RESEARCH

UK Hotel Market Outlook

Autumn 2018

Park Hyatt Hotel London

Summary

- Record RevPAR in London and Regional UK markets, however growth is slowing.
- Supply growth expected to put pressure on tertiary assets in some markets going forwards.
- Strong investment volumes, especially in the Regional UK market.
- Some yield compression for core assets in prime UK markets.

UK Economic Overview

UK economic growth although weak, demonstrates underlying resilience:

0.4% in Q2

GDP growth up from 0.2% in Q1

39m visits

Sterling remains weak which has driven inbound leisure tourism to a record high in 2017

4%

Unemployment has reached a record low, not seen since 1975. We expect employment growth to slow in 2018, but remain positive

86,000

The number of EU nationals working in the UK decreased to 2.28 million from April to June 2018, this is the largest annual decline since records began in 1997

0.75%

The Base Rate was raised by 25 basis points in August: further increases are not expected in the short-term

Latest consensus forecasts, September 2018

	2018	2019	25-year trend
Economic growth (GDP)	1.3%	1.5%	2.5% pa
Private consumption	1.1%	1.2%	
Employment growth	1.0%	0.4%	0.7% pa
Bank Base Rate (Q4)	0.76%	1.11%	
CPI – Inflation (Q4)	2.2%	2.1%	
RPI – Inflation (Q4)	3.2%	3.1%	

Source: HM Treasury (Compilation of forecasts, GVA)

In June the government published the Brexit white paper setting out its proposal which has come to be known as the 'Chequers Deal'. A key feature includes a common rulebook around trade in goods although several issues remain ambiguous or unaddressed, including arrangements on services which account for almost 80% of UK output. Indeed, both sides have ramped up preparations for a no-deal outcome which is becoming a real possibility as we near the exit date.

UK economic growth, although weak, demonstrates underlying resilience amid increased uncertainty. GDP growth strengthened to 0.4% in Q2, up from 0.2% in Q1 having been boosted by warm weather and the World Cup. A more recent publication by Office on National Statistics indicates GDP growth accelerated to 0.6% in the three months to July.

The value of Sterling remains considerably lower than its pre-referendum level and whilst this has been negative for UK consumers, it has meant the UK has been seen as a good value for money destination which, alongside positive global growth, has supported inbound tourism. We expect Sterling to remain weak over the medium term however, the exact path of the exchange rate will be heavily dependent on how Brexit negotiations unfold.

The labour market continues to strengthen with the unemployment rate remained at 4%, down from 4.3% last year, the joint lowest since early 1975. The total number of employees in work between May and July 2018 rose to 32.4 million people, an increase of 261,000 compared to a year ago. Employment growth has been largely driven by full-time employment and, with little spare capacity left in the UK, we expect employment growth to shrink in 2018 but remain positive.

The number of EU nationals working in the UK decreased by 86,000 to 2.28 million from April to June 2018, this is the largest annual decline since records began in 1997. This is likely to add significant pressure on staffing for sectors notably the hotel industry, which employ a significant number of EU nationals.

Wage growth picked up to 2.9% excluding bonuses, and to 2.6% including bonuses. Pay growth is anticipated to improve over the course of this year and next in line with the tight labour market. This may alleviate some pressure on consumers although, a significant boost in spending and growth is unlikely as household budgets have been constrained for a prolonged period with spending supported by borrowing.

The Monetary Policy Committee (MPC) expects domestic cost pressures to rise given the tight labour market conditions and unanimously voted to raise the Base Rate by 25 basis points to 0.75% in August.

CPI inflation increased to 2.5% in July, up from 2.4% in the previous month and is the first ascent since November 2017. Despite the recent upwards swing, inflation should gradually decline reaching the target 2% by the end of next year (assuming the UK avoids another depreciation in Sterling).

Economic growth remains muted and we do not expect growth to pick up at least until next year. This is largely a result of subdued consumer spending growth and the drag on business investment arising from the ongoing uncertainty around the outcome of Brexit negotiations.
The Treasury consensus forecasts have downgraded economic growth from 1.7% in 2017 to 1.3% in 2018 before rising to 1.5% in 2019.

