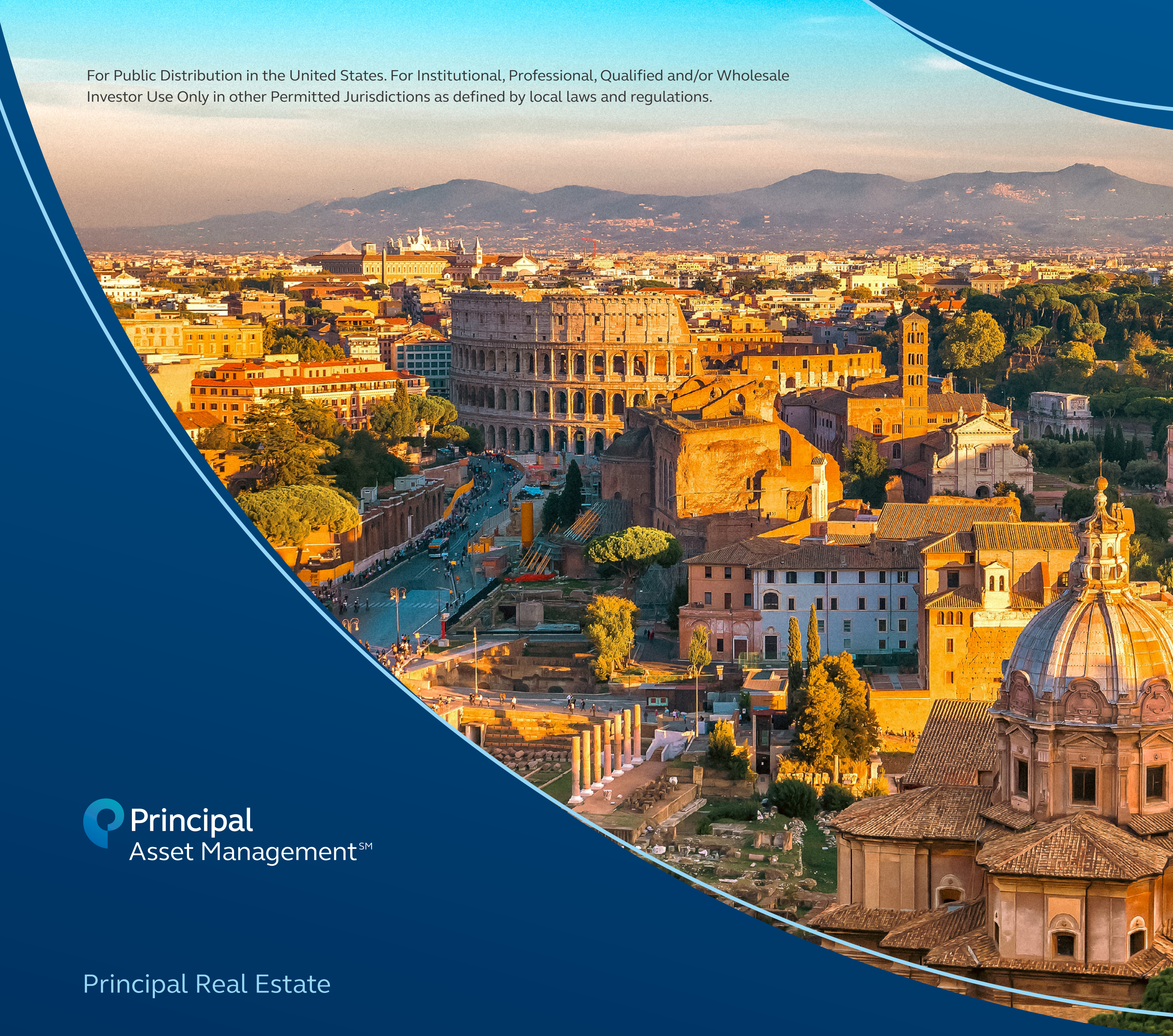


Principal Asset Management℠

Principal Real Estate

European Hotel Sector 2024 Outlook

Strong fundamentals continue to underpin a market with strategic opportunities.

