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Principal Real Estate

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EUROPEAN HOTEL SECTOR:

Short-term distress and strong long-term fundamentals create value opportunity

AUTHORS

Graeme McCormack
Head of Fund Management – Hotel & Leisure Division

Hugo Steen
Head of Investments – Hotel & Leisure Division

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.

KEY TAKEAWAYS

- For a subset of the European hotel sector—in particular, independent owner-operators—weaknesses exacerbated by the COVID-19 travel shutdown are now being made worse by high inflation and rising interest rates, creating distress. There is a window of opportunity to acquire these hotels at discounted pricing.
- While many independent owner-operators are facing distress, the underlying long-term fundamentals for the European hotel sector are strong—robust demand, limited supply, attractive yield premiums, and high liquidity. Near-term headwind risk adds to the longer-term upside of a value-add investment strategy.
- Discounted pricing opportunities (driven by distressed ownership) and strong fundamentals create a value opportunity for investors in the European hotel sector. Targeting independent hotels that are well located but underperform and require investment offers significant scope to create value through upgrading, repositioning, and improved operations.

A subset of the market faces distress

The COVID-19 pandemic caused an unprecedented shock to the hospitality sector. Across the board, operators experienced the largest revenue drops on record. Many encountered a cashflow crisis. Those that survived did so 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); and landlords offered to defer rent payments amid fear of tenant's insolvency and empty premises.

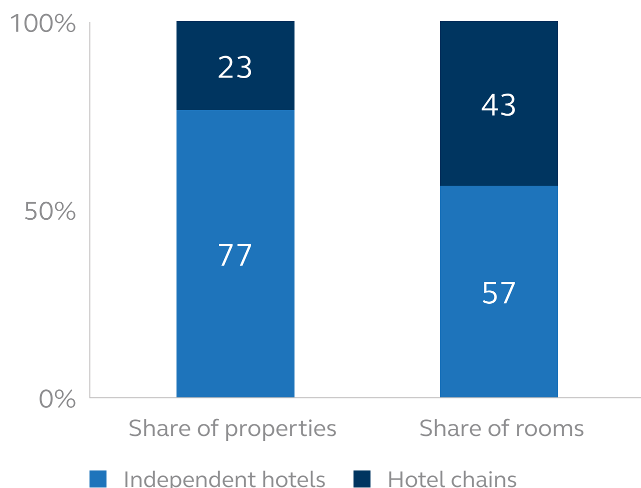
COVID cracks

Many hotel operators emerged from the crisis in relatively good health, ready to capitalise on a rebound in travel. Others – particularly those that went into the pandemic less equipped to absorb losses, such as independent owner-operators without deep pockets – emerged significantly weaker. For example, where larger ownership groups might have been able to change capital structures and draw on different types of equity, for many smaller independent owner-operators the only option for staying afloat during the pandemic was taking on more debt.

Independent owners represent a large majority of the European hotel sector, 77 percent of hotels and 57 percent of hotel rooms (see Exhibit 1).

EXHIBIT 1: Independent hotels make up the largest share of the European hotel market

European hotel market share breakdown (%)



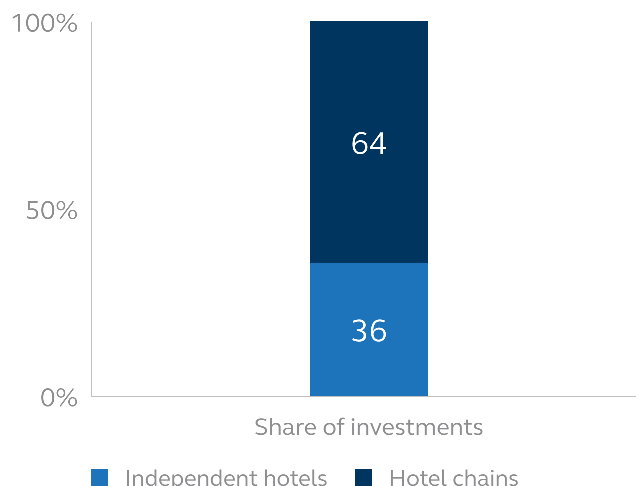
Source: STR, December 2022 and Statista, November 2022

In addition to weakness borne out of the pandemic, many independently owned properties – despite being well located – are operationally underperforming and have been historically underinvested. Many independent owner-operators do not have modern business models and have not had the capacity to invest in their premises, particularly in the light of the havoc wrought by the pandemic, which decimated revenue. In the post-pandemic recovery, a prolonged period of underinvestment has put smaller operators into a structural disadvantage against larger hotel chains with deeper pockets and modern management.

