Reasons to be cheerful
Uncovering value at the top of the real estate cycle
Part 1: Owner-operated hotels in Europe

With the majority of commercial real estate sectors at their peak globally, especially in gateway cities, Schroders Real Estate has been hunting for specific segments which are not just attractive today but, in the context of our ‘mega-theme’ framework, have structural support reasons which should mean they will sustain their value in future and offer upside potential.

Owner-operated hotels in Europe (branded under hotel management agreements or franchise agreements) is a sector that has these characteristics and represents a compelling investment opportunity for investors seeking:

– Exposure to a large ‘alternative’ property sector
– A premium yield and total return compared to similarly-located office assets as well as leased hotels
– Positive structural changes to demand and supply

Introduction

Total returns in the UK and European commercial real estate markets are forecast to weaken over the next five years compared to the last five. Prime yields are at an all-time low across many sectors (figure 1) and rental growth is starting to slow. This is concerning investors (figure 2) and pushing them to consider investment opportunities in alternative, non-mainstream sectors that offer comparatively attractive income and/or total returns and are driven by long-term structural changes which are independent of the economic cycle. These sectors should be relatively defensive and offer portfolio diversification.

Some segments such as student accommodation and build-to-rent residential, for example, have already seen significant yield compression as institutional investors have entered those markets. However, there are still several segments which have yet to gain the attention of professional investors and which offer not just attractive risk-adjusted returns today, but may also benefit from future yield compression as they become mainstream.

Figure 1: Net initial yields by sector in the UK

![Graph showing net initial yields by sector in the UK from Dec 14 to Mar 19.](Source: MSCI, May 2019.)
economic power from West to East. We are now seeing the emergence of a sixth mega theme – positive impact investing – and believe that moving forward, all our investments should have a positive social impact for occupiers, communities and investors. By interpreting the interplay between the mega-themes we have sought to uncover attractive opportunities in today’s commercial real estate market where sustainable income and/or capital growth might be derived in future.

In the case of owner-operated hotels in Europe, the mega-themes that support the investment case are:

– Urbanisation and the competing demand for city centre space is limiting new hotel development opportunities
– An increasing number of older, wealthier people with a greater propensity to travel and stay in hotels
– Technology reducing the relevance of brands and increasing the importance of on-line travel agents
– An increasing middle-class in Asia, particularly China, with an experience-focused consumption pattern

The investment case is set out on the following pages.

What do we mean by owner-operated hotels?

– For many years there was only one model of ownership and operation. The big brands (e.g. Marriott, Hilton, Intercontinental, Accor) owned most of their hotels, both the real estate and the underlying operating business. The hotel staff were their employees and, as owners, they were fully exposed to the upside and downside of the P&L. This capital-intensive model was gradually phased out as the big groups disposed of their hotel properties and simply leased them back. The brands still had full exposure to the operations, but the cost of the real estate went off balance sheet
– The simplicity of the hotel leasing market saw cap rates decline significantly for properties under this form of ownership. Long term, often inflation-linked, leases to well-known large brands have been seen as a proxy for Fixed Income exposure and institutional investors piled in almost regardless of the type, quality or location of the hotel. It has become all about the covenant and even then investors have become less discerning
– As accounting standards changed to bring these capital/finance leases back on balance sheet, the model has moved to its latest incarnation - hotel management agreements (HMAs) and/or franchise agreements (FAs). Under HMAs/FAs, the brands no longer pay a rent; in fact, they no longer pay anything. It is the owner of the business (who may also own the real estate) who pays the brand a slice of the gross revenue in return for the use of the brand and its marketing and reservation system. The hotel owner now has full exposure to the upside and downside, and owns not just the real estate but the underlying operating business and the staff. The brands by comparison receive a variable fee linked primarily to revenue, with limited exposure to profitability
– Many less-sophisticated hotel investors have not realised exactly what they have signed up to and, after an initial honeymoon period, those properties which have not been managed tightly enough and/or the capex has been insufficient or not focused on the appropriate area, have seen a decline in revenue and an even more pronounced fall in profitability which is very hard to rebuild without substantial capital investment
– As a consequence, in Europe in particular, there now exists an opportunity for the professional hotel investor to acquire some of these undermanaged and underinvested hotels which are either distressed in their own right, or owned by distressed owners, and then inject capital into the right areas and reconfigure the management team for the precise nature of the opportunity. The US market has operated in this way for 20 years where the three actors are institutional capital owning the real estate and the underlying business, with a specialist operating partner to ‘manage’ the business which includes paying a fee to a brand under an HMA or FA.
The investment case for owner operated hotels in Europe

1. Structural changes in demand

Spending on tourism – encompassing both leisure and business travel – grew significantly faster than world GDP in the period 2007–17 and this gap is predicted to widen between 2017 and 2027, thanks to broad-based growth in travel spending (figure 3).

Over the earlier period, leisure tourism spending grew at a compound rate of 3% a year, compared with global GDP growth of 2.4%. Business travel grew significantly less quickly, expanding at 1.8% a year from 2007 to 2017. In the coming decade, spending on leisure tourism is forecast to accelerate further, while expenditure on business travel is expected to pick up significantly. This will lead to both a more broad-based pattern of growth in overall tourism spending and to a larger gap between rates of tourism spending and global economic expansion.

**Figure 3: Global GDP and tourism expenditure (p.a.)**

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<tbody>
<tr>
<td>Leisure tourism spending</td>
<td>3.38%</td>
<td>4.12%</td>
<td>49.8%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Business travel spending</td>
<td>1.80%</td>
<td>3.23%</td>
<td>37.5%</td>
<td>5.6%</td>
</tr>
<tr>
<td>Total tourism</td>
<td>3.00%</td>
<td>3.93%</td>
<td>47.0%</td>
<td>1.2%</td>
</tr>
<tr>
<td>World GDP</td>
<td>2.40%</td>
<td>2.71%</td>
<td>30.6%</td>
<td>2.9%</td>
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There are several key factors that explain these robust forecasts for tourism expenditure, relating both to consumers’ opportunity to travel and to their patterns of consumption. Factors such as increased investment in transport-related infrastructure and the growing availability of low-cost air travel naturally expand the opportunity to spend money on tourism. However, other issues also play a significant role.

In particular, the strong growth of the so-called ‘experience economy’, in which consumers are spending a growing proportion of their disposable income on experiences and services, as opposed to material possessions, is a key reason for the buoyant demand outlook in the tourism industry. According to research by McKinsey in 2017, in recent years consumer spending on experience-related services such as travel has grown 1.5 times faster than overall consumer spending, and almost four-times faster than consumer spending on goods.

This shift in spending patterns is variously attributed to a growing tendency to seek happiness through shared experiences and the pervasive influence of social media, which feeds a fear of missing out.

The second key growth factor in global tourism is the fast-growing appetite for international travel among China’s huge middle class. Chinese travellers are now the second-largest group of inbound travellers to Europe, accounting for about 25m hotel nights in 2016, the most recent year for which figures are available. They remain a significantly smaller group of visitors than US tourists, who spent about 74m nights in EU accommodation during that year. However, the Chinese contingent is growing very rapidly, doubling its number of hotel nights between 2012 and 2016. Chinese outbound tourism is forecast to continue growing strongly, rising from 145m outbound trips in 2017 to 400m by 2030, for a compound annual growth rate of just over 8%.

Europe is the largest single beneficiary of this robust growth dynamic, given that it accounts for more than half of all inbound tourism arrivals globally. According to the United Nations World Trade Organisation, inbound arrivals globally reached 1.4bn in 2018, of which Europe accounted for 713m, up 6% on the previous year. This robust performance illustrates Europe’s huge worldwide appeal as a tourism destination.

Among affluent Chinese, Continental Europe continues to be regarded as a prestigious destination thanks to its diversity, history, heritage and well-developed consumer markets, compared to the US which may be the home of capitalism, but lacks the cultural diversity and history of Europe.
2. Constrained supply

In spite of buoyant global demand for tourism travel to Europe, the supply of new rooms entering the continent’s hotel market remains extremely muted, having grown at just 1% per year over the past seven years (figure 4).

This situation is forecast to persist in Europe, rather than the rest of the world. While Europe may represent 29% of the current global supply of hotel rooms (figure 5), its development pipeline (figure 6) is just 17% of the global industry total. As a result, the existing shortfall between the supply of tourist accommodation and the numbers of people arriving at European destinations will become further entrenched in the years ahead.

3. Consequent supply and demand imbalance

It is clear that there has been and will likely remain a long-term structural imbalance between a constrained supply of new rooms coming on to the market – particularly in key city-centre locations – and accelerating demand from tourism and business travellers (figure 7).

As a consequence, average occupancy rates are on a strong upward trend and are ahead of rates in other parts of the world. In 2017, average occupancy across Europe reached 71.9%, compared with 70.9% in Asia-Pacific, 65.6% in the Americas and 62.1% in the Middle East and Africa. This is set to continue as the growth in occupied rooms far exceeds the growth in rooms available (figure 8).
These positive demand/supply dynamics are fuelling robust growth in the sector's key performance metric – revenue per available room (RevPAR) – and naturally underpin the long-term investment case for this asset class (figure 9).

In addition, the emergence of large online travel agents ('OTAs') such as Expedia (Hotels.com) and Priceline (Booking.com and Kayak.com) has provided a powerful additional distribution channel for hotels to increase

Home-sharing has had limited impact on the hotel market?

Home-sharing websites appear to radically boost the supply of available accommodation by making thousands of private properties accessible to travellers. Their emergence has inevitably raised questions about the threat they could pose to established hotel businesses, even though home-sharing is not a new concept.

Evidence from Paris, the largest city market in the world for Airbnb, suggests that the spread of home-sharing poses little direct threat to hotel occupancy, given that hotel revenues in the city have continued to grow even as Airbnb has established itself. This pattern is replicated across Europe, where hotel revenues in 'winning cities' are at an all-time high.

A key reason for this is that the way travellers typically use the two types of accommodation tend to differ.

- Hotel stays are on average shorter than home-sharing bookings, at one to three nights: travellers choose longer stays for Airbnb bookings in part because the extra fees for cleaning and website commission payable for home-shares push up the cost of shorter bookings significantly

- Equally, travellers booking home-shares are often seeking a different type of service, prioritising a private kitchen and self-contained space for children, for example, rather than the higher level of service and the product consistency they would expect from a three or four-star branded hotel

The other reason for the limited impact on the hotel market is that home-sharing websites created a more formalised means for private owners to access the traveller market. A lot of this accommodation already existed but operated in a 'grey' market environment.

Note: Revenue per available room (RevPAR) is a key indicator of hotel operating performance. RevPAR is obtained by dividing total rooms' revenue by the number of available rooms over a given period. It can also be calculated in a simpler way by multiplying the occupancy rate by the average daily room rate.

In addition, the emergence of large online travel agents ('OTAs') such as Expedia (Hotels.com) and Priceline (Booking.com and Kayak.com) has provided a powerful additional distribution channel for hotels to increase
occupancy levels. It has also amplified the impact of their own marketing programmes by benefiting from the OTAs’ additional marketing spend.

4. Attractive yield premium

Although less well known than other alternative real estate asset classes, such as student accommodation, hotels are one of the largest of the main ‘alternative’ asset classes in European real estate and have become an increasingly liquid market in recent years. Investment volumes of €21.7bn in 2017 represented the third consecutive year of €20bn-plus flows into European hotels (figure 10) – almost three-times greater than total investments in student accommodation during that year and 12% of the overall real estate market.

Figure 10: European alternative real estate investment volume by sector

By comparison, hotel-focused vehicles account for 6% of the US REIT sector by market capitalisation (figure 12).

Figure 12: US REIT sector by market capitalisation

Hotels are an overlooked area of the real estate universe, often because of their perceived operational complexity and the specialist knowledge required to invest successfully. This has led to a heavy focus on ownership of the real estate only, generating income from a lease to a branded operator. While this may suit institutional investors looking to match long-term liabilities, we see limited additional value in this segment as yields have compressed (figure 1).

However, we do believe that in the owner-operator segment, there is still considerable value to be generated given the yield premium relative to office assets of 50–250 bps across Europe (figure 13).
An increasing number of institutional investors are seeking to partner with specialist asset managers to access this market due to this premium and to diversify their portfolios. It is therefore only a matter of time before this yield premium starts to erode. However, this will clearly support prices for those investors which also enter the market today.

5. **Opportunity in owner-operated vs. leased**

Due to the historic popularity of the lease model amongst real estate investors and desire of the major hotel chains to move to the branded approach (i.e. lack of new supply in the leased segment), the net initial yield on hotels sold under the lease model of ownership have tightened considerably.

Furthermore, fixed rate leases are much more susceptible to rises in interest rates which, although not imminent in Europe, will cause the value of such investments to reduce much sooner than for owner-operated hotels.

While many investors like the perceived safety of the lease covenant compared with the owner-operated model, we believe this is illusory. Firstly, the investor has no upside exposure, but arguably more importantly, if the hotel is fundamentally not trading as well as expected, then its inherent value will become impaireed over time such that even if the tenant continues to pay its rent, the hotel value at the end of the lease will be lower (all other things being equal). Thus an investor in a leased hotel is still exposed to the downside, but gets no benefit from the upside.

While the fixed lease ownership model may suit institutional investors looking to match long-term liabilities, we see limited additional value in this approach.

In Europe we see the best risk-adjusted value in the owner-operator segment where not only is there the opportunity to capture upside value from rigorous asset management, but the yield premium available is 100–150bps on average across major European cities compared with fixed leased ownership (figure 14).

![Figure 13: Hotel yield spread relative to Offices (Q3 2018)](image1)


![Figure 14: Hotel management agreement hotel yield spreads relative to hotel leases (Q3 2018)](image2)

Uncovering value at the top of the real estate cycle

Part 1: Owner-Operated Hotels in Europe

Understanding and accessing the sector

Investing in specialist sectors requires specialist analysis. Where to look, and how to size up the risks specific to that area poses a challenge that not all investors are equipped to undertake independently.

While hotels in their most generic sense are a relatively mature sector across Europe, the owner-operator model has proven challenging for many investors, including specialist real estate investors. They have often made an investment on the basis on sentiment or emotion without having the specialist skills and experience that are required to identify and underwrite investment opportunities at the right price. In addition, in-depth asset management knowledge is required to inject and manage capital investment in the right areas of the hotel as well as to manage the in-house hotel staff, in order to implement the right strategy to not only boost revenue but also generate sustainable profits.

We consider the best risk-adjusted opportunities to be 3–5* hotels located in ‘winning destinations’ where the structural changes in supply and demand are at their most pronounced and their most sustainable going forward. Individual hotels should also be in proven destinations with proven demand rather than trying to develop new destinations which can involve considerably more risk. Exposure to both leisure and business travellers also helps to smooth peaks and troughs in demand since they tend to travel at different times. These properties tend to be of a suitably large size, both in terms of floor area as well as capital deployment, to make hands-on intensive asset management worthwhile.

Summary

- Yields across most global commercial real estate markets and sectors are at historic lows and future returns are consequently expected to be lower than the past few years. Despite this, we believe there are still reasons to be cheerful for investors willing to devote the time to consider the less well-trodden path as there are still pockets of value to be uncovered which will also add diversity to portfolios.

- Schroders’ mega-theme framework for considering the drivers of future occupational demand has identified owner-operated hotels in Europe as a sector with the right characteristics to benefit from these themes. In particular, the favourable demographics of a wealthy retirement-age population in Europe and dramatic growth in the Asian middle-class, both having a greater propensity to travel without economising in home-share accommodation. An on-going lack of new development means net demand and hence profitability should be sustainable even if there are some temporary blips due to weaker economic growth or terrorist attacks for example.

- With yields currently at a meaningful premium compared with leased hotels, there is still considerable value to be gained from entering into the owner-operated market before it becomes institutionalised. It is the dominant ownership model in other parts of the world and we believe it offers investors the best risk-adjusted opportunities in the European hotel market. However, hotels do require specialist management, perhaps more so than any other form of real estate given the daily turnover of ‘tenants’ – the guests.

Schroder Real Estate

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