The European hotel market rebounded strongly after the COVID-19 pandemic (explore past performance in detail in our first paper in this series). By the end of 2023, in most European markets, performance had surpassed pre-pandemic levels when measured by revenue per available room (RevPAR) due to more prioritisation of travel, pent-up demand, and unique opportunities within Europe for both domestic and foreign travellers. Strong performance is expected to continue, and the European hotel market is forecast to grow at a compound annual rate of 15 per cent between 2022 and 2027—reaching EUR 44 billion in 2027.[1]

However, despite the strong hotel trading performance, the European hotel investment market still has areas of distress, presenting investment opportunities. Increased debt taken on during the pandemic, combined with now higher debt costs, is starting to take hold and we are seeing more signs of distress in the market. Many hotel owners are now looking to “rotate assets”, and banks are applying more pressure on borrowers to sell down assets to reduce debt ratios.

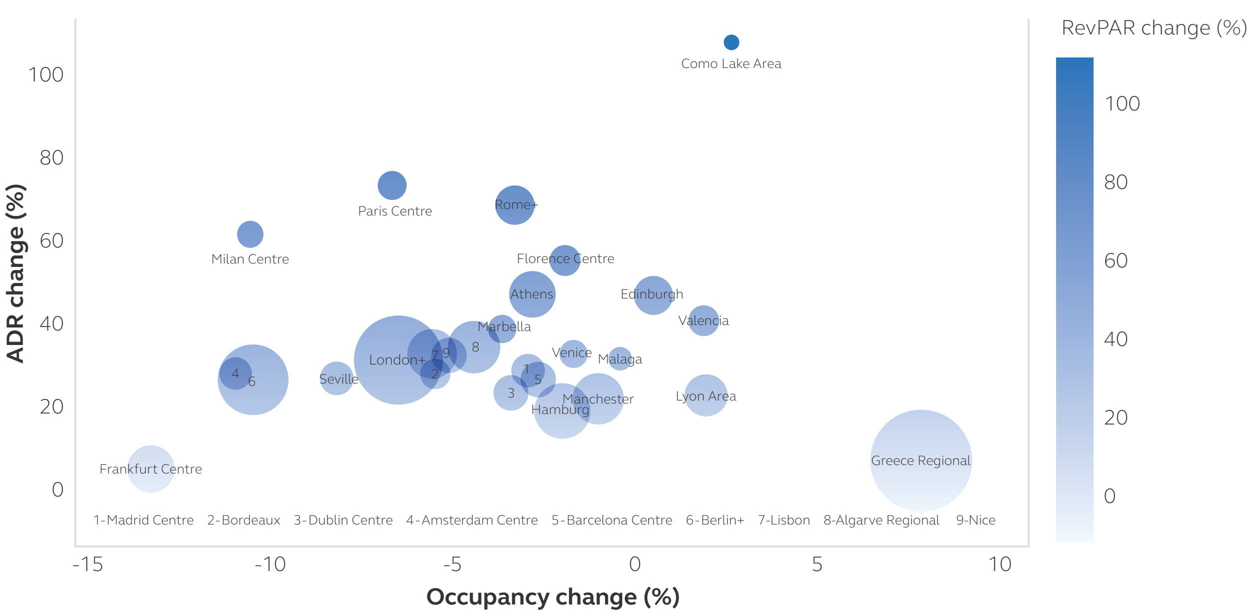
As the global economy continues to recover and long-haul flight patterns ramp up, we expect strong travel demand to continue to support hotel trading performance, however, stressors like the higher cost of debt will continue to mount. We believe more assets will come to market at more attractive pricing from 2024 to 2026.

KEY TAKEAWAYS

- Lodging demand is expected to grow faster than supply.
- Hotel performance should remain strong, though average daily rate (ADR) may level off.
- Inflation and interest rates will likely ease, though distressed properties—and discounted pricing opportunities—will potentially increase.
- As a result, we expect to see higher transaction volumes in 2024 and a moderate drop in valuations and pricing.
- We see a strong window of opportunity for those with a clear strategy and skill set to unlock value in the hotel sector.

