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PRINCIPAL REAL ESTATE

European Hotel Sector: Creating value through demand-driven transformation

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The COVID-19 pandemic dealt an unprecedented blow to the hospitality industry. Fortunately, travel has rebounded, and strong fundamentals bode well for the European hotel sector in the medium and long term. Yet for some hotel operators, cracks that surfaced during the pandemic are being made worse by high inflation and rising costs of debt. We believe this combination of strong fundamentals and pockets of distress presents unique opportunities for investment in the European hotel sector. Explore the investment case in our first paper in this series.

The first step in a value-added investment strategy is finding undervalued or illiquid hotels with good micro locations in attractive markets. An attractive *market* is one that has multiple demand drivers, where hotel performance has been strong, pricing is attractive, and new supply is limited. An attractive *property* is one that is in a strong strategic location with a building structure that can be optimised to leverage local demand drivers and achieve increased profitability. The property should be underperforming relative to similar properties in the market. Explore how to identify such opportunities in our second paper in this series.

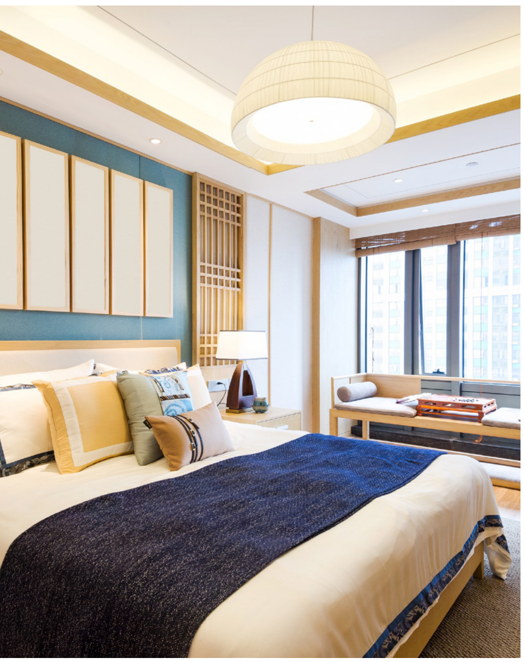
Once a property has been identified, the next step is to create value through some sort of transformation. The key is understanding how demand has changed and how to transform the property to better meet that demand. Transformation could involve brand repositioning, or a targeted capex initiative such as expansion or refurbishment, or an operational change such as implementation of technology. In this paper, the third in our *European Hotel Sector* series, we share our expertise on changing demand drivers and value creation strategies to capitalise on new market dynamics and assets' unrealized potential. The goal is to fill hotel rooms at higher rates; providing the performance boost that will generate profit at asset disposition.

KEY TAKEAWAYS

- The travel landscape has changed considerably over the last decade. Demand has risen in aggregate and new types of demand have emerged. Consumers are increasingly prioritising experience and hotels that offer consistently reliable service, alongside local authenticity. Nearly half of the market spend comes from Millennials and Gen Z, whose preferences have historically not been well addressed. Value creation is about capitalising on these trends to boost hotel profitability.
- The opportunity lies in transforming the property to better suit a particular demographic given changing demand drivers. This could involve brand repositioning, or a targeted capex initiative such as sustainability-focused refurbishment, or an operational change such as implementation of technology.
- Whatever transformations value creation involves, specialist skills are essential for maximising the real estate investment and the hotel investment. From choosing the 'right' brand for the location and market, to determining which capex initiatives will generate the best return, to managing operations for top and bottom-line performance, specialists' market-specific and domain-specific expertise maximises value creation.

Changing demand drivers

The travel landscape has changed considerably over the last decade. Demand has risen in aggregate, and new types of demand have emerged. Consumers are increasingly prioritising experience and hotels that offer consistently reliable service alongside local authenticity. Nearly half of the market spend comes from Millennials and Gen Z, whose preferences have historically not been well addressed. Value creation is about capitalising on these trends to boost hotel profitability.