While independently owned and operated hotel rooms comprise 57 percent of the European market, they have received just 36 percent of the investment (see Exhibit 2). That underinvestment represents a structural disadvantage caused by lack of funding, scale, and marketing and distribution.

EXHIBIT 2: Independent hotels are historically underinvested

European hotel investment share breakdown (%)



Source: STR, December 2022 and Statista, November 2022

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Mounting pressure

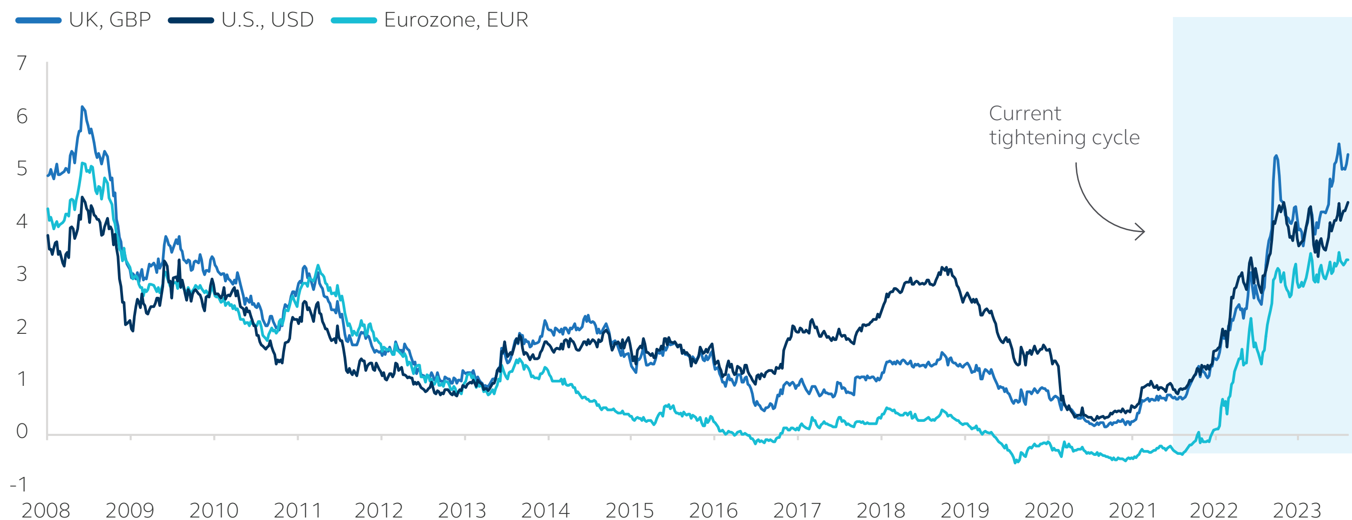
The combination of weakness borne out of the pandemic, operational underperformance, and chronic underinvestment has left many independent owner-operators particularly vulnerable. Those challenges are now exacerbated by high inflation and rising costs of debt – which put disproportionately greater pressure on the balance sheets of small-to-midsize owners, forcing a growing number to seek recapitalisation or asset sales.

Although tourism has rebounded, expenditure levels have increased sharply too. The current inflationary environment is in part a hangover from pandemic-era stimulus. It is also driven by the energy shock caused by Russia's invasion of Ukraine and by a tight labour market that has pushed up wages. Those inflationary pressures affect all hotel operators, of course, and operators should be able to reprice rooms to keep pace with inflation. But rising competition from large hotel chains drives up real cost pressure as operators aiming to protect their market share may have to renovate their facilities or implement other capital expenditure programmes.

Perhaps the most significant effect of rising inflation is that it has driven the European Central Bank (ECB) to significantly tighten monetary policy. Interest rates in the Eurozone and the UK have increased sharply since January 2022, one of the most aggressive rate-hike cycles in history (see Exhibit 3). Significantly higher cost of debt is an additional pressure that will likely push more hotel assets into the market.

