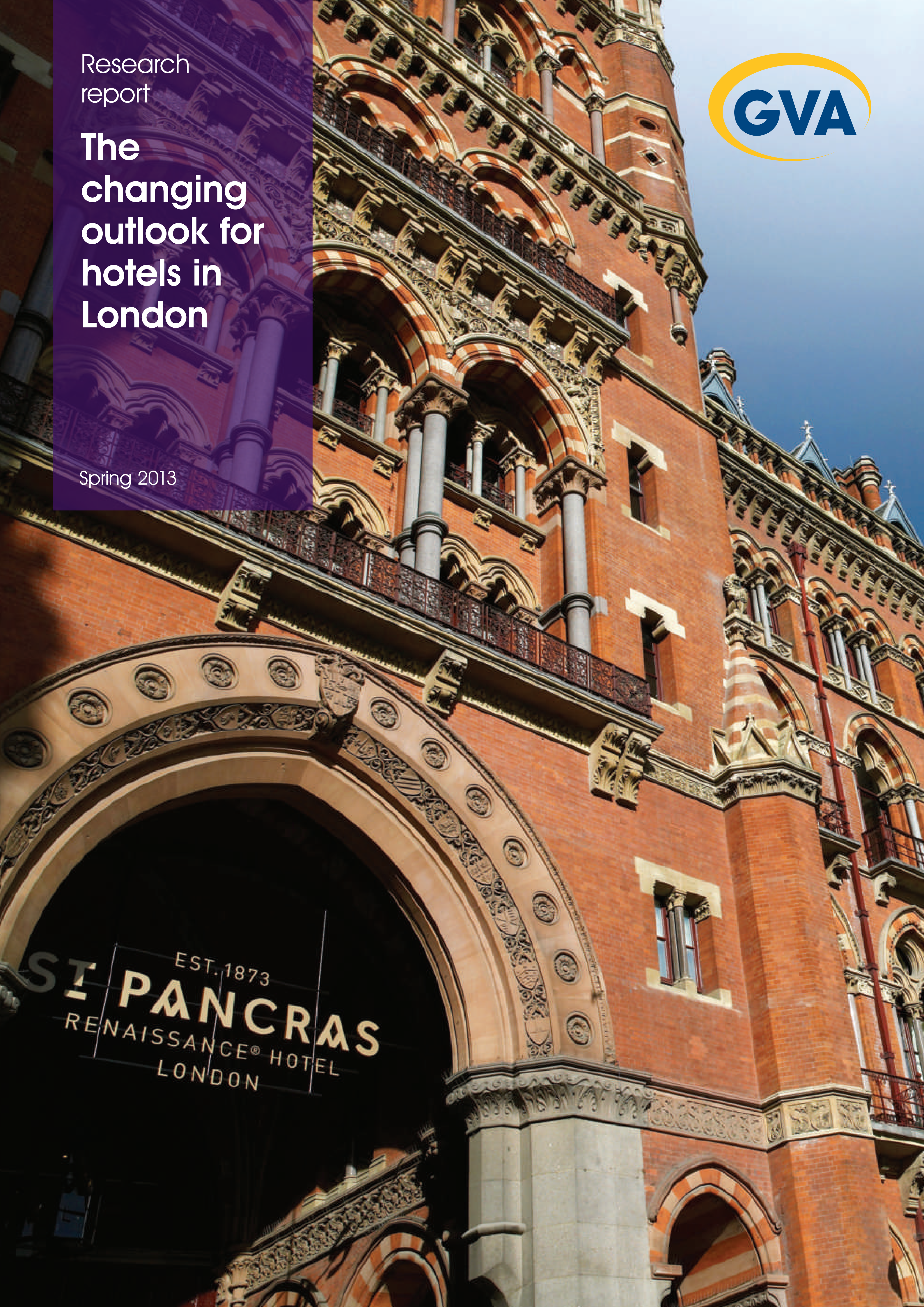
Research report

The changing outlook for hotels in London

Spring 2013



Executive **summary**

- The West End remains at the heart of London's hotel market, accounting for a third of total stock and 46% of the total number of hotel investment deals in 2012.
- A combination of economic, infrastructure and policy driven factors are creating an eastwards shift in hotel supply with the City fringe, Canary Wharf and Stratford the core growth markets. In the City, over 16,000 beds which have gained planning consent since 2007 were previously used as office space, roughly 67% of consented supply in this one market.
- A weakened office market in the City and more affordable land values have helped attract developers to these new growth sectors. The total pipeline in Tower Hamlets of 4,800 beds is equivalent to 12% of the Mayor of London's target of 40,000 additional beds between 2011 and 2031. Over 25% of London's future supply of 26,200 beds with planning permission or under construction is in Tower Hamlets, Newham and the City.
- Connectivity to good transport links has always played a vital role in the London hotel market, and the next major development will be Crossrail in 2018. GVA estimates that this will add an additional £5.5 billion to property values along the route and it will play a key role in the continuing shift within the London hotel market.
- Access to finance remains the largest obstacle to the delivery of future hotel stock in London. Nearly half the future London hotel pipeline is speculative development which may never materialise if performance in other land uses such as offices improves.

Introduction

Since the turn of the century the London hotels market has enjoyed better fortune than many other property sectors. Admittedly there have been a few bumps along the way, but the problems in the market have been minimal compared to those felt in larger, commercial markets.

