Hospitality and Leisure
Hospitality Directions Europe

Hotel real estate: hunkering down

Key highlights from Emerging Trends in Real Estate Europe 2009

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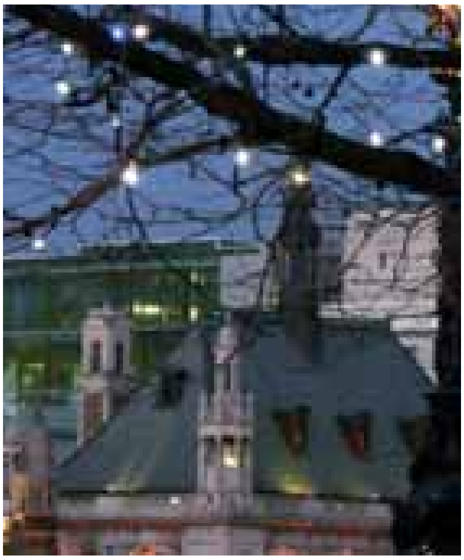


Overview of European real estate prospects

Emerging Trends Europe is based on surveys and interviews with over 500 of the real estate industry's leading authorities. Participants expect that 2009 will be a difficult year for their industry in general and hotels are no exception. The global financial crisis has buffeted Europe's economies, darkening the prospects for real estate. Transactional markets will recover slowly, inhibited by caution and a lack of debt on the part of equity investors. A significant amount of distressed property is expected to come onto the market.

European governments are taking action to reboot their economies' growth, but most western European countries will experience a recession during 2009, while in eastern Europe gross domestic product is forecast to grow at slower rates than recent years.

There is substantial equity pencilled in for European real estate in 2009. Our survey indicates that the main sources will be private property vehicles and conservative institutions like sovereign wealth funds, insurance companies, and pension funds. However, they are waiting for property prices to stabilise before loosening their purse strings.

Private property vehicles have raised substantial amounts of equity for European real estate: €23 billion in 2008 alone. But many existing funds will struggle to maintain performance and refinancing will be an issue.

In 2009, debt for European real estate will be in short supply as banks rebuild their balance sheets. Relationship banking is back, as are conservative loan-to-value ratios and tighter underwriting generally. With securitisation of commercial loans effectively dead, large deals will be difficult to finance.

Public-traded real estate companies' shares are trading at historically large discounts to their net asset values. Investors are circling, but waiting for real estate prices to bottom out before striking.

Investors expect to find opportunities in direct real estate in Europe in 2009. They favour the safety of the larger, more liquid markets: the United Kingdom and Germany. However, the emerging markets of Russia and Turkey also remain popular because of their longer-term potential.

Capitalisation rates for all sectors are expected to continue moving up in 2009. The UK is furthest along in this process of adjustment. The combination of rising capitalisation rates and lower interest rates is creating a positive financing gap for European real estate, despite increased margins on lending.

Rising capitalisation rates and economic turbulence are making investors refocus on mainstream commercial property sectors instead of higher-yielding but riskier alternatives. But demographic trends are underpinning a growing interest in healthcare and senior living facilities and high commodity prices have

Hotel real estate: hunkering down

sparked a mini-fad for agricultural investment. Infrastructure, with its bondlike cash flow, also remains on the radar.

For individual property types, the prospect ratings declined by more than one full point for all categories bar one. Most property types are viewed as offering "fair" prospects. Retail is the leading major property sector, followed by hotels, mixed use, rental apartments, office, industrial/ distribution, and residential for sale, in that order. The range amongst the top six of these is very narrow and none really stands out. Looking at subsectors, central city offices are clearly preferred over suburban offices. The concern about quality is reflected in the preference for deep liquid markets and city centre locations.

The outlook for property development is quite dismal. Hotels, mixed use, and central city offices were rated as presenting the best opportunities, but the prospects are fair at best for these.

Yields for prime property will weather the storm better than secondary and tertiary quality real estate; values for the latter are expected to take a severe beating.

What are the prospects for hotel investment?

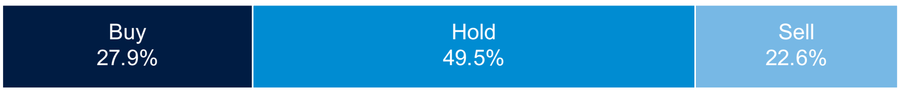
Although the retail sector was once again awarded the top spot among property types for investment prospects, it only just hung on to the top spot with the hotel sector following closely behind. Economic development will determine just how rewarding these investments will be.

The rating for the hotel sector dropped from "moderately good" last year to "fair" for 2009, with respondents making the following comments: "I would expect to see further expansion of the established brands, with the new, boutique brands finding it harder to compete for sites." "The outlook for hotels is relatively good. [The] sector has been one of the best performers over the past year, with good rental growth." Another says, "Very specialist sector, but still strong demand. [I am] not sure why this is the case." "With a good hotel manager and a good location with sufficient rates, hotel investment is a real low-brainer. Triple-net contracts secure the condition of the hotel, and rent is flowing. The choice of the right manager and the right location is crucial, though." At this point, some investors sound a note of caution: "[Hotels are] too complex, need management experience." "Hotels [are a] more risky business," and "[We are] wary of hotels, [but] will look at them selectively." See chart 1.