EXHIBIT 1: In most European hotel markets, revenue has surpassed pre-pandemic levels

Selected European markets performance in 2023 over 2019*



Source: STR, December 2023

*Bubble size indicates the number of rooms in 2023 and reflects cities where hotels have been handpicked as custom for those markets.

[1] Mobility Foresights: Market Research Report—Hotel Industry in Europe 2022-2027, November 2022.

Travel demand outstrips supply

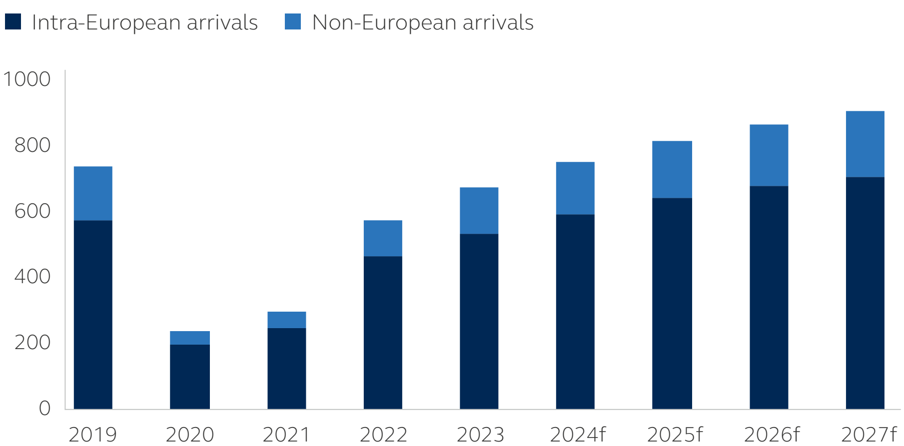
In the post-pandemic era, consumers are placing a higher priority on travel. This shift started long before the pandemic as generational preferences changed, but pandemic-induced isolation accelerated it. We expect the European hotel sector to continue its long-term upward trajectory, underpinned by global mobility growth, rising middle class in developing countries, and a mounting desire to devote more time to leisure activities and memorable experiences (see Exhibit 2).

An increase in international travel means demand in the European market is growing faster than lodging supply—a good sign for investors (see Exhibit 3). The factors contributing to constrained supply include:

- Building constraints in high-demand areas such as historical locations and city centres
- Not enough land for new buildings
- Some cities are blocking conversions and new hotel licenses

EXHIBIT 2: International tourist arrivals is forecast to continue rising, well above the 2019 peak

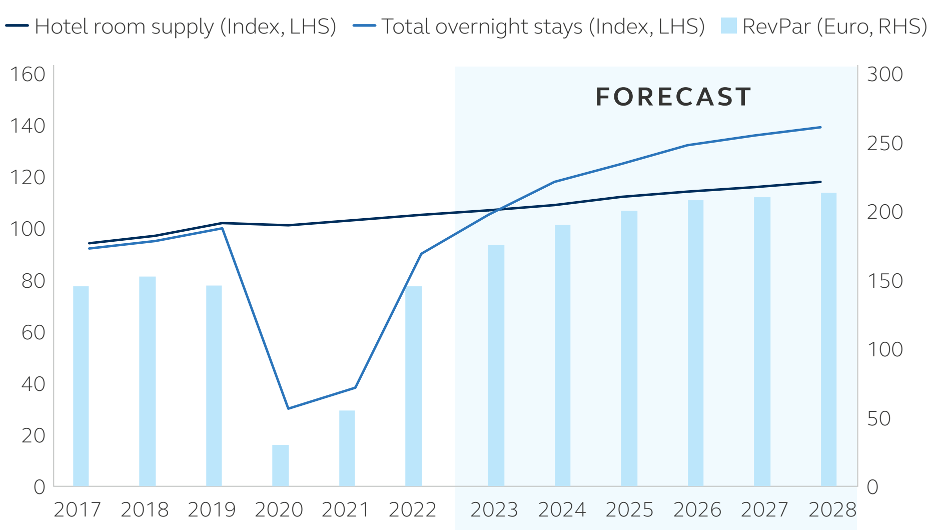
Arrival to Europe, million visitors



Forecast released December 2023. Source: European Travel Commission

EXHIBIT 3: Lodging demand is forecast to grow faster than supply by 2024, and RevPar is forecast continue to increase at a steady pace