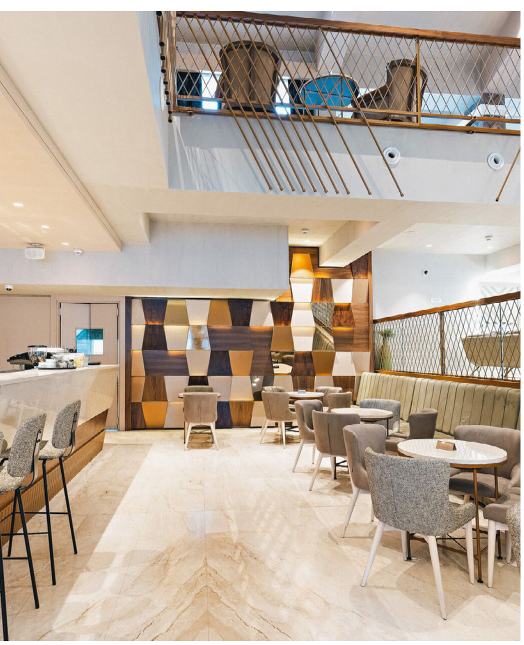


The Internet democratised information.

Before the internet, consumers relied on familiar global brands to provide a level of comfort when travelling to a faraway place. Brands' locations were harmonised to maintain standards and provide familiarity; they could be counted on for consistent quality of product and service.

As use of the internet rose, new online platforms made it easy to find and compare hotel options in even the most distant locales. Pictures and guest reviews provided consumers a realistic sense of what to expect at any given property, and consumers became more comfortable choosing lesser-known hotels with more local authenticity. Now travellers don't have to settle for the standardised global brand experience that is basically the same in London as in Lisbon; they can get the local experience and the connection to the community, without risking comfort, quality, or service.

To capitalise on this new demand, savvy well-known global brands have moved from standardising the product to standardising the service, offering more individualisation including through authentic local experiences. Lifestyle brands, for example, increasingly focus on food and beverage (F&B) and creating environments where locals hang out—because those are the places travellers want to hang out, too.

