

# Hotel Research

## UK Hotel Investment report

2008



The Montcalm, London.

### **“The underlying fundamental of hotel trading remains strong and will underpin investment demand and performance”**

**Philip Johnston, Head of Hotels**

- Annual economic growth will be slower in 2008. Room rates and occupancy remain sensitive to the patterns of consumer demand on a global basis.
- Visitor number data for 2007 is expected to show an annual fall, but numbers should see a marginal increase in 2008.
- Rental growth will slow in 2008 and 2009 but will remain in positive territory during the next five years.
- Despite the global financial turmoil, some investors remain optimistic and view the current market as a buying opportunity. Some hotel groups have committed to substantial acquisitions.
- Rise in Central London values in 2007 but provincial hotels growth more muted.
- With the lack of decent prime hotel assets coming to the market, fuelled by strong trading conditions, there is little reason to sell.
- Sale and leasebacks may become more difficult due to higher yields and strong trading numbers.

Savills  
Research

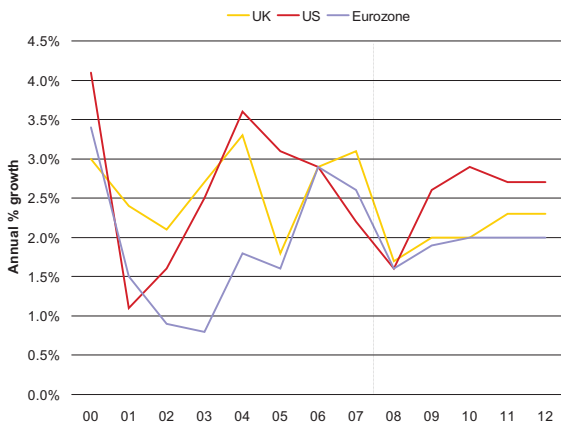
[savills.com/research](http://savills.com/research)

savills

# Market drivers

During the start of 2008, the Governor of the Bank of England presented one of the most pessimistic forecasts for the UK economy since the bank gained independence in 1997. However, it seems that any economic downturn will be short-lived, but will still impact on business and consumer spending during the next 12 months. This will impact on the hospitality sector. Growth in business services, despite the credit crunch turmoil, is expected to remain at trend rates, which should help to support a limited level, but slower, business travel growth.

## The economic shock will be contained within 2008



Source: Consensus Economics

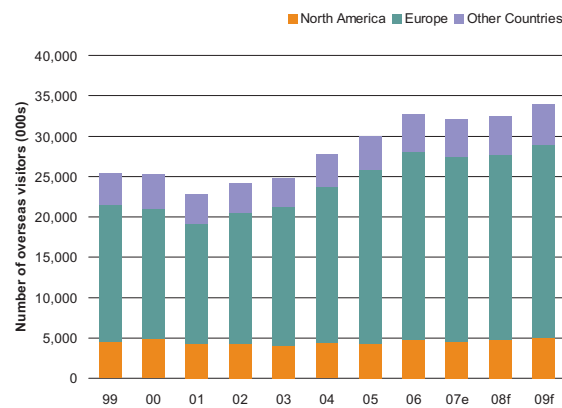
In comparison to previous years, 2007 was relatively quiet in terms of unforeseen impacts on the UK hospitality market. There were some security scares at UK airports, but thankfully uneventful. The economy has dominated the headlines and now the UK is beginning to enter a period of lower base rates despite the inflationary pressures. The impact will be a weaker Pound which is attractive to overseas visitors.

There are signs that the US is entering a recession. The question is how short and sharp the shock will be to the US economy and the dependent economies around the World. The tax rebates to US taxpayers, in the region of \$167 billion, will help to re-ignite the market. It is likely that other economies will have to follow suit with fiscal and monetary measures to stimulate their economies. The US market is key to the UK hospitality industry as it accounts for between 15% and 20% of visitors to London and the rest of the UK.

A positive outlook for the hotel sector in 2008 has been reported by TRI Hospitality Consulting. Operators have expressed a view that room rates and occupancy will be at least static or higher during 2008. The survey does also highlight, however, that the UK consumer will have a higher impact on the out-turn for this year. Household spending is expected to remain positive this year, but at 1.7%, will only grow at about half the rate experienced during 2007. The fourth quarter data for 2007, showing visitors to the UK, is not

yet available. However, data for the first three quarters of 2007 and a Q4 Savills forecasts presents an estimation for 2007. This is shown below. It is likely that visitor numbers will show -2% fall in 2007 for the UK total - the rationale is that the first three quarters showed lower growth than the respective quarters in 2006. The fourth quarter is expected to be significantly lower. We forecast business and the holiday visitors numbers will present muted growth during 2008 as a response to the anticipated slowdown in the wider economy, but will be marginally higher than 2007.

