A **Bilfinger Real Estate** company

GVA

The changing face of the UK hotel sector

Autumn 2014

08449 02 03 04
gva.co.uk

Introduction

The hotel sector in the UK is showing an improved trading performance, and there is increasing investor demand and levels of new supply not seen since the financial crisis. Yet despite this encouraging outlook, the sector is undergoing an important change.

Due to the economic challenges of recent years, an increasing number of hotels have experienced falling occupancy levels and revenues which has placed a strain on the viability of their operation. Non-prime assets in what could be considered to be tertiary locations, with limited ability to capture a significant market share, have struggled and, in a number of cases, continue to be operationally challenged.

While some 5,300 new bedrooms are due to open in the next two years, nearly 2,000 existing bedrooms were lost in 2013. Much of this new supply is in the budget sector, and the trend towards larger, 100 plus bedroom schemes is putting extra pressure on the bottom end of the market.

Those smaller, lower rated hotels, typically located in less accessible locations and lacking in capital investment, instead have to assess non-viability and consider alternative land uses. This report takes a detailed look at the impact that this is having on the hotel market, what options are available for underperforming hotels and also includes some case study examples where alternative use strategies have been pursued to maximise the property potential of hotels.

Market change

The hotel sector continues to grow as a property asset type, and as such it has had to adapt not only to changing customer demands but also to the demands of the property market.

Amongst investors, the preferred types of hotels these days generally offer better operational efficiency with more that 100 bedrooms, particularly for limited service brands, whereas a large amount of older existing stock in these groups tends to be smaller, in the region of 50 beds or less.

Investors in the hotel sector have, over the last couple of decades, increasingly focussed on the covenant strength of the operator and/or the trading performance of the hotel, the suitability of the property from a branding perspective and the longevity of the property to meet guests evolving requirements. Consequently, in some instances it can be cheaper to build from new rather than modify existing stock, especially so when including the past impact of the Disability Discrimination Act and new energy efficiency requirements relating to zero carbon and minimum rental standards.

The change in hotel requirements is highlighted by the fact that, for all schemes currently in the pipeline which are confirmed to open in 2014 or 2015, the average number of bedrooms is 108, while the average number of bedrooms in hotels which have closed in 2013 is 28, as highlighted by Figure 1.

The contrast is most obvious when comparing the 2 and 3 star sectors (probably mainly independent operated hotels) with the budget sector, where lower average room rates determine the need for higher density. Consequently the difference in the average number of bedrooms between new and closed is 116 to 61, meaning that the pipeline stock is almost double the size of that it is replacing. At a national level, the average number of bedrooms per hotel has been gradually increasing over the last decade by an average of 1.2% per annum, from 43.5 to 48.2 beds. By the end of 2015, the average number of beds will have risen to 49.4.

Over the course of 2013, some 70 hotels closed in the UK resulting in the loss of 2,000 hotel beds. Only 18% of these hotels were part of a chain, the majority being independent (Figure 2). In terms of the total number of beds lost last year 78% where rated three star or under. This share rose to 95% for independent beds.

In terms of overall numbers, it would appear that the hotel closures in 2013 are the thin edge of a much larger change that has materialised since 2003. A recent report by Melvin Gold Consulting estimated that as many as 39,174 hotel beds were lost between 2003 and the end of 2013 – equivalent to over 3,500 beds per annum, representing 2,139 hotel closures over this period.

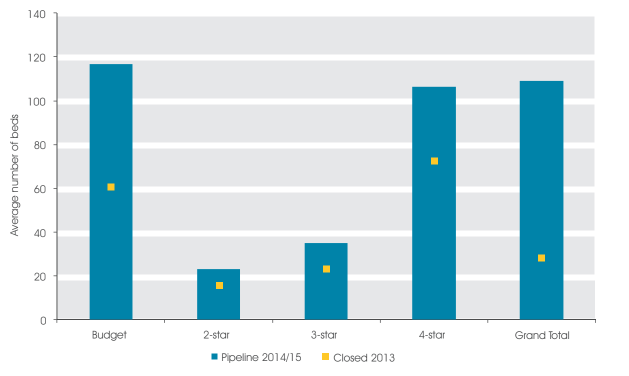
The lion's share of these were small unbranded independents in coastal locations, markets that have been hardest hit by a combination of high supply, out dated hotel product, falling occupancy levels and latterly the impacts of economic downturn.