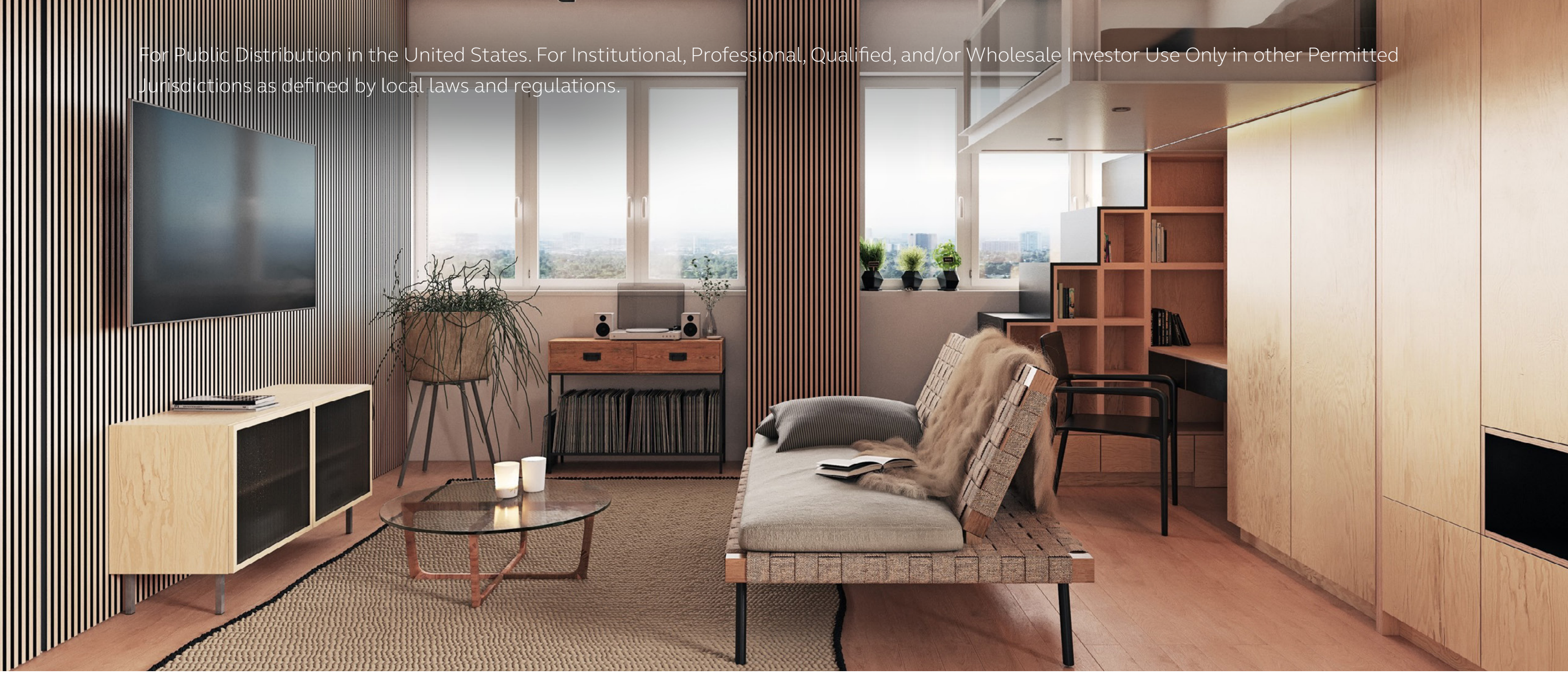


Post-pandemic, experience matters more.

As travel continues its post-pandemic rebound, new patterns are emerging. As discussed in the previous papers in this series, leisure travel has rebounded more strongly than business travel, and there is a new trend toward 'bleisure' travel—that is, adding leisure weekends onto working trips, extending holidays by working from holiday, and even taking work on the road for months at a time. Significantly, people are travelling for longer periods and spending more on environmental factors, health, and wellbeing.

More people (and more types of people) are travelling.

Inflation notwithstanding, air travel is now more relatively affordable than ever before. The emergence of low-cost airlines in the last decade has accelerated this trend. With the increasing accessibility of air travel, combined with the post-pandemic focus on experiences and growth of middle classes in the developing world, more people are travelling than ever before. And, more types of people are travelling. Gone are the days of the monolithic traveller persona; there is now a wide range of preferences and price points for the hospitality industry to serve.



The sharing economy has created a new segment.

Platforms like Airbnb have blurred the lines between accommodation types; residential units and serviced apartments now compete with hotel rooms by being sold for shorter lengths of stay. These platforms are increasingly popular; rentals accounted for six percent of demand in Europe and the U.S. in 2019, up from three percent in 2015.

The rise of sharing platforms has not, to date, cannibalised hotel revenue; it has changed existing segments and created new demand areas and opportunities. Rather than taking share away from hotels, Airbnb has created new segments by offering an alternative product often preferred by small groups, longer-stay customers, and families.

One example is the rapid growth of hybrid products such as aparthotels—entire apartment blocks devoted solely to short-term leases. The aparthotel product performed much better through the pandemic due to its flexibility and adaptability; large hotel operators are now rapidly developing products in this space.

Sustainability considerations are now at the forefront for investors, owners, operators, and guests.

There is increasing momentum and focus in the European real estate industry on addressing sustainability. The focus comes from regulators and investors, but also from consumers who are increasingly making hotel selections with sustainability considerations in mind. Just a few years ago, sustainability was a competitive differentiator; today it's a competitive necessity. It is also key to a profitable disposition of the asset; buildings not compliant with sustainability regulations may attract fewer potential buyers and suffer price discounts.

Millennials and Gen Z are underserved.

Younger adults spend about €350 billion per year on travel, which represents 43 percent of the hotels and other travel accommodations market.[1] Yet less than three percent of hotel rooms have been designed for this consumer group.[2] Particular characteristics of this demographic include strong preferences for spending discretionary income on experiences rather than material goods and a penchant for travelling whilst working remotely. These 'digital nomads' and other younger consumers are still more price conscious than older generations.

The particular preferences of this demographic have historically not been well met. Global hotel brands, for example, don't typically offer enticing remote work options, and pricing is often misaligned with younger people's needs. Yet hostels—the lodging of choice for previous generations' backpack-toting world travellers—do not typically provide the level of amenities that increasingly sophisticated Millennials and Gen Z demand. Short-term rentals, particularly 'sharing economy' options like Airbnb, typically lack the experience opportunities that many younger people seek while travelling.

[1] AARP and United Nations World Population Prospects, 2019. *Hotel and Other Travel Accommodation Global Market Report 2021: COVID-19 Impact and Recovery to 2030*, The Business Research Company, January 2021.
Selina estimate based on travel spend by generation and population size by generation.

[2] Selina estimate, which includes about 475,000 boutique and soft brand hotel rooms per STR Global Reports as of 2020.

