Real Estate

Principal Asset Management℠

# The Decisive Eye

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**Paradox or opportunity:**

## Hotel investment strategy in Europe


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# Executive summary

Europe's vibrant travel industry saw a rebirth in 2022 as the leisure traveler surged with the effective ending of the COVID-19 pandemic. It was a miraculous recovery after the hotel industry suffered a near-death experience during the pandemic.

The recovery in global growth has pushed inflation to uncomfortably high levels, well above central bank targets, forcing strong monetary tightening to slow down the consumer who remains eager to spend, especially on leisure.

A paradox faces much of the developed world: consumers are willing and eager to spend, but central banks are applying the brakes on credit through higher interest rates to reduce inflation. For hotel investors, this paradox in Europe is creating some intriguing investment opportunities.

A fragmented hotel market, with most assets still being independently owned and operated, is facing the headwinds of higher labor and interest costs while being squeezed by larger chains using modern business models. As a result, fertile opportunities to engage in hotel strategies across Europe have emerged.

## Introduction

COVID-19 paralysed global travel, upending one of the key pillars of the modern economy. The pandemic had a deleterious impact on the travel industry, leading to a near collapse in occupancy levels in hotels across the world. Major global destinations fell silent as travel halted with some of the most historic cities in Europe desolate. Investor sentiment plunged along with hotel occupancy and, for 18 months, the leisure industry endured trial by fire. The emergence of effective vaccines paved the way for travel to resume in 2021 and surge in 2022. Nowhere was this more apparent than in Europe, long a global destination for tourism and business travel, where the rebound has been remarkable.

But along with the recovery in travel and revenue, came the challenge of higher inflation, partially enabled by a remarkable fiscal and monetary response to counter the effects of the pandemic. As 2022 progressed, the spectre of inflation emerged as a major concern and the ECB began the process of removing monetary accommodation and increasing interest rates. In a few months, the global dialog shifted from easy money to restrictive policies throwing a shadow on the nascent recovery in Europe and globally. Hotel owners and operators have become a bit more anxious as the threat of slower growth or even recession emerges as an overhang on the generally constructive outlook for travel. However, recent news on Europe has been more encouraging from a demand perspective, though the outlook for the capital markets remains more challenging. This has set up an intriguing environment where hotel occupancy is forecast to remain robust but where owners, particularly those poorly capitalized, will struggle to remain competitive. It is this paradoxical environment where hotel investors can find some interesting opportunities to secure and turn around attractive assets into a growing pool of demand.

## A brighter economic outlook

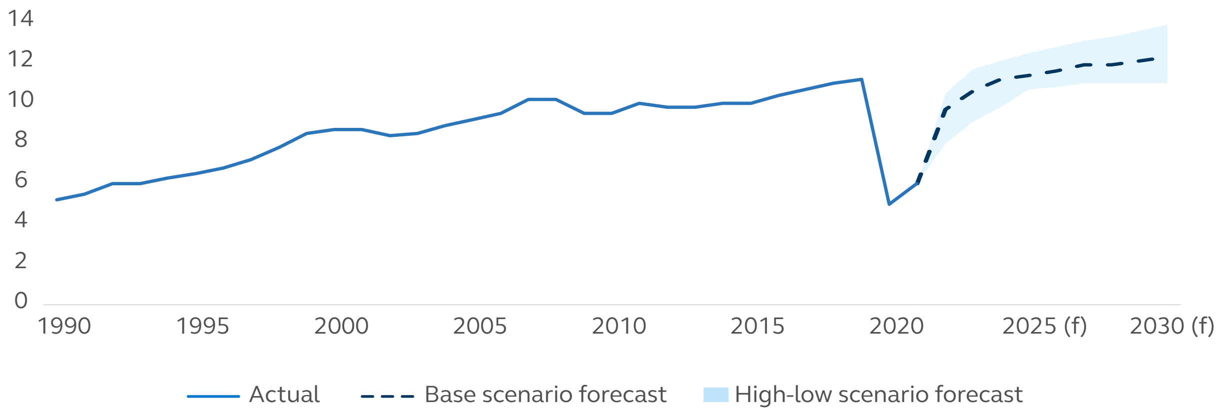
Europe's outlook has notably improved compared to the last quarter, as the risk of a major energy crisis during the winter months has been averted. In fact, Europe delivered a positive fourth quarter of growth buoyed by unusually warm weather, energy-saving efforts, and liquefied gas imports from new partners. Wholesale energy prices have fallen sharply to levels last seen before the invasion of Ukraine, with positive knock-on effects on inflation expectations, and growth projections. Additionally, three recent developments contributed to uplifting the prospects of the world's economy; the reopening of China after three years of strict COVID prevention measures; a new mammoth programme of subsidies to stimulate green investment in the U.S.; and a modest slowing in global inflation, which should ease the pressure on central banks to keep tightening monetary policy.