Chart 1: Hotels – Prospects and recommendations

2009	Prospects	Rating	Ranking
Investment prospects	Fair	4.8	5th
Development prospects	Fair	4.6	1st

Investment Recommendation of Survey Respondents



Source: Emerging Trends in Real Estate Europe 2009 survey

Hotel real estate: hunkering down

> "Four-star and five-star hotels have [been] developed in response to an extended period of personal wealth and generous corporate expense policies. [They are] likely to be hard hit and have heavy fixed costs."

Undersupply drives interest in some markets

The affection for the sector may be the result of serious undersupply, particularly in some parts of the new Europe. "[The] hotel sector [is] still phenomenally active around the world, eg, Russia and the Balkans," says one respondent. Some respondents are particularly drawn to the luxury segment, "The outlook is good, with no reductions in term of prices expected." "Hotels are one area where transactional activity is likely to rise. The sovereign wealth funds are still interested in trophy-asset hotels and prices are holding up reasonably."

Others express a less enthusiastic view: "Super hotels continue to be built with little sense or logic. Four-star and five-star hotels have [been] developed in response to an extended period of personal wealth and generous corporate expense policies. [They are] likely to be hard hit and have heavy fixed costs." That not everyone has a taste for the high-end market is expressed in these remarks: "Budget hotels will do well at the expense of the luxury end of the market." "I expect investment and development within the limited-service market to flourish". "Limited service hotels are attracting huge interest due to their 'fixed' construction costs and low level of staffing. This means they convert to profit at a much better rate than their high-end counterparts. They can achieve significant economies of scale compared to the upper end of the market. Furthermore, the market they service is less price sensitive than the mass market [of] a four-star [hotel], whilst their cost base is significantly lower."

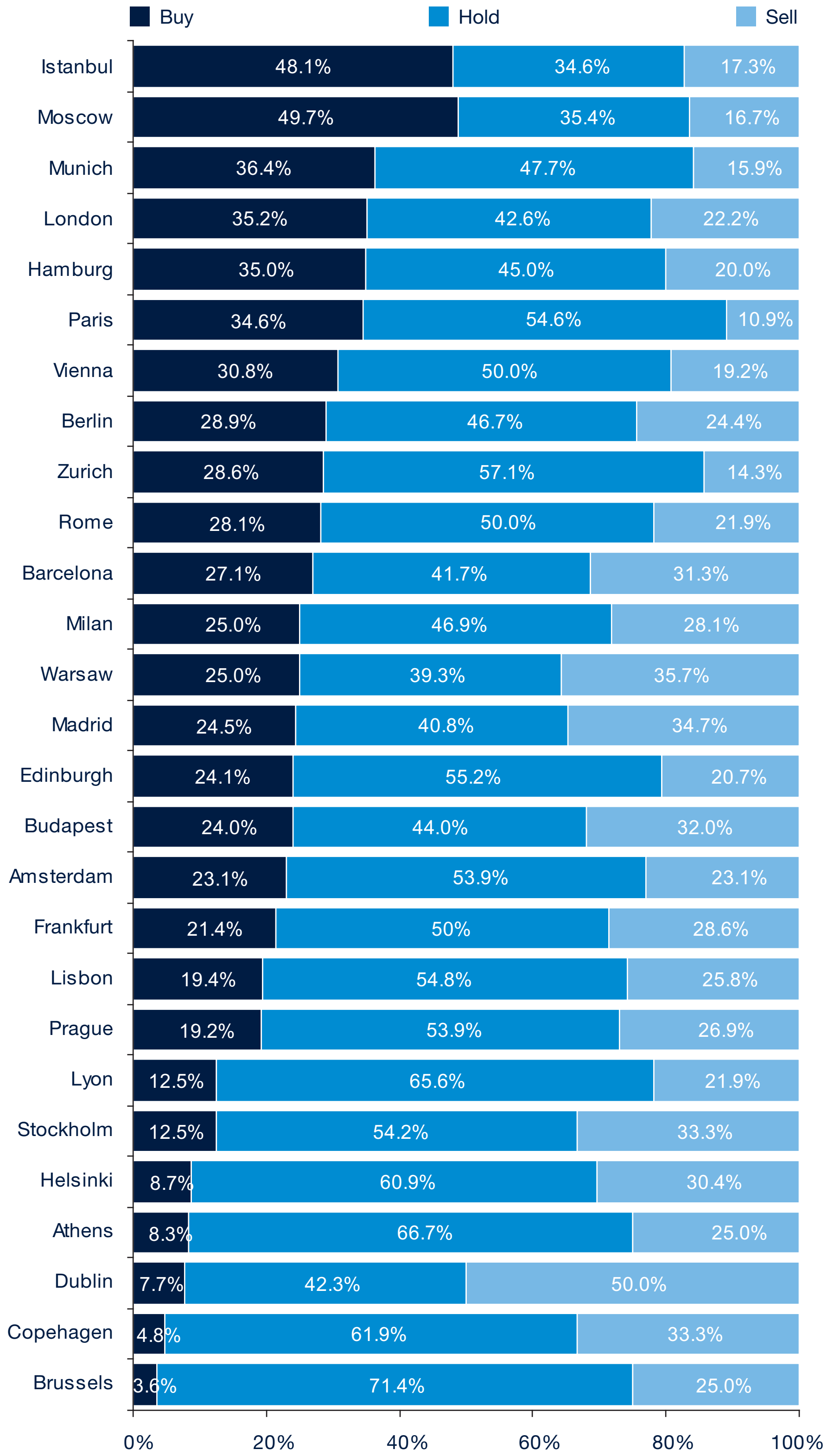
No go in the middle?