There have been several drivers behind this period of prosperity. London has become recognised as a leading global city, not just in a business and financial sense, but culturally and commercially as well. There has been a significant amount of investment into infrastructure, with railways in particular, and in preparation for the city's hosting of the Olympic Games.

Attitudes to property have changed as the sector has matured. In 2000, the majority of hotel operators were owner occupiers and there were a limited number of developers with the desire and ability to deliver quality hotel developments. Owners of leading trophy assets will always look to maintain a freehold interest or long leasehold, but a greater degree of flexibility of ownership has seen a shift towards management or leasehold structures, increasing the sector's appeal with investors.

While there has been a 27% increase in international visits to the UK as a whole from 2002 to 2011, the number of international visits to the capital have risen by 32% - from 11.6 million in 2002 to 15.3 million in 2011. The UK figure excluding the capital has seen an increase of just 23%. With London still ranked as the world's leading global financial centre, then the hotel sector in the capital has a strong base on which to build.

This report examines how the market in London has performed and the changes and challenges that lie ahead. Has the sector turned into an asset bubble about to reach tipping point or is the current rate of growth sustainable?

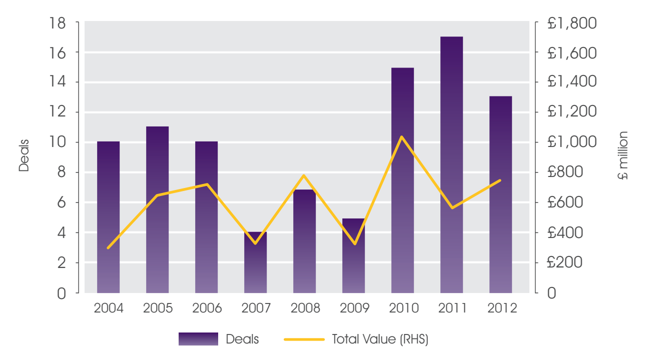
Sector performance

Investment

In 2012 there was a decline in the number of hotel investment deals, falling by 24% compared to 2011, although the total value of all transactions increased by 34% year-on-year to £736.4 million. This was boosted by the sale of Land Securities New Arundel Court scheme to Waterway PCP which distorts the figures as the hotel is part of a mixed use scheme, but even without this one deal, there were some robust sales including the Hoxton (£65 million) and the 4.8% yielding Cavendish Hotel on Jermyn Street at £158.8 million.

