European Hotel Investment, Q2 2015

European hotel investment on course for €20bn in 2015

Hotel Investment Volume
+39% Q2 Y-o-Y

All Sectors Investment Volume
+20% Q2 Y-o-Y

Investment market (€ millions)	2015 Q2	2014 Q2	Y-o-Y % Change	H1 2015 as % of previous full year
United Kingdom	2,693	245	+998	61
Germany	904	1,252	-28	49
France	577	533	+4	108
Spain	731	356	+105	122
Italy	236	110	+115	54
Ireland	14	0	N/A	686
Nordics*	104	592	-82	19
CEE**	60	542	-89	14
Benelux***	370	284	+30	104
European Total****	5,709	4,103	+39	85

Source: CBRE, 2015

*Consists of Denmark, Finland, Norway, Sweden. ** Consists of Austria, Poland, the Czech Republic, Hungary, Slovakia, Romania, Estonia, Latvia, Lithuania, Russia, Ukraine, Bulgaria, Croatia, Serbia. *** Consists of Belgium, Netherlands and Luxembourg. ****The country/regional volumes provided do not add up to the European Total.

The total 2014 European hotel investment volume eclipsed the peak of the previous cycle causing many to call the top of the market – unable to predict the future buyers having witnessed swathes of hotel stock fall under private equity ownership. Not to mention the dark clouds that were ominously building over the Eurozone.

However, investor appetite for hotel stock has appeared unrelenting through the first half of 2015. Commercial real estate in general is benefiting from a structural shift in interest rates and the subsequently humble yields offered by government bonds. Economic recovery is driving employment, consumer spending and unlocking an increasing number of European hotel markets, whereby opportunistic capital can hunt for investible product with confidence in the prospects for growth. Countries where the hotel landscape was considered to be further along in the cycle, such as Germany, France and the UK, continue to register mounting deal volumes – attracting significant institutional interest and a growing weight of Asian capital.

Through H1 European hotel deal volume is some 85% into the total level of investment for full year 2014. Historically the climax of the year has always resulted in a surge of deals, which if repeated, would push hotel investment over the €20 billion threshold for the first time in the history of the asset class.

HIGHLIGHTS

UK

The UK investment market remains particularly buoyant, perceived as a safe haven in the broader economic context and therefore remaining popular with traditional investors as well as new entrants dipping a speculative toe into the European hotel real estate arena. At €2,693 million, the Q2 deal volume for the UK exceeded the long-run quarterly average by over €2bn.

Few transactions took place in Greater London throughout Q2; however, the high pricing, depth of bidders and sharpness of yield would suggest that this is related to scarcity of stock and not the slight decline in market gross operating profit per available room (GOPPAR) (-2.5% Y-o-Y H1 2015). Growth in hotel room supply is currently outpacing demand growth in the capital and an active pipeline suggests little change in the short to mid-term.

29 individual transactions in Regional UK through the second quarter signals strong liquidity. Coupled with H1 Y-o-Y improvement in hotel profitability of over 9% and it comes as little surprise that yields are continuing to trend stronger. The overall provincial supply risk still appears relatively benign; however, investors should remain diligent to pockets of highly concentrated hotel development in some locations.

Italy

The surge of North-American opportunistic capital into Southern Europe has so far favoured Spain's economic recovery over Italy's bruising triple-dip recession. There remains profound pessimism about the Italian economy ingrained in the Italian psyche, however, the recovery has now seemingly begun, albeit on a weaker basis than the euro area as a whole. Notwithstanding, the hotel deal volume has started to creep up – the Q2 volume having reached €291 million, €203 million above the long-term quarterly average.

Most of the transactions have taken place in strong tourism locations such as Venice and Rome where robust trading performance has been underpinned by increasingly mobile North American, Northern European and Asian travel markets. Investors will likely wait for economic recovery to gather more momentum before committing capital to Italy's more domestic and corporate markets.

Notably Italy's first loan book hotel asset has come to market – the Molino Stucky in Venice – and investor interest is understood to be particularly high. The government is likely to stop short of creating a public vehicle to clean up non-performing loans (NPLs); however, fiscal incentives and legal reform is set to encourage banks to crystallise NPLs which will be a catalyst to intensified disposal of distressed real estate debt. Steps to cut out bureaucracy and minimise the lengthy loan-to-own process of around 4 years will no-doubt add to the appeal for many an opportunistic investor.

Ireland

Q2 was a relatively slow quarter for hotel transactions in Ireland - something of a respite following a particularly eventful first three months. Through H1 the Irish deal volume is already €442 million ahead of the total transaction volume for full year 2014.

Whilst Irish hotel deals have seemingly monopolised the headlines over the last 24 months, many trades have centred around non-performing debt – some of the assets involved are now coming back to the market as equity following the realisation of loan-to-own strategies and thus making a mark on the country's investment volume.

The strong Irish economic recovery continues to lift domestic hotel demand and the low value of the euro is behind inbound visitor growth from Ireland's two largest source markets; the UK and the US. Regional markets are increasingly seeing the impact of recovery in hotel performance and recent deals comprising mid-market assets in provincial cities are ultimately a reflection of this trend – many of the purchases involving domestic capital. Dublin, however, remains a firm favourite with international investors and the market continues to sustain heady growth in hotel revenues and profitability. Market occupancy over the last 12 months is in excess of 80% and operators are leveraging the migration of multi-national firms to the city in order to drive rate and thus the bottom line, with GOPPAR having increased by 34.1% Y-o-Y for H1.