Is this change something that is only to be expected as part of a cyclical downturn or is it something more fundamental? Over the course of the next two years to the end of 2015, over 27,000 new hotel beds are scheduled to open, suggesting that the sector remains in good enough health to warrant this new level of supply (Figure 3).

The most telling aspect though is that over half of these beds are in the budget sector (56%), with independents providing just 2% of beds within that category. National brands (such as Premier Inn) account for 53% of all budget beds and international brands (Ibis, Holiday Inn) a further 43%.

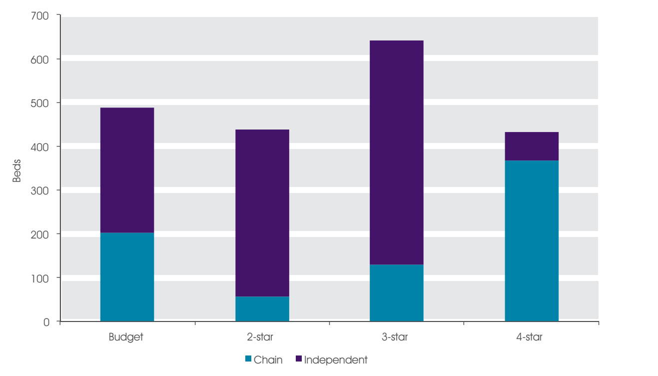
The majority of new independent beds are concentrated in the four and five star categories, with 85% combined and are likely to be considered as boutique hotels. Compared to the whole market, independent beds account for a third of the total pipeline of four and five star beds due to open by the end of 2015 as national and, to a certain extent, international chains continue to grow their budget brands.

Figure 1- Average bed numbers by type



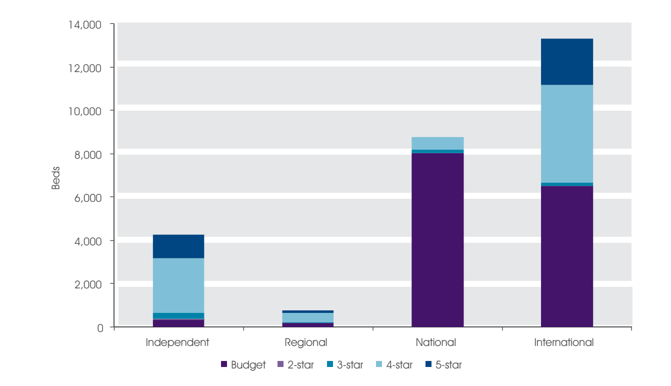
Source: AM:PM

Figure 2- Beds closed in 2013



Source: AM:PM

Figure 3- Future pipeline by type and provider



Source: AM:PM

Macro-economic factors

Room rates, incremental spend, occupancy levels and operating costs all contribute directly to the viability of a hotel. During the financial crisis, the hotel sector was hit on several fronts with falling occupancy levels, rising food and energy costs, falling property values and a lack of finance at a time when the sector has rapidly increased in terms of beds and the number of operators.

In addition to this, other factors also come into consideration such as location, the reliance upon local transport links, businesses and tourist destinations, or the size and quality of the building.

UK plc has been buoyed by the strength of the economic recovery, while a favourable exchange rate is helping to attract overseas visitors. However, the Eurozone is only just returning to limited growth post-recession and that market has a material influence on the level of economic activity in the UK. Domestic and business stays have helped the sector to a certain extent, but much of this is concentrated in the main markets such as London and regional cities.

