the market since March 2015 and had previously received failed bids from Sahara Group and the Qatar Investment Authority.
- Leonardo Hotels, the European arm of Israeli company Fattal Hotels, acquired a group of five three-star Scottish hotels from Portland Hotels for a reported £40 million. The 536-bedroom group includes two hotels in Edinburgh and one in Glasgow.
- Swedish real estate company Pandox acquired the 398-bedroom Hilton London Heathrow Airport for £80 million from Davidson Kempner Capital Management. The hotel is operated by Hilton under a revenue-based lease agreement until 2043 and is one of three properties that Hilton operates under leasehold agreements at Heathrow Airport.

IN FOCUS

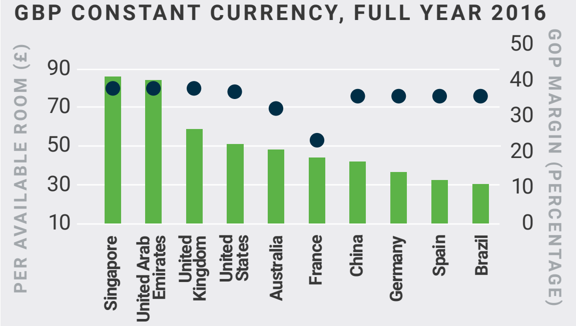
Following last year's Brexit vote, the UK's hotel performance has thrived. With international arrivals projected to rise 5.1% for the full year,[6] RevPAR has grown accordingly. STR's year-end forecasts have London's RevPAR increasing 7.4% and Regional UK (UK excluding London) RevPAR increasing 4.5%. As hotel operators look to maintain this strong growth in a post-Brexit economy, one of the biggest concerns is controlling costs, in particular labour.

In the lead-up to the June 2016 referendum, the UK's minimum wage rose 7.5%,[7] which was the highest increase since 2001. Total labour costs for UK hotels rose 4.1% in 2016 and accounted for 44.4% of total operating expenses. Although labour costs continue to rise, there is also concern within the industry around sourcing staff, with net migration falling to its lowest level in three years, declining 81,000 to 246,000 as of March. Of the decline in net migration, 51,000 can be attributed to the net migration of EU citizens.[8] In addition to the increase in payroll costs and the net migration decline, the country's expanding hotel supply means a higher demand for staff. The main takeaway? Labour cost inflation show little sign of waning.

Another line item that has recently drawn attention is the cost of food. National concern has mounted that UK consumers could see increased food prices as import taxes increase following Brexit. Although UK hotels saw a 1.2% decrease in food costs throughout 2016 (6.5% of total operating expenses), food prices have risen this year in eight of the nine months leading to the end of September 2017. Hotels are seeking to optimise food and beverage operations more than ever, and many are opting to remove traditional room service offerings, reflected in a 4.0% decline for in-room dining. The rapid supply and performance growth we have seen in the UK's budget hotel sector highlights the benefit of a limited-service operating model. Full-service hotels continue to adapt to meet the dining needs of their guests while also attracting local residents to visit their restaurants and bars.

FIGURE 4: MAJOR GLOBAL COUNTRIES – GOPPAR ACTUAL, GOPPAR PERCENTAGE MARGIN

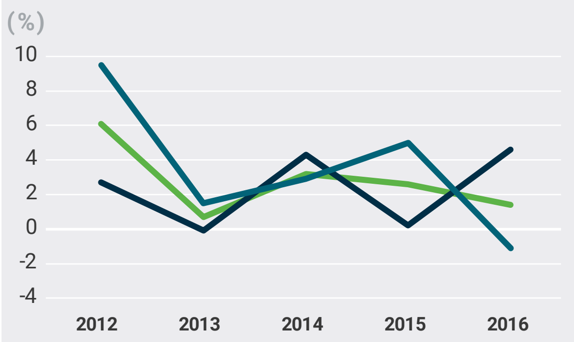
GBP CONSTANT CURRENCY, FULL YEAR 2016



GOPPAR ● GOP percentage margin

Source: STR

FIGURE 5: LONDON VS REGIONAL UK – REVPAR, DEPT. EXP., GOPPAR PERCENTAGE CHANGE



RevPAR Dept. exp. PAR GOPPAR

Source: STR

No assessment of hotel costs would be complete without mentioning online travel agencies (OTAs). OTA commissions are discussed in countless publications, conferences and boardroom meetings, and although negotiated contracted commissions from the major ones are coming down, OTA bookings continue to grow each year on top of an already substantial base. Hotels have adapted to the challenges of the modern distribution landscape, optimising their revenue streams. Some London hotels manage to achieve a gross operating profit percentage margin above 45%, efficiently yielding occupancy and ADR despite considerable supply growth.

