UK hotel investment defies expectations, recording £6.0 billion of investment in 2019

Knight Frank

UK Hotel Capital Markets

Investment Review 2020

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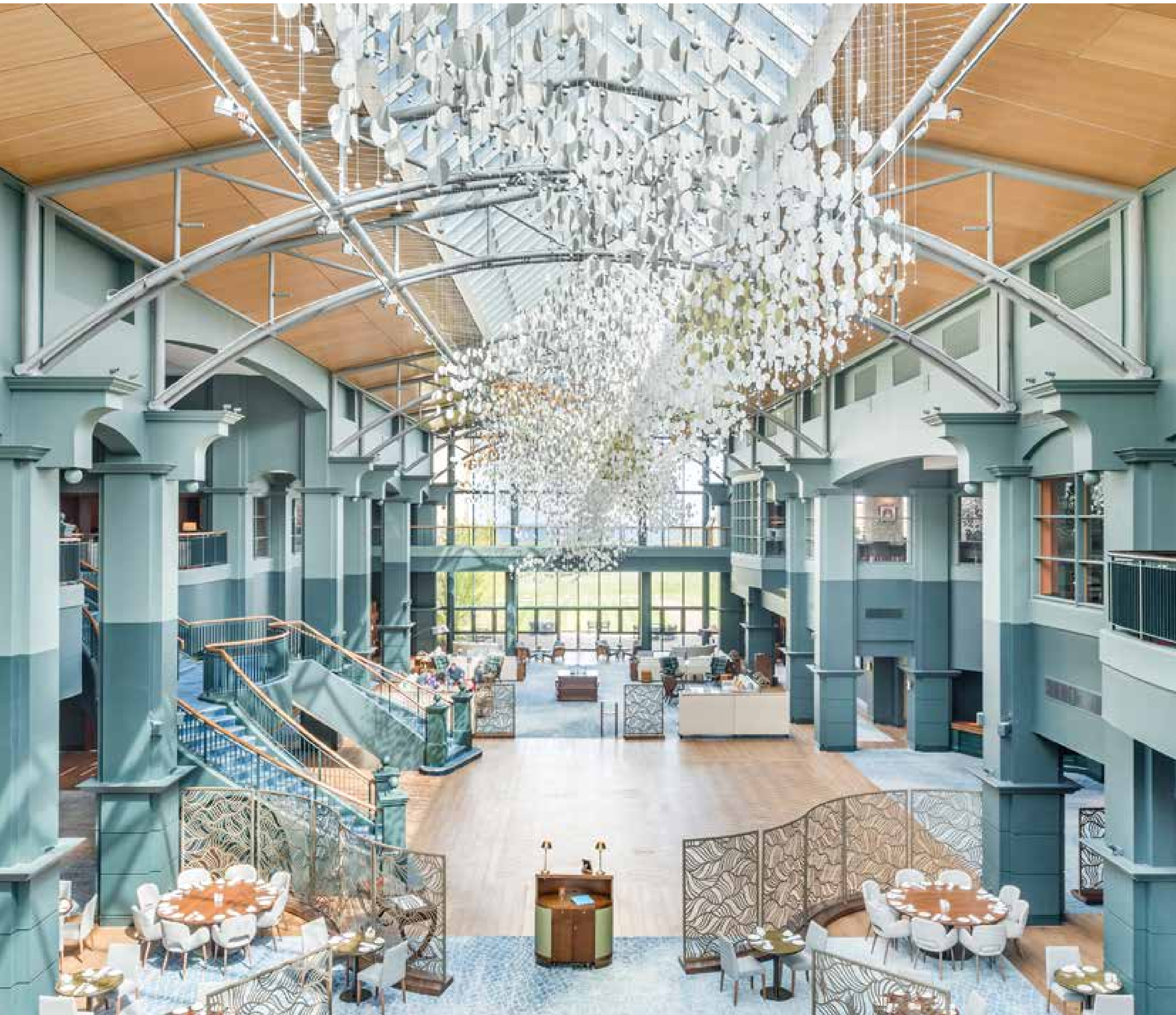


TRANSACTION OVERVIEW

Despite investment activity dampened by Brexit related uncertainty and a turbulent political landscape, full year 2019 UK hotel investment defies expectations, recording £6.0 billion of investment.

PHILIPPA GOLDSTEIN
HOTEL ANALYST

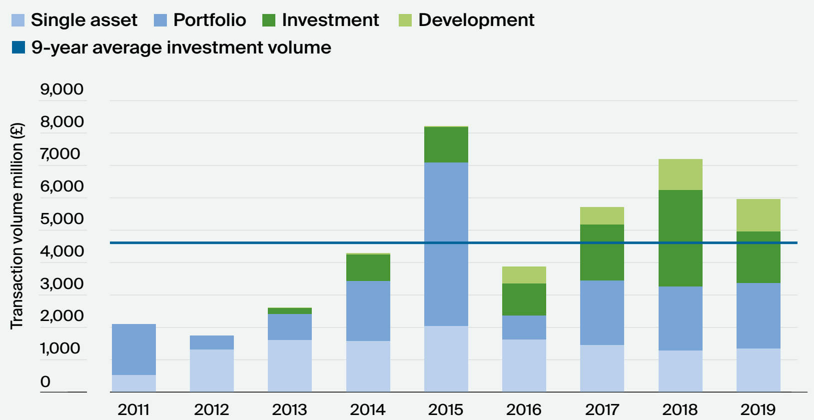
This impressive level of investment activity was achieved as a result of continued strong demand from investors seeking long term, secure income streams; institutional investors seeking a diversified portfolio with alternative property types favoured ahead of other mainstream property; and changing long-term positive drivers, such as growing demand to spend on experiential travel and location based experiences, shaping the future of the sector.

Following an exceptional level of portfolio activity in 2018, year-on-year hotel transaction volume slowed by £1.2 billion for the full year 2019, equivalent of a 17% decline, but witnessed a decline of only 3% compared to the 5-year mean average of £6.2 billion.

The weight of capital invested into alternative property types during 2019 was significant, with the level of investment rising by 4.8% compared to the previous year to approximately £17.8 billion, comparable to the level of investment in offices, but by contrast all other mainstream property types witnessed steep declines in investment. Robust levels of hotel investment by institutional investors, rising by 26% in 2019, reinforces the amount of capital being allocated to alternative income assets in pursuit of greater portfolio diversification as well as targeting assets and sectors with the greatest scope for income growth.

In 2019, a scarcity of assets for sale in the hotel sector resulted in a declining market share of the hotel asset class in the UK Specialist Property Sector, contributing 28% of the total investment volume, with rising investment levels from student accommodation and the healthcare sector. Confidence in the hotel sector remains strong, driven by a resilient trading performance and greater understanding of the fundamentals of the UK hotel sector. A shortage of opportunity to purchase, combined with a wider pool of investors has led to certain buyers either compromising on the type of opportunity purchased or agreeing to pay higher multiples of EBITDA. Stripping out the effect of the £1 billion sale of the Grange portfolio and excluding all development and ground lease transactions, the average transaction price per room sold throughout the UK remained on par with 2018 prices, with just over 1% growth at £168,000 per room.