UK Hotel Performance

Record revenue per available room levels have helped hotels in the UK maintain strong performance levels in 2018. Whilst growth has slowed, due partly to significant new supply, the wider performance of both London and the Regional markets is encouraging going into the potentially more turbulent waters of 2019.

Whilst most major regional markets have seen RevPAR growth this year, the story has been mixed. Glasgow has witnessed amongst the highest RevPAR growth of any major UK city to date, due in part to events such as the inaugural European Championships, The 25th anniversary of Celtic Connections and Glasgow Film Festival. Of the major UK markets Heathrow has posted arguably the weakest RevPAR performance. Despite the airport handling record passenger numbers, significant new supply appears to have absorbed demand to some degree. The top performing markets of 2018 are highlighted in Figure 1.

According to data from Visit Britain, 2018 is expected to record levels for inbound tourism to the UK; both in terms of visits and visitor spend. Despite falls in visitor numbers from several key European markets, events such as the Royal Wedding and Farnborough International Airshow have led to higher overall visitor volumes, with the US in particularly posting strong demand. Weak medium term currency forecasts suggest the UK will remain a good value for money destination next year, with the current strength of the US and emerging economies boding well for the sector. We highlight the year on year change in total visitor numbers in Figure 2.

Domestic demand seems less certain with UK GDP growth expected to slow in the year ahead as public spending cuts and Brexit-related uncertainty continue to weigh on the economy. Notably, the impact of Brexit on domestic corporate demand is yet to be seen and may be the truer determinant on UK hotel performance in 2019.

Inflation, which has arguably been the clearest economic effect of Britain's vote to leave the EU so far, has continued to cause concerns for UK hoteliers in 2018; devaluing and frequently exceeding RevPAR growth. Whilst expected to decelerate as we exit the EU; we expect inflation to continue to exceed RevPAR in many UK markets in the year ahead. We highlight London and Regional RevPAR performance relative to the key inflation metrics of RPI and CPI in Figure 3.

Supply Increases

Both London and the Regional markets have seen a high volume of new supply this year. With another 30,000 hotel bedrooms expected to enter the UK market before 2020 we expect to see further polarisation of performance with location, condition and good management becoming increasingly important. We anticipate new supply to impact short term market performance to some degree in Heathrow (3,107 additional rooms expected by 2020), Manchester (2,808 rooms) and Liverpool (1,804 rooms). Supply growth as a proportion of existing supply in key UK markets is highlighted in Figures 4 and 5.

Top 5 markets by RevPAR growth

Top 5 RevPAR Growth	Growth %
Gatwick Airport	9.7%
Glasgow	8.9%
Brighton	8.0%
Aberdeen	5.7%
Liverpool	5.6%

Figure 1

Source: STR Global 2018

Top 10 international markets by volume of visitor nights (2017)