In spite of the cost challenges UK hotels currently face, the country ranks in the top three for gross operating profit per available room (GOPPAR), coming in at £58. This reflects a gross operating profit margin percentage of 38.6%, which puts the UK ahead of the US, China, France, Spain, and Germany, and behind only Singapore and the United Arab Emirates.

The hotel industry has faced a stream of headwinds in recent years, including rising costs, supply growth, terrorist attacks, and the evolution of third-party distribution and sharing economies. Looking at the five-year trend for the UK, the correlation between departmental expenses and GOPPAR is clear. But in the face of it all, we consider hotel operators will continue to adapt and innovate to drive continued growth and profitability, and thereby value. **A**

Source for all data is STR unless otherwise specified.

[6] Tourism Economics

[7] www.gov.uk

[8] Office for National Statistics

INVESTMENT INDICATORS FOR Q4 2016 TO Q3 2017

FIGURE 6: GLASGOW

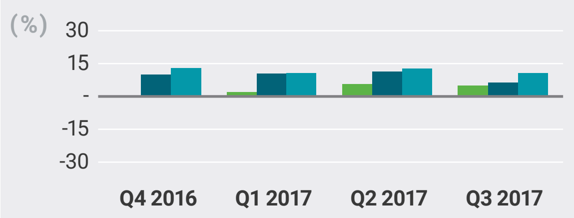


FIGURE 7: BELFAST

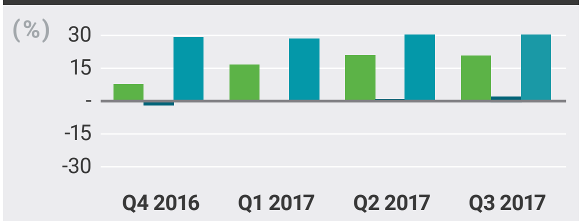


FIGURE 8: LIVERPOOL

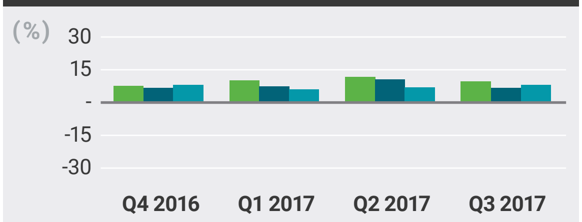


FIGURE 9: BIRMINGHAM

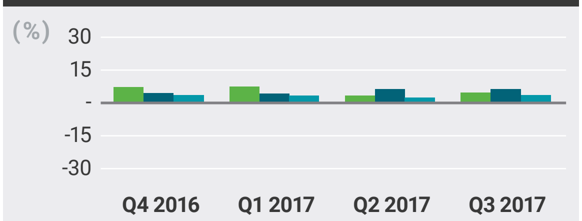


FIGURE 10: CARDIFF

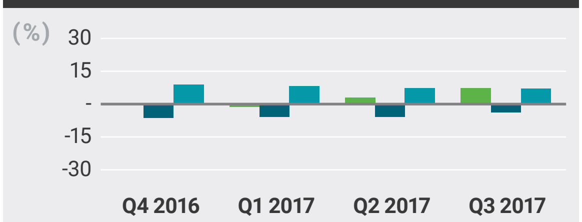


FIGURE 11: BATH

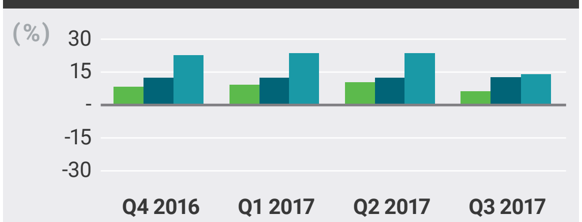


FIGURE 12: ABERDEEN

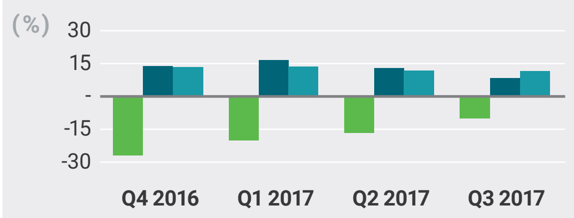


FIGURE 13: EDINBURGH

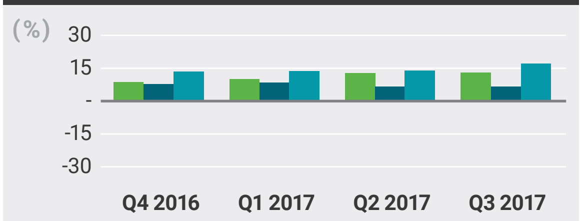


FIGURE 14: NEWCASTLE

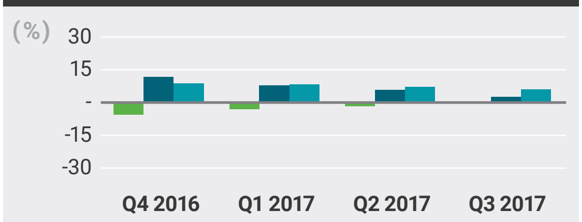


FIGURE 15: LEEDS

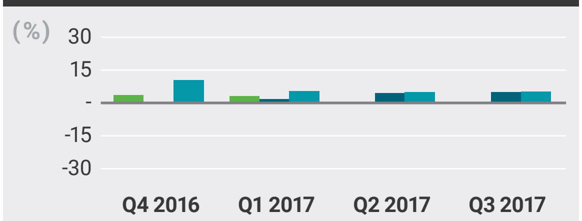


FIGURE 16: MANCHESTER

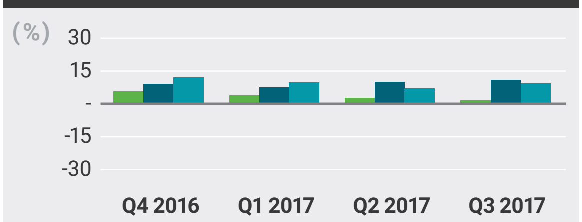
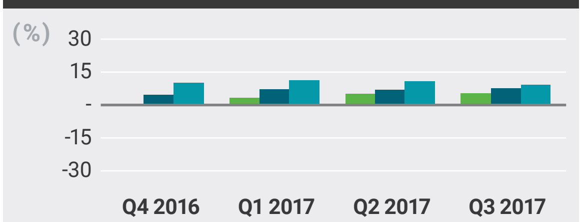