Fig 1: UK total hotel investment volumes 2011-2019



Source: Knight Frank Research

This scarcity of supply for sale, and indeed lack of investment grade hotel product, has continued to fuel strong interest in hotel development, with over £1 billion of funds invested in sites deemed suitable for hotel development or forward funding of future hotel projects. Some 28,000 new hotel rooms are currently under construction in the UK and due to open during 2020, equating to a 4.2% increase in supply and with a further 15,000 new rooms under construction and set to open by 2022.

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The average transaction price per room sold throughout the UK remained on par with 2018 prices at £168,000 per room.*

(*excludes the Grange portfolio, developments and ground lease transactions)

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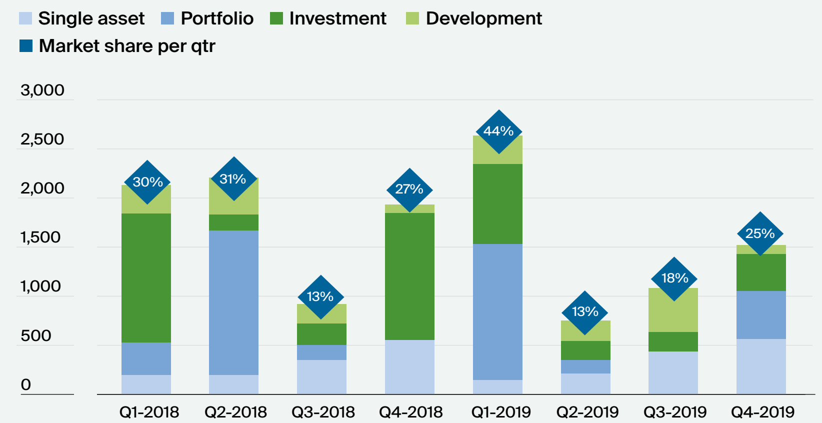
Hotel investment topped and tailed the year. The first quarter of 2019 saw the greatest share of deal volume, with £2.6 billion of deals completing during the first three months, equivalent of 44% of the total transaction volume. This was driven by a significant volume of portfolio activity, totalling over £1.6 billion and which accounted for 62% of the annual £2.6 billion of investment in portfolio transactions. Nevertheless, the £1 billion portfolio sale of four Grange hotels located in London, masked the wider national trend of a slowdown in hotel investment. A lack of clarity over the UK's position outside of the EU, combined with a turbulent political climate, led to minimal investment during Q2 and Q3, as investors deferred their investment decisions and owners, continuing to enjoy a robust trading environment, postponed decisions about bringing assets to market.

During the final quarter of 2019, hotel investment once again turned up a gear, with approximately £1.5 billion of deals completing, equivalent of 25% of the total transaction volume. Single asset deals completing during Q4 totalled over £560 million, representing 42% of the total annual single asset transaction volume. Meanwhile portfolio investment in Q4 totalled over £510 million, representing 21% of the total annual portfolio investment activity.

The Hare & Hounds Hotel, Tetbury. Knight Frank advised on the sale of Cotswold Inns & Hotels, sold to Fullers Plc for £40 million.

Fig 2: UK hotel investment volume per quarter 2018-2019



Source: Knight Frank Research

UK HOTEL CAPITAL MARKETS 2020

HOTEL INVESTMENT TRENDS

"Thou Shalt Not Sell" sentiment stunts investment levels in 2019

Whilst a broad range of buyer profiles has cushioned the impact of slowing investment activity, the political uncertainty engulfing the British economy during 2019, resulted in some investment decisions being put on hold.

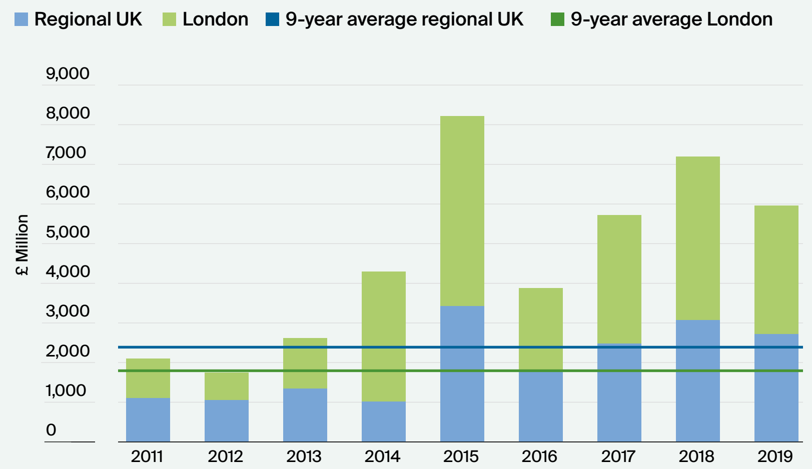
Continued low interest rates and extended hold periods are some of the factors influencing an existing owner's decision to review their investment portfolio and to consider options other than a sale. Indeed, persistently low interest rates have instead navigated owners to unlock attractive financing terms as a late cycle strategy. Furthermore, strong competition in the debt market has further widened the choice for borrowers, thereby facilitating the route to refinance.

Exit strategies are also being reviewed and hold periods extended due to the challenges of redeploying capital once a property has been sold. With strong and growing demand for investing in specialist property, retaining the allocation in hotel real estate can be difficult due to the strong competition from a widening pool of buyers. During 2019, holding the asset for longer has been the route of choice, however, where a sale has been actioned, the underlying reason has been the need for liquidity, often disposing of non-core assets in order to raise capital to fund development projects or finance refurbishment programmes.

In 2019, significantly increased activity was recorded involving Commercial Mortgage Backed Securities (CMBS), effectively non-recourse loans which enable increased liquidity. In late Q4, Goldman Sachs launched a £300m CMBS, collateralised by a senior loan extended to Thailand's DTGO Corporation for its acquisition of the UK Marathon portfolio; meanwhile, Morgan Stanley launched the £350 million CMBS for London & Regional's UK hotel portfolio. Both of these structures are leveraged at around 60% - 65% LTV. A key advantage of these interest-only loans is that they offer lower debt service payments, freeing up cash flow and providing the borrower with liquidity to refinance existing debt and finance for planned investment projects. However, they are not without their risks, because a CMBS loan not only requires the debt to be serviced on time, but borrowers are burdened with rigid cash management demands, such as quarterly DSCR (debt-service coverage ratio) tests. A dent in revenue could potentially throw the borrower into default.

Nevertheless, these CMBS structures show that there is sufficient demand for investment in open-ended real-estate debt by investors seeking to increase their portfolio allocation of illiquid secured debt.