Value creation through transformation to meet new demands

The value creation opportunity lies in transforming the property to better suit a particular demographic given changing demand drivers. This could involve brand repositioning, or a targeted capex initiative such as sustainability-focused refurbishment, or an operational change, such as implementation of technology.

Repositioning

Understanding the most effective brand for an asset is a key element of any investment; choosing the 'right' brand for the destination may lead to higher investment returns. The 'right' brand for the destination depends on the building, the micro location, and the market dynamics including how well demand is served by current supply. There are still advantages to well-known global brands, which may attract more direct bookings (and therefore profitability, because direct bookings don't require commissions to online travel agencies). But no longer is a well-known global brand always the right choice.

True lifestyle brands

True lifestyle brands are all about experience. These hotels focus on food and beverage, design aesthetics, and attracting locals to create life in the lobby and other common spaces to position the hotel as a place people want to be. The attractive, 'place-to-be' environment allows for higher room rates, driving higher revenue and profit per square metre compared to a traditional hotel. Lifestyle brands have become popular in recent years as they offer the more experience-driven stay travellers increasingly demand.

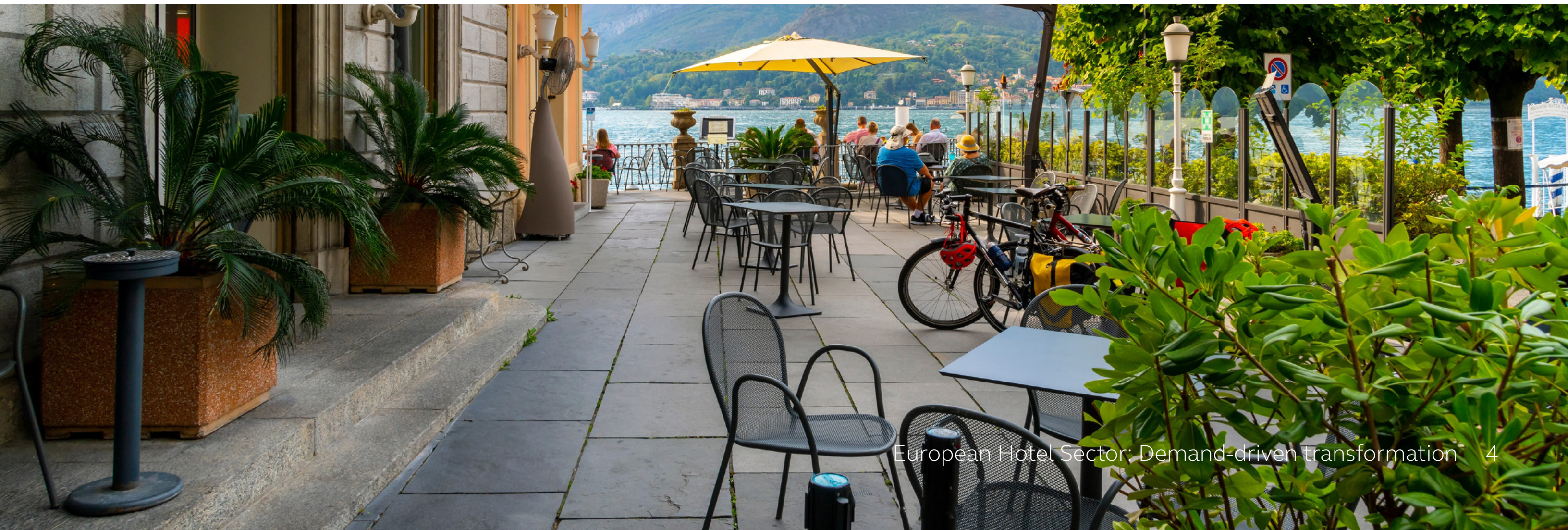
In one Amsterdam example, a traditional property was dated and lacked vibrancy. It was acquired off market, then extensively renovated and repositioned as a boutique luxury lifestyle hotel. The ground floor was reorganised and optimised to create an urban oasis with lively food and beverage (F&B) areas that established the hotel as a local destination. Post-renovation, hotel revenues nearly doubled.

Digital brands

Digital brands are hotels with fully digitalised operations. In a digital brand hotel there is no lobby, no restaurant nor bar, no spa. Guests interact, as necessary, with the hotel operator via a smartphone app. As such, operating costs are significantly reduced. One advantage of this digital model is the ability to profitably operate smaller hotels where the small size precludes profit opportunity under a traditional model.

Hybrid hospitality

Hybrid hospitality is a unique offering that blends hotels with other property types. Aparthotels are a perfect example. With synergies driven by sharing economy platforms like Airbnb, hybrid hospitality caters to a demographic not well served by traditional, lifestyle, or digital brand offerings.



Targeted capex initiatives

Targeted capex initiatives such as expansion and/or refurbishment are often part of successful repositioning for value creation.

Expansion

Expansion may be part of brand repositioning. For example, two adjoining independent hotels in a prime location in a top destination city could be combined into one larger hotel and repositioned as a luxury brand, more suitable to the location and the market. That type of expansion and repositioning can also help attract operators better suited to the new position and market.

Refurbishment

In addition to, or instead of expansion, refurbishment may also be part of brand repositioning. For example, a vacant 64-bed hotel in a prime location in central Rome is being combined with adjoining former office buildings for redevelopment into a 155-room luxury lifestyle hotel. The new driveway, set amongst gardens, will provide a sense of grandeur upon arrival, and a pool area with manicured gardens will be ideal for leisure guests and as a summer events space. An innovative luxury brand will be selected to operate the hotel in alignment with its new positioning.

Refurbishment may also be focused on boosting sustainability. In addition to ethical and moral issues, a clear and authentic approach to sustainable redevelopment has the potential to deliver better returns given sustainability considerations are now at the forefront for investors, owners, operators, and guests. Whilst sustainability used to be a competitive advantage, in the future it is likely to be an imperative for both strong operational performance and at asset disposition.

Sustainability-orientated value creation may include efficient design (for greater use of space, higher occupancy, better material usage, and lower energy consumption), socially responsible construction, and refurbishment with locally sourced furniture, fixtures, and equipment. Technology implementation—for resource use monitoring, for example—can enable greater operating efficiency.

Operational changes

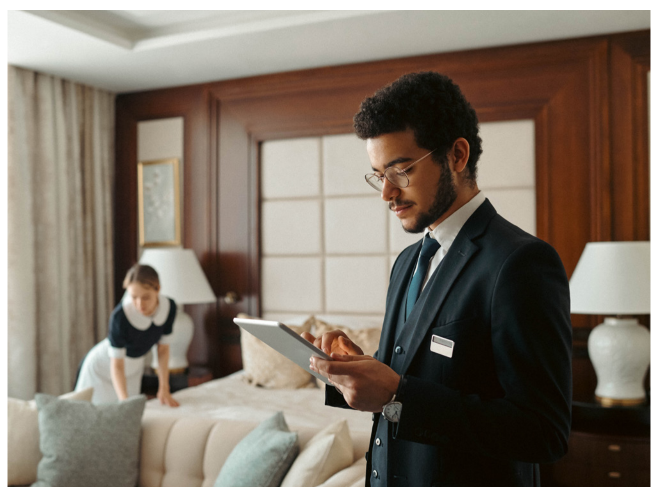
Often, repositioning and targeted capex initiatives necessitate operational changes as well. Those changes may involve selection of an operator more in line with the new brand position, or more sustainability focused operations, or the implementation of technology.

Sustainability focused operations

Sustainability focused operations can drive value creation to enhance potential returns. With the right operating partner to implement sustainability focused operational strategies, a hotel can command potentially higher room rates from sustainability conscious guests and better profit margins from lower operating costs. Sustainability focused operational tactics may include single-use plastics policies, leveraging local supply chains where possible, local staffing, carbon offsetting measures, and food management and recycling. Results can include increased guest satisfaction leading to higher occupancies, lower operating costs thus higher profits, and a more authentic experience creating a better product.

Technology implementation

Technology implementation is typically part of digital brand repositioning, and may be leveraged by other types of brands, as well to deliver better service and reduce operating costs. Technology can replace many guest services (such as check-in/check-out and concierge), as well as back-end processes to help reduce inefficiencies and costs. Digitalisation is one strategy for responding to the demand created by the rise of the sharing economy, and is frequently an important element in repositioning a brand to cater to the preferences of Millennials and Gen Z.



PRINCIPAL REAL ESTATE HOTEL TEAM CASE STUDIES

Repositioning, conversion, and expansion of luxury lifestyle hotel in London

At acquisition, the asset was a tired 4-star hotel in need of major refurbishment, located in prime central London. The property had relatively small rooms (a barrier to a classic luxury concept) and very limited common space (reducing the likelihood that it would become a lively local hangout). But given its excellent micro location in Mayfair, the dynamics of the local market, and its availability vacant possession, the asset represented a prime opportunity for redevelopment into a luxury lifestyle hotel.

Redevelopment involved a full restructure of the ground floor to significantly increase common space. Enticing food and beverage outlets were added—including a restaurant with a two-star Michelin chef and a trendy cocktail bar. Two new floors were added above the original hotel, increasing the overall room count and adding more spacious suites to better balance the room profile. New interior décor was locally sourced in line with the brand's ESG goals and made of natural materials in line with the luxury concept.

The hotel was transformed into a vibrant hub within the heart of Mayfair, attracting locals and travellers alike; thus, created attractive value for investors.

Repositioning and technology implementation by digital brand/operator

This digital brand hotel operator offers travellers a 100% digital experience and thereby competes with both hotels and Airbnb rentals. Growing rapidly, the company operates 3,800 units in 27 cities across 9 countries.

Digitalised operations facilitated by the implementation of technology platforms enables the company to maximise revenue potential and lower operating costs. Minimal staff and streamlined services lower operating costs and boost bottom-line performance. Since there are no lobbies, breakfast rooms, kitchens, or the like, extra rooms can be added to maximise revenue potential. As a result, the digital model may deliver profitability even in properties with low room counts—particularly beneficial in Europe's historic city centres where building extensions can be difficult to achieve.

Amongst travellers whose preference includes a digitalised experience, including Millennials and Gen Z, the digital brand is an effective competitive differentiator. Advantages for guests include check-in done online prior to arriving at the hotel (eliminating queues in the lobby). Check-out is also online, allowing guests to walk straight out of the hotel when they are ready to leave. Regular touchpoints, such as notifications about early check-in and late check-out are sent automatically to the guest's phone. Guests can request instant assistance on WhatsApp or via the app.

For illustrative purposes only.

The importance of specialist skills

From choosing the 'right' brand for the location and market, to determining which capex initiatives will generate the best return, to managing operations for top and bottom-line performance, specialists' market-specific and domain-specific expertise maximises value creation.

Whatever transformations value creation involves, specialist skills are essential for maximising the real estate investment and the hotel investment.

REAL ESTATE-SIDE SPECIALIST SKILLS

- Micro location characteristics
- Local market demographics
- Local market demand drivers
- Leases
- Covenants
- Guarantees
- Return profile
- Debt financing
- Construction

HOTEL-SIDE SPECIALIST SKILLS

- Operating contracts
- Hotel concepts
- Brands
- Hotel operations
- Sales and marketing
- Revenue management
- Technology
- Consumer trends
- Market disruptors

Specialists' market-specific and domain-specific expertise maximises value creation. For example, a local hotel investment specialist can advise on selecting the 'right' brand for a specific location and market, since the 'right' brand can potentially lead to higher investment returns. Because the 'right' brand depends on the building, the micro location, and the market dynamics including how well demand is served by current supply, having a local market specialist is essential. Local experts can spot trends and identify threats early to help enhance returns through early mover advantage—acquiring assets in up-and-coming locations at a lower price and benefiting from market value appreciation more significantly.

When value creation involves targeted capex initiatives, a local specialist can advise what investments may generate additional rate and how to allocate spend to drive bottom line. Having a sustainability specialist during this phase can be beneficial as well.

A specialist can guide the design process to ensure functionality and operational requirements are met. On the operational side, specialists should be actively engaged in the profit and loss of the hotel operation to improve top and bottom-line performance.

Conclusion: Transforming the property to better meet changing demand creates value

The travel industry has changed dramatically in recent decades. Rising demand and new types of demand, are driving opportunities to acquire a hotel property at a discount, then transform it to better meet demand—boosting profitability as a result.

The next step in a value-added investment strategy is operations. Identifying and implementing the optimal operating structure, and choosing and managing the ideal operating partner are key ways to maximise hotel performance—and boost profit at asset disposition. That will be the subject of our next paper in the European Hotel Sector series.

Risk Considerations

Investing involves risk, including possible loss of Principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. All these risks can lead to a decline in the value of the real estate, a decline in the income produced by the real estate and declines in the value or total loss in value of securities derived from investments in real estate.

International investing involves greater risks such as currency fluctuations, political/social instability, and differing accounting standards.

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