FIGURE 17: LONDON



Key for all: ■ Demand growth ■ Historical supply change ■ Active pipeline
Source for all: AM:PM, STR

Note: Demand growth calculated as the average quarterly RevPAR change over the last four quarters
Historical supply change calculated as change in hotel bedrooms between September 2015 and 2017
Active pipeline calculated as active pipeline as a percentage of current supply

ABOUT AM:PM

AM:PM is the most advanced system for staying on top of hotel supply development. Currently available for the UK and Ireland, AM:PM was acquired by STR in 2016, and is currently being integrated for several markets around the world. With AM:PM, you can stay informed on new hotel openings, pipeline construction and development, closures, rebrands and transactions and access intuitive reports. Beyond the updates, you can visualize this data with our fully functional map tool.

ABOUT HVS

HVS is the world's leading consulting and services organization focused of the hotel, mixed-use, shared ownership, gaming and leisure industries. Established in 1980, the company performs 4,500+ assignments each year for hotel and real estate owners, investors, lenders, operators and developers worldwide. HVS principals are regarded as the leading experts in their respective regions of the globe. Through a network of more than 40 offices and 350 professionals, HVS provides an unparalleled range of complementary services for the hospitality industry.

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ABOUT STR

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All hotel performance data included in this report was provided by STR unless otherwise indicated.

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