Herein lies the paradox for investors: it is the strength in underlying demand that is keeping inflation levels elevated. A higher inflation outlook will ensure that the European Central Bank (ECB) continues to "pump the brakes" of the economy until core inflation returns under control, a task which is yet to be accomplished. As a result of tightening monetary policy, interest rates in the Eurozone and the UK have increased sharply by 250 and 325 basis points since January 2022, one of the most aggressive hiking cycles in history. Due to a transmission time lag, the full impact on the real economy, particularly consumers and housing, will be felt over the coming months and will likely be a headwind to consumption. Finally, the ECB is expected to gradually start normalising its balance sheet this year, by offloading some of the €5tn bonds accumulated over the last decade. Known as quantitative tightening, the process may strain the credit market and drive-up borrowing costs further imperiling the recovery.

For hotel investors, the improving outlook for the economy needs to be balanced against materially tighter credit conditions, which is likely to exert a drag on growth. This push and pull between growth and tightening credit sets the stage for an interesting landscape into which hotel investors can find opportunities. It is this unique paradox which investors face in the coming months.

**EXHIBIT 1:** The number of European flights is expected to break above pre-pandemic high in 2024

**Number of flights in Europe, annual, million**




Source: Eurocontrol, April 2022

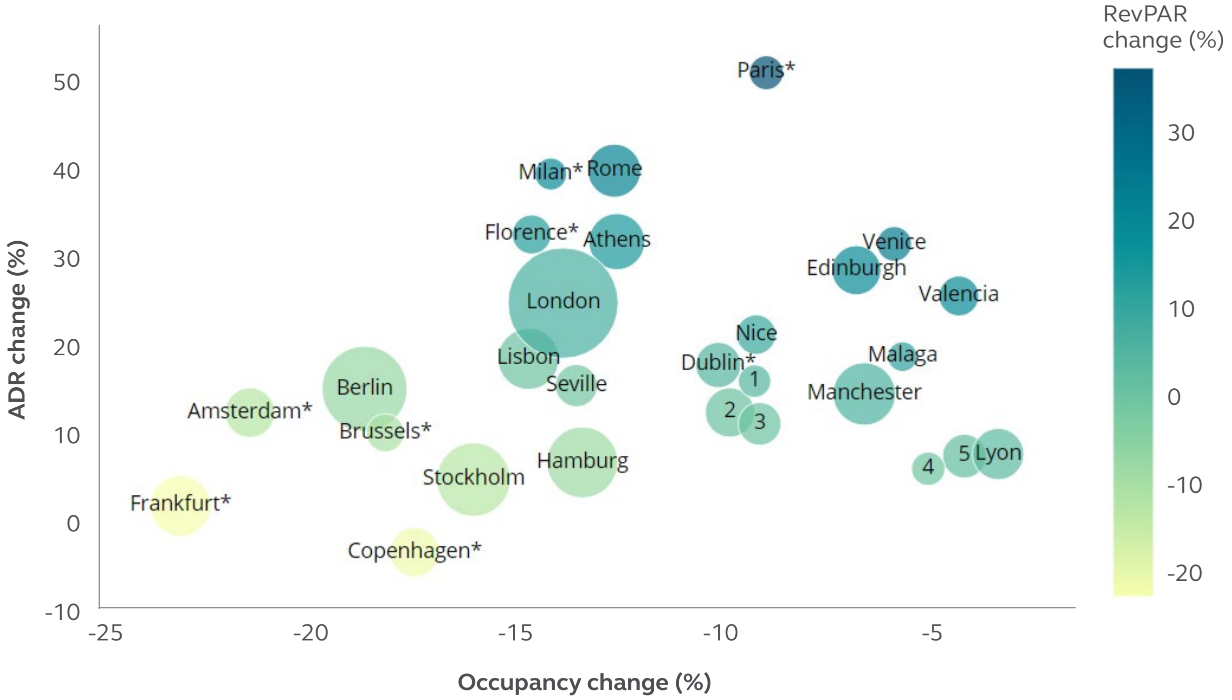
## Though Europe's economy will be sluggish, its travel industry should boom

