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PRINCIPAL REAL ESTATE

European Hotel Sector: Identifying opportunities for value creation

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A combination of strong fundamentals and pockets of distress presents unique opportunities for investment in the European hotel sector. (Explore the investment case in detail in our first paper in this series.) Targeting independent hotels that are well located but underperform and require investment offers significant scope to create value through upgrading, repositioning, and improved operations.

In this paper, the second in our *European hotel sector* series, we share our expertise on finding those value creation opportunities—undervalued or illiquid hotels with good micro locations within attractive markets.

KEY TAKEAWAYS

- An attractive market is one that has multiple demand drivers, including strong demand for both leisure and business travel, where hotel market performance has been strong and pricing is attractive, and new supply is limited.
- An attractive property is one that is in a central location with curb appeal, and maintained well enough that any short-to-medium term defensive capex requirements are limited. The property should be on a lot sized for efficient deployment of capital, which is underperforming relative to similar properties in the market.
- Selecting markets, micro locations, and properties with these characteristics can potentially uncover unique opportunities to create value through upgrading, repositioning, and improved operations.

Market characteristics

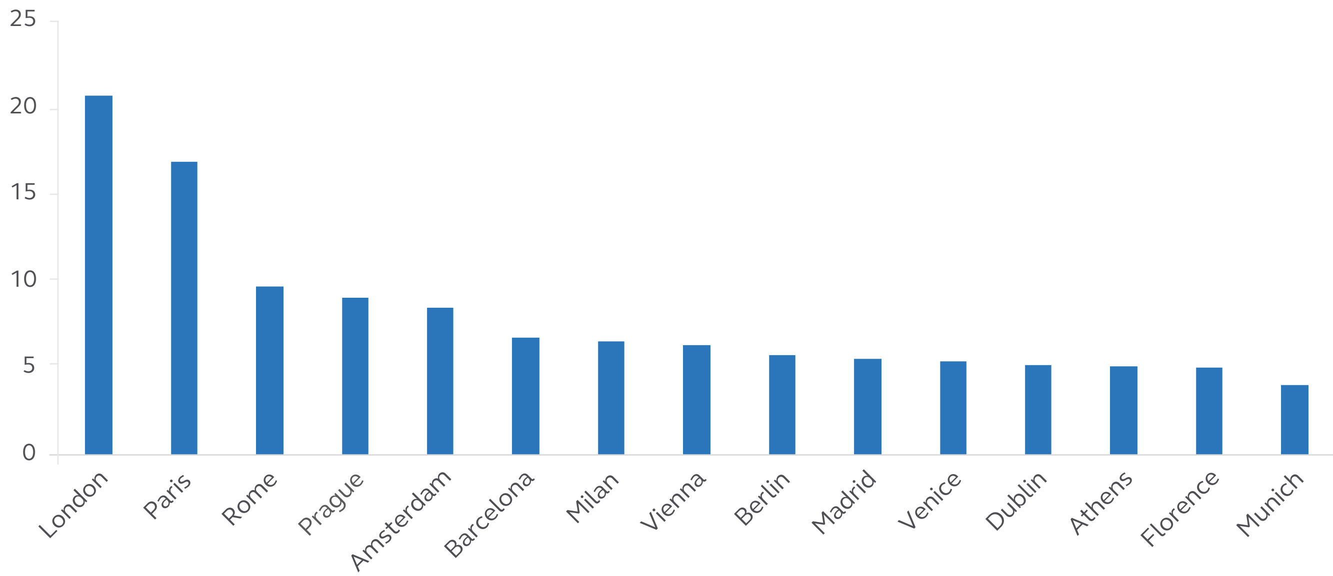
An attractive market is one that has multiple demand drivers, including strong demand for both leisure and business travel, where hotel market performance has been strong and pricing is attractive, and new supply is limited.

Multiple demand drivers including strong demand for both leisure and business travel

In the aftermath of the COVID-19 pandemic, consumers are prioritising travel—in part a reaction to pandemic isolation and in part a generational shift. Indeed, while both business and leisure travel have rebounded in the years since the pandemic, leisure travel has rebounded most significantly. Top factors influencing leisure demand include cultural and historical attractions, sports and entertainment events, food and drink, shopping, nightlife, accessibility, safety, and cost.

EXHIBIT 1: In markets attractive for leisure and business, travel has rebounded

Top European cities by number of visitors, 2022, millions



Source: Euromonitor, December 2022

The most ideal is a dual-demand market—major gateway cities and increasingly secondary cities where there is strong demand for both business and leisure travel. Dual-demand markets are particularly attractive as travelers mix business and leisure more and more (e.g. tagging leisure weekends onto workweek trips or extending holidays by working from the hotel).

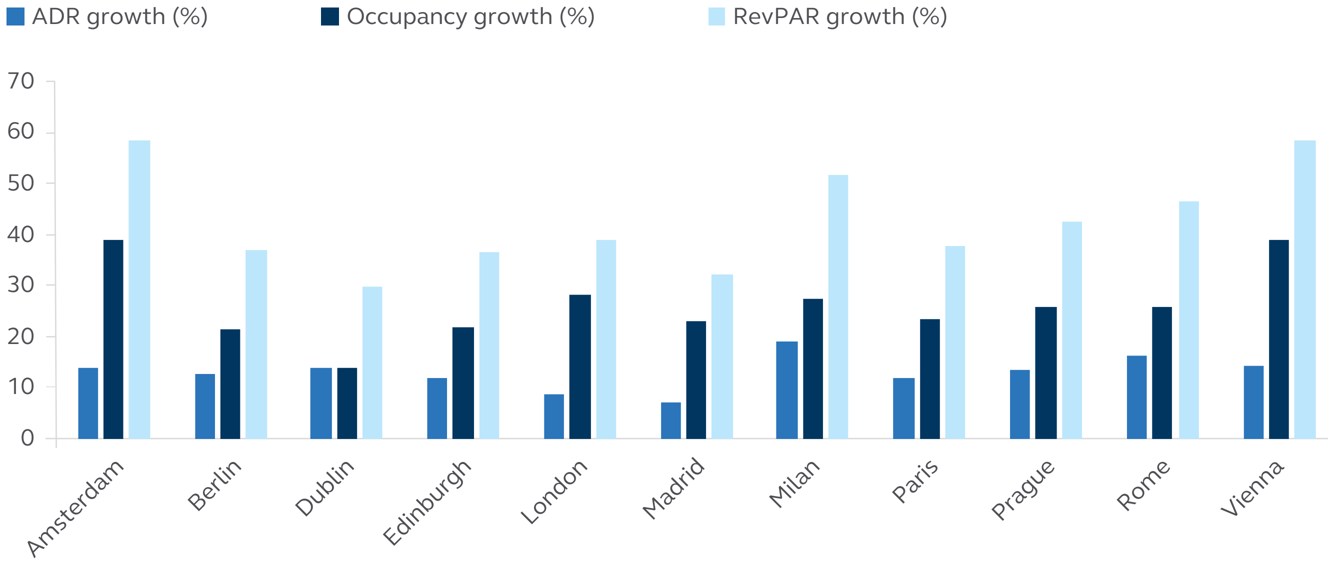
In addition, dual demand is a natural hedge against a downturn in one travel segment. Because business and leisure travelers typically travel at different times of the week and the year, dual demand is more consistent demand. And competition between segments allows for higher rates, which creates more upside potential for investors.

Strong hotel performance and attractive pricing

An attractive market is one where hotel performance has recovered well in terms of occupancy and room rates (see Exhibit 2) and, at the same time, pricing on hotel sales suggests plenty of discounted opportunities (see Exhibit 3).

EXHIBIT 2: In the most attractive markets, hotel performance has rebounded

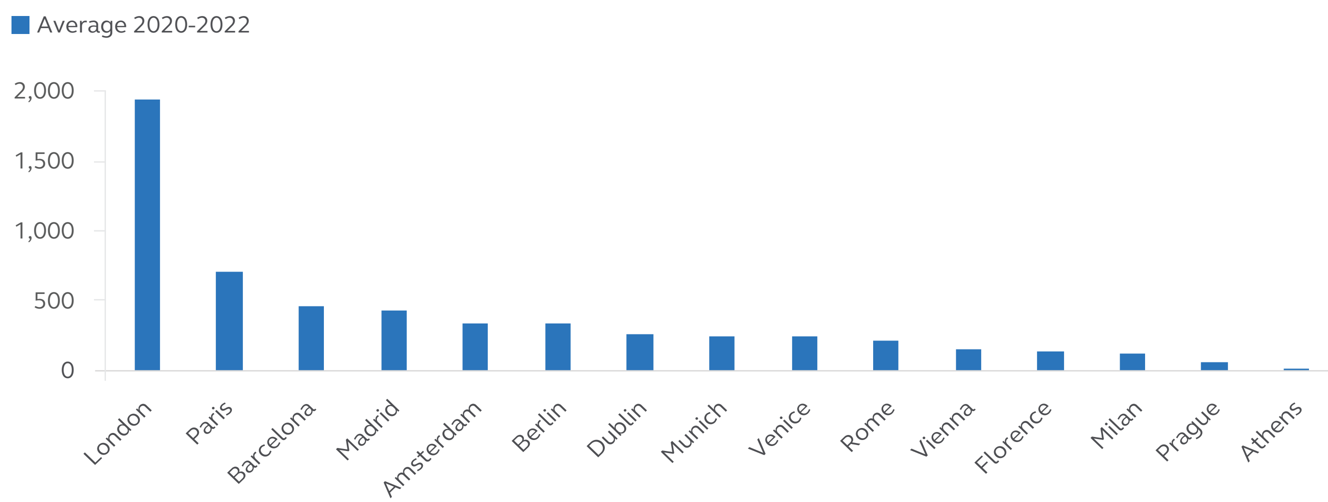
European hotels performance, 1H23 vs 1H20



Source: HotStats, June 2023

EXHIBIT 3: In the most attractive markets, hotel transactions are strong

Hotel transaction volume, EUR million



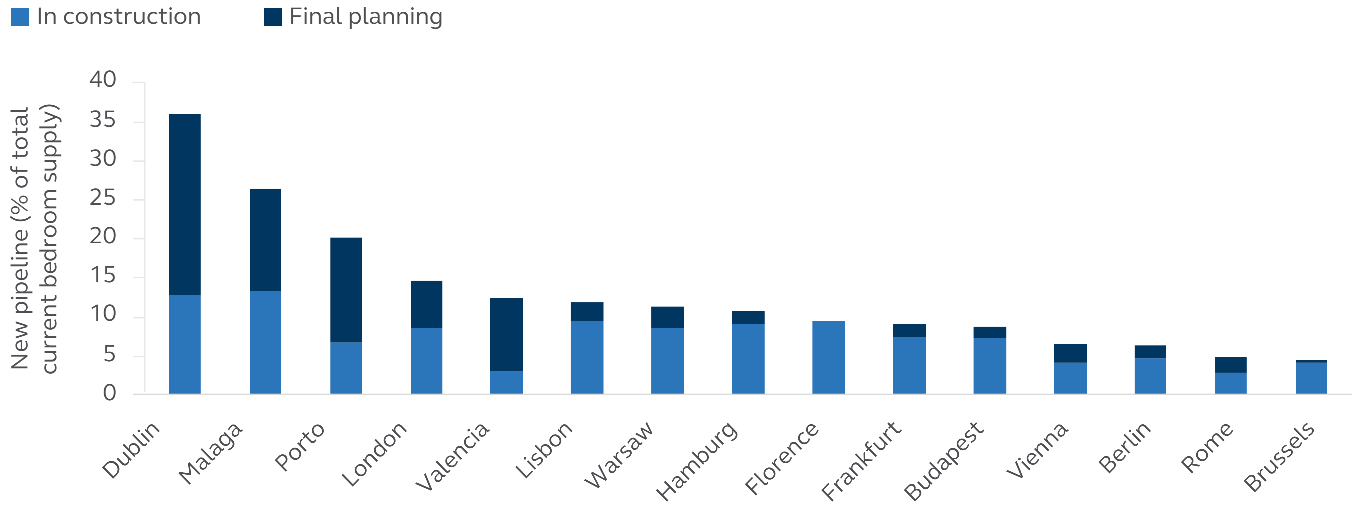
Source: RCA, June 2023

Limited new supply

Markets where new supply is limited are particularly attractive for a value creation investment strategy. Historical city centres, where demand is typically highest, have a natural cap on supply because there is only a finite number of buildings. Furthermore, in some cities, new supply is limited by regulation, such as historical building protection in Rome and moratoriums on new hotel licences in Barcelona and Amsterdam.

EXHIBIT4: New hotel room pipeline is very low in most European cities

New pipeline, % of total current bedroom supply



Source: STR, May 2023.

Micro location and property characteristics

An attractive property is one that is in a central location with curb appeal, maintained well enough that any short-to-medium term defensive capex requirements are limited, on a lot sized for efficient deployment of capital, which is underperforming relative to similar properties in the market.

Central location with curb appeal

In most markets, ideal micro locations are central—near cultural and historical attractions, sports and entertainment venues, food and drink, shopping, and nightlife. In addition, ideal locations have curb appeal—that is, they are enticing for travelers. A hotel located in the city centre near cultural attractions that is next to a petrol station, for example, likely won't have curb appeal. On the other hand, a beautiful property on a quiet tree-lined street that is a 15-minute car ride away from the city centre is also not likely to offer optimal value creation potential.

Identifying properties with the highest value creation potential requires much more than Google maps and street view. For properties that will be repositioned as lifestyle brands, in particular, up-and-coming sub-markets within a city likely offer the highest level of localised value growth as they become more popular. Hence the value of a local expert who can identify these rising hot spots to enable acquisition at a lower price and stronger market value appreciation.

A hotel acquisition undertaken in Cologne, Germany provides a good example. The location was strategically excellent—in the heart of the city centre, overlooking the famous cathedral—but the immediate area had become rundown. The property was on the doorstep of a noisy, messy civil works project that had been dragging on for years, though the result would be a beautifully manicured pedestrian square. The messiness of the civil works project and uncertainty about its timing drove a discount at acquisition. After five years the civil works project was completed, as was a renovation of the hotel, and revenues were forecast to rise 40-50%.

Well maintained building on well-sized lot

The condition of the building and size of the lot are key determinants of what work can be done to create value. Ideally the property has been maintained well enough that any short-to-medium term defensive capex requirements are limited. Lot size matters for efficient deployment of capital; it determines, for example, whether the number and/or size of rooms could be reconfigured, whether space is available to add a rooftop lounge or a pool, or whether street-facing space could be expanded or otherwise reconfigured.

A pair of hotels in Rome, Italy provide a good example. These are two independent hotels with 70 and 90 rooms, respectively, next door to each other in a prime location in the heart of the city. The buildings and lots are such that they can be combined into one, resulting in the size of property that would better appeal to the kinds of brands that could boost performance—and revenue.

An additional property in Rome provides a further example. Also ideally located in the city centre, this is a vacant 64-bed hotel with adjoining shell and core former office buildings. With the extra space of the adjoining buildings, the property could be redeveloped into a 160-bed luxury lifestyle hotel with bold and innovative design, rooftop pool and garden pool—the kind of property that could command higher room rates.

Underperformance relative to similar properties in the market

The final property characteristic driving value creation is underperformance—as measured by occupancy and room rate—relative to similar properties in the market. The end goal, after all, is to achieve high occupancy at increased room rates. (Bottom-line profitability depends more on rate than on occupancy.)

Performance metrics are relatively accessible in most markets, and it is often helpful to have relationships with local operators who understand the nuances of the particular market and can advise on the often off-market properties that are underperforming.

Conclusion: Finding value-creation opportunities

> Selecting markets, micro locations, and properties with these characteristics can uncover unique opportunities to create value through upgrading, repositioning, and improved operations.

As we've written before, we believe there is a solid case for investing in the European hotel sector. Over the last nine months we have seen an increase in strong investment opportunities and expect this to accelerate, with conditions prime over the next 12-36 months for acquiring well-located hotels at cyclically low values.

Once value creation opportunities—those undervalued or illiquid hotels with good micro locations within attractive markets—have been identified, the next step is adding value through extending, repositioning, refurbishment, rebranding, optimising technology and/or through working with carefully selected operating partners to maximise top and bottom-line hotel performance.

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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