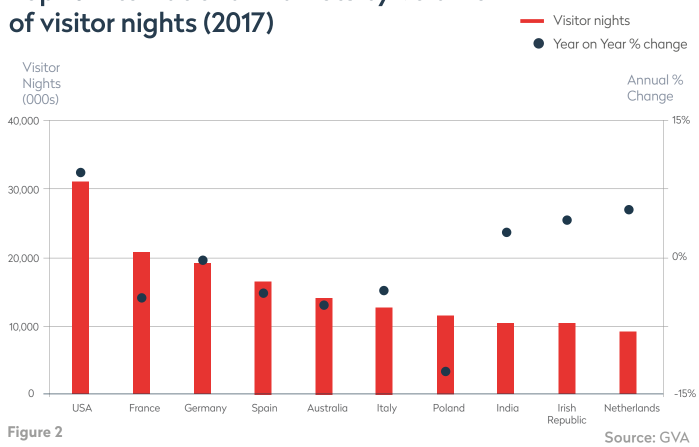

Figure 2

Source: GVA

Five year RevPAR performance vs inflation 2014-year to date August 2018

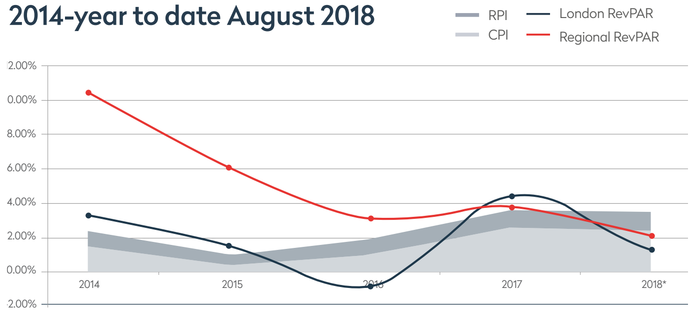

Figure 3

Source: GVA

Transactions and Investor Appetite

Increase in bedrooms

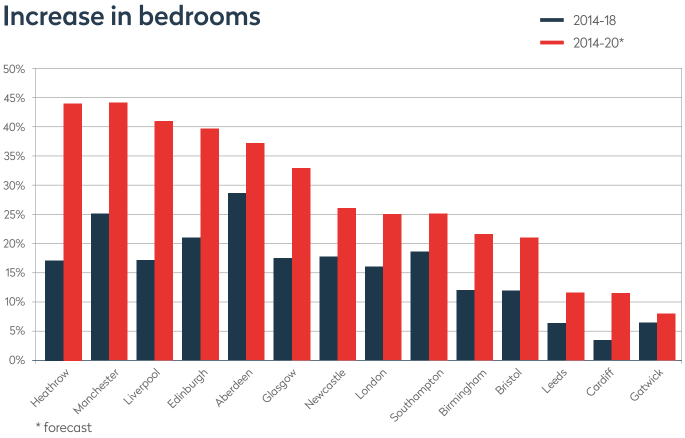

Figure 4 Source: STR Global

Top 5 markets by supply increase

Key Cities	Pipeline Rooms 2018-20	% of Current Supply
London	10,739	8%
Heathrow	3,107	23%
Manchester	2,808	15%
Edinburgh	2,210	15%
Liverpool	1,804	22%

Figure 5 **Source:** AM:PM Hotels Database

Despite the macroeconomic headwinds the UK hotel investment market has remained robust in 2018, continuing its evolution into a core investment sector. Investment sentiment remains especially strong for branded well located stock, with both yield compression and operational performance driving value growth.

The £858m acquisition of the Principal hotel group (10 operational Principal hotels, two operational De Vere properties and one development site) by French company Convivio (formerly Foncière des Régions) from the US-based Starwood Capital Group marked the largest UK hotel property transaction of the year so far. The purchase, which provides IHG with the opportunity to introduce the luxury boutique brand Kimpton Hotels & Restaurants into the UK for the first time, suggests a move away from the 'asset light' approach IHG has adopted in recent years. IHG will operate the hotels under managed leases, along the same lines of only four other managed hotels leased by IHG across its global portfolio. The price paid for the largely leasehold portfolio reflected a record price per room in several regional UK cities and arguably reflected minimal yield arbitrage considering the commercial ground lease nature of many of the key assets.

The disposal of UK hotel assets by US private equity has been a key theme of 2018, with Lone Star's sale of the final 25 hotels from its Amaris Hospitality portfolio for £600 million in May 2018 another clear example. The deal followed the sale of the portfolio's Jurys Inn chain to the Israeli-based Fattal Hotels Group and Swedish hotel investment company Pandox for £800m in December 2017. The Texan private equity group, which refinanced its remaining 40-strong portfolio of UK hotels, managed by Shearings Leisure Group, in March 2018 has realised in excess of £2bn since beginning its hotel disposal programme with the sale of Atlas Hotels in April 2016.

We highlight the largest portfolio transactions of 2018 in Figure 6.

Rise of fixed income

Long income let to prime covenants has continued to strengthen in 2018 with an ever increasing buyer pool with significant funds to deploy leading to record low yields. In January 2018 the 140 bedroom Travelodge Kings Cross Central sold at a record low of 3.07% to a UK Pension fund, marking the sharpest yield in the sector to date. The lack of alternative operators offering strong covenants in regional markets appears to be the principal impediment to further growth in this sector in the short term. We highlight key recent fixed income deals in Figure 7.