Total overnight stays and hotel supply indexed to 2019=100



Source: CBRE, Oxford Economics PMA, PGIM Real Estate Q3 2023

The 2024 Olympics in Paris

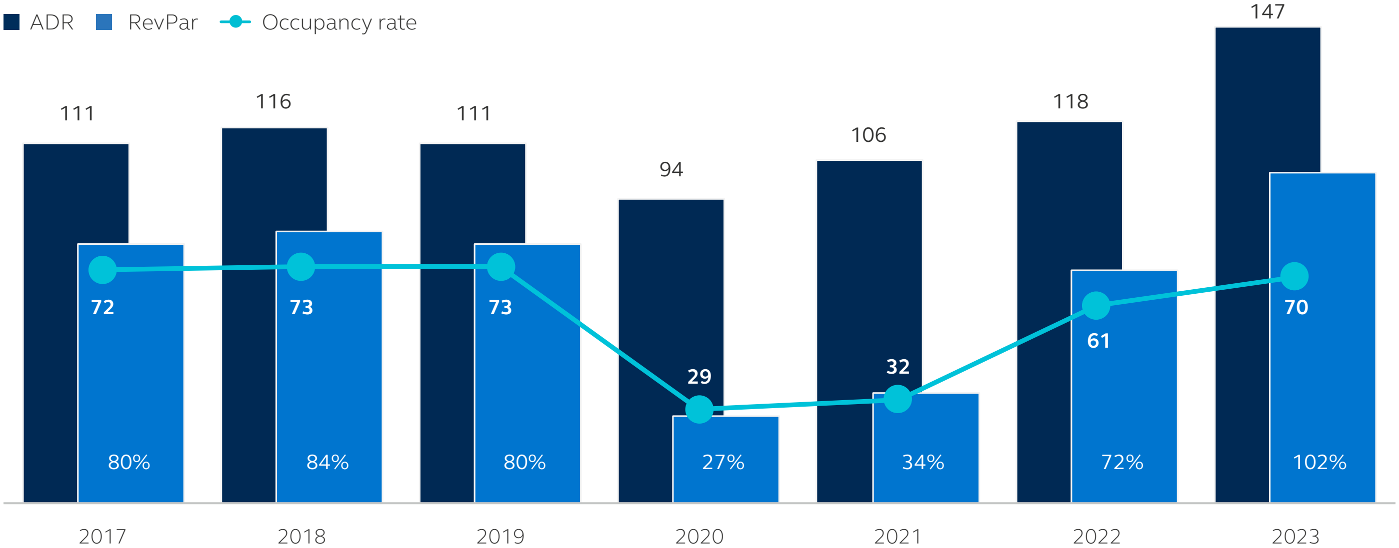
The Olympics are forecast to have a considerable impact on the hotel sector in Paris, with positive follow on—impacts from long-haul travellers extending their visit to other European destinations.

Hotel performance will remain strong, though average daily room rates (ADR) may level off

From 2021 to 2023, there was a strong rebound in trading performance, with RevPAR significantly surpassing 2019 levels (even when adjusted for inflation), driven by robust ADR growth. At the same time, occupancy hasn't fully recovered (see Exhibit 4). In 2024, we expect RevPar to continue to grow but at a slower rate. ADR growth will likely slow as more travellers feel their pockets squeezed from past inflation and the broader economic impact filters through. Occupancy should increase to reach full recovery.

