

# Asset Appeal if the Price is Right

CON QUIGLEY examines European hotel asset value trends.



The landscape of the global hotel investment market has undergone significant change over the last decade. From 2003 onwards hotel transaction volume increased exponentially, culminating in record hotel investments of €20bn in the EMEA region (Europe, the Middle East and Africa) in 2007. However, the credit

crunch had a major impact and in 2009 total EMEA investment was 85% below 2007's record figure. In order to understand this in full we must analyse historic trends in the market.

It is important to note that hotel values are determined by certain market fundamentals, some of which include

and fixed income streams (approx 75-100 basis points). As a result, hotels were no longer a specialised asset class, becoming more appealing across the investor spectrum. As a result, notable new entrants to the market included institutional and private equity investors.

New investors were not only attracted by the lower yields but also by the new way hotel deals were being structured. This was driven by a trend, started in the 2000s, whereby owners sold their hotel assets while retaining management in either lease back or manage back deals (separating the 'bricks and brains'). This played a major part in shaping hotel investment activity during this boom period enabling new investors to acquire from major operators the large hotel portfolios entering the market. Hotel assets offered the opportunity for investors to diversify and through these newly structured deals and complex investment tools, perceived the opportunity risk to be lowered. Consequently, hotel portfolio sales hit a record high with EMEA hotel

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We anticipate a further increase in distressed sales in 2010 especially as senior debts mature on large portfolios acquired in 2005-2007. However, banks may be reluctant to foreclose, potentially realising losses on these portfolios. This will enable opportunistic buyers to enter the market as well as wealth funds and high net worth individuals. In addition, as pricing and multiples return to the levels hoteliers are prepared to pay, we may see such investors entering the market. Highly-leveraged investors such as private equity funds who previously dominated the market are expected to remain less active.

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location, size, ownership structure, branding, hotel performance and yield (this is the required rate of return that investors apply to a particular opportunity, ie if a hotel generates £1m profit and the investor's required return is 10%, the maximum price the investor can pay for this opportunity is £10m in order to achieve the required return; as a consequence, the lower the yield the higher the value).

From 2003 yields for all property classes started to fall noticeably due to the increased liquidity in the debt markets as a consequence of banks' more aggressive lending strategies (higher LTVs (loan to values) and lower margins). This had the twin effect of driving down investors' return requirements and fuelled a property boom through to 2007. In 2007 hotel and office yield differentials across Europe were at an all-time low of approximately 100-120 basis points (100 basis points is equal to one percentage point). In addition, the gap between management and lease contracts narrowed with minimal differential reflected between trading

investments peaking in 2007 at an estimated €20bn total investment volume. The period 2005 to 2007 will be remembered as the years of inexpensive available debt, compressed yields and large portfolio divestments.

The hotel investment market shifted significantly with the credit crunch when finance virtually disappeared, lenders became much more cautious and projects proved more difficult/impossible to finance. As a consequence, equivalent yields for commercial property investments softened by approximately 30% (with broad variances depending on property type and location). For example, in Dublin, prime office yields which were just below 4% in 2007 softened to 7.5% at the end of 2008, most of the yield shift occurring in Q4 2008. As an illustration, assuming a stabilised income, such a yield shift would imply a staggering 46% drop in value. London City and West End prime office yields were at 4.25% and 3.75% respectively at the peak in 2007 and then moved out to 6.65% and 5.5% respectively by Q4 2008.

Hotel yields across Europe echoed this movement which has had a huge impact on hotel values.

A large gap opened between buyer and seller expectations with buyers hoping distressed assets would come to market. In 2009 total EMEA hotel investment was 85% below 2007's record figure as owners were reluctant to sell into an illiquid market, unless forced to. As a result, the majority of assets that came to market were distressed, albeit at significantly lower levels than anticipated. However, some quality properties have transacted, notably, the sale of the 105-key Stafford Hotel, London to the El Sharkawy family in September 2009 for approximately £77m off a reported yield of 5.1%. In addition, Invesco Real Estate has been active lately with the acquisition of the Radisson Blu Hotel in Hamburg, Germany, for €155m and five European Accor Hotels. Despite recording the largest fall in transactions, the UK remained the most active in 2009 with approximately 29% of total volume. Another trend in transactions in 2009 was the focus on single assets, comprising 65% of total EMEA transaction volume versus a third in 2007.