The West End maintained its position as the main market for investment activity, unsurprising given that it accounts for a third of London's beds. Overall, nearly half the total number of deals in London were located here, accounting for 68% of the total value, compared to the nine year average of 60%. Having had a strong year in 2011, investment activity in the City and east London remained subdued in 2012 by comparison, with just two deals including the Holiday Inn and Staybridge Suites at Stratford, although the number of deals in these locations could increase once the Olympic Park legacy works have been finalised.

Figure 1 – Hotel investment in London



Source: PropertyData

Revenue

Although occupancy levels in 2012 failed to build on those recorded the year before, overall occupancy rates for London remained over 10 percentage points above the regional UK average at 80.6%, despite falling from a rate of 82.1% in 2011.

Rather than just a result of one-off events, the continuing uncertainties with the Eurozone and weak global outlook have also contributed to falling occupancy rates and revenues. One positive in this regard for the UK is continued weakness of £ sterling in comparison to other major currencies since the start of the financial crisis.

Figure 2 – London performance data

	Occ %		£ ADR		£ RevPAR	
	2012	2011	2012	2011	2012	2011
London	80.6	82.1	138.94	133.75	111.93	109.82
Regional UK	69.9	70.9	59.19	58.64	41.38	41.60

Source: STR

One measure that can be apportioned to the impact of the Olympics, and other fillips such as the Farnborough Airshow and the Jubilee, is the increase in the Average Daily Rate (ADR) from £133.75 in 2011 to £138.94 in 2012. Initial forecasts for 2013 suggest that this rate will fall back in line with trend once the short impact of the games has passed, although continued above target inflation may temper this to some degree, as will the return of the summer leisure and corporate trade which avoided London in Q3 2012 to a certain extent.

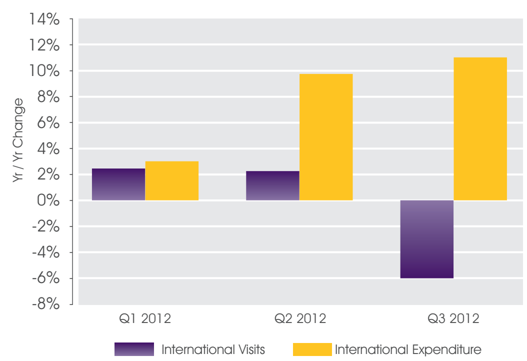
The growth of almost 4% in ADR helped revenue per available room (RevPAR) rise by 1.9% year-on-year, to £111.93 for 2012 compared to £58.32 for the UK. The differential between RevPAR for the capital and the rest of the country is one of the performance fundamentals that makes London so appealing for investors and occupiers alike.

Demand

It was widely expected that despite the benefits of the Olympic Games in Q3 2012, there would be a detrimental knock-on effect for the rest of the tourism industry with non games – related visitors put off by the disruption surrounding the event.

The number of international visits to London fell by 6% year-on-year in Q3 2012, reversing the increases recorded in the first half of the year to take the year to date number of international visits for London to 11.5 million in September 2012. This was just 0.8% down on 2011.

Figure 3 – Annual visits & expenditure



Source: ONS

For the UK as a whole there was a 2.8% drop, ranging from -3% for the rest of England (excluding London) and -12.4% in Scotland. Even Paris, a rival city expected to benefit from London's unique dilemma, recorded a fall of 1.6% for Q3 2012. On a more positive note, the shortfall in numbers was cancelled out by an increase in spending. Overseas expenditure in London increased 11.4% in Q3 2012. This brought the year to date total for London to £7.5 billion in September, up 8.6% year-on-year.

The changing London market

In order for London to meet demand and maintain its status as a leading global city the hotel market needs to have a level of dynamism and perhaps more importantly the ability to adapt and change. Land uses within the capital continually change over time and the hotel sector is no different. Shangri La's Shard arrival in London Bridge is evidence of that, as is the growing East London city fringe market.