EXHIBIT 4: RevPar and ADR are higher than any previous peak, but occupancy isn't quite back to pre-pandemic levels

Market performance (€, percentage, 2017–September 2023)



Source: STR, Principal Real Estate, May 2023

Group travel and its impact on ADR and occupancy

Like occupancy, group travel—one of the major travel sectors—has yet to return to full performance. We can expect some impact on ADR and occupancy rate as group travel recovers. Group travel usually boosts the occupancy but can be a drag on ADR.

ADR and occupancy are closely linked. Like most market analysts, we see ADR growth flattening out as a natural process of revenue production in hotels and as occupancy recovers to previous levels. Although there are headwinds—inflation and economic softening—there are strong fundamentals as demand outstrips supply. Therefore, we expect top line growth in European hotels in 2024.

Performance by segment

The luxury and economy segments of the market have been the strongest performers post-pandemic (see Exhibit 5). We expect to see continued growth in both luxury and economy in 2024.

Luxury

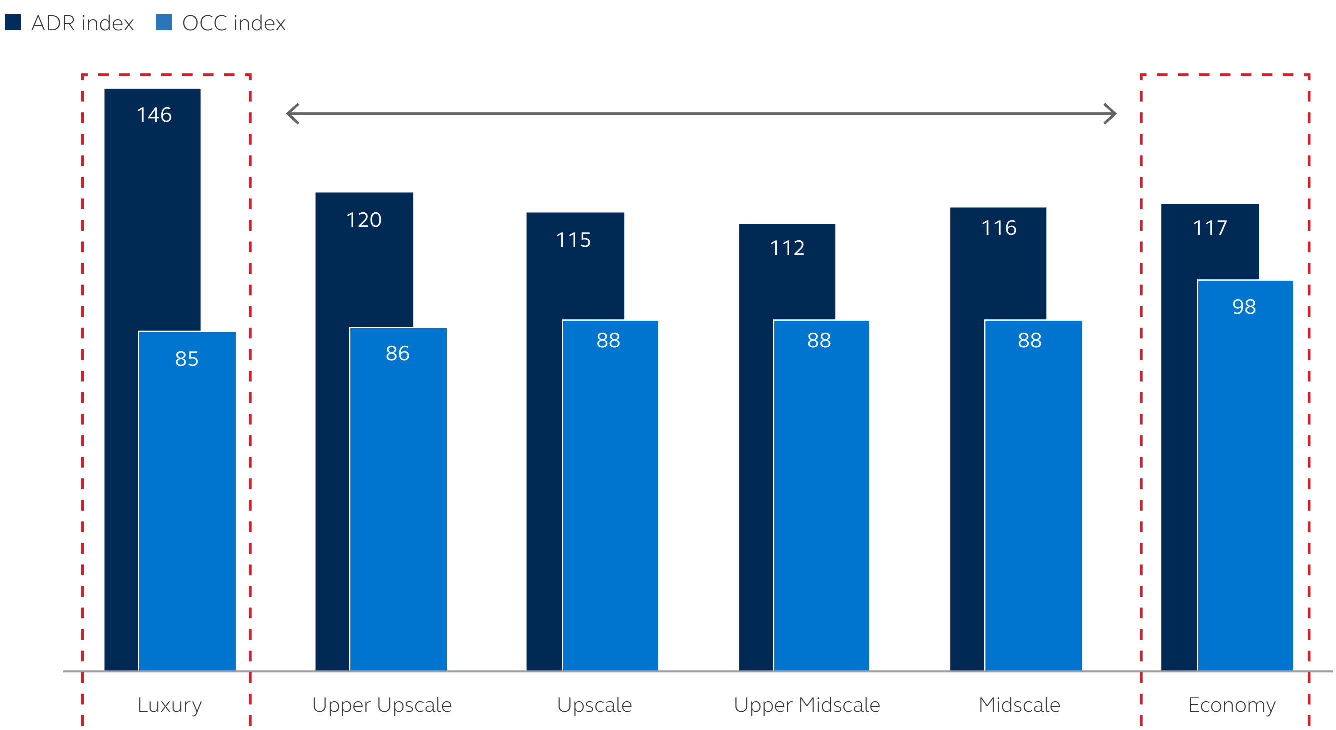
In the luxury segment, performance was driven by very high ADR growth while occupancy remained at similar levels to other segments. The growth in this area remains an interesting opportunity in certain markets as the luxury segment still benefits from limited supply in many markets. In 2024, we expect higher performance from occupancy and a flattening of the curve on ADR growth. It is unlikely that ADR will continue to grow at the rate it has already achieved.