While both the high-end and the budget market find supporters in the investor community, the middle ground seems to be something like a "no go" area. "Hotels that are not either budget or luxury will be destroyed due to rising costs." The key is to have a good business model for the hotel which is something "more difficult for the middle-range operators in the three- and four-star segment." Without a unique profile in terms of location or facilities, "the only thing they can do is to drive down prices. Occupancy will drop most in this area."

"We use variable leases, so [we] have shared in the upside of the operating business. Whilst occupancy levels have fallen, room rates have

Hotel real estate: hunkering down

Chart 2: Hotel Buy / Hold / Sell Recommendations by City



Source: Emerging Trends in Real Estate Europe 2009 survey

risen." Other investors take a more conservative approach and restrict their role to that of "a property investor, not an operator." Talking about investment opportunities, one interviewee says, "A few deals are going on that I think we should look at. You can dream of the type of hotels you want to do a deal with or you can adapt yourself to the reality of the market. There are only a few deals that exist. My preference would be to avoid the high end of the market, but can we find deals?"

Where are the best bets?

Istanbul and Moscow top the list as most favoured locations, although Moscow may be used as a proxy for the Russian market at large. "Moscow [is] still grossly underserved for a city of this size." "We don't see a lot of opportunities, but if they are presented we will take a look." In Moscow, "you have got the highest hotel rates in the world, you've got only high-end hotels. Supply has caught up a bit with demand," but "there is certainly demand right across the country. All of the hoteliers are desperate to roll out hotels across Russia, a lot of cities have not got a decent hotel." This is reiterated by this observer, "If you are travelling around Russia, you have got nowhere to stay." See Chart 2.

Another buoyant market is Turkey, which is expected to "grow rapidly, especially business hotels." Elsewhere, there may be room for particular hotel types in some locations. One investor "remains interested in three-star hotels, of which there is an undersupply in London." His business model is based on reconfiguring smaller hotels. A drawback is lack of debt finance, as "banks are insisting on a 50 percent loan to value, which is too lowly geared to get a decent return on equity."

Hotel real estate: hunkering down

John Forbes, real estate leader in Europe, Middle East and Africa, PricewaterhouseCoopers, remarked:

"This is going to be a tough year for many investors. For those who bought at the top of the market it could be a struggle for survival, particularly if banks become more aggressive in dealing with covenant breaches. On the other hand for those with equity to invest, there will be opportunities as the banks start to take action. Although new debt will remain in very short supply, banks may have little alternative to remaining as lenders during the restructuring of defaulting borrowers."

Where to avoid?

The most pronounced sell recommendation is out for Dublin, which attracted a 50 percent sell vote, but sell recommendations were also relatively high in Warsaw and Madrid, and sellers also outnumber buyers in Brussels, Athens, and the capitals of Nordic countries by a large margin.

The authorities speak of regeneration, but practical policies are a different matter entirely. "The opportunities exist, but on a very small scale." Just how the obstacles can be overcome has been shown in Porto and is being noted by this interviewee, "The market has shown signs of vitality as a result of an efficient public agency for regeneration of downtown Porto, combined with a new law that makes block-approach developments possible and feasible."

What next?

This paper presents the key highlights for the hotel property sector from PricewaterhouseCoopers' recent report, Emerging Trends in Real Estate Europe 2009. Although it was published in early 2009, the survey was undertaken late 2008 and opinions expressed may have hardened since then as the economic situation has deteriorated further. The hotel sector was a relatively late entry into the economic fray, but is now under pressure and faces an extremely challenging year as the global recession deepens and travel demand weakens. Hotel investment volumes in the UK alone are reported falling by almost 70 per cent during 2008. Trading performance is expected to deteriorate in the year ahead with PwC's forecast for the UK anticipating overall RevPAR falls of almost 19 per cent in the baseline scenario and 24 per cent in the downside scenario.

Although investment activity has slowed, respondents to the Real Estate Survey suggest that there "are likely to be some distressed sales" and highly leveraged investors are tipped to move into troubled waters. "It is the problems from financial gearing that will force some funds to make short-term decisions to sell." However, they conclude that the "price declines should lead to interesting investment opportunities in 2009/2010."

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