Many larger hotel owners have had to struggle with loans, as capital values have fallen, triggering unsustainable LTV ratios. The restructuring of a number of bank loans has seen LTVs of 128%, 152% and 174% for some UK portfolios, whilst smaller independent hotels at the lower end of the spectrum have also come under significant financial pressure.

By and large, the main indicators for the sector at a UK level remain positive, although performance has been polarised between London and the regions. The fundamentals that underpin the market in the capital such as tourism and business travel mean that occupancy levels have remained relatively stable over the past seven years, while the standard performance benchmark, revenue per available room (RevPAR), has steadily increased by 21% over this period. In contrast, while occupancy levels in the regions are now above 2007 levels, RevPAR was down by 5% on a comparable basis in 2013. However, we anticipate that RevPAR for 2014 will exceed the 2007 level on a non inflation adjusted basis.

Year	London		Regional UK	
	RevPAR £	Occupancy %	RevPAR £	Occupancy %
2007	94.11	80.6	46.07	70.2
2008	96.92	79.3	44.98	67.7
2009	93.37	80.4	39.98	64.7
2010	102.18	82.1	41.19	67.1
2011	109.82	82.1	41.60	70.9
2012	112.96	80.6	41.38	69.9
2013	113.63	82.2	43.66	72.35

Source: Hotstats

Micro-economic factors

Location is one of the key considerations for determining the viability of a property, and hotels are not exempt from this factor. For smaller independent hotels in particular, they can be at a significant operational disadvantage if the location is substandard or secondary, whereas many of the larger hotel companies have the resources to ensure that they are located in key positions.

Close proximity to key business drivers such as major travel routes or terminals are essential for many hotels more reliant upon overseas tourists and the business market, albeit not so essential for those predominately leisure focussed operations that may trade off their remoteness. In this case, other considerations which may help drive tourism such as national parks, the coast or additional facilities such as a spa, golf or wedding venue.

One final factor that can have a significant impact is the building itself. The overall quality, size and condition can all determine whether the hotel can be operationally viable or not. As our case studies later in the report show, some of these micro-specific factors can be in place, such as a prime riverside location, but the cost of making any improvements to the quality of the building could prove to be unviable.

Financial viability

One of the main determinants behind a hotel's viability is value. The general decline in hotel values during the economic downturn has had a particular effect on loan to value ratios with many hotels, particularly outside London, falling in value below the level of outstanding loans. Falling revenue levels have made it difficult for many hotels to keep up loan repayments sometimes leading to administration, and in some instances, closure. Subsequently, many banks have been left with hotel assets that are worth less than the money they are owed, stimulating a search for a higher value alternate use.

This does not apply solely to revenues and operating costs of the existing scheme, but also any potential value that could be released via a change of use. While this might be less of a concern for the larger national and global operators/owners who may take a more strategic look at the viability of a hotel in terms of location or use, smaller independent operators are arguably more susceptible to the impact of changing values and market forces.

Since 2007, financial viability has been placed under further stress with the fallout of the financial crisis having a particularly noticeable impact on the cost and availability of finance for individuals and small businesses. Whereas pre-2007, hotel owners and occupiers would have been likely to use finance, equity release or re-mortgage in order to help fund improvements, this has been more difficult and expensive in the current market.

It is forecast by Capital Economics that hotel capital values will only see an increase of 0.8% in 2014, which is negative in real terms, taking into account inflation. This follows falls of 0.2% in 2013 and 2.4% in 2012. It will not be until 2016/17 that growth reaches above 2%.

Change of use

Since 2009, when the impact of the recession and the financial crisis was at its worst, hotel owners, funders and advisors' have taken an active role in seeking to maximise the value of their site from an alternative use.

Over 380 hotels have submitted planning applications for change of use, the majority of these between 2011 and 2012. These figures are based solely on applications for change of use. They exclude schemes which include the continuing presence of a hotel as part of the future proposal, or extending the existing use, or those which have closed down and have no plans going forward.