Historically the traditional hotel locations have concentrated on the West End, along the Thames in Central London and around the major transport termini. The West End still remains a key market, as investment activity shows, and will continue to attract leading hotel brands. Yet the prime residential market has caused a sharp increase in land values in areas such as Mayfair, Bayswater and Knightsbridge, while luxury retail and the arts have expanded beyond their traditional domains. The main consequence of this is that for a large number of operators in the mid range and budget markets, costs in these parts of Westminster and Kensington and Chelsea are too high. The hotel sector now has to compete with office space which is being lost to higher value uses, while new planning obligations such as the Community Infrastructure Levy (CIL) will force mixed use developers to look towards the mid range or budget class by default.

This is not to say that there will be no new provision in these markets. Estimates show that there are currently fewer than 30 beds in Kensington and Chelsea with either planning permission or under construction, but in Westminster the consented pipeline increases to 2,246 beds, the fourth highest amount on a borough by borough basis. Many of these beds will be due to a rationalisation of existing stock, as the last few affordable central locations such as Bayswater are being replaced with top end boutique beds if not already lost to residential use.

The locations with the largest pipeline with planning consent or under construction are the City (2,428 beds) and Tower Hamlets (2,608 beds). Taking into account the number of beds at pre planning or application stage, then the pipeline for Tower Hamlets increases to almost 4,800 beds, which is equivalent to 12% of London's planned additional beds for the 20 years to 2031. Over a quarter of the total pipeline for London is concentrated on these two boroughs and Newham.

Both these boroughs are home to major business districts which, although they have differing approaches to development, both provide greater flexibility for hotel development than the West End. The City has seen demand for office space fall since the financial crisis in 2008 and this has had an impact on values, particularly in fringe locations. Confidence has also been instilled by strong sales of the Hoxton and Crowne Plaza in Shoreditch, underlining investor confidence in these new growth hubs built around the City fringe markets.

Landlords have been encouraged by a change of planning policy in the City that has encouraged alternative uses which provide a more vibrant, mixed and less office focused environment. Since 2007 planning consent has been granted for over 1,600 beds in the city for buildings that were previously used as offices, equal to 67% of consented supply.