It should be mentioned that performance growth of late in the Irish capital has been relatively unconstrained in light of very little new supply entering the market. Whilst the confirmed pipeline for the city is still relatively low, investors should be aware of the increasing amount of speculative hotel development projects which could douse the fire should they come to fruition.

Yields

Yields continue to trend stronger across most European markets. Whilst there remains confidence in trading performance growth, assets encumbered by a generally less-flexible management contract (MC) are transacting at a higher yield profile than for assets unencumbered or operated under a franchise agreement. As the sector inevitably moves through the cycle and performance growth prospects become less certain, it will be of interest to see if hotel investors seek comfort in the management of an internationally renowned brand – a trend that has manifested itself previously into MC yield-stability throughout periods of trading performance and capital value volatility. However, the growing presence and track-record of third-party management companies will inevitably have an impact, as investors build faith in their ability to navigate choppy waters with the support of an impartial operator, frequently offering more owner-friendly contract terms, and whilst maintaining full control of their asset.

Assets encumbered by an operational lease have experienced considerable downward pressure on yields over the last 12 months. The institutional appetite to invest in core real estate has heightened considerably resulting from low interest rates and the associated impact on bond yields. It is widely considered that the lower interest rate environment is a structural shift and whilst rises are on the horizon, interest rates and bond yields will remain low in comparison to the previous cycle. This could result in the yields for leased assets trending stronger for longer given that the risk premium for real estate will remain relatively substantial for the short to mid-term.

Figure 1: European hotel lease yields relative to office yields – Q2 2015

Source: CBRE, 2015

When comparing hotel lease yields to office yields across European locations (figure 1), there are a number of nuances that impact the yield spread between the asset classes. Regional UK leased hotel yields have registered lower than those for offices in Q2 – this has resulted from robust provincial hotel performance, the availability of strong covenants and typically longer hotel lease terms.

Given the earlier stage at which Spanish markets are positioned in their recovery, there is greater perceived risk across all asset classes and thus yields are relatively high in a European context. Spanish hotel performance is displaying impressive growth in key cities and yet the spread of yield in comparison to offices is particularly high, largely due to a lower availability of strong covenants. Whilst the international brand representation in the leased hotel space remains low, there will continue to be fragmentation in covenant strength and inconsistency in yield spreads across borders.

Hotel operational lease yields*	2015 Q2	2015 Q1	2014 Q2	Q-o-Q change (BPs)	Y-o-Y change (BPs)
Germany (Top 5)	5.00	5.00	5.25	0	-25
Vienna	5.00	5.00	5.05	0	-5
Warsaw	6.00	6.00	6.00	0	0
Paris	5.00	5.00	5.00	0	0
Regional UK (Prime)	4.75	5.00	6.00	-25	-125
London	4.25	4.25	5.25	0	-100
Dublin	6.00	6.00	6.50	0	-50
Madrid	6.50	6.50	6.50	0	0
Barcelona	6.25	6.25	6.50	0	-25
Oslo	5.25	5.50	5.75	-25	-50
Rome	6.00	6.00	6.00	0	0
Milan	6.25	6.50	6.50	0	-25
Amsterdam	5.60	5.75	5.75	-15	-15
Brussels	5.50	6.00	6.00	-50	-50

Source: CBRE, 2015

*Operational lease, local lease terms apply, typical cap rates.

Hotel management contract yields*	2015 Q2	2015 Q1	2014 Q2	Q-o-Q change (BPs)	Y-o-Y change (BPs)
Germany (Top 5)	6.00	N/A	N/A	N/A	N/A
Vienna	6.00	6.00	6.00	0	0
Warsaw	7.25	7.25	7.25	0	0
Paris	5.25	5.25	5.50	0	-25

Regional UK (Prime)	7.25	7.50	7.75	-25	-50
London	5.75	6.00	6.00	-25	-25
Dublin	7.25	7.25	7.50	0	-25
Madrid	7.25	7.25	7.50	0	-25
Barcelona	7.00	7.00	7.25	0	-25
Oslo	7.50	7.50	7.75	0	-25
Rome	7.00	7.00	7.25	0	-25
Milan	7.25	7.50	7.50	-25	-25
Amsterdam	6.10	6.25	6.75	-15	-65
Brussels	7.25	7.75	7.75	-25	-50

Source: CBRE, 2015

*Based on upscale assets, hotels operated by internationally renowned brand under a management agreement , non-guaranteed variable income stream, typical cap rates.

Hotel vacant possession yields*	2015 Q2	2015 Q1	2014 Q2	Q-o-Q change (BPs)	Y-o-Y change (BPs)
Germany (Top 5)	5.75	N/A	N/A	N/A	N/A
Vienna	5.75	N/A	N/A	N/A	N/A
Warsaw	7.00	N/A	N/A	N/A	N/A
Paris	5.10	5.10	5.50	0	-40
Regional UK (Prime)	6.50	6.50	6.50	0	0
London	5.00	5.00	5.00	0	0
Dublin	6.25	6.50	6.75	-25	-50
Madrid	6.75	6.75	6.75	0	0
Barcelona	6.50	6.50	6.75	0	-25
Oslo	6.50	6.50	6.75	0	-25
Rome	6.50	6.50	6.75	0	-25
Milan	6.75	7.00	7.25	-25	-50
Amsterdam	5.85	6.00	6.50	-15	-65
Brussels	6.75	7.50	7.50	-25	-50

Source: CBRE, 2015

*Based on upscale assets, hotels unencumbered and operated independently or under a franchise agreement, non-guaranteed variable income stream, typical cap rates

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