Key portfolio deals of 2018

Address	Hotels	Bedrooms	Price (£ million)	Price per room (£)	Yield	Month	Vendor	Purchaser
Project Dragon (Principal Portfolio)	13	2,406	858	356,000	c.7%	May-18	Starwood Capital (US)	Convivio (France)
Project Ribbon (17 Holiday Inns, 3 Crowne Plaza)	20	4,840	750	155,000	c.7.25%	Apr-18	Apollo (US)	Vivion (Israel)
Amaris Hospitality Portfolio (21 x Accor, 4 x Hilton)	25	3,766	600	160,000	c.7.75%	May-18	Lone Star (US)	LRC (Israel)
Project Dragonglass (7 Hiltons)	7	1,300	135	104,000	c.7%	Feb-18	Park Hotels & Resorts (US)	Starwood Capital (US)

Figure 6 Source: GVA

Key fixed income investment deals of 2018

Address	Bedrooms	Price (£ million)	Price per room (£)	Yield	Month	Purchaser
Grove Portfolio (4 London Travelodges – Battersea, Kingston on Thames, Ilford and Kew Bridge)	336	72.5	215,000	4.88%	Jan-18	Private Propco
Malmaison York	150	44.4	296,000	4.54%	Apr-18	Lothbury Investment Management
Travelodge Euston	150	42	280,000	3.25%	Sep-18	La Salle
Travelodge Heathrow T5	296	40	135,000	5%	Jul-18	Sidra Capital
Travelodge London Kings Cross	140	36.3	259,000	3.07%	Jan-18	UK pension fund

Figure 7

Source: GVA

Institutions emerge as key investors

Another key trend of 2018 has been the rise of institutional money in operational hotels. Driven by the sharpening of yields in the fixed income arena, an increasing number of funds have been tempted into accepting operational risk. Arguably the most notable recent example of institutional money flowing into the UK hotel sector was Schroders' acquisition of Algonquin, a specialist pan-European hotels investment and management business with 7,500 hotel rooms for €1.8bn.

This followed L&G's £49.35m acquisition of the Hampton by Hilton at Stansted Airport in October 2017, a landmark transaction that marked one of the first major UK pension institutions to invest in operational rather than fixed income hotels.

We understand that the transaction equated to a yield of c.6.75% off projected Year 1 trade and a price per room of £137,000.

Blackrock appear to have followed suit with their acquisition of the Hilton Garden Inn Birmingham Airport which completed in September 2018. The yield reportedly reflected 7% off projected stabilised trading performance and a price per room of £170,000. We anticipate that the hunt for yield will lead to further institutional investment of new build limited service assets in core strategic locations in 2019.

We highlight key 2018 single asset operational investment deals in the UK and the Regions in Figures 8 and 9.

Key variable income London single asset transactions of 2018

Address	Bedrooms	Sector	Price (£)	Price per room	Month	Purchaser
Hilton Kensington	603	Luxury	260	£430,000	Oct-18	Cola Holdings
The Beaumont	73	Luxury	C.125	£1,700,000	Sept-18	Barclay Brothers
The Curtain	120	Luxury + Club	100	£750,000	Aug-18	Reuben Brothers
5 Strand (development)	200	Upscale	90	£450,000	Jun-18	ABIL Group
Ashley Hotel Paddington	50	Tourist	13.7	£274,000	Apr-18	Mayfair investment management

Figure 8

Source: GVA

Key variable income regional single asset transactions of 2018 (Operational)

Address	Bedrooms	Sector	Price (£)	Price per room	Month	Purchaser
Waldorf Astoria Edinburgh	241	Luxury	85	£353,000	Jan-18	Twenty 14 Holdings
Radisson Glasgow	247	Upscale	39	£157,000	Sep-18	Pandox
Hilton Garden Inn Birmingham Airport	178	Midscale	30	£175,000	Sep-18	Blackrock
The St Johns Hotel, Solihull	180	Midscale	19	£105,000	Jun-18	CL Capital
The Langstone Hotel	148	Midscale	c.15	£98,000	Aug-18	Lion Quays Hotel Ltd (Dr Ashok & Swarnlatha Bansal)

Figure 9

Source: GVA

Yields and Values

2018 has seen the sale of a number of prime and trophy assets, with record breaking yields and prices being paid in markets including Cardiff, Edinburgh and Glasgow. The dichotomy between pricing of prime and secondary assets appears to be widening in 2018 as the majority of both international and institutional capital remains fixed on best in class property.