This paradox wherein consumer demand for travel is strong, even as central banks do their utmost to cool growth, sets up an interesting investment opportunity for hotel investors. Though we do expect consumers are likely to come under pressure, we don't foresee travel being impacted, given the unique situation where we find the global travel industry, which has just begin to recover from the near shutdown of two years. In fact, flights in Europe are expected to increase steadily (Exhibit 1, previous page).

When the World Health Organisation declared a public health emergency in March 2020 and restriction measures forced roughly 80% of all hotel establishments on the continent to close their doors, the tourism industry was on its knees. In 2022 when travel began to resume, the summer rebound in the sector took even the most seasoned operators by surprise. Most of the European hotel markets returned to pre-pandemic revenue levels, as measured by RevPAR, the industry benchmark tracking top-line financial performance. This recovery was a remarkable achievement, driven by an increase in the average daily room rates (ADR), which in several markets jumped way ahead of inflation (see Exhibit 2). On the other hand, occupancy still offers significant margins for improvement because some countries—including China which alone contributes to 25 million nights in European accommodations per annum on average—have just started to reopen their international borders. Looking to 2023 and beyond, we anticipate that the ongoing recovery in travel within and to Western Europe will remain robust. From a demand perspective, we believe the hotel investor in Europe faces a strong period of growth.

**EXHIBIT 2:** Most European hotel markets recovered above pre-pandemic levels, driven by price growth (ADR)

**Selected European markets** performance in 2022 over 2019**




1= Rotterdam, 2= Barcelona, 3=Madrid, 4=Warsaw, 5=Bordeaux
* Includes city centre only
** Bubble size indicates the number of rooms in 2022
Source: STR, December 2022

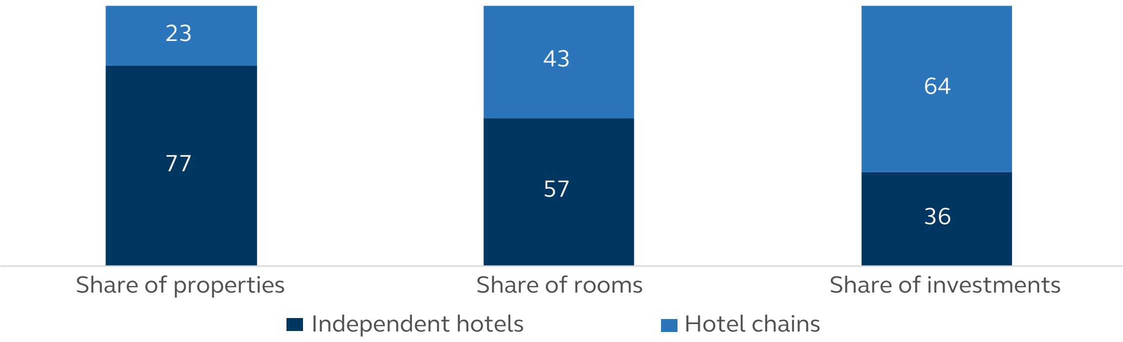
## Not all investment opportunities are born equal

While the medium-term outlook for the hospitality industry is promising, the same cannot be said for all businesses operating in the sector. The European hotel industry is idiosyncratic in terms of its ownership, investment levels, cost, and lease structures. The steady increase in interest rates has elevated the cost of debt materially and put pressure on operating margins particularly for smaller, less well-capitalized owners. Moreover, hotel ownership is highly fragmented in Europe which places greater pressure on the balance sheets of small-to-midsize owners and opens the door to experienced investors to take advantage of the promising outlook on travel.

## The European hotel market remains highly fragmented

Although hotel chains have gained market share over the last few years across Europe, their presence is not as dominant as in many other regions of the world. The European hotel market remains highly fragmented, with most assets still being independently owned and operated. Many owners have not had the capacity to invest in their premises, particularly in the light of the havoc wrought by the pandemic, which decimated revenue. Moreover, many family-owned hotels do not have modern business models, thus, paving the way for being acquired and optimised through renovations, repositioning, and branding. According to STR, at time of writing, there are roughly 200,000 hotel establishments across the continent—equivalent to roughly six million bedrooms. The independent segment contributes for 77% of all properties and 57% of all rooms, since independent hoteliers are on average smaller in size compared to chains. But when we look at the share of investments, the picture is quite different, with independent hotels lagging with 36% of the total capital spent—a structural disadvantage, mainly caused by lack of funding, scale, and sometimes, specific skills such as marketing and distribution.

**EXHIBIT 3:** Independent hotels on average suffer from chronic underinvestment
**European hotel market share breakdown, %**




Source: STR, December 2022 and Statista, November 2022

## Rising costs pose a challenge for many operators

Operators in the hospitality sector survived the COVID-19 pandemic thanks to the contribution of multiple stakeholders. Governments deployed a series of measures to cushion the impact of lockdowns, ranging from financial aid, cash grants, tax reliefs, and furlough schemes. Lenders provided liquidity through covenant waivers and loan guarantee schemes (i.e. moratoriums). Landlords offered to defer rent payments amid fear of tenant's insolvency and empty premises. But all these extraordinary measures are now ebbing, leaving operators to rely purely on their own resources when coping with the challenges looming on the sector. Although tourism has rebounded, expenditure levels have increased sharply too. The rise of staff wages, input costs, interest rates, and lending premium are likely to put a strain on weaker operators whose balance sheet have not fully recovered from the COVID period. Additionally, mounting competition from large hotel chains is also expected to increase cost pressure, since those players aiming to protect their market share may have to renovate their facilities or implement other capital expenditure programmes.

## Rigid operating agreements put strains on hoteliers

Hotel management agreements are the legal bindings governing the relationship between hotel owners and operators. In the U.S., these agreements are primarily structured via franchise or management contracts, whose fees are based on a percentage of revenue or profits. On the contrary, in most parts of Europe, hotels are predominantly operated under a lease contract, which obliges operators to pay a fixed amount regardless of the economic cycle. As such, European operators are more exposed to higher volatility and higher risks. On one hand, they enjoy extra profits in expansionary periods, but on the other, they take on a significant financial burden when vacancy increases, as their share of fixed costs is higher. The same is applicable to the independent hoteliers who own their own premises, an arrangement also widely relevant in Europe.

Fragmented ownership, rising costs, and rigid management agreements are the core reasons why we expect a growing number of owner operators and smaller groups to shift to an asset-light strategy (seeking to dispose their assets and having more liquidity to manage their accounts) and focus on operations rather than the pure real-estate element, opening the door to a large part of the market that traditionally was difficult to penetrate.