Economy

The economy segment has performed strongly in the post-COVID era with solid occupancy and ADR growth. Occupancy has recovered much faster than in other areas and is the only segment where occupancy is almost at 2019 levels. Traditionally, in weaker economic periods, the economy segment performs best as many travelers 'trade down' and corporate travel budgets get slashed. Economy will continue to benefit from traveler volumes increasing as flight patterns return to normal. ADR is likely to grow at a much steadier pace than we've seen over the past three years.

EXHIBIT 5: The luxury and economy segments saw the highest growth in 2022

Performace by segment, indexed to 2019, Full year 2022



Source: STR, Principal Real Estate, May 2023

Leisure

In 2022 and 2023, leisure and resort-driven destinations bounced back strongly as travellers immediately focused on holiday destinations following the release of pandemic-related restrictions. Market research shows that many people are prioritising experiences and travel over other types of disposable income spending.[2] We expect to see continued strong performance in the medium term, even in the face of broader economic headwinds.

Business

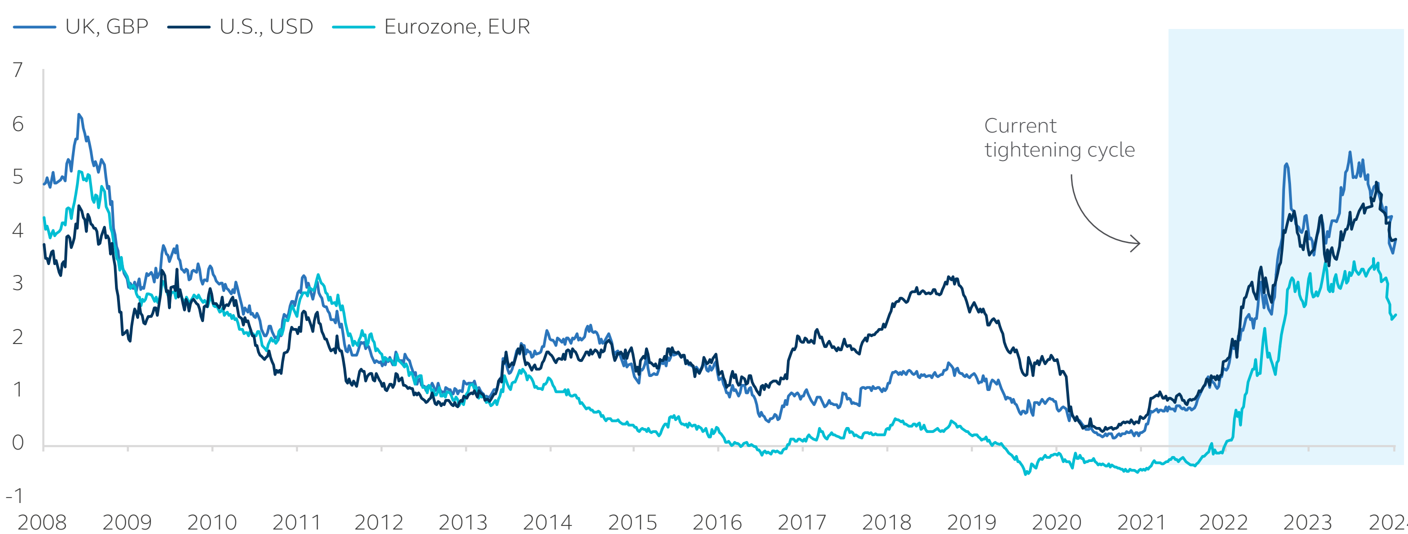
Business travel was a little slower to return post-COVID as organisations wrestled with the new normal of video conferences and increased working from home. However, contrary to many commentaries, business travel has returned strongly in 2023, with the power of in-person meetings still proving to be an essential tool for many businesses. As more companies in China and other non-European markets return to business as usual, we expect further growth in 2024.

Inflation and interest rates should ease though discounted pricing opportunities will potentially increase

The post-pandemic increase in interest rates is putting pressure on owners to sell assets, creating opportunities for new investors to take advantage of discounted pricing. Inflation is coming down in most countries, and interest rates are expected to follow slowly. For investors buying now, we expect interest rates will likely decrease to more normalised rates in five to seven years, supporting strong sale opportunities.

EXHIBIT 6: Rising interest rates likely to ease in 2024

Five-year swap rates (%)



Source: Macrobond, Principal Real Estate, December 2023

[2] Alvarez and Marsal, Travel in Flux, 2023

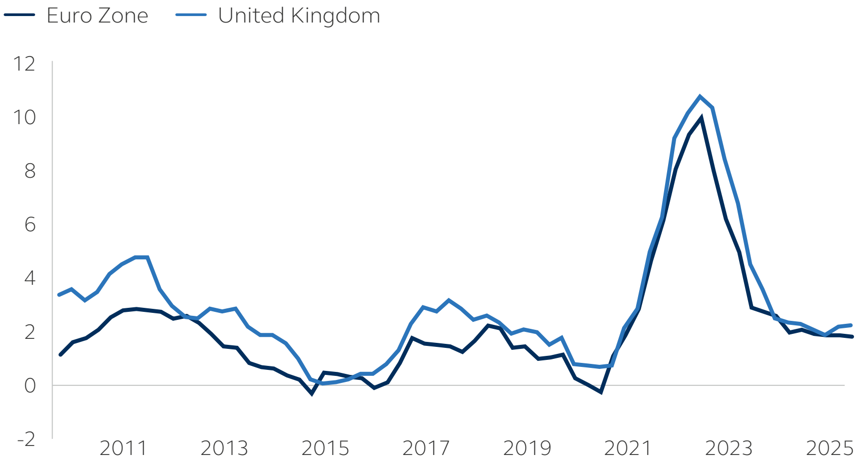
From a trading perspective, we do not expect to see a major impact from easing inflation and interest rates, just as higher interest rates and inflation did not negatively impact demand significantly.

Discounted pricing opportunities will potentially increase

The value opportunities created by strong macroeconomic growth and high demand alongside pandemic-era stress on independent owner-operators will likely remain in 2024.

EXHIBIT 7: High inflation expected to ease in 2024

CPI



Source: Moody's , forecast as of December 2023.

Nearly 60 percent of hotel properties are owned by smaller independent owners-operators, and many of these need refurbishments and are not operated to their potential.[3] Additionally, many independent owner-operators face distress due to pandemic-related challenges such as operational issues, chronic underinvestment, inflation, and rising interest rates. Even as inflation and interest rates ease, these factors still weigh strongly. Furthermore, we expect other stressors to persist, leading more owners to sell their hotels, often off-market and at discounted prices, for quick and straightforward transactions.

Increase in transaction volume in 2024

We expect more hotel properties to come to market this year, driven by increased pressures on various ownership groups to sell, likely leading to a rise in deal availability. Furthermore, dry powder has diminished, and limited new capital has been raised. With less competition for deals and an increased supply of hotels for sale, we expect pricing to continue to soften through 2024.

CONCLUSION:

The window of opportunity for investors remains open

We believe there remains a strong case for investing in the European hotel sector—with a solid foundation of growth and a promising outlook. In 2023, we saw a much stronger rebound than forecasted, proving the sector's resilience. As the effects of high inflation and high interest rates kick in, we expect to see more deals coming to the market at discounted prices. With less capital chasing the same deals, we see a strong window of opportunity for those with a clear strategy and skill set to unlock value in the European hotel sector.

[3] Statista, November 2022 and Principal Real Estate, December 2023

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