Whilst there has been yield compression in some secondary and tertiary markets in 2018, this has been predominantly limited to well invested assets which can be easily bolted onto existing platforms. Notably, some of the larger portfolio transactions of 2018 would suggest that premiums (of anything up to 10%) have once again been paid for regional platforms.

Whilst double digit hotel returns are now uncommon in corporate freehold UK hotel assets, this is as much about an increasingly analytical buyer pool looking at FF&E and notional management fee deductions as yield compression. We have seen an increase in the average time necessary to close transactions this year, as buyers increase their technical and financial due diligence. We expect this to continue into 2019.

Ground rents continue to be a contentious topic but are being deployed as a successful capital release strategy on an increasing number of good quality UK single assets and portfolios. Unrelenting demand for secure long let income (typically around 15% of EBITDAR) and an increasing number of funds looking to acquire this product has driven yields down in this sector. The pool of senior debt providers for the retained leasehold interest remains somewhat limited however following concerns of long term sustainability from a majority of high street lenders. Whilst we wait to see how purchasers of the retained long leasehold interests will react in a weaker market, the Principal deal (which included five of six hotels whose freeholds were sold in a £90m ground lease deal in 2011) suggests, at the current time, that buyers are adopting minimal yield arbitrage for high quality assets in prime locations. Whilst there has been scant evidence of retained interests of secondary assets, we consider that the delta between freehold and long leasehold may increase significantly in the event that the market softens.

We forecast deal volumes to be in the region of £6.6bn by the end of 2018 which would equate to a circa 20% increase on volume in 2017. Notably, we anticipate that the Regional UK market will achieve record levels of hotel investment in 2018 due in part to significant portfolio volumes. Additional portfolio transactions which may close before the end of the year include a portfolio of four prime central London hotels, a portfolio of six regional Park Inns and the remaining 13 hotels within the De Vere portfolio. Furthermore we understand that the nine regional Hilton hotels, formerly owned by Vincent Tchenguiz are, at the time of writing, under offer. Whether these deals complete before year end remains to be seen. We highlight UK transactions over the last five years, including our 2018 forecast (as at October 2018) in Figure 10. We additionally provide our opinion of yields and the movement in values per bedroom in London, Regional UK Prime and Regional UK Secondary markets in Figures 11 and 12.

Five year UK hotel transaction volumes (2014-18)