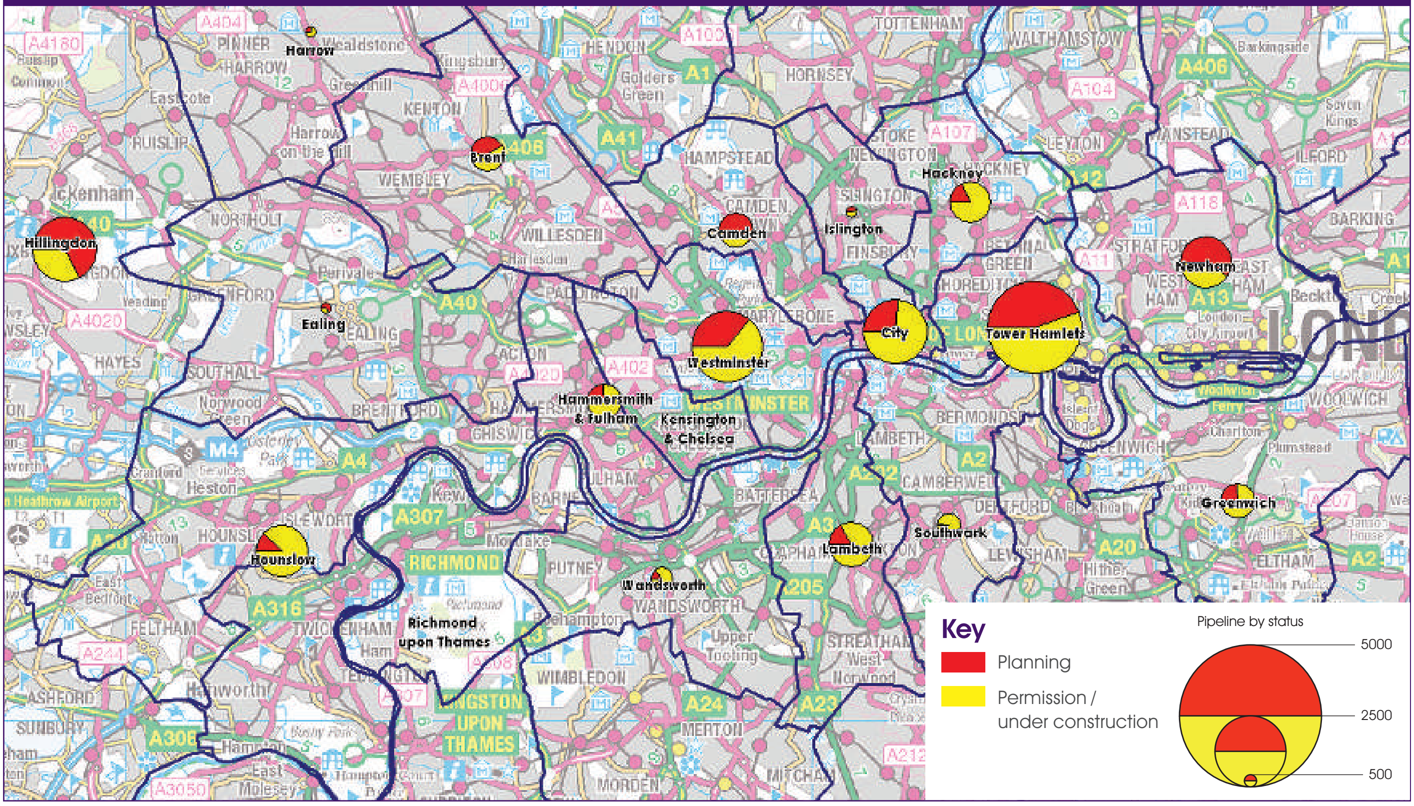
In Tower Hamlets and more recently Newham, Canary Wharf is becoming more established as a mixed use destination, albeit still heavily commercial based; and Stratford is starting to find its feet following the opening of Westfield, the international rail station and of course the 2012 Olympics. These markets will continue to grow as all-round destinations and will improve even more once Crossrail is delivered in 2018.

Recent investment and development activity both show that there is an eastwards shift in the London hotel market and this is set to continue with emerging niche products. The Mayor's London Plan estimates that there will be 40,000 new additional beds in the capital by 2031. As shown in figure 5, outside central London, these are expected to be concentrated in four main areas – Wembley, the south west Thames/M3 corridor (named in the policy document as London Arcadia), Greenwich Riverside and finally the Lea Valley, which stretches north from the Olympic Park up towards Stansted airport and the M11.

While Wembley is a strong location, following recent large openings any new development in this market will also require a diversification of demand away from one-off events to support any sustained expansion.