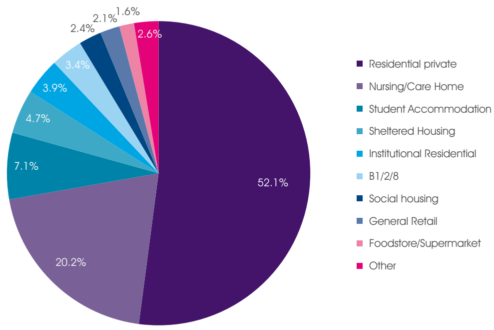
The most common alternative use is private residential, accounting for 52% of all applications. This is unsurprising given the historic and more recent gains in house prices. The contrasting values between hotel use and residential will be analysed more later in this report.

Given the costs of upgrading older hotels to comply with the evolving requirements of guests, it is of little surprise that uses with accommodation as an integral part equate to the majority of all planning applications for hotel sites. The second most popular use is for nursing and care homes (20%), with the fast growing student housing sector at 7%. The other types of accommodation preferred include institutional, sheltered and social housing, although these tend to be at the lower value end.

Non-accommodation or commercial use applications constitute less than 9% of the total. Of this, relatively few are for change of use to restaurants or bars on a stand-alone basis (0.9%) without some element of residential use also attached. The most common commercial use is for office (3.4%) or retail (3.7%).

Across the UK, the number of hotels looking to change use varies significantly. The areas with the least are the North East (3%), London (5%) and Wales (6%), whereas those with the highest share are the South West (19%), North West (16%) and South East (13%). It is also relevant to highlight that what may be the reason for the number of change of uses in one region may differ to another. For instance, higher average house prices could be the main driver for change in one market, whereas a weak hotel market

Figure 4- Preferred alternative uses for hotels 2009-2013



Source: Egi

or low revenues could be to blame in another.

Planning context

The issues of hotel viability and change of use also have implications from a planning perspective. At a macro level, the impact of the loss of hotels to redevelopment since 2009 has been softened by the considerably higher volume of supply that is being developed as the sector continues to strengthen and mature.

At the micro level however, local authorities have to weigh the impact of the loss of employment space and business rate revenue against the benefits of meeting housing targets or providing long term care for an aging population. There is also the issue of developing on brownfield land in existing use, or the more electorally unpopular option of developing on green land.

Case Studies

Brighton and Hove

GVA are advising administrators on the sale of an independent 84 bedroom hotel on the border between Brighton and Hove.

Over the last twenty years Brighton has become a strong business and cultural tourism destination buoyed by an expanding cultural media and technology sector. This has resulted in the addition of 1,014 new hotel bedrooms to a stock of 2,097 bedrooms only twenty years earlier. The majority of this stock was added to central Brighton.

The challenge

The addition of these new rooms was bound to have an effect on older hotels in less advantageous operational locations. The administrators' hotel lies outside central Brighton some distance from the main conference centre and does not benefit from a direct seafront position. Consequently the hotel's peripheral location, with regard to the main business conference and cultural markets, was exposed by the recession and it closed at the end of 2012 , before the appointment of administrators.

The solution

Our advice to the administrators was that it would be challenging to sell the property as a closed hotel in such an off-pitch location. In view of the extensive work that would be required to bring the hotel back to a competitive condition, we did not feel it would optimise the sale process to pursue a disposal solely to a hotel owner, even if they could raise the finance necessary to purchase and restore the building as a functioning hotel. We were, therefore, asked to advise on the market and the potential to obtain planning permission for alternative uses.

Brighton & Hove is an extremely popular place to live, but with the sea on one side, and the South Downs National Park on the other, the opportunities for new housing development are severely limited. As a result, the housing market is very strong. Even though it has a strong resort and resilient local economy, Brighton & Hove Council has recognised that with the opening of a large number of new hotels, its hotel market needs a period of re-adjustment. It has, therefore, reduced its core hotel policy area to protect the main hotels in central Brighton, but allow a more flexible approach to proposals outside this area.

GVA, therefore, advised the administrators that there was a reasonably good prospect of achieving planning permission for conversion of the hotel to residential apartments and we were instructed to submit a planning application. Using local architects to draw up a scheme that retains the historic features of the building which lies in an conservation area. Following positive feedback from a public exhibition, an application to convert the hotel into 50 apartments and mews houses was submitted and subsequently approved.

Eastbourne

GVA was approached by developers interested in converting an independent three star, 45 bed hotel in Eastbourne into residential apartments.

The town has a very large stock of hotels with a great number benefiting from a seafront position. By contrast, this hotel is a few streets back from the seafront, and after several years of marketing by different agents, was unable to attract a hotel purchaser. Potential purchasers that looked at the hotel were always able to find an alternative in a better location on the seafront where they could tap into the leisure tourist market.

Although the hotel lies close to Devonshire Park, Eastbourne's main conferencing area, conference delegates tend to favour the larger four and five star hotels on the seafront and the number of conferences and delegates to Eastbourne is quite small compared to other destinations.

As a hotel converted from three former townhouses, there are a number of stairs and steps to negotiate, including a mezzanine entrance. This has made it difficult for the hotel to attract the coach tours market which provides little income in any event.

The challenge

The hotel is within the local plan's tourist accommodation area where the planning authority seeks to retain the town's stock of hotels, unless it can be demonstrated in individual cases that it is no longer viable to do so.

The solution

GVA's specialist hotel consulting team, GVA RGA, were instructed by the developers to advise upon the viability of improving the hotel to make it more attractive to the coach and conference markets.

Our consultants considered restructuring the ground and basement floors to provide a large enough function room with level access to make the existing 45 bedroom hotel work as a conference and coaching hotel. However, it was concluded that the costs associated make this option unviable.

They considered converting one of the former townhouses back to residential apartments to provide finance for investment in a smaller 30 bedroom hotel and converting two of the former townhouses to provide for investment in an even smaller 15 bedroom guest house that could be targeted at the higher end leisure market.

The study found that only the latter 15 bedroom option would provide any sort of return. As a result of this study, our specialist hotel planning team was instructed to submit a planning application to convert two thirds of the hotel into residential apartments and one third into luxury guest house accommodation which is currently being considered by the council.

Shepperton

This 31 bedroom riverside hotel is located in an outstanding setting alongside the River Thames in Shepperton, Surrey.

The Challenge

As a small hotel away from central London's corporate and tourism markets, and too far from Heathrow in relation to much larger corporate hotels on the airport's doorstep, the hotel trading relied upon visiting friends and relatives and weekend weddings and functions. These markets were insufficient to trade the hotel at an optimum level through the recession and administrators were brought in who commissioned GVA to sell the hotel.

GVA's hotel agents advised that the market for such a small hotel in this location away from corporate demand sources would be challenging and that an alternative use should be considered to maximise the sale proceeds.

The Solution

GVA's specialist hotel planning team were therefore asked to review the planning framework relating to the site and considered that there were no planning policies that should prevent the change of use of the property and conversion of the hotel to residential use in this location. The hotel was in fact located within a conservation area so a change of use that could help to preserve the long term viability of property was thought to be more favourably received.

GVA's planning team wrote to the council with a pre-application enquiry, and received a response which largely concurred with our own analysis. The planning team's analysis and the council's response were used in marketing the property to prospective purchasers and the hotel was sold on an unconditional basis to a residential developer.

Chester

GVA was appointed by administrators to market for sale a portfolio of hotels in the North West.

One of the hotels was located approximately one mile from Chester city centre. The hotel was an attractive former two storey residential property, which had been significantly extended along one side. There was also a separate two storey building to the rear, which had also been converted to bedroom accommodation. The hotel provided 31 bedrooms in total and was situated on an approximately 0.34 hectare (0.83 acre) site with a landscape garden and 50 car parking spaces.

The Challenge

The hotel presented well externally but would have benefited from refurbishment internally. As a result, the trading performance of the hotel had been declining year-on-year. The hotel had also previously benefitted from having another group hotel across the road, which provided food and beverage facilities for guests but that hotel had been sold by the owners two years previously.

We received a number of enquiries from hoteliers, with offer levels based on a multiplier of the hotel's proven trading performance. The danger was that offer levels would fall further as time went by, without investment being made in the hotel.

The Solution

The hotel was extensively marketed and interest was received for conversion to student accommodation and from a retirement home builder for redevelopment. Through careful management of the process a competitive bidding situation ensued. The end result was a speedy sale of the property, for alternative use, at a purchase price that maximised the sale proceeds.

Conclusions

Overall, the general outlook for the hotel sector is positive. Yet like all alternative sectors, the market is undergoing a period of significant restructuring as it matures and evolves as an asset type. This is reflected in the significant increases in capacity within the sector, as the effects of the financial crisis start to wear off. But not only are the number of beds and hotels increasing, so too is the quality.

So what is driving this change? As hotels increase in popularity as an investment class, then the sector needs to realign itself with the preferred model of those looking to invest in it. Central to this is the need for better hotel stock, which offers greater appeal to larger corporate occupiers and less risk to funds and investors looking to move into the sector.

The consequence of this is that smaller independent operators who fail to provide a quality offering face ever greater pressures. This part of the market lost more beds at a ratio greater than four to one in 2013 compared to hotel chains, and it is not just a result of structural changes to the sector that have contributed to this decline.

The financial crisis and economic downturn claimed some high profile victims within the hotel sector, but at the same time many independent operators also faced considerable challenges on several fronts, with falling occupancy levels, rising running costs, higher VAT and the limited availability of finance at the forefront.

As the sector starts to become increasingly dominated by larger, high density national and global occupiers, it is understandable that smaller operators, or their investors, consider opportunities for releasing value by way of alternative land uses. The resurgent housing market means that there is now, in a number of circumstances, a significant disconnect in terms of value of a site run as a hotel or with planning permission for conversion into some type of residential use in the right location. As the hotels market continues to become institutionalised, this is a trend that is certain to continue.

London West End
London City
Belfast
Birmingham
Bristol
Cardiff
Dublin
Edinburgh
Glasgow
Leeds
Liverpool
Manchester
Newcastle

Published by GVA
10 Stratton Street, London W1J 8JR

GVA is the trading name of GVA Grimley Limited and is a principal shareholder of GVA Worldwide, an independent partnership of property advisers operating globally **gvaworldwide.com**

For further information please contact:

Andrew Dobson
Building Consultancy
+44 (0)20 7911 2286
andrew.dobson@gva.co.uk

David Jones
Business Rates
+44 (0)20 7911 2389
david.jones@gva.co.uk

James Pullen
Business Rates
+44 (0)20 7911 2536
james.pullen@gva.co.uk

Max Gaunt
Business Consultancy
+44 (0)131 469 6022
max.gaunt@gva.co.uk

Richard Gaunt
Business Consultancy
+44 (0)20 7911 2034
richard.gaunt@gva.co.uk

James Williamson
Investment and Agency
+44 (0)20 7911 2109
james.williamson@gva.co.uk

Martin Taylor
Planning
+44 (0)20 7911 2220
martin.taylor@gva.co.uk

Rachel Whaley
Planning
+44 (0)113 280 8081
rachel.whaley@gva.co.uk

John Ramsay
Project Management
+44 (0)20 7911 2747
john.ramsay@slw.co.uk

James Kingdom
Research
+44 (0)20 7911 2125
james.kingdom@gva.co.uk

NAPM RECYCLED 50% APPROVED

08449 02 03 04
gva.co.uk

09694