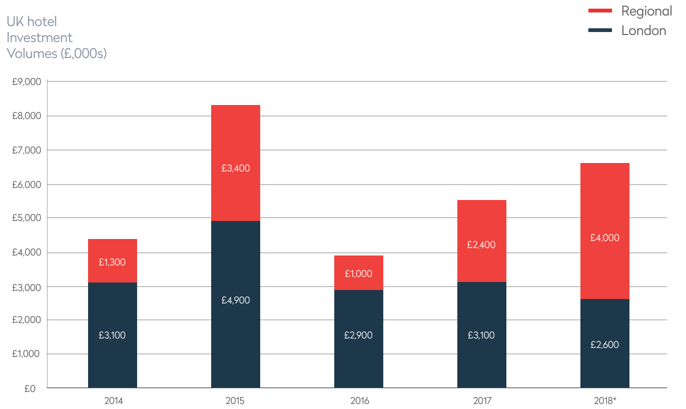

Figure 10 Source: GVA

UK hotel yield profile 2014-2018

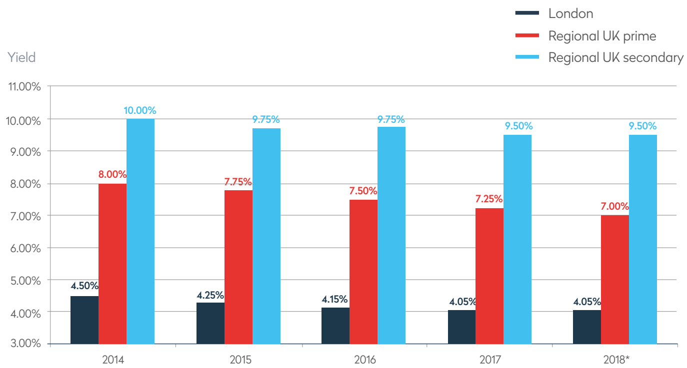

Figure 11 Source: GVA

UK hotel values per bedroom 2014-18

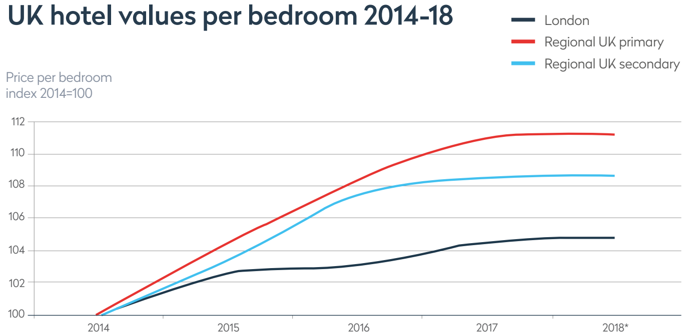

Figure 12 Source: GVA

N.B please note that the transactional evidence provided within this document has been sourced from anecdotal evidence and freely available information and should not be relied upon.

Key hotel openings in 2018 included

1. The Principal, London: The former Russell Hotel, 334 bedrooms, opened earlier this year following a £70m transformation
2. Radisson Red Glasgow: 174 bedroom new build
3. The 192 bedroom University Arms Cambridge re-opened following an £80m refurbishment
4. The 54 bedroom Belmond Cadogan is set to reopen this year after a four-year, £28m renovation

Key hotel transactions

5. 241 bedroom Waldorf Astoria, Edinburgh, acquired by Twenty 14 Holdings for £85m
6. 120 bedroom Curtain Hotel and Members Club in Shoreditch by the Reuben Brothers for a reported £90m
7. 148 bedroom Holiday Inn, York to Rockspring (leased to Kew Green Hotels) for a reported £15.3m
8. Hotel Development 5 The Strand acquired by Abil Group for a reported £90m

Hotel Build Costs Dashboard

Development costs continue to be a point of concern for perspective developers. In order to offer some guidance, GVA have looked at c. 70 projects across different classifications and present some updated development costings schedule by grade.

Luxury

	Construction Cost				FF&E	
	£k/key		£k/m²		£k/key	
	Lower	Upper	Lower	Upper	Lower	Upper
Luxury	500	750	4.6	6.6	73	294
Upper 5 star	350	400	3.9	4.6	56	98
5 star	200	330	2.5	3.7	36	73
Boutique, London	170	210	2.0	2.7	35	42
Deluxe, London Conversion	140	200	2.5	3.5	28	49

Source: GVA

Economy

	Construction Cost				FF&E	
	£k/key		£k/m²		£k/key	
	Lower	Upper	Lower	Upper	Lower	Upper
City Centre	60	70	1.8	2.6	9	11
Out of town	50	60	1.6	2.0	9	11
Budget	45	55	1.6	2.0	9	11

Source: GVA

Note: These metrics should be used as a high level indication of cost only with a margin of +/- 15%. Cost data extracted from a large sample of hotels across the value range

Mid - Upper Upscale

	Construction Cost				FF&E	
	£k/key		£k/m²		£k/key	
	Lower	Upper	Lower	Upper	Lower	Upper
Apart hotels	115	130	2.3	2.7	11	21
City Centre	109	143	2.0	2.4	22	36
Out of town	98	126	1.9	2.3	17	29
Limited offer/branded	77	109	1.8	2.4	14	29
Limited offer/mid-range	71	94	1.9	2.3	14	24

Source: GVA

UK regional variation construction costs

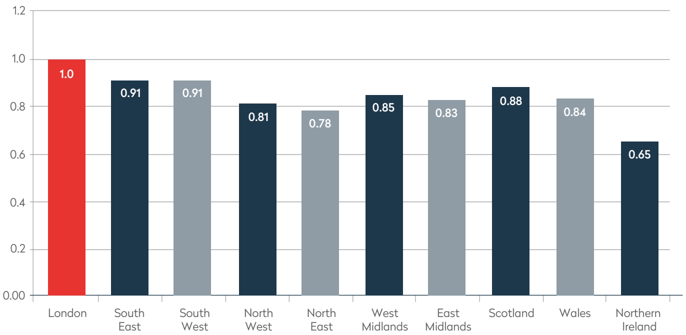

Figure 13

Source: GVA

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