# Tailored investment strategies to turn around neglected assets

Against this backdrop of an improved outlook for growth and travel, fragmented ownership, rising costs and rigid operating agreements, we believe there is a solid case for investing in the lodging sector. Refurbishing and upgrading well-located old hotels to raise ADRs is perhaps the best-known investment strategy, but certainly not the only one to consider. Our investment thesis pivots around identifying markets and owners in cities with strong leisure components, as our analysis suggests this segment should benefit from favourable structural trends over the upcoming investment cycle (see call-out boxes). Our investment thesis also rests on the ability to source off-market deals and create value for investors by developing the right repositioning plan that best fits each specific asset. It is also important to reposition assets carefully curated in partnership with some of the most innovative hotel brands, each of whom is best in class in a particular segment or niche. Some specialise in creating unique hybrid solutions blending the threshold between accommodation and entertainment. Others bring alive specific lifestyle concepts to intercept and retain a particular customer segment and boost financial performance.


### Lifestyle-led repositioning

Besides small details, such as interior décor and style, the hotel model has not evolved much for decades. However, in the last few years, new emerging trends have transformed peoples' lifestyle and travel expectations, boosting the demand for innovative hotel products, which are offering a unique lifestyle approach to lodging. Such lifestyle-oriented options are scarce across Europe, especially in trendy and vibrant locations, offering many opportunities of repositioning and transforming hotels into sought after assets. These hotel brands are attracting millennials and urban explorers whose preferences are skewed towards experiencing unique cultures and being part of vibrant communities, rather than the size of a bedroom. As such, these buildings integrate smaller but unique hotel rooms together with stylish restaurants, bars, co-working space, and other adaptable areas for special events, including live music, art exhibitions, and conferences. Contrary to traditional hotels, these brands embrace an open-door policy, encourage interactions between its guests and the local community, often becoming a landmark physical destination for its specific target audience, and a digital constant presence in the background of people's selfies and social media posts.

### Technology-led repositioning

Travel has moved up in peoples' priority list, and what was once perceived as a luxury, has broadened across all tourist types, including those on a budget. Lodging demand is set to become less dependable on the economic cycle as people appear less willing to cut travels and experiences compared to other areas of potential savings. Meanwhile, the use of the internet, smart phones, and apps have made travelling easier and contributed to the boom of alternative accommodation solutions, which are expected to grow by 16% compound annual growth rate (CAGR) over the next seven years globally. We believe this segment has significant addressable potential in Europe as well, and one strategy could consider converting small assets, with between 20 to 50 rooms, into fully digital lodging operators able to marry the comfort of a bed and breakfast experience with technology, convenience, and quality standards. By providing a fully digital guest experience and eliminating the number of staff on site, these hotel types are able to reduce operational costs by 60% compared to standard hotels.

**CONCLUSION:**

## Paradoxes often provide investment opportunities

There are times when contradictory information make investment decisions challenging to execute. As John Keynes once remarked, "If the barometer is high, but the clouds are black, it is not always rational that one should prevail over the other in our mind." Uncertainty is not an investor's friend. Undoubtedly, there is uncertainty on how the global economy will cope with strong central bank action to tighten monetary conditions. However, COVID-19 was also a unique event that put global travel on hold but also demonstrated its necessity as a part of modern society. While the broader economic environment cannot be detached from consumers, the future of travel in Europe is likely to benefit from the very unique nature of the pandemic that is unleashing pent-up demand.

Traveling has snapped back and resumed its long-term growth trajectory underpinned by global travel, rising middle class in developing countries, and mounting desire to devote more time for leisure activities and memorable experiences. Our analysis shows a large number of independent hoteliers across the continent may not be in a position to benefit from this positive outlook, as a prolonged period of underinvestment has put these operators into a structural disadvantage against larger hotel chains with deeper pockets and modern management. Higher inflation is putting pressure on wages and lending costs and has started to strain balance sheets, forcing a growing number of small owners and independent operators to seek recapitalization or asset sales over the coming months. We believe this could open the door to a significant portion of the market that has historically been difficult to penetrate and create an investment strategy that can take advantage of a fundamental tenet of society that COVID-19 served as a timely reminder for.

**Risk Considerations**

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