EXHIBIT 3: In Europe, interest rates have increased sharply since January 2022

Five-year swap rates (%)



Source: Macrobond, Principal Real Estate, August 2023

For many of the smaller, less well-capitalised owner-operators, higher interest rates on loans taken out to survive the pandemic are increasingly untenable. While lenders were patient during the pandemic and its immediate aftermath, many are now putting pressure on their clients to find arrangements that will be more stable for the long-term. For borrowers that are not able to afford the cost of debt now based on their current leverage amounts, the answer may be selling some of the portfolio.

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Discounted pricing opportunities

Weakness borne out of the pandemic, operational underperformance, chronic underinvestment, and now inflationary pressure and rising interest rates have created distress for many independent owner-operators. That presents discounted pricing opportunities for investors, as many of these owners are looking to sell their hotels, often off market and at a discount for a quick and straightforward sale. Our view is that pressure on owners who have carried assets through the pandemic will result in more assets coming to market as owners seek to get their capital stack structures in better long-term shape and debt costs and profitability on a more sustainable footing.

Opportunities for acquisition at discounted pricing

Independent/hotel owner operators

- Suffering the most from the pandemic after funding operating losses for 2 years
- Many looking to exit the business and cash in on their real estate
- Prefer a quiet and easy exit route

Hotel operating groups

- Looking to offload owned hotels to fund losses
- Particularly those with a high number of lease commitments
- Historically these groups have done this during market downturns

Banks/lenders non-performing loans (NPLs)

- Shown high levels of patience due to large amounts of liquidity and strong balance sheets
- Higher interest rates are forcing them to enforce highly leveraged owners to put assets up for sale

Developers

- Removal of development finance and increasing construction costs have put some developers under cash flow pressures
- Underwriting assumptions as start of development no longer hold true, may be forced to sell below build cost

Private equity funds

- Upcoming refinancing at higher debt costs will force some funds to sell down assets
- Many funds entering sunset sell-down periods

Long-term fundamentals are strong

While many independent owner-operators are facing distress, the underlying long-term fundamentals for the European hotel sector are strong – robust demand, limited supply, attractive yield premiums, and high liquidity. Near-term headwind risk adds to the longer-term upside of a value-add investment strategy.

Demand for European hotel rooms is robust

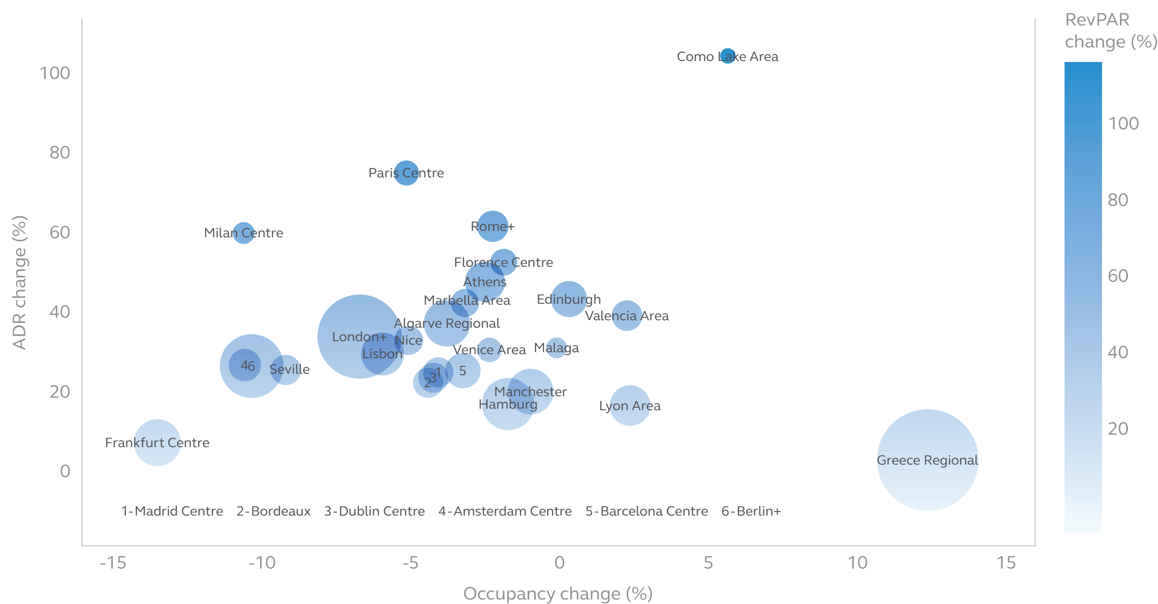
Coming out of COVID, many analysts predicted that it would take three to five years for the travel industry to recover to 2019 levels (a peak the market had been growing to). Actually, by most measures, in many markets travel recovered in less than a year. Drivers of robust demand for European hotels include:

- Consumers are prioritising travel. In part a reaction to pandemic isolation and in part a generational shift, consumers are now more eager to spend money on experiences – travel in particular – than consumables. Europe accounts for almost two-thirds of the world's tourist arrivals.
- While many real estate sectors have been undermined by the internet (i.e., remote work and online shopping), hotels provide a service that is difficult to replace online. You can 'travel' to Paris on your laptop, but you can't sip a café au lait under the Eiffel Tower.
- Western Europe represents a unique travel opportunity for both European and international visitors who can visit multiple countries in even one day.

Most of the European hotel markets have returned to pre-pandemic revenue levels, as measured by RevPAR (revenue per available room), the industry benchmark tracking top-line financial performance (see Exhibit 4). This recovery was a remarkable achievement, driven by an increase in the average daily room rates (ADR), which has even outpaced inflation (see Exhibit 5). In many markets, both RevPAR and ADR are significantly above 2019 levels; for some hotels, operations have become more profitable as a result.

EXHIBIT 4: In most European hotel markets revenue has surpassed pre-pandemic levels

Selected European markets* performance in 2022 over 2019



Source: STR, December 2022
*Bubble size indicates the number of rooms in 2022. + reflects cities where hotels have been handpicked as custom for those markets.

The strong recovery has continued into 2023. Many analysts had forecasted a slowdown this year, assuming inflation would reduce expenditures on non-essential items such as travel. Yet year-to-date travel has continued to be robust with ADR growing at its second-fastest level in almost a decade.

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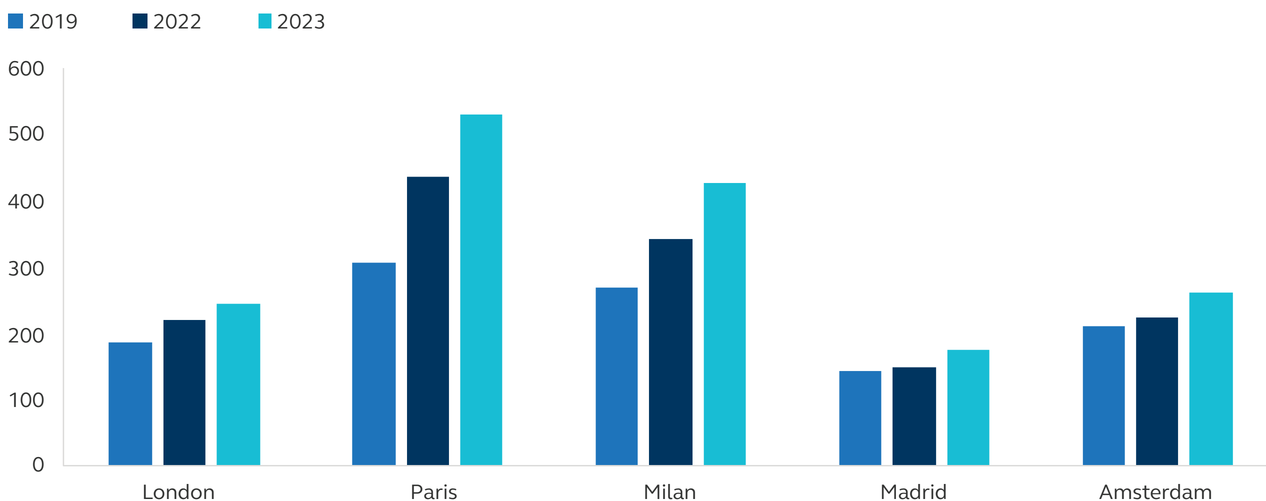
EXHIBIT 5: Hotel ADR continues to grow across top European city destinations
ADR, Euros