Fig 3: UK hotel transactional activity London v regional UK 2011-2019



Source: Knight Frank Research

London – subdued investment volume, declining by 11% year-on-year

Despite the significant quantum of new hotels opening, London's resilient and robust trading performance, standing as one of Europe's top performing hotel markets ensures that the city remains attractive to hotel investors.

Whilst scarcity of assets for sale and continued yield compression prevents certain buyers from accessing the market, London has witnessed a healthy investment market, boosted by the portfolio sale of four Grange hotels and certain other London assets transacting as part of a wider portfolio sale. Increasingly, single asset hotel transactions in London have sold off-market, as hotel owners reap the rewards of a relatively strong trading environment, choosing to sell only if the proposition of a sale meets or exceeds their price expectation.

In 2019, London recorded a total of £2.7 billion investment for all types of hotel transactions. This represented a decline of 11% in transaction volume, when compared to 2018, but a rise of 10% compared to the investment volume recorded in 2017. Excluding developments, London witnessed some 31 deals completing, recording a fall of 17% in terms of transaction volume, whilst the number of hotels transacting declined by 30% and hotel bedrooms exchanging hands fell by 35%. Despite the fall in investment, London's share of total UK hotel investment volume increased to 43%, with the transaction price per room increasing by 41% to approximately £457,000 (excluding development and ground leases) – facilitated by the fact that 74% of London's transaction volume involved a five-star asset. The sale of the four Grange hotels, which accounted for 47% of London's total investment volume, contributed significantly to this rise in the average transaction price per room, achieving a selling price of £765,000 per room.

In 2019, London hotels continued to enjoy a solid year of RevPAR growth, buoyed by continued strong inbound visitor arrivals. However, with rising operational costs and only marginal growth in GOPPAR, this has provided the impetus for owners to consider a potential sale.

In total, 18 single asset hotels transacted as a going concern in London in 2019, recording 17% of London's total investment volume, with an average transaction price of £402,000 per room. Whilst this represents a 10% decline in the average transaction price per room, it is important to note that there were no big ticket sales. By contrast, in

Knight Frank advised Kennedy Wilson on the sale of the Fairmont St Andrews. Acquired by the Hong Kong investor Great Century Hotels, off a guide price of £55 million.

2018, The Beaumont hotel transacted at approximately £2 million per room. A further 13 hotels transacted in 2019, as going concerns, as part of various portfolio deals, accounting for 41% of London's total transaction volume (versus 21% market share in 2018).

On the decline in London during 2019, was the volume of investment deals, which recorded a 62% fall in investment with both the number of deals and volume of fixed and variable leased assets declining. A lack of quality core investment grade stock becoming available, is the over-riding reason for a decline in fixed lease asset transactions. Furthermore, the ongoing Brexit induced uncertainty, with the threat of a no-deal Brexit, led to a significant number of investors, in particular European and North American investors, to defer their investment plans in London and the UK.

Regional UK – Declining portfolio activity tempers investment levels

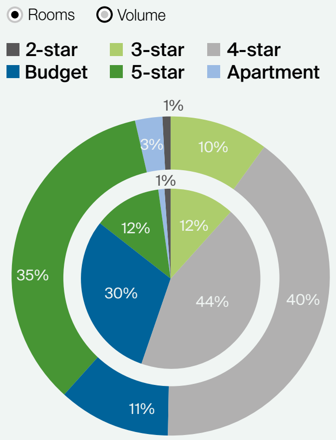
The total volume of hotel transactions in regional UK equated to £3.2 billion, a decline of some 20% compared to 2018, but equalling the level of investment recorded in 2017.

A sharp decline in portfolio transactions (both transactions sold as a going concern and as an investment sale) was the underlying catalyst for the significant fall in regional UK investment in 2019. Portfolio transactions represented 35% of total regional investment, (compared to 53% in 2018), with the transaction volume declining by 47% to £1.1 billion, compared to the previous year. However, the average transaction price per room increased by 16% to £147,000, due to fewer limited service portfolios transacting.

The number of single asset investments in regional UK also fared less well in 2019, recording 77 hotel deals, representing a 24% decline in the number of hotels changing hands compared to 2018. However, a varied and deepening pool of investors and diverse sources of capital seeking to invest in quality provincial stock, have contributed to a surge in the average transaction price per room. As such, in 2019, the transaction price per room for single asset hotels transacting in regional UK increased by 40% to £168,000, with total investment volume of around £875 million, 5% ahead of the transaction volume recorded for single assets in 2018.

The Close Hotel, Tetbury (part of the Cotswold Inns & Hotels portfolio which sold for £40 million, with the seller represented by Knight Frank.)

Fig 4: UK hotel investment 2019 by grade volume v rooms



Source: Knight Frank Research

Across all regional UK hotels (excluding developments and ground lease transactions), the average transaction price increased by 20%, to approximately £146,000 per room.

A more detailed review of the types of hotels transacting by star-rating, shows a correlation between development trends and investment activity. Given the long-term shift, where there is increasing consumer demand for experiences and focus on lifestyle hotels, this offers a compelling opportunity for investors.

An analysis of regional investment during 2019, revealed the 4-star sector increasing its market share, capturing 62% of all regional UK transactions (excluding developments), of which 66% of the investment in the 4-star sector was acquired by an overseas buyer. Meanwhile, as budget operators extend their regional presence in smaller towns and cities, and further reinforce brand presence through multiple hotels in larger cities, the branded budget sector, which offers investors long-term, secure income and strong covenants, has generated a further 19% of regional hotel transactions, with 81% of the investment backed by a UK investor.

OVERSEAS INVESTMENT

Brexit uncertainty limits overseas investment activity

In 2019, overseas buyers invested over £2.0 billion into the UK hotel market, more than halving their investment compared to the previous year, with 73% of overseas investment targeted at regional UK and 27% towards London. Overseas investors accounted for just 35% of total investment activity in the UK in 2019, compared to 68% in 2018, with investment severely restricted by a lack of suitable opportunities and the uncertainty brought about by Brexit. Overseas investment accounted for 46% of total regional UK transaction volume, attracted by greater yield potential than compared to London, where the share of overseas investment fell to just 20%. By contrast, in 2018, overseas investment accounted for 81% of the transaction volume in London and 58% in regional UK.

In 2018, inbound investment from Europe increased phenomenally, exceeding £2 billion and accounted for 27% of the total overseas volume, due to the significant portfolio acquisitions from Covivio and LRC Europe. By contrast, in 2019 European investment fell to approximately £665 million, equivalent of an 11% share of total overseas investment.

Investment from East Asia was the only region from which UK inbound investment achieved respectable growth, with £600 million of investment, doubling its investment compared to 2018 and contributing 10% of the total transaction volume from overseas investors. This growth, however, was largely due to the investment by Thai conglomerate DTGO, with the acquisition of the Marathon hotel portfolio. At a transaction price of £450 million, the current strength of the Thai baht against the pound, combined with the potential for achieving a greater return on equity in the UK than compared to other Asian markets, were significant considerations for securing this deal, which equated to 75% of the total investment volume from East Asia.