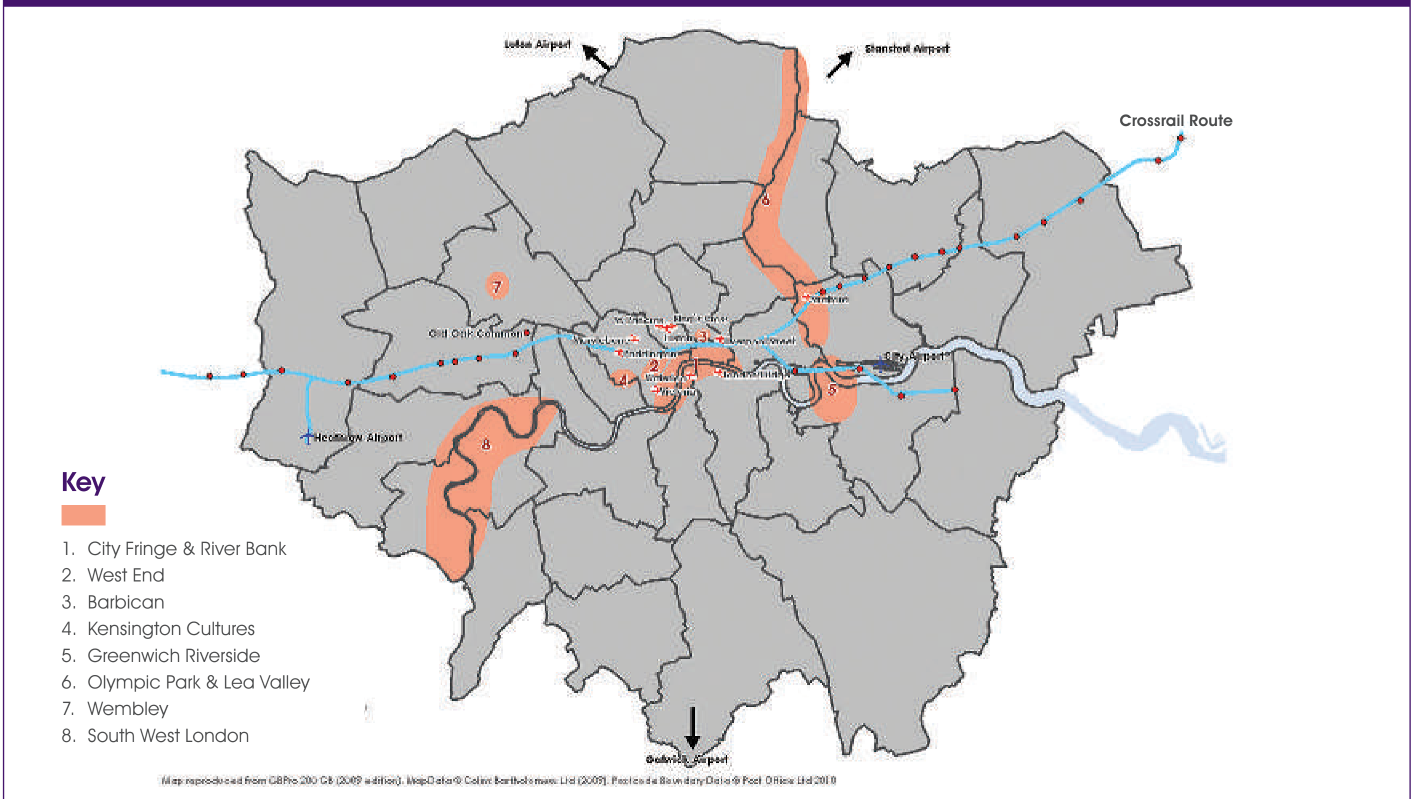
The other three areas – two in the east and one to the south west, all have their benefits and will attract investment but, purely in terms of value and competing land uses, the east offers greater scope of higher density development at lower cost, as well as greater investment into infrastructure.

Figure 4 – Future London hotel supply (over 500 beds)



Source: AM:PM

Figure 5 – London Plan growth areas

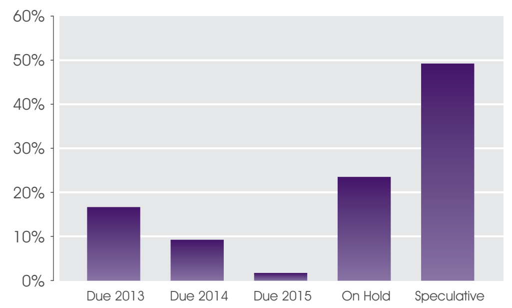


Source: The London Plan, GVA

The total pipeline for the capital which has either planning permission or under construction amounts to more than 26,200 beds. However, it is by no means a given that all this supply will be delivered. Over a quarter of the total bed numbers are due to open in the next two years, such as the Hilton at Bankside and London Edition off Tottenham Court Road. But nearly the same number of beds (23%) are currently on hold and almost half are classified as speculative development.

One of the biggest obstacles for all property development remains access to finance. There is appetite from lenders but on the condition that there is a strong business model and a good location to underpin their investment. The more marginal the location, the more questions are likely to be asked. Revenue levels vary greatly across the capital and if these were ever to fall, the impact would be greater in peripheral locations rather than the central prime areas. The further away the expected delivery date of any future beds in these outer locations, the greater the uncertainty as to when they will be delivered.

Figure 6 – London pipeline delivery



Source: AM:PM

Where the opportunities lie

Aside from land value and competing uses changing the shape of the London hotel market, the other key driver for growth and change is infrastructure. There are three main projects which will have a significant impact on the sector, namely Crossrail, High Speed Rail (HS2) and the more thorny issue of Heathrow expansion or a new hub airport elsewhere.

The most immediate of these schemes is Crossrail, which is due to launch in 2018 and will run from Heathrow and Maidenhead in the west, through central London and out via Canary Wharf to Woolwich in the south and Shenfield in the east via Stratford. Work is already underway on building the new stations and tunnels for this high speed line that will carry over 200 million passengers per annum and provide connections with all five London airports and Eurostar.

GVA has determined that the line will add over £5.5 billion to capital values along the route which will connect Heathrow, the West End, the City and Canary Wharf and has acted as a catalyst for the focusing of hotel development in the City and further east on both sides of the Thames.

HS2 remains a more long term project still very much at consultation stage, with the final route likely to change. It is proposed that the main terminus will be Euston, closely adjacent to the existing HS1 (the Channel Tunnel rail link) at St Pancras. Having the two main high speed rail networks so close together would create additional demand. Further west, an interchange with Crossrail and southwest-bound trains at Old Oak Common would also benefit from additional supply.

The overall pipeline for Hounslow and Hillingdon, the two boroughs that serve Heathrow, currently stands at just under 6,000 beds, with 57% of those either consented or under construction. Should the notion of Boris Island or an enlarged Stansted ever take off, then the proposed 2,500 beds still awaiting consent in the Heathrow market may never materialise. More importantly, questions will arise about the level of demand for existing stock in that market while those hotels in the east with easy access to Essex or the Kent estuary will benefit.

Admittedly, as an airport already running at over 97% capacity, the Heathrow market won't disappear overnight, but the ongoing uncertainty about its future role and possible expansion may cause a degree of inertia as investors and occupiers wait to see the policy outcome before making wholesale commitments to this location.

Conclusion

We expect that while the year ahead may not be as strong as 2012 for the hotel sector, the London market will remain robust in 2013. Without any major events and a continuing weak global economic outlook, occupancy rates may ease further, although the current level suggests that the sector is strong enough to cope with this.

London continues to attract new brands, with Oberoi and Kosmopolito looking to get a foothold, but it is important to make sure that despite the strength overall of London as a market, the product fits in with the location. The range of hotel products on offer is becoming even more varied, with the new generation of hostels and budget accommodation likely to be the next growth market.

But it is not just the type of hotel in London that is becoming more diverse. A combination of policy and economics is creating an eastwards shift of stock, with a large proportion of London's future supply concentrated in new emerging locations outside of the traditional central hotspots.

How much of this pipeline, which is currently driven by developer appetite, will eventually be realised remains to be seen. In our opinion, there will be a reasonably high level of aborted schemes due to the challenges of funding property development. There is a huge amount of variation within the pipeline and it is important to establish what is deliverable. In many instances this large increase in supply is coming from a low supply base, in areas forecast for significant property development and economic growth.

As in any market, developments located adjacent to major transport routes will always do well, if the businesses are well managed. Revenue rates will improve as an area improves and investment into infrastructure helps to both accelerate this and is key to sustaining performance. London remains a varied market but the changes in the past 10 years to areas such as London Bridge, Kings Cross and now Stratford show the benefits transport upgrades can have on a local market.

However, our word of caution relates to a danger that current planning policy is putting too much emphasis on increasing supply in peripheral London markets. Such schemes are likely to feel the effects of any downturn in the sector more noticeably should trading conditions soften. Central London has built a track record of bouncing back strongly from any major event which has hit occupancy or revenues but the further out the market expands the more this strength is diminished.

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