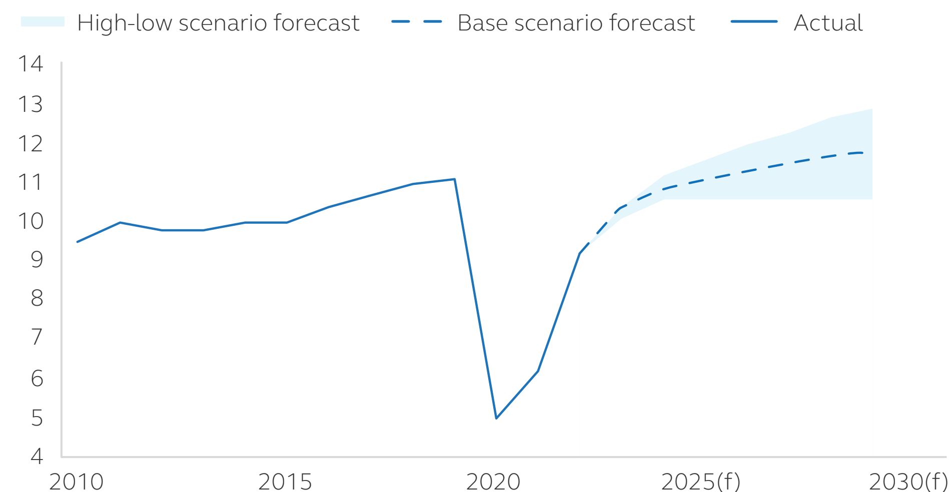


Source: STR, June 2023

While revenue had recovered by 2022, occupancy rates remained an area of opportunity. Travel from countries like China (which alone contributed to 25 million nights in European accommodations per annum on average) has only recently resumed (China, for example, fully re-opened its borders in January 2023). We expect occupancy rates at European hotels to rise over 2023 and 2024 as travel from here and other non-European countries stabilises.

Forecasters expect international travel into Europe and flights within Europe to surpass pre-pandemic levels by 2024 (see Exhibit 6). Occupancy rates will likely follow suit, further improving profitability. Overall, we believe the European hotel sector faces a strong period of demand growth.

EXHIBIT 6: Flights within Europe expected to surpass pre-pandemic high in 2024
Number of flights in Europe, annual, million



Source: Eurocontrol, March 2023

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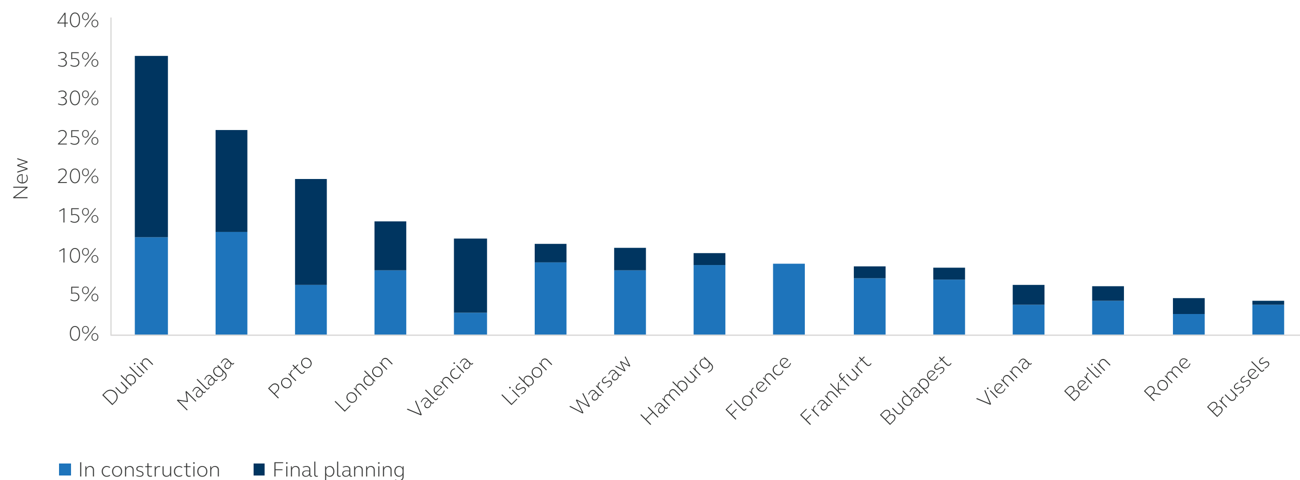
In most European cities, hotel room supply is limited

There are significant barriers to entry that keep hotel room supply limited in most European cities, particularly in old city centres where demand is highest. Several cities do not allow new hotel construction at all. Despite high demand, in many European cities pipeline for new hotel rooms is below 15 percent of current supply (see Exhibit 7).

EXHIBIT 7: New hotel room pipeline is very low in most European cities

New pipeline, % of total current bedroom supply



Source: STR, May 2023

Hotels currently offer an attractive yield premium

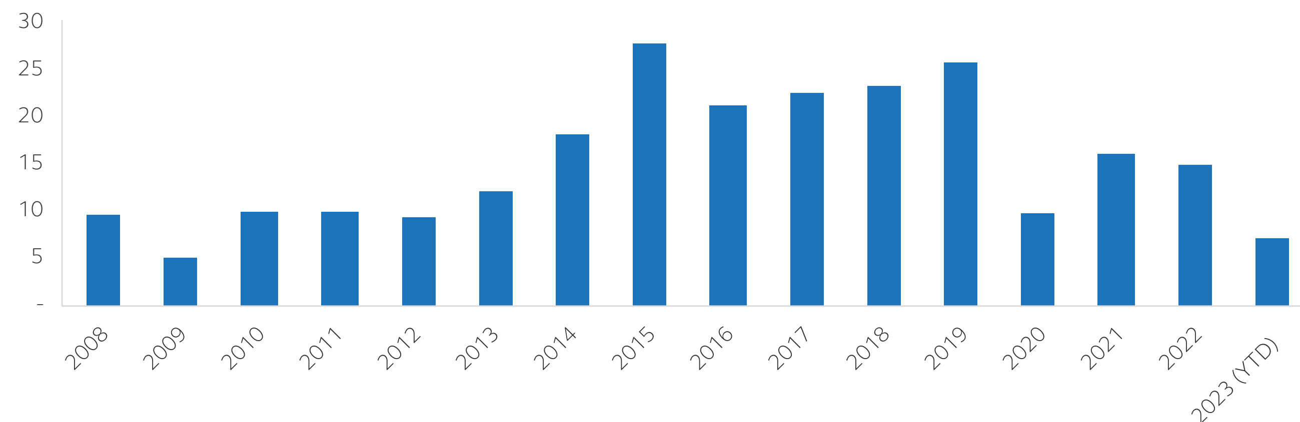
Cap rates for all types of hotel properties are historically 100 or even 200 basis points higher than for other types of real estate. The pandemic initially widened this yield premium although more recent uncertainty in the office and retail sectors has narrowed this slightly as yields in these sectors have risen. Today, leased hotels offer a yield premium above traditional real estate classes of 100-150 bps across major European markets. Managed hotel yields provide an additional 100 bps yield premium.

Hotel real estate has shown a high degree of liquidity

In the decade before the pandemic, European hotel transaction volume grew in a steady upward trajectory, highlighting the rising popularity of this asset class. Unsurprisingly, 2020 saw a sharp drop in volume as both buyers and sellers waited to see how the COVID-19 crisis unfolded. Country-by-country reports indicated a strong rebound in transaction volumes across the board through the end of year 2022. However, while commercial real estate capital flow declined significantly across all sectors in the first half of 2023 as compared to the same period in 2022, European hotel sector transaction volume remained broadly unchanged.[1]

EXHIBIT 8: European hotel transaction volume

Billion Euro



[1]Source: RCA, Principal Real Estate, August 2023

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Near-term headwind risk adds to the longer-term upside

Near-term economic headwinds are not likely to negatively affect a medium-term value-add investment strategy. More likely, they would increase the potential upside by further discounting acquisition prices. In the five-to-seven year time horizon of a value-add investment strategy, current headwinds such as inflation, rising interest rates, and energy insecurity are likely to have stabilised. Furthermore, the most significant source of resale value comes from repositioning the asset – value largely independent of near-term headwind risks, which can also be factored into the future business plan.

Conclusion: A window of opportunity for investors

Discounted pricing opportunities (driven by distressed ownership) and strong fundamentals create a value opportunity for investors in the European hotel sector. Targeting independent hotels that are well located but underperform and require investment offers significant scope to create value through upgrading, repositioning, and improved operations.

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 18-24 months for acquiring well-located hotels at cyclically low values. We see significant opportunity to target areas of distress to acquire undervalued or illiquid hotels with good micro locations within attractive markets. We believe value can then be added through extending, repositioning, refurbishment, rebranding, optimising technology and through working with carefully selected operating partners to maximise top and bottom-line hotel performance.

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