Hotel performance also played a major part in the softening of hotel yields. The reduction in leisure and corporate travel following the credit crunch resulted in declining occupancy rates across Europe, increasing downward pressure on rates. Most European revPAR declines started in the last quarter of 2008 and continued throughout 2009. However, Dublin's revPAR was already falling in 2007 by 2.3% to €80.71. This continued into 2008 with a 13.2% drop to €70.08 and 22.3% in 2009 to €54.47.

London trading was also impacted, albeit to a lesser degree, with revPAR falls of 3.8% in 2009 to £93.10. This is largely due to the strong fundamentals of the London hotel market and the weakness of the pound which encouraged European tourists to take advantage of the favourable exchange rate. London's historic revPAR growth had been significant with an 11.7% increase in 2007 to £94.12 and 15.8% in 2006 to £84.30. As a result of the weakening European trading performance, there was a further deterioration of confidence in the hotel market.

This combination of softened yields and revPAR reductions directly impacted on hotel values across major European markets with drops averaging 40-50% from the peak of the market to mid-2009. This is a theoretical value based on calculated anticipated yields since there were so few transactions during this period.

The cost and availability of debt remains a key factor in shaping the current market. Lenders insist they are still lending. However, the terms offered have changed significantly with lower LTVs (50-60% compared to 85% pre-crisis) and higher arrangement fees. The maximum multiple is currently eight times distressed EBITDA (Earnings before Interest, Taxes, Depreciation, and Amortisation) and therefore the 60% LTV ratio is purely theoretical. There is also a continued problem distinguishing real value in the market with so few transactions therefore the most accurate guidance is investor sentiment. Nevertheless, the gap between buyers' and sellers' expectations remains and although this is narrowing neither

party is willing to reduce its return expectations.

Yields have started contracting and finance is available for the right project. The most attractive deals are receiving attention with a preference for fixed-income, smaller lot sizes, existing proven hotels, gateway cities, high-quality operator/tenants, budget/economy segment and trophy assets. Currently, there is limited appetite for management contracts, mid-market hotels, large portfolios, large lot sizes, weak tenant covenants and secondary locations. Portfolio deals have to a large extent disappeared from the market and the focus remains on single assets.

The competitive arena has now decreased as reduced debt and lower earnings do not deliver private equity returns hence these investors have fallen out of the market. Cash availability is key. High net worth individuals (HNWI) have a purchasing advantage and opportunistic and traditional investors have entered the market. These investors anticipate a more realistic yield differential as they are typically long-term holders who account for the additional risk of hotel investment.

It is doubtful that we will ever see equivalent pricing as witnessed during 2003 and 2007 return. Any increases in value are likely to be due to improving hotel performance. Although yields have started to contract again, we do not anticipate the yield differential between hotel and office yields to return to boom levels but remain at historic levels of around 200 basis points on average across European markets. Equally, fixed and trading incomes are not expected to contract to historic differentials. Fixed income yields (ie from leases) will be discounted compared to trading incomes (from management contracts) to reflect the increased security that such investments offer and vice versa (likely by up to 175-250 basis points).

We anticipate a further increase in distressed sales in 2010 especially as senior debts mature on large portfolios acquired in 2005-2007. However, banks may be reluctant to foreclose, potentially realising losses on these portfolios. This will enable opportunistic buyers to enter the market as well as wealth funds and HNWIs. In addition, as pricing and multiples return to the levels hoteliers are prepared to pay, we may see such investors entering the market. Highly-leveraged investors such as private equity funds who previously dominated the market are expected to remain less active. It should also be noted that there are early signs of investment yields starting to contract, if only marginally.

As regards hotel performance, we anticipate 2010 to be flat across Europe in revPAR terms and expect hoteliers to focus on boosting occupancy before increasing rates as any rate increases will be met with strong resistance in the current market. We anticipate early signs of recovery in hotel performance (revPAR) in 2011 and a stronger upturn in 2012. As the global economy recovers, we anticipate falling return requirements in the investment market, ie lower yields. Together these factors will drive the recovery of hotel asset values.

In summary, there is still investor appeal for hotel assets. However, these assets must be in the right location, with the right lot size, ownership structure, performance and price, otherwise value will be discounted. ♦

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