## Visitor numbers fell in 2007, stabilising in 2008



Source: Office for National Statistics / Savills

The potential budget cuts companies within the financial sector will be implementing will have a negative impact on the level of business travellers to the UK and particularly London in 2008. The impact of the financial market turmoil and subsequent write-off for sub-prime losses is reverberating through the City. As a result, while business traveller sector has shown higher growth than leisure during the last couple of years, this may now reverse.

The prospects for the hotel investment market is underpinned by the operational performance of the specific assets. A review, therefore, of the performance of the hotel sector generally is pertinent. According to TRI Hospitality Consulting, despite a very slight fall in occupancy levels last year, the growth in room rates wholly supported the room revpar, showing a 7.1% increase. Geographically, there was a variation with London presenting a 10% increase in room revpar versus 4% in UK provincial hotels. This type of performance in tougher economic conditions helps to maintain investor interest.

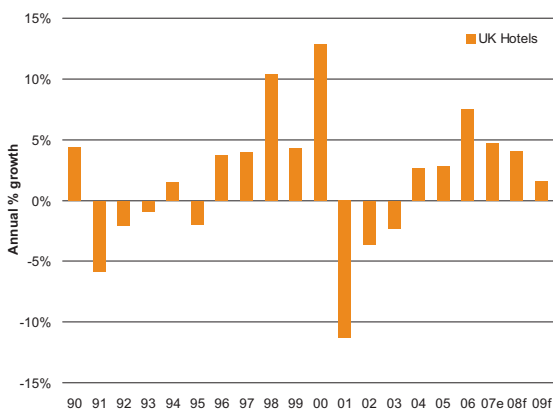
The serviced apartment market will also see relatively strong income returns during 2008, above those in the private residential sector. Further analysis and views on this particular sector can be found in the Savills' 2008 UK Serviced Apartment market report. Generally, with regards to the hospitality property market, it is as vital as ever to ensure that true and accurate advice is sought on all issues related to the industry.

# Hotel investment performance

The majority of data used in this section is from Investment Property Databank (IPD). IPD track a small proportion of institutionally held hotel property. The IPD index consists of £860 million of hotel property, by capital value, within 68 properties. Forecasts have been derived from a Savills in-house model based upon the IPD 'all property' model.

Rental growth is expected to slow over the next couple of years and a marked cycle is expected to emerge. The key point is that rental growth will remain positive.

## A distinct rental growth cycle is emerging



Source: Investment Property Databank

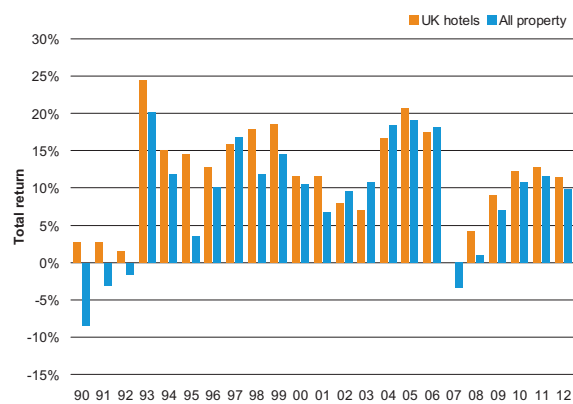
The charts show what happened during a severe economic slowdown, as seen in the early 1990s. Overall, hotel rental growth weathers better than the 'all property' market, where rental growth was -12% in 1992 compared to -2.1% for the hotel sector. The only reversal to this trend was in 2001 which was in response to the events of 9/11, which had a direct impact on the hotel sector. What has been seen recently, as supported with the economic change shown on page 2, is that the general UK property investment market experienced a level of changing sentiment that had not been seen since the early 1990s. The quick turnaround in sentiment is reflected in the yield movement shown on page 4.

In short, the general property market is expected to enter a period of short and sharp downturn in total returns, which is reflective of the economic outlook. The 2007 out-turn will show the full brunt of the investors' turnaround in sentiment, but this will also partially feed through to the recovery expected later this year.

The impact of the UK 'all property' model was trying to apply negative returns to the hotel sector for 2007. However, Savills made a consideration of the relatively mild impact in the early 1990s during a recession. Therefore, allowing returns to fall below zero is unjustified. Savills have set hotel returns to zero for 2007 with 4.2% for 2008.

Potential impacts on the investment market may come from a double whammy of Government tax changes in 2008. Firstly, there is the abolition of taper relief from April this year. As an example, a business asset, such as a hotel, held for two years would have attracted the most generous relief with 25% of the gain charged to tax. A 40% taxpayer would have to pay an 'effective rate' of 10%, however, this is being replaced by 18%. This may lead to more assets being disposed leading up to April. Secondly, the removal of the hotel building allowance may impact on supply as the larger hotel

## Hotels will outperform UK 'all property'



Source: Investment Property Databank / Savills

providers reign in their investment plans. The removal of the 4% tax concession over the first 25 years of every newly built hotel will have an impact on the level of investment in the sector due to the potential restriction on new supply. Potentially, there will be fewer future investment opportunities. Although, of course, this can have a positive and negative impact - the lack of product reduces investors' interest and may stall capital value growth, but a tightly supplied market may also maintain investment values on the existing stock. The latter is most likely.

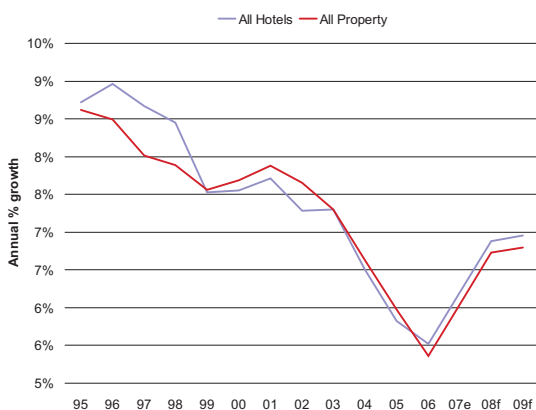
Overall, the key question is what is the outlook for hotel property returns over the medium-term. As shown in the chart above, total returns will move in-line with UK property. However, hotels will offer superior returns versus the UK 'all property' measure. It is also likely that overall return levels will enter a period of generally lower levels - on average total returns have been in the region of 14% during the last five years. The next five years is expected to be around 10% per annum on average. As shown in the table below, Savills Research have expressed the specific forecasts for total returns and rental growth. The more positive outlook for this year, for the hotel sector, is evident.

	Total Returns		Rental Growth	
	2007	2008	2007	2008
UK Hotels	0.0%	4.2%	4.7%	4.1%
UK All Property	-3.4%	1.0%	4.6%	3.7%

# Investment transactions

On a global basis, it has been estimated by Real Capital Analytics that global hotel sales in 2007 were in the region of \$100 billion (£52 billion). A large proportion was in the US driven by Blackstone's \$26 billion acquisition of Hilton Hotels. Moving from 2007 into 2008 was a period of changing sentiment and a contagious uncertainty. As 2008 progresses, we expect that 'recovery' and 'growth' will make their way back into market commentary.

## Yields show a continued reversal in 2008



Source: Investment Property Databank / Savills

Of course, however, there are commentators that consider that the global financial turmoil is yet to fully filter through to the global economies. The 'wait and see' approach has been adopted. Sentiment as much as specific financial inertia seems to be driving the market at present. Some core investors are looking through the negativity to identify investment opportunities despite the financial turmoil. 2008 will mark a period of a polarisation between investors, split between those that are willing to take the risk and higher potential returns and those that are more risk averse. Following approximately £3 billion of UK hotel investment transactions in 2007, this year is expected to show the fall-out from the credit crunch. This will make debt for property harder to come by and may have a dragging effect on the level of investment transactions during 2008. However, encouragingly, overall investment interest remains buoyant.

The yield movement has been firmly upwards during the latter half of 2007. There was a point during the latter part of 2007 and early part of this year where the cost of debt touched a higher point than yields. This has now corrected with cost of debt back around the 5.2% level, although banks margin on lending is greater than seen previously.

2007 was a record year for hotel trading growth, especially in London, and 2008 shows no sign of slowing with operators generally optimistic for continuing room rate and revpar growth. This has helped hotel assets remain in demand from both owner operators and investors. Whilst the credit crunch may

have moved out yields by 100 basis points, hotels on prime assets may be closer to 50 basis points. But what if trade dips (leading to an erosion of profits).

Generally, hotel investment trading could slow down in 2008 depending upon a hotels corporate make up. For example in the City financial institutions laying off staff in light of the financial turmoil. The result may be a fall in the number of conferences and functions.

Some investors are currently not looking for opportunities, believing prices may fall further. However, there are still a number of buyers including overseas private investors, property companies, operators, private equity and real estate investment companies.

Yields were already starting to move out in Spring 2007 following the announcement to phase out of Hotel Capital Allowances, with some investors withdrawing from the market. The sentiment following the impact of the credit crunch exacerbated yield movement. Some Central London hotel investments were sub 5% in early 2007, are now 5%+, but still in demand. Larger transactions above £100m are harder to fund due to syndication market difficulties and halt in securitisation. Buyers with high equity currently have strong negotiation position.

Accor continue to undertake sale and leasebacks throughout Europe with 57 hotels in France and Switzerland sold to a consortium managed by AXA for £518m in 2007 representing a yield of 5.7%.

The key hotel deals during 2007 include: JER: More Than Hotels: 11 Express by Holiday Inn hotels for £116m in October; Whitbread acquired Tulip Inns in September for £44m to convert to Premier Inns. Savills sale of Blakes Hotel for a second time in 18 months for circa £30m. Apart from transactions, Savills were involved in the successful float of 9 major hotel assets on AIM in 2007.

Overall, it is likely that there will be a reduced volume of transactions this year but there will be underlying activity with investors and operators monitoring the markets to judge when to become active again. Much depends on the banks rather than movements in the base rate. The elements affecting a banks lending criteria and hence kick-starting investment are as follows:

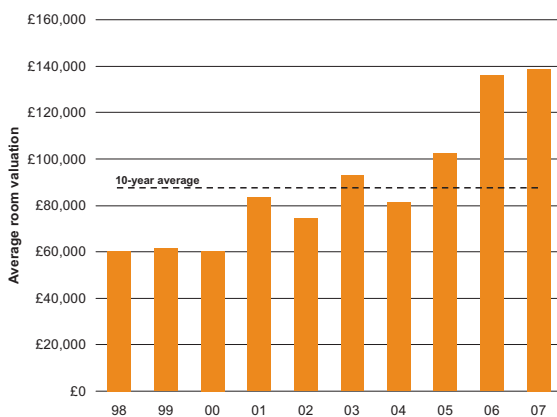
- The banks pricing off the Libor rate, as they pass on their cost of borrowing;
- Loan-to-value ratios which have moved against high geared investors; and
- The general availability of debt which at present is very tight except to the banks undoubted customers.

# Savills' valuations and outlook

## Savills' valuation analysis

This section is based upon the in-house data collected by the Savills Hotel Valuation department and illustrates the valuation activities of the team. This provides an insight into the level of performance and scale of work undertaken. In the last 12 years, in total, Savills has valuation information on approximately £12.3 billion of property within the hospitality industry. 'Pure' hotels make up 84% of the total with a total historical valuation total of £10.3 billion.

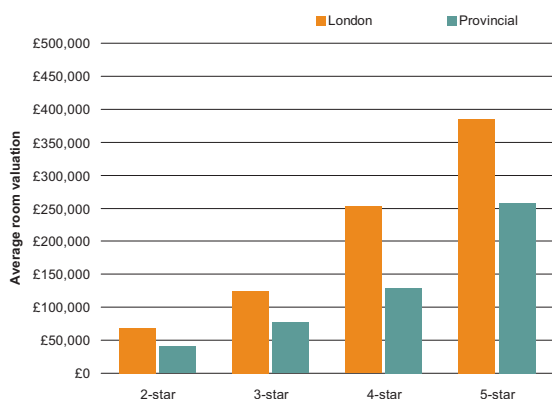
### Average room values increased in 2007



Source: Savills

Based upon a sample of properties valued, across a broad range of quality and type, it is relevant to compare room valuations for 2007 to previous years and present the 10-year average line. Values were slightly higher in 2007 by 2.1%. Average room values have increased by 130% between 1998 and 2007. Below, data for the last 10 years, despite containing periods of price falls, interestingly shows the average room value on a star and locational basis. The 'gap' between 4 and 5-star in London remain proportionately lower than the UK provinces. A 100% difference has been recorded between the provincial 4 and 5-star hotels in the UK provinces versus just 50% for London.

### Average room valuations over 10 years by rating



Source: Savills

## Market outlook

What is being seen in the wider commercial property market will no doubt have implications for the hotel sector. In the past, as already discussed, the hotel sector has tended to weather better during economic downturns than the wider commercial property market. This combined with the lack of decent prime hotel assets coming to the market we suspect will insulate values from any dramatic falls, particularly in London.

Despite this, the fact that hotels are in the hospitality and tourism business, means that it will be the strength of the worldwide economy which will dictate performance going forward during the remainder of 2008 and beyond. The continued deterioration in the US economy will be key and will have implications on the UK hotel sector. However, the increasing number of Chinese and Indian visiting the UK could easily outweigh any potential fall in US visitors and provide the support to the market.

In respect of hotel investments, traditional Travelodge/Premier Inn leases remain in demand, although yields have perhaps moved 50-75 percentage points in the last 12 months. The sale & leaseback activity is slowing and new investments are becoming limited to new developments, which are obviously slower and fewer to come through to the market.

Despite the expectation for a rise in average yields in the short-term, longer-term, we anticipate yields to remain at low levels, albeit not at the same level seen in 2006/07. This will happen provided the Bank of England continues its trend to reduce rates, inflation remains at a reasonable level and the Pound value falls attracting further overseas visitors, continued hotel trading and ultimately higher levels of investment.

There is still potential for sale and manageback and rents linked to turnover, although many investors are not willing to accept a potential reduction in income if trade falls. Marriott are considering taking on the role as employer of the hotel staff under a management contract, which has traditionally been the responsibility of the hotel owner/investor. This may enhance the appeal of management contracts to investors that have traditionally shied away from this form of investment.

In conclusion, the market has fallen victim to the credit crunch but with easing interest rates we remain overall optimistic in the hotel sector where the underlying fundamentals of the businesses that drive the investment values hold strong. We also believe that whilst sale and manageback should continue to make sense in the current environment, sale and leaseback may be less attractive to operators in releasing value given yields have moved out but EBITDAR multiples remain strong.

# Savills services and contacts

## Hotels and serviced apartments

Savills are market leaders, having sold and transacted more than 250 hotel and serviced apartment sales in Central London alone. Sales include trading hotels at both corporate and private levels, from tourist class to 5 star deluxe hotels. Based throughout the UK and Europe, we provide the complete package from acquisition and planning stage, through to lease, management contract or turn-key negotiations and sale of investment.

In 2007, Savills provided advice regarding Park Plaza, Park Inn, Hilton and David Lloyd portfolio's in the UK and advised on the sale of Blakes Hotel in London and Cambridge Moat House as going concerns, as well as the Thistle hotel portfolio.

Savills remain one of the most experienced agents and valuers in the industry. Annually, we handle some €7.5bn worth of hotel assets transactions and valuations across the UK and Europe.

## Research

Savills Research provides detailed advice to clients in locations throughout the UK and overseas. We are unique in our ability to advise across all property sectors - commercial, residential, rural and leisure - providing detailed market data and analysis for each. We provide specialist advice to the public and private sectors including development feasibility, relocation consultancy, demand analysis, local and structure plan reviews, inward investment advice, development strategy and data mapping and catchment analysis.

## For further information please contact



**Philip Johnston**  
Head of Hotels  
+44 (0)20 7409 8815  
pjohnston@savills.com



**Iain Lock**  
Agency  
+44 (0)20 7409 8797  
ilock@savills.com



**Miles Auger**  
Agency  
+44 (0)20 7409 9951  
mauger@savills.com



**Adrian Archer**  
Valuation  
+44 (0)20 7409 8874  
aarcher@savills.com



**Steven Lang**  
Research  
+44 (0)20 7409 8738  
slang@savills.com

### Savills plc

Savills plc is a leading international property services company with a full listing on the London Stock Exchange. The company has undergone dynamic growth in recent years establishing itself as a powerful player on the international stage with offices and associates throughout the UK, Europe, Americas, Asia Pacific, Africa and Middle East. In addition, Savills is the trading name for the property service subsidiaries of Savills plc which advise on commercial, rural, residential and leisure property. Other services include corporate finance advice, property and venture capital funding and a range of property related financial services.

*This report is for general informative purposes only. Whilst every effort has been made to ensure its accuracy, Savills accepts no liability for any loss or damage, of whatsoever nature, arising from its use. The content is strictly copyright and reproduction of the whole or part of it in any form is prohibited without written permission from Savills Research. February 2008.*

Savills  
Research

[savills.com/research](http://savills.com/research)

savills