

United Kingdom fixed-income hotels: an investment fashion that's here to stay

News and views from the CBRE Hotels Fixed-Income Breakfast



Investor interest in fixed-income hotel real estate is at unprecedented levels. Fund managers increasingly see leased hotel assets as an attractive portfolio option amid the current low interest rate environment.

The scale of investor appetite was underlined by CBRE Hotels' inaugural Fixed-Income Breakfast, where attendees representing leading UK and European investor groups debated the key challenges and opportunities within the European hotel sector.

Those taking part were drawn from major institutions as well as the newer contenders in the hotel investment space. They were joined by sector specialists from CBRE, plus representatives from the occupier side and expert commentators from the advisory/professional services arena. This report brings together highlights from their discussions.

WHY FIXED-INCOME HOTELS?

Long leased, fixed-income hotels offer a number of advantages to investors. They provide the opportunity to match a fund's liabilities with inflation linked (RPI or CPI) property leases; plus they can also offer good quality covenants. In addition, lot sizes tend to be manageable.

As such, the fixed-income hotel space is an opportunity many investors have sought to capitalise on in recent years, with large institutions and emerging specialists all vying for available stock.

Lee Bruce, Senior Director in CBRE's Valuation & Advisory team, said: "Four years ago we were typically valuing around £2 billion of fixed-income property stock each year, on behalf of a handful of very large institutions. Today that number has risen to some £9 billion and we're acting for more than a dozen funds. We now

find many of our clients are very comfortable having a portion of their funds invested in hotels, as investor knowledge has improved and market supply is healthy. The majority of this activity is in the budget sector, which is growing significantly in the UK and across Europe.

The level of potential supply into the UK's hotel space was underlined by Robert Chess, CBRE's Senior Director, Hotel Valuations, EMEA. He noted: "CBRE Hotels has been analysing the hotel pipeline in the UK regions, using the AM:PM Hotels Database as our source. With 30% of the pipeline expected to have a fixed-income structure in place and to be investment-grade product, this would create an additional £2 billion worth of real estate investment stock. This is based on leases of around £3,500 to £4,000 per room and acquisitions at a net initial yield of circa 5%.

“So we are talking about a significant – and growing – investment opportunity in the UK regions. In London, with the commensurate higher rents and sharper yields, the value of potential new supply is almost incalculable.”

CBRE Hotels’ analysis of RevPAR (Revenue per Available Room) since 2008 reveals that the budget sector has performed significantly better than the full-service sector in that period. This is a scenario Joe Stather, Head of Hotels Research, EMEA, ascribed to consumers being driven towards budget options during the downturn then remaining loyal to those brands once the economy picked up.

He said: “A comparison of RevPAR indices makes it clear why so much of the leased product in the UK is coming into the budget space. And even though some would argue that we are at or near the top of the cycle, we feel there’s still a compelling story in terms of pricing. This is especially so given the recent falls in bond yields, which have given a boost to the risk premium attached to fixed-income hotels.”

THE UK’S ‘BIG TWO’ BUDGET OPERATORS BOTH LOOK TO THE FUTURE

Leading budget brands Premier Inn and Travelodge are gearing up to provide a sizeable proportion of the new fixed-income hotel stock in the UK market. Market leader Premier Inn (a subsidiary of Whitbread Plc) now operates 65,000 bedrooms nationwide and, according to Whitbread’s central London Acquisitions Manager, Jonathan Langdon, it opened 4,250 rooms nationwide last year - a new hotel every circa 10 days throughout the 2015/16 financial year. With some 13,000 further beds secured in its immediate development pipeline, Premier Inn is on track to achieve its target of 85,000 rooms by 2020.

Langdon noted: “Most of our recent transactions have leant towards operational leases rather than freeholds. We remain very committed to London, where we see extremely strong fundamentals and further room to grow our market share. Our recently launched ‘hub by Premier Inn’ format offers us another route into this market, especially so in Central London.”

FIXED-INCOME HOTEL RISK PREMIUMS

Figure 1 shows the London fixed-income hotel risk premium at the end of Q2 2016, currently standing at +327bps on the 10-year gilt yield. In 2008 the risk premium was -71bps, suggesting that +398bps of yield has been created in the fixed-income hotel space over the last eight years. Furthermore, fixed-income hotel yields have shown to be less volatile (Std. dev. 0.61) than office yields (Std. dev. 0.79) between 2006 and 2016.

Figure 1: London – Fixed-income hotel risk premium

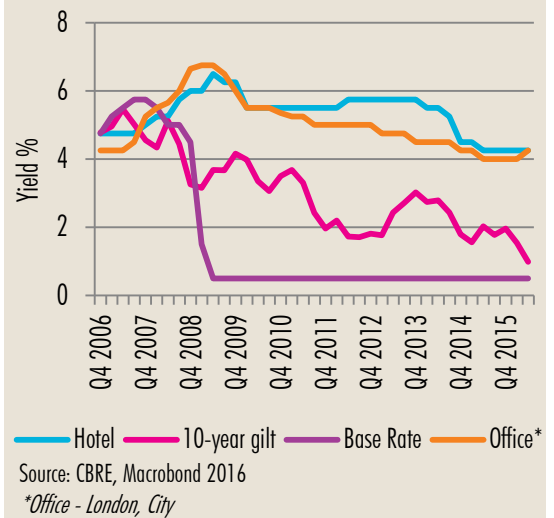


Figure 2: Regional UK – Fixed-income hotel risk premium

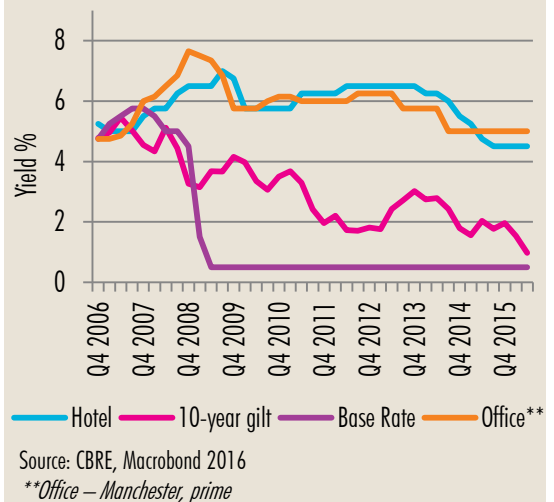


Figure 2 shows a Regional UK fixed-income hotel risk premium on the 10-year gilt of +352bps as of Q2 2016. Fixed-income hotel yields have shown to be less volatile (std. dev. 0.71) than office yields (std. dev. 0.75) over the period analysed.

Subject to building efficiencies, hub by Premier Inn enables around 30% more bedrooms from the equivalent space, driving higher revenues per square foot a ‘sweet spot’ that Langdon said was vital to making the numbers stack up in London’s high value commercial real estate market. In many cases though, such as West Smithfield (Farringdon) where planning consent as now been granted, Premier Inn came in as a more efficient use of the space. He also cited the acquisition of a former office building in London’s Marylebone, which is being converted to a 300 bedroom hub by Premier Inn format.



Above: hub by Premier Inn bedroom and a floorplan showing the comparison between hub by Premier Inn and a typical Premier Inn bedroom.

“By reconfiguring the building we were able to make the financials stack up compared with office use. The opportunity presented by the inefficiencies of the existing building (30% differential of gross to net area) and overly generous floor to ceiling heights have enabled us to gain two extra floors within the existing massing and potentially drive up to 50% more useable space,” he commented.

Competing budget brand Travelodge has had some well-documented difficulties in recent years, but over the past 12 months it has seen asset prices creeping upwards. James Routledge, Senior Director at CBRE Global Investors, puts this down to the company’s improving covenant. He said: “We’ve probably

bought four or five Travelodge properties in the last 18 months. The people now running the business possess a decent plan and seem much more focused.”

Kris McPhail, Director – Investments at M&G, agreed, while adding: “Travelodge’s management recognises that their covenant is not as strong as Premier Inn’s, so they are willing to disclose more trading information to help investors’ understanding of the underlying business. This certainly gives investors more confidence.”

Patrick Grant, Partner at Alpha Real Capital, believes that the company’s provision of a sinking fund for continuous refurbishment of its hotel estate has also been a major plus in rehabilitating Travelodge among the investment community.



Above: Travelodge London Liverpool Street – acquired in July 2016 by YT Realty for £42m, circa 4.8% initial yield.

Elsewhere in the budget segment, new names are beginning to make their presence felt, while generating some eye-catching real estate transactions of their own. Lewis Corby, Associate Director, Advisory Services at CBRE Hotels, highlighted ‘aparthotel/serviced apartment’ operator Staycity as a potential name to watch.



Above: Staycity in Hayes, London – acquired in March 2016 by Schroder UK Real Estate Fund (SREF) for £32.4m, 5.5% initial yield.

He remarked: “The Staycity in Hayes (West London) sold to Schrodgers for a net initial yield of 5.5% and the asset attracted a great deal of institutional demand despite the covenant not being there. In this case, investors looked at the quality of the underlying asset and the rent to profit comparison, as well as being attracted by the locational strengths of Hayes as a regeneration area that will benefit from the launch of London’s Crossrail network.”

BREXIT – INITIAL REACTIONS FROM THE ROOM

With the Hotels Fixed-Income Breakfast taking place just days after the United Kingdom voted to leave the European Union, it was inevitable that discussion would turn to the possible impacts on the sector from this momentous decision.

While much of the media seems intent on whipping up a Brexit crisis, around the table the views were more sanguine, with any market uncertainty seen as having only a short-term impact.

Lisa Neubueser, Director of Hotel Fund Management at Invesco Real Estate, noted: “There was definitely a dip in transaction activity into the UK in the lead-up to the referendum, because investors rightly wanted to see what the outcome would be. Now that the results of the vote are known, you could argue that there should be more certainty, even though it is not yet clear exactly how the Brexit will proceed.

“So it is fallacy to believe that things are substantially less certain now than they were before.”

Transactional evidence from the market seems to support this view. Marc Nelson, Associate Director, Investment Properties EMEA at CBRE Hotels, pointed to two hotel sales – one in France and one in Belgium – that were in progress either side of the referendum and have since closed successfully with no changes to terms.

He explained: “In neither case did we see any flinching from the buyer. And we are working on a number of properties throughout the EMEA region where we have not encountered any concerns – if anything we are witnessing

greater interest in ‘safe havens’ like Germany. There is of course a potential risk of Brexit contagion, but we believe the key cities in Europe will stay strong. At the end of the day people still need to commit capital.”

CBRE Global Investors’ James Routledge added: “We have to consider the sources of investment capital coming into Europe. This makes currency the most interesting play, given the falls in sterling and the euro against global currencies. We have seen noticeable interest in the UK from Far Eastern and US investors, who have been attracted by the fall in sterling and the perception that asset prices have come off slightly.”

Gary Jones, COO of Aprirose Investments, was keen to emphasise the positives. He said: “The big funds may have stopped buying in the run-up to the referendum, but we didn’t. When we called up our hotel tenants immediately after the referendum result was declared, they told us their business projections are better under a Brexit scenario than a Remain one. Our tenants were happy.”

If there is a potential cloud on the horizon it could come from tighter controls on immigration from the EU to UK. Joe Stather, Hotels Intelligence Manager, EMEA, at CBRE noted that 27% of UK hotel workers are foreign-born, and with payroll accounting for some 32% of average UK hotel revenues, any contraction of the labour market would impact profitability.

“That said, the budget sector is less exposed in this regard due to the staffing model being based on a smaller number of multi-skilled employees,” he added.

COULD IFRS 16 PROVE A BIGGER HEADACHE TO FIXED-INCOME PROPERTIES THAN BREXIT?

If Brexit is one source of uncertainty within the fixed-income hotel sector, another is the new IFRS 16 accounting standards, which are due to come into effect on January 1, 2019.

Graham Bearman, Assistant Director of accountants E&Y, explained how the new standards will change the way lessees incorporate leased assets on their balance sheets. Stressing that this would largely mean business as usual for landlords, he added that it

could have some fairly fundamental implications for tenants.

“Under IFRS 16, tenants will have to account for most lease structures on their balance sheets, recognising an asset and a corresponding lease liability. This means interest and depreciation expenses rather than rent will go through the cash flow statement, potentially changing the business’s funding profile,” he said.

In terms of potential outcomes, Bearman thinks tenants may reassess the relative merits of purchasing versus renting real estate assets. The exemption of turnover-based leases from IFRS 16 may also drive occupiers to seek those structures, even though these would be less attractive to long term, fixed-income investors given the likely effects on asset values.

A further implication may be that tenants seek to secure shorter lease terms as well as more flexibility in lease agreements. “Leased interests of less than 12 months are among the exemptions to IFRS 16, as are service concessions, licenses, management agreements and franchises. It is a completely new ball game for tenants,” Bearman explained. However, it was noted that fixed elements often seen in management agreements, such as the owner’s guaranteed return, may also be liable to the recognition on balance sheet.

From the tenant’s perspective, Premier Inn’s Jonathan Langdon admitted that the initial impression inside his company was that the new legislation was “not particularly helpful”. He added: “How substantial the implications will be for us is hard to say at this stage and we have a working party in place to assess this. However, we would certainly hope that the attraction of our covenant and the lease lengths we offer do not become factors that work against us.”

CONCLUSION

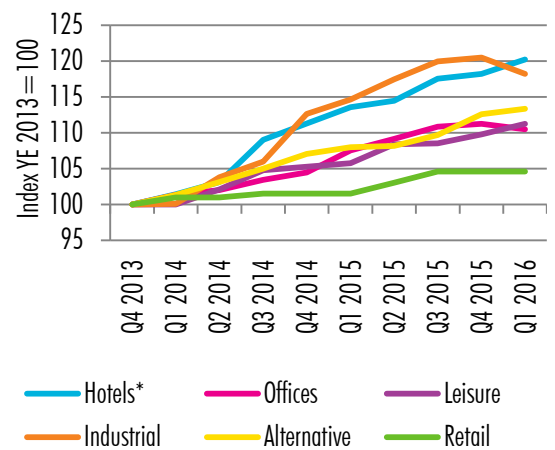
Are fixed-income hotels simply a fashionable portfolio addition, or are they here to stay? The quality of both the attendees to our event and the discussion they generated would suggest the latter. This is certainly the view of CBRE’s Lee Bruce.

He said: “Hotels are here to stay. It should be remembered that while the long income

investors are relatively new to the scene, hotel assets have been in balanced and retail funds for some time. We might even see some of that stock coming out of the retail funds during the next few months, and if it does I would expect it to be snapped up by the long income funds.”

CBRE’s Robert Chess concluded: “Even with recent events adding a layer of uncertainty, we are seeing sustained interest in investing in hotel assets in Europe. There are several pre-existing economic factors expected to play out in the rest of 2016 and into 2017, but while acknowledging these we don’t see any significant reasons why the performance of European hotel assets should slide backwards.”

Figure 3: Long-income fund capital value indices



Source: CBRE UK National Valuations 2016
*Hotels subject to lease

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