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Overseas investment halved in 2019 accounting for just 35% of total UK investment, due to Brexit uncertainty and a lack of quality product, which offered investors an acceptable level of return.

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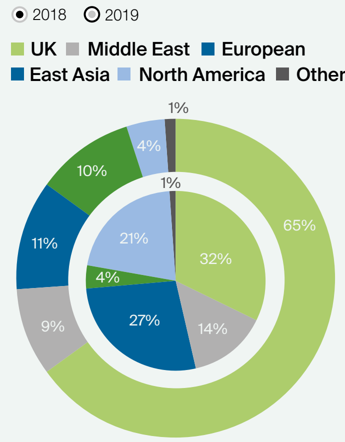
A second significant acquisition made by an Asian investor involved the purchase of the Fairmont Hotel in St Andrews to the Hong-Kong based purchaser Great Century Hotels. Knight Frank represented the seller Kennedy Wilson, with the asset transacting off a guide price of £55 million. This activity outside of London supports the trend of strong demand for quality provincial hotel opportunities from a diverse group of buyers, despite investment levels in 2019 being subdued.

Total investment from Israel accounted for an 8% share of overseas investment into the UK hotel market, this activity was dominated by acquisitions made by a single investor, the HNW family office of the Dayan family. Investors from UAE and Egypt accounted for the only other activity from the Middle East, but accounted for less than 1% of overseas activity.

Inbound capital from North America declined steeply, representing just 4% of overseas investment, compared to £1.5 billion of investment the previous year when Brookfield acquired the SACO portfolio for £457 million. Over half of the investment from North America came from one buyer, AJ Capital Partners, who completed on three single asset transactions in the cities of Oxford, Cambridge and St Andrews. The purchase of the 70-room Macdonald Rusacks Hotel in St Andrews as a development opportunity is an example of the value-added opportunity that certain overseas investors seek as a compelling reason for their investment in the UK.

Fig 5: Buyer origin
2019 v 2018



Source: Knight Frank Research

ADVENTUROUS JOURNEYS, AJ CAPITAL PARTNERS

Phillip Allen, Chief Development Officer

What makes the hotel sector attractive and what percentage of your investments comprise hotels?

Hospitality investment is our "raison d'etre" and virtually all of our investments are in this sector. We are passionate about hotels because they are fun, fascinating businesses that allow for a degree of creativity that is hard to find in other asset classes. We are a vertically integrated hotel owner, operator and real estate developer, operating in dynamic markets and delivering distinctive projects. We own and operate the Graduate Hotels brand, which our Founder and CEO, Ben Weprin, created and launched in 2014. Our domestic portfolio comprises a collection of twenty-two Graduate boutique hotels and five independent, boutique hotels. We have an additional eleven hotels under development.

Specifically – Why invest in the UK today, what makes it an attractive proposition?

As Americans, we are fascinated by the history and character of so many British towns and universities. The first American university was founded in 1636 – Oxford has that beat by five centuries! The Graduate collection celebrates the alumni, traditions and distinctive character of each university community where we have a hotel, and the universities in the UK provide so much to work with in that regard. We like to say that we tell stories through design, and there are plenty of stories to be told when you are dealing with universities that are several centuries old. Our strategy in the US is to offer the best, most distinctive hotel in university-anchored communities. We believe that model will also work in the UK. Of course, there are no language barriers and the UK higher education system is advanced and mature, and relatively similar to the American system.

The UK offers significant opportunities and growth potential to develop the Graduate brand on an international scale. We are excited to launch Graduate in the UK, with the opening of our new Cambridge and Oxford properties in the spring of 2021. The St. Andrews Rusacks Hotel is located in one of the most iconic golfing destinations in the world, and it will remain an independently branded boutique hotel, but will also go through a complete renovation.

What is driving future acquisitions?

We typically seek to acquire under-utilized real estate in irreplaceable locations. We work tirelessly to create timeless and authentic spaces that connect meaningfully with the local community, as well as to both domestic and international visitors. We are a private equity funded company, and of course our investors have certain return expectations. But we are not short-term investors. Our aim is to reimagine and redevelop assets that may not be living up to their potential. We want to bring them back to life and to hold them for the medium to long-term. Whether a property is part of the Graduate collection or not, it will benefit from our incredibly talented creative team, which provides bespoke design of every element of each hotel.

What are the key characteristics you look for in a hotel acquisition?

Location is critical. For the Graduate collection, we need to be near a significant university. We love historic university towns and cities that benefit from attractive supply and demand characteristics, in high-growth and high-culture communities. Through our in-depth market knowledge and expertise, our intensive capital investment and our bespoke design, we aim to make the ordinary, extraordinary, creating something unique and special. Our aim is to unlock the unrealized potential in each asset, through thoughtful restoration and bringing to life the charm, architecture, surrounding setting and history of each property.

What are your thoughts concerning Brexit?

I can't add anything to the Brexit discussion that hasn't already been said, and, as an American, I don't think I should try. I will only say that we are sanguine about the long-term future of travel and tourism in the UK. The things that make this country great for those of us in the hospitality business – the history, traditions, culture, architecture, and natural beauty – are not going to change because of Brexit. We're committed to growing our business in the UK and we think the future is brighter than ever here.

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The UK offers significant opportunity and growth potential to extend our successful model and build a platform from which to launch and develop the Graduate brand in the UK.

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What markets are you currently focused on in the UK?

Like everyone else, we would love to be in London, but the competition is keen there, and we're going to be patient to find the perfect opportunity. We are interested in most of the other major UK markets, including Leeds, Manchester, Liverpool, Edinburgh, and Glasgow, but we are also looking at some smaller university-anchored towns such as Durham, Exeter, and York. We're hopeful that we will find a few projects where we can partner directly with the universities, as we have done successfully in the US.

UK HOTEL CAPITAL MARKETS 2020

LAKE MERRITT UK INVESTMENTS

Prab Thakral, Advisor to Lake Merritt

What makes the hotel sector attractive and what percentage of your investments comprise hotels?

Lake Merritt UK Investments have a £25 million (equity) closed-end hotel property fund, with capital raised primarily from HNW Asian investors. The fund is entirely focused on investing in freehold and long-term leasehold UK hospitality assets. We currently have three hotels in the fund and we are actively undertaking due diligence on two more potential acquisitions. The fund has additional capacity, with potential for a further three hotels. Lake Merritt is now raising its second closed-end hotel property fund, aiming for a first close of £50 million equity, with a target AUM (assets under management) of £100 million, providing capital for a further 10 to 15 hotel acquisitions.

Specifically – Why invest in the UK today, what makes it an attractive proposition?

The UK is generally considered to be stable, in the medium to long-term. By investing in the UK we achieve enhanced geographical diversification and improved cash-on-cash return on equity, compared to key Asian markets. We are seeking to capitalise on the opportunities presented by the prolonged uncertainty surrounding Brexit, which is negatively affecting the appetite for traditional private equity, therefore creating a scenario of less aggressive pricing and where sterling continues to be weak against the Thai Baht and the US Dollar. Our focus is on regional UK, which we consider offers the most attractive yields.

How has your investment criteria changed over time and what is driving future acquisitions?

Our investment criteria has remained the same since inception of the fund which we launched over 2 years ago. We seek to invest in secondary cities or the outskirts of primary cities which benefit from strong connectivity and demand drivers and accessibility to international visitors. We typically seek smaller lot sizes compared to other investors. Of particular interest are assets in distress, under invested or a change in circumstances, where we consider there is strong potential for asset management and revenue management opportunities. We firmly believe that this strategy will ultimately provide us with the greatest return on investment. Any investment must exceed a certain yield threshold and targeted returns for investors need to be in the mid-teen range.

What are your expectations in terms of hold period?

We plan to keep hold of all assets in the fund for a minimum period of five years. We have no plans for an early exit. Our current focus is on acquiring assets to ensure the fund is fully invested. As we move closer toward the fund's maturity, the focus will then increasingly shift towards maximizing valuation on exit.

What are your target returns for investors, are your investments largely income driven or geared towards growth in the capital value?

We are primarily income driven, which is achieved through exploiting revenue management and asset management opportunities. We forge strong relationships with 3rd party asset managers locally, but we are also focused on building a specialist platform and team, having our own expertise on the ground. We operate independently branded properties, which we consider provides the best efficiency for the markets in which we operate, without overloading the business in costs. In essence we adopt a value-added approach.

In terms of strategy, what segment of the hotel market are you targeting?

Our investments focus on three-star or four-star products, often select service. Currently we focus on investments geared towards the mid-market, but following an acquisition, through our revenue management skills, we may seek to reposition the hotel to achieve our goal of income growth.

What limitations are there which could potentially prevent you from achieving your investment criteria?

The significant strengthening of sterling and continued yield compression are two factors which we need to keep on our radar, as both have the potential to undermine the returns that we require. Our main focus is on the UK, in particular secondary cities, which present an opportunity to achieve higher cap rates than compared to key Asian cities. There is always the potential, however, to look beyond the UK for our future funds.

How do you typically finance your acquisitions and how accessible do you find the debt markets?

We fund all our acquisitions with debt and equity. We secure debt finance on competitive terms from UK traditional banks, with whom we have developed good relationships.

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We operate independently branded properties, which we consider provides the best efficiency for the markets in which we operate, without overloading the business in costs. In essence we adopt a value-added approach.

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The 78-room Hydro Hotel, Windermere, acquired by Lake Merritt Investments in April 2019.

INVESTMENT STRUCTURE KEY TRENDS

UK institutional investors ranked as top UK buyer

Total institutional investment into the UK hotel market, focusing on long-term fixed income, totalled £2.5 billion in 2019, with roughly a 40% to 60% split between London and regional UK. Investment from UK institutional investors totalled over £2 billion, more than doubling their investment compared to 2018. Institutional investment accounted for 35% of total UK hotel investment and secured the highest net capital inflows of all investor types, with £1.8 billion of institutional funds staying within the sector. Overseas institutional investors, were the fifth most active investor type with approximately £380 million of investment, contributing 15% of total institutional funds and represented 6% of total UK hotel investment.

The recent political turmoil and heightened concerns caused by Brexit have undoubtedly been carefully considered by institutional investors, along with specific macro-themes, particularly the low interest rate environment. Given that institutional investors operate in a highly regulated environment and the principles of alignment and transparency are fundamental to the core of their business, the level of investment recorded during 2019 and consequently their increased exposure into UK hotel real estate, confirms that they are cognisant of the risks and opportunities involved.

As such, hotels as an asset class that are on fixed lease interests continue to be considered as one of most attractive sectors within real estate, offering great scope for a secure and sustainable income stream. Moreover, with government bonds expected to remain at current low levels for some time to come, investment in hotels offers an attractive illiquidity premium and, alongside proactive asset management and selective development risk, provides significant scope for income growth.

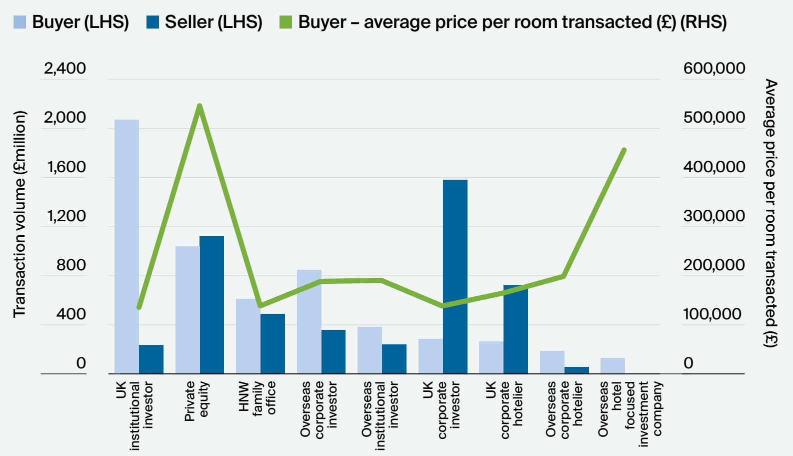
Private Equity – One key deal drives investment volume

The acquisition by Queensgate Investments of the four London Grange hotels for approximately £1 billion drove investment volumes up by 80%, accounting for a 17% share of total UK transaction volume, with 96% of private equity investment concentrated in London.

Meanwhile, private equity investors continue to check out of the UK hotel sector, with over £1.1 billion of divestment, accounting for 19% of the total UK transaction volume. The majority of disposals by private equity investors focused on Regional UK, which accounted for 77% of the transaction volume, with private equity sellers representing 26% of total regional UK divestment. The combined activity of Marathon Asset Management, Queensgate Investments and Starwood Capital accounted for 85% of the total divestments made by private equity investors.

In addition to private equity investors, two other investor groups were responsible for over £1 billion each of asset disposals. The UK Corporate Investor was the largest group, offloading over £1.6 billion of assets, representing some 27% of total divestment, followed by the UK Private Hotelier investor group which represented a further 19% of disposals.

Fig 6: Total UK hotel investment volume 2019 – by investor profile
(Buyers v sellers)



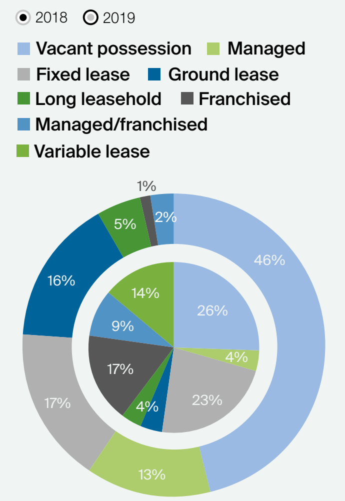
Source: Knight Frank Research

Vacant possession transactions on the rise

Hotels that sold with vacant possession represented the largest group of hotels in the UK changing hands in 2019, in both London and regional UK, with a total value of £2.3 billion. This represented a 44% increase in investment volume compared to the previous year and a surge in its market share rising to 46% of total transaction activity in 2019, compared to 26% in 2018.

London transactions represented over 62% of the total assets sold with the benefit of vacant possession, some £1.4 billion, and equivalent to 67% of the total London transaction volume. By contrast, vacant possession transactions represented only 31% of the volume of transactions in regional UK, due to a more balanced spread of investment activity from other structures, including assets sold subject to a management agreement and ground leases, both advancing in 2019.

Fig 7: Investment structure – total UK 2019 v 2018



Source: Knight Frank Research

Fixed lease investment dampens

During 2019, the fixed lease sector witnessed over £820 million of investment, equating to 16% of the total UK transaction volume and was ranked as the second largest investment structure. Fixed lease investment activity fell by 43% in the UK during 2019, due to a lack of sizeable portfolio transactions, with the shortfall of £600 million split roughly 50:50 between London and Regional UK.

In regional UK, fixed lease activity was ranked as the second largest investment structure, representing 22% of the total regional UK transaction volume, with over £600 million of investment and accounted for 75% of total UK hotel fixed lease investment. In London, by contrast fixed lease investment represented a 9.5% share of the capital's total transaction volume.

Despite continued strong demand for long-term, secure income streams, this decline in fixed lease investment can be attributed partly due to a lack of investment grade opportunities becoming available, but also partly due to covenant congestion. This is an emerging trend, whereby certain funds have reached saturation point of certain covenants within an asset class, but with increased appetite to acquire core-plus and value-add real estate investments. As such, institutional funds, with solid understanding of the hotel sector, have begun to seek out select opportunities to diversify into other segments, such as the four-star market, with either a lease in place or taking operational risk via a management contract.

Knight Frank advised The Kaleidescope Collection on the sale of No.15 Great Pulteney, Bath. Sold to a private UK hotelier.

Robust growth in London's average transaction price per room?

Headline numbers indicate strong growth in London's average transaction price per room, rising by 41% to £457,000 per room (excluding development and ground lease transactions), suggesting a resilient trading performance, combined with a scarcity of assets for sale, allowing sellers to hold out on price. However, a deeper, investigative analysis stripping out the sale of the Grange hotel portfolio and the ground lease transactions which followed, reveals that London's average transaction price per room actually recorded a decline of 5% to £303,000 when compared to 2018. In addition, with no sizeable transactions taking place, the average price per room for hotels selling on a vacant possession basis would have resulted in a decline of almost 30% to £321,000 per room.

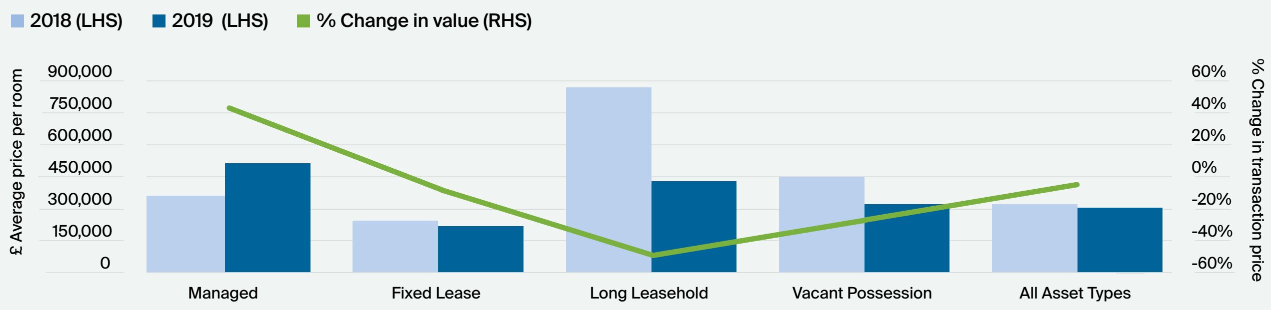
Fixed lease and long leasehold transactions have also witnessed a fall in the average transaction price per room in 2019 - which in 2018 witnessed the sale of the long-leasehold interest of Beaumont Hotel (selling at close to £2 million per room), as well as some fixed lease SACO assets transacting, which elevated the average transaction price per room sold.

In regional UK, varying degrees of change in the average transaction price per room were observed between the different structures, due largely to the composition of hotels transacting. For example, in 2018, the inclusion of a number of SACO assets unduly increased the average transaction price of managed assets, resulting in an overstated decline in the average price per room in 2019. Significantly fewer corporate hotel transactions subject to a franchise agreement took place in 2019, resulting in a 22% fall in the transaction price per room. Meanwhile, the Schroders acquisition of the Sofitel London Gatwick contributed almost exclusively to the 150% rise in the average value per room of long leasehold assets in regional UK.

The average transaction price in regional UK of £146,000 per room, increased by 20% year-on-year. Due in part, to the rising price per room paid for fixed lease assets.

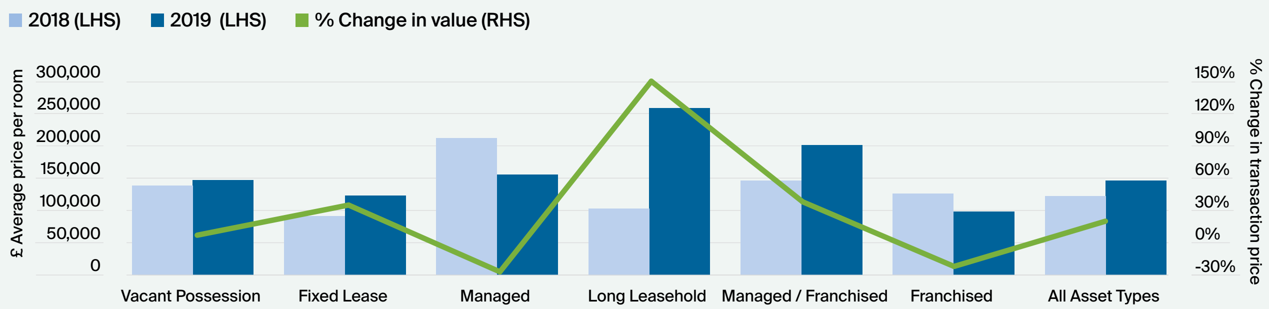
(excludes developments and ground lease transactions)

Fig 8: Average price per room transacted 2019 v 2018 by investment structure – London (£)



Source: Knight Frank Research. * All Asset Types excludes development & ground lease transactions; Vacant possession average transaction price excludes the Grange portfolio.

Fig 9: Average price per room transacted 2019 v 2018 by investment structure – Regional UK (£)



Source: Knight Frank Research. All Asset Types excludes development & ground lease transactions.

HOTEL INVESTMENT BY UK REGION (EXCLUDING LONDON)

Manchester ranked as the most liquid regional UK hotel market.

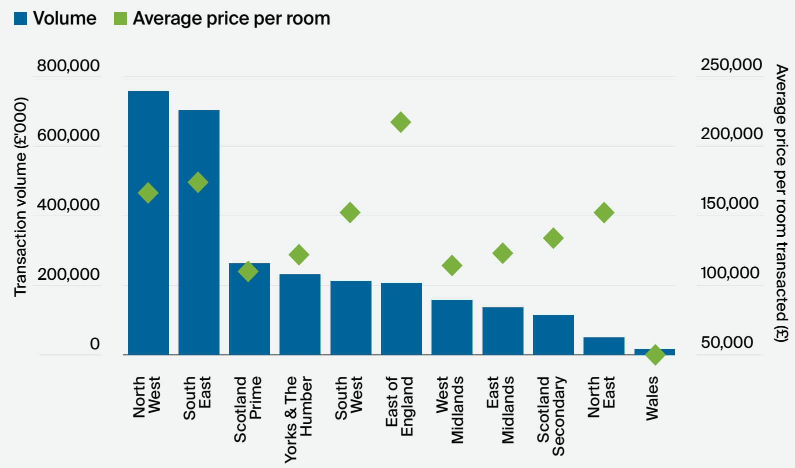
A review of the geographical distribution of investment by region and by city, revealed that Manchester was ranked as the regional UK city with the greatest volume of hotel investment in 2019, with some 13 transactions totaling £500 million and with an 18% share of total UK regional investment. As a result, the North West was ranked as the most liquid region, despite lower investment in Liverpool. Meanwhile, the city of Chester recorded a significant uplift in activity due to three hotels transacting as part of larger portfolio transactions.

The South East of England (excluding London) was ranked as the UK's second most active region for hotel investment, with transactions of over £700 million. Whilst investment volumes in the South-East were at a comparable level to 2018, fewer hotels transacted. Albeit, with some sizeable, quality stock transacting, the South-East recorded a surge in the average transaction price per room, rising by 47% to £163,000.

Transaction activity was particularly strong in Oxford, resulting in the city being ranked as the second most active hotel market, accounting for a 27% share of the transaction volume in the South East, with a total investment of around £190 million. The properties transacting included the sale of the remaining two Principal hotels to Covivio, the Macdonald Randolph acquired by AJ Capital Partners and Belmond Le Manoir Quat' Saisons transacting as part of a portfolio deal acquired by LVMH.

One further sizeable asset which transacted in the South East was the sale of the 518-room Sofitel London Gatwick, acquired by Schroders Real Estate and BAE Pension Funds, for £150 million. Meanwhile, to the East of England in Cambridge, two large transactions

Fig 10: Regional UK hotel transactions 2019 by UK region

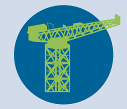


Source: Knight Frank Research

TOP 10 REGIONAL UK CITIES FOR HOTEL INVESTMENT 2019

Manchester
Volume: **£500 million**
Rooms: **2,400**
Av price per room: **£210,000**

Oxford
Volume: **£190 million**
Rooms: **500**
Av price per room: **£400,000**

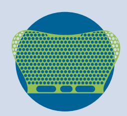


Glasgow
Volume: **£170 million**
Rooms: **1,750**
Av price per room: **£95,000**

Gatwick Airport
Volume: **£150 million**
Rooms: **518**
Av price per room: **£290,000**

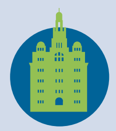
Cambridge
Volume: **£135 million**
Rooms: **430**
Av price per room: **£315,000**

Leeds
Volume: **£100 million**
Rooms: **820**
Av price per room: **£124,000**



Birmingham
Volume: **£95 million**
Rooms: **800**
Av price per room: **£120,000**

Chester
Volume: **£80 million**
Rooms: **670**
Av price per room: **£114,000**



Liverpool
Volume: **£80 million**
Rooms: **600**
Av price per room: **£135,000**

Bristol
Volume: **£70 million**
Rooms: **425**
Av price per room: **£162,000**

took place, involving the 138-room DoubleTree by Hilton Cambridge and the 155-room Tamburlaine Hotel for £355,000 per key.

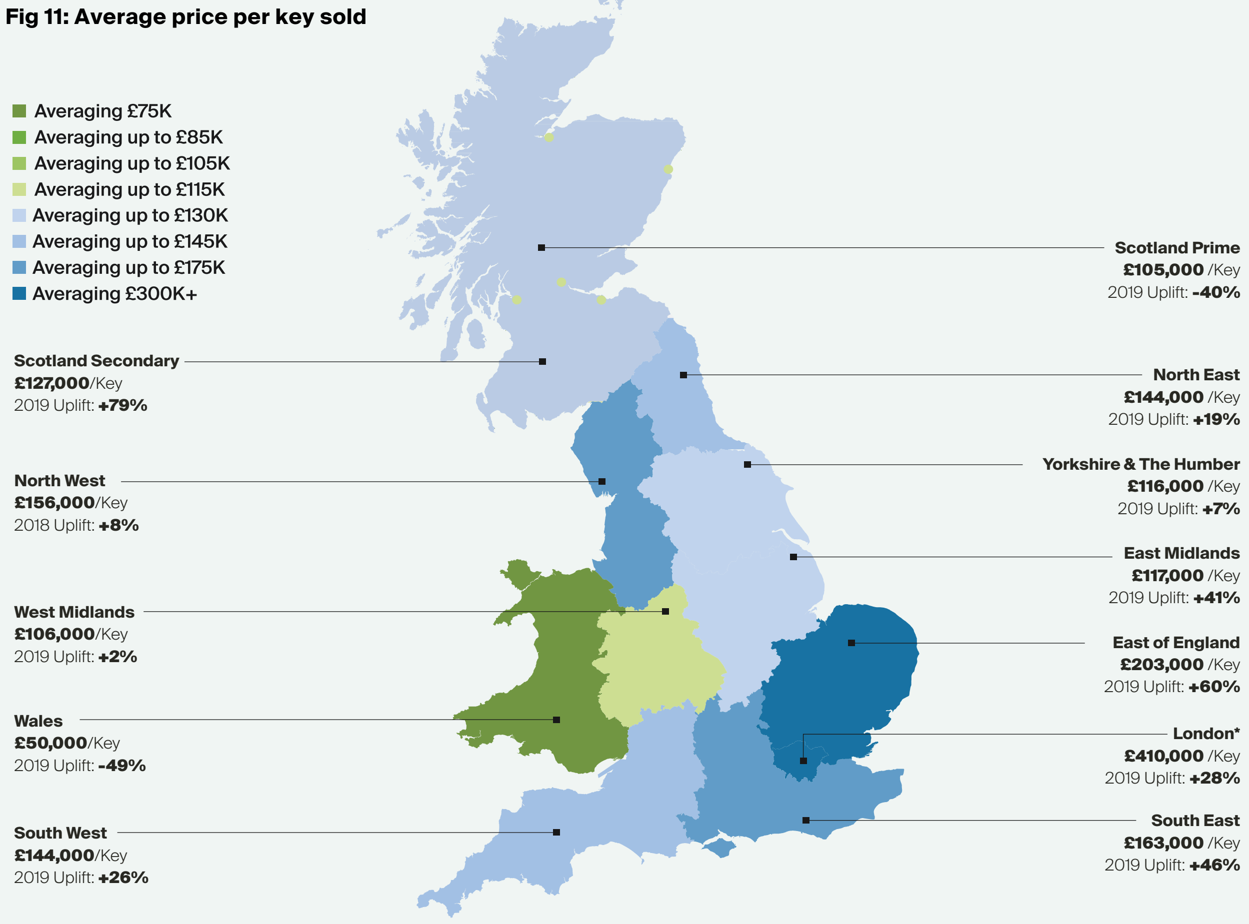
In Scotland, we define the region making a distinction between major prime cities (Edinburgh, Glasgow, Aberdeen and Inverness) and the rest of Scotland which we have termed as Scotland Secondary. Scotland's prime cities were ranked as the third most active region for hotel investment, with approximately £260 million of investment, but with no significant trophy asset sales recorded in Edinburgh during 2019, the transaction volume was significantly lower, down by 70%. Instead, Glasgow was ranked as Scotland's most liquid city, with a total of nine transactions, comprising over 1,700 rooms and resulting in a transaction volume of approximately £170 million.

Elsewhere, Scotland's secondary cities have recorded significant transaction activity, with approximately £115 million of investment, comprising some 900 rooms and 12 assets transacting. The Fairmont St Andrews was central to the uplift in activity, contributing approximately 45% of the investment in region.

The region of Yorkshire & Humber was ranked as the fourth most liquid region, with over £230 million of investment accumulated from a total of 19 assets exchanging hands. In particular, some significant branded hotel stock changed hands as a result of various regional portfolio acquisitions. These assets included the Hallmark Hull, Hilton Leeds City, Hilton York, The Crowne Plaza Harrogate and the DoubleTree by Hilton Leeds. As a region, the market achieved an average price per room of £116,000, an uplift of 13% compared to the previous year.

In Wales, very limited transaction activity in Cardiff resulted in a substantial reduction in the region's investment market, with transaction volumes declining by 89% and the average transaction price per room falling by 49%. Nevertheless, Cardiff remains an attractive city for investment, despite the temporary dearth of hotel stock exchanging hands.

Fig 11: Average price per key sold



Source: Knight Frank Research. * Excludes development transactions

Fig 12: Leading hotel transactions

BY INVESTMENT STRUCTURE

	LARGEST PORTFOLIO TRANSACTION	LARGEST SINGLE ASSET TRANSACTION LONDON	LARGEST SINGLE ASSET TRANSACTION REGIONAL UK	LARGEST FIXED LEASE TRANSACTION LONDON	LARGEST GROUND LEASE TRANSACTION	LARGEST DEVELOPMENT TRANSACTION
ACQUISITION	Grange Hotel London Portfolio	Harrington Hall Hotel	Sofitel Gatwick Airport	Zinc Hotel Portfolio	Portfolio of 3 Grange Hotels	Paddington Site – Premier Inn & Wilde Aparthotels by Staycity
INVESTOR	Queensgate Investments	APG Asset Management & London Central Portfolio	Schroders Hotel Real Estate (BAE pension fund)	Vivion Investments Sarl	Alpha Real Capital	M&G Real Estate
INVESTMENT	£1 Billion (£765,000/room)	£125 Million (£622,000/ room)	£150 Million (£290,000/room)	£246 million (£170,000/room)	Confidential	£200 Million

Source: Knight Frank Research

BY TYPE OF INVESTOR

	PRIVATE EQUITY	HNW FAMILY OFFICE	UK INSTITUTIONAL INVESTOR	OVERSEAS INSTITUTIONAL INVESTOR	OVERSEAS CORPORATE HOTELIER	OVERSEAS CORPORATE INVESTOR	UK CORPORATE HOTELIER	UK CORPORATE INVESTOR
LEADING INVESTOR 2019	Queensgate Investments	Vivion Investments / Dayan Family	M&G Real Estate	APG Asset Management & London Central Portfolio	Adventurous Journeys Capital Partners	DTGO Corporation	London & Regional	The Ability Group
TOTAL INVESTMENT	£1 Billion	£485 Million	£525 Million	£125 Million	Confidential	£450 Million	£60 Million	£58 Million

Source: Knight Frank Research

STRONG SURGE IN GROUND LEASE INVESTMENTS

A prominent trend in UK hotel investment during 2019 involved a striking increase in the number of hotels involved in ground lease transactions, rising by more than 3.5 times compared to the previous year.

Transaction volume of approximately £800 million was recorded in 2019 which represented a 13% share of total UK hotel transaction volume.

In the past, whilst sale-and-lease back deals have proved a successful form of financing, today structures for investing in long-lease hotel real estate (which are effectively capital raising vehicles for the seller of the freehold), are increasingly taking the form of income strip and ground rent deals. Growing awareness of ground rents and their attractive characteristics has led to increased popularity of this investment structure, and hotels are particularly well suited to this form of investment, given that rental income tracks inflation, making such deals attractive to an investor's liability-matching strategy.

The Grange Hotel, Tower Bridge – Knight Frank advised Aviva Investors on the acquisition of the ground rent.

The level of ground rent transactions which completed in 2019 is proof that there is a much wider pool of buyers willing to invest in these structures. Ground rents are usually acquired through private transactions, but with robust portfolio activity from private equity investors and corporate hoteliers, there has been significantly more scope for institutional investors to carve out such structures.

Ground rent transactions typically offer the longest dated structure, with lease terms ranging between 100 years and 999 years. Cash flow constitutes the majority of the return due to the extremely long investment horizon. A key issue for the investor is therefore, the need to ensure the continuity of income. From both a tenant and an investor's perspective, it is important that the rent is set at a sustainable level and that it remains affordable throughout the lease. For an investor, insuring against the risk of the rent flow being interrupted is as important as insuring the underlying real estate asset itself. One of the greatest attractions of this structure to the investor, is that the condition of the real estate is critical to the operation of the business

and it is therefore unlikely to become functionally obsolete in the short-to-medium term, with the tenant held accountable for the maintenance of the property.

In 2019, a total of 13 ground lease transactions were executed, involving some 57 hotel assets. Institutional investors totally dominated the ground rent market, with a 99% share of the total investment, whilst ground rent transactions accounted for 32% share of total institutional investment. The volume of ground lease deals was elevated to new heights in 2019 as a result of two separate ground lease transactions, which occurred simultaneous to Queensgate Investments' acquisition of four Grange hotