Hospitality and Leisure
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European hotel real estate: a long, slow haul back

Key highlights from Emerging Trends in Real Estate Europe 2010

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PricewaterhouseCoopers

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Emerging Trends in Real Estate Europe

Emerging Trends in Real Estate® Europe is a trends and forecast publication now in its seventh edition. A joint undertaking of the Urban Land Institute (ULI) and PricewaterhouseCoopers, the report provides an outlook on European real estate investment and development trends, real estate finance and capital markets, property sectors, metropolitan areas, and other real estate issues. The report represents a consensus outlook for the future and reflects the views of more than 645 individuals across a wide range of experts – investors, developers, property companies, lenders, brokers, and consultants – including those involved with the hotel sector.

Caution drives the real estate outlook

Europe's real estate industry is cautiously picking itself up and surveying the road ahead. Across all sectors, including hotels, participants are cautiously optimistic about prospects for their industry in 2010. Europe's economies are recovering and transactional markets are thawing, but there are major uncertainties overshadowing these positive trends. Concerns centre on two specific issues: whether the withdrawal of government stimulus packages will choke off a fragile economic recovery in Europe, and how the financial system will deal with both the large amount of real estate debt on banks' balance sheets and the commercial mortgage–backed securities that are maturing.

Although there is substantial equity available for European real estate in 2010, primarily from conservative institutions like insurance companies, sovereign wealth funds, and private property vehicles, they are very selective about what they will buy, focusing on prime income-producing property. In addition, private property vehicles are sitting on a large amount of equity earmarked for European real estate, but there is widespread disillusionment with the fund format amongst investors and those seeking to raise fresh equity in 2010 will find it difficult.

The publicly traded real estate companies' fortunes are taking a turn for the better. Their shares have rebounded sharply and they are well positioned to take advantage of buying opportunities in 2010. The squeeze on debt available for European real estate is easing, but credit remains tight in 2010. Banks are still deleveraging and deciding what to do with their damaged loan books. Larger deals will require banks to club together or syndicate the loan, and relationship banking is back. Underwriting continues to be strict, with low loan-to-values and copious covenants. It is not yet clear how Europe's financial system will cope with refinancing the large amount of real estate debt that is due to mature over the next five years.

However, it is unlikely that European banks will opt for large discounted disposals of distressed loans and assets as they are more likely to work them out over time. Alternative debt providers like insurance companies, pension funds, and opportunistic new lending platforms may help in the process.

Investors are seeking safety, concentrating on core and core-plus assets in mainstream commercial property sectors. Higher-yielding niche sectors are temporarily relegated to the watch list for most.

So what has all this meant for hotels and what is the outlook for 2010?

In the following pages we present the key highlights for hotels from this year's *Emerging Trends in Real Estate Europe.*

Hotels have slipped down the property investment league

Respondents to the Emerging Trends Survey were asked to rank the attractiveness of key property sectors. In this year's survey hotels dropped from second place last year to twelfth place in 2010, to sit firmly at the bottom of the table. In the survey existing hotel performance expectations are generally rated "modestly poor", while new hotel acquisitions are perceived to have slightly better prospects and are considered "fair."

Such downbeat views are confirmed by the fact that, according to leading hotel sector real estate participants, hotel transaction volumes in 2009 sunk to their lowest annual level since the 1990's, as investors retreated and debt markets remained illiquid.

Transaction volumes are thin on the ground

"The hotel market has been [affected] by the global recession and is bouncing along the bottom as transaction volumes remain very thin. In the first six months of 2009, the volume of transactions was similar to that of the same period in 2002, one of the worst periods." "Very, very quiet on the transaction front." "It has always been the slightly more adventurous investors who got into hotel ownership and whilst there has been a huge element of education over the last five years to widen interest in the sector, if we want some real stability we need to attract people like the pension funds and the longer-term investors."

It may be a while off for these investors to arrive, particularly as hotel assets are now viewed as a risky asset class. "We think that this kind of asset is really becoming more risky. On one side, the new rent contracts are variable and based on the return of the hotel itself; and on the other, a strong knowledge of the hotel manager's quality is required." "Contracts are such that the hotel manager transfers the entrepreneurial risk to the investor." "Hotels are doing quite badly, so that there are several renegotiations of the contracts where the rents are calculated as a percentage of sales, with an increase in the risk for the owner." "We don't terribly like the risk, as a whole it is not our sector."

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European hotel values fall by up to 40% and opportunity knocks (but no one's selling)

The hotel sector "is seen [as being] in big crisis," hence "our objective is getting out of the hotel sector." Trading conditions for hotel operators will remain difficult. "2010 will be a hard year.""[The] hotel industry is late in the real estate cycle. Therefore, recovery will not take place before 2011," and "negative forecast for 2010. Recovery as from 2011 expected."

Table 1: Hotels – prospects and recommendations

	Prospects	Rating	Ranking
Existing Property Performance	Modestly Poor	4.18	12th
New Property Acquisitions	Fair	4.76	10th
Development	Modestly Poor	3.91	9th

Source: Emerging Trends in Real Estate Europe 2010.

This seems to suggest that the hotel sector offers an opportunistic play: "bottom of the cycle, interesting time to look at them and buy them." "There are opportunities. Returns are now sensible and there are distressed situations." For the time being, these seem to be more of a theoretical nature. "Partly due to the low interest rates, banks didn't have to pull the plug on many loans. Because of that, the bid/ask spread is very high—people aren't prepared to sell at discounts when they see what the purchase price was even two years ago."

As mentioned previously, in the ranking for the main sectors, hotels dropped from second place last year right down to the bottom spot. See Table 1 above. Rated 4.2 points, performance expectations are "modestly poor." New hotel acquisitions receive a higher rating of 4.8 points and prospects are considered "fair." Yields are expected to increase by 15 basis points, evidencing the poor outlook for the category.

Which categories offer the best investment? It depends ....

Opinions on the relative performance of the different hotel categories span a wide range. For some, "the top end of the market—i.e. four- and five-star hotels—suffers a lot." "The best return [forecasts] for hotels are for the medium-level categories, while luxury and low-budget ones are generating profits." "Best values will be among three- to four-star portfolios." "Volume business will fare best. However, there will be interest in opportunities all through the spectrum." Others expect a polarisation. "The two-star segment will grow, four star will do well, three-star will become extinct." "Middle market is getting killed." "Budget hotels are performing well, so they will also in 2010." Weaker chains will face a tough time, "due to a lack of access to booking systems."

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Best bets: “Top-end hotels in London are doing fine. Super top end is holding up.”

According to *Emerging Trends*, in general (for all property) London ranked top for new property acquisitions with investors citing the dramatic falls in capital values and the weakness of the pound making prices look attractive. In 2009 London was ranked 15th for overall development and now it is ranked fourth for existing properties and first for new opportunities. London hotel values in particular, although reduced, have held up remarkably well partly driven by the lack of available properties.

Cities that were thought to offer the best hotel acquisition opportunities, according to the survey, are Paris, Istanbul, London, Barcelona, Madrid, Moscow, Munich, Berlin, Athens, and Rome.

“London and Paris are the two markets that have the strongest interest from non-European investors. Whilst there is interest in other significant cities, these two are head and shoulders above the others in terms of interest.”

Proceed with caution: budgets in Poland, affordable hotels in Russia and tourist hotels in Spain

Tourist hotels in Spain are expected to benefit from economic recovery in other parts of Europe. While occupancy rates showed a “decrease of 10 percent, the high dependence on U.K. and German [visitors means that] they will recover in line with their economies.” Barcelona is facing “oversupply in the luxury sector. Tourism will be reduced in the next years, with direct impact in the sector. Cost-cutting policies in companies will have direct negative impact on the urban sector. Lower rates and lower occupancies. 2010 will not be better than 2009.”

“The Moscow hotel market looks a bit shaky. Not really much happening. Hotels are clearly one of the most problematic areas anywhere in Russia, primarily in Moscow. A lot of activity was directed at the more glamorous stuff of which there was oversupply.” At the same time, there is a shortage of hotels in the lower segments. “The recession is adjusting behaviour to do something far more sensible in terms of hotels, but again that is the most positive spin you could put on it.”

This budget segment may also be an interesting investment proposition in Poland. “People are travelling in Poland and they want to stay in cheap roadside hotels. In the medium term, that is quite a sustainable model. In all of central Europe, any strategy that looks at trying to focus on growing spendable income at the lower level comparative to the West in our view is quite an interesting one.”

Avoid:

“Berlin [is] massively oversupplied in the last five years; the crazy thing is people still want to buy hotels.” “Berlin is a difficult market—family-owned hotels will die.” Some of the smaller capitals and secondary cities have been dropped from investors’ radar screen. Cases in point are Lyon, Edinburgh, Copenhagen, and Dublin.

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Conclusion

Hotels have been one of the sectors most impacted by the credit crunch and values have fallen significantly. Jones Lang LaSalle Hotels (JLLS) have reported that global hotel transaction volumes sunk to the lowest annual transaction level of the decade, slipping a further 64% from 2008, to $9.4 billion in global hotel sales in 2009. JLLS expect EMEA hotel investment volumes to total around $5.5 billion in 2010. If achieved that would be up 50% from 2009. Investment activity in EMEA is forecast to accelerate toward the end of 2010, driven by strengthening investor confidence. According to PwC's *'UK Hotels Forecast 2010 and 2011: On the comeback trail'*, a recovery in the UK is likely to be led by London where an incipient (but slow) recovery in business travellers could help occupancies stabilise further, improving ARR through a changing customer mix and driving a RevPAR gain of around 5.8% this year. However the spectre of weaker than expected economic growth and public sector cutbacks 'turning off' travel in the public sector and in companies reliant on the public sector, hovers over any growth.

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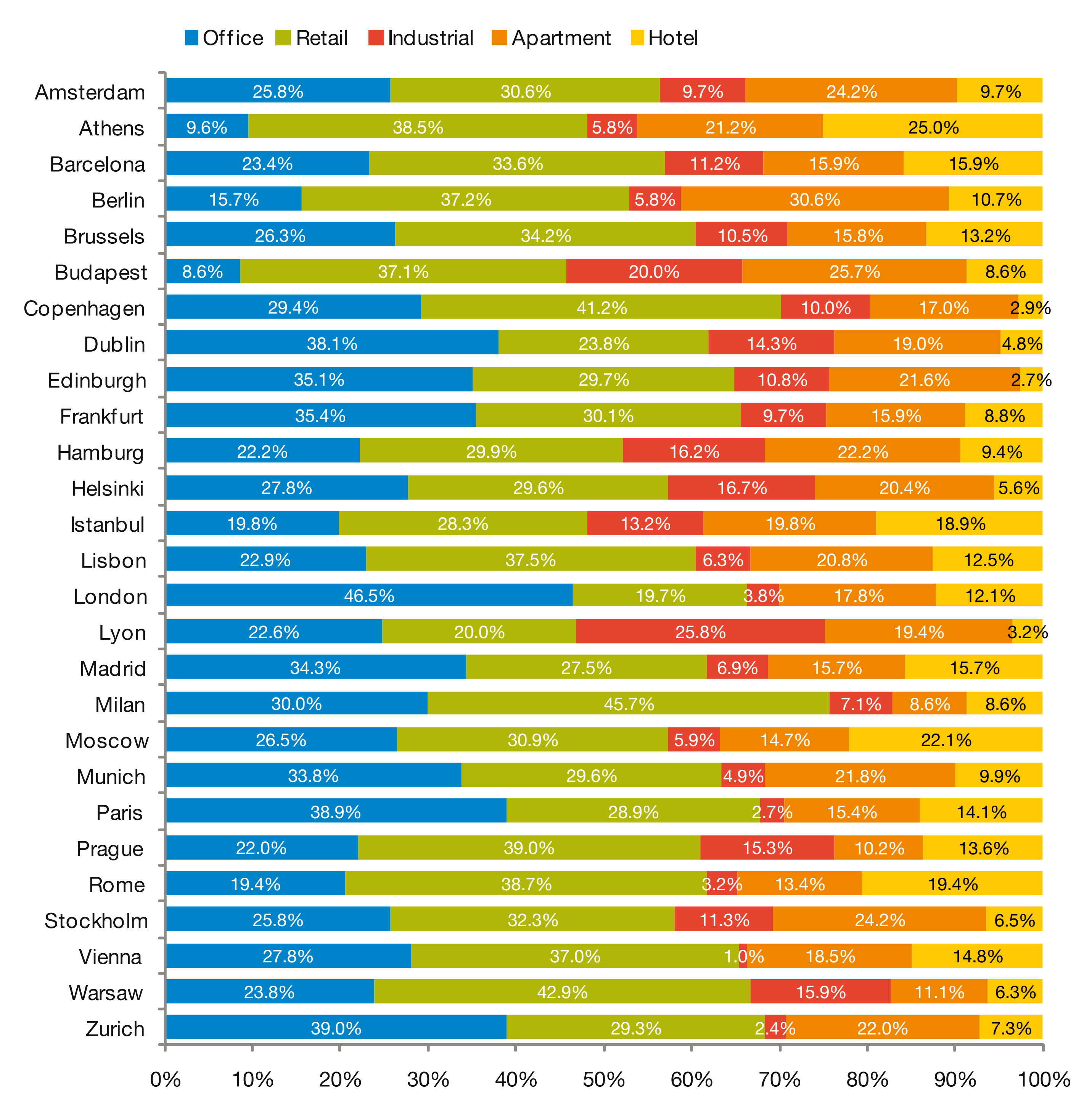
Chart 2 – Best Sectors for Acquisitions by City



Source: Emerging Trends in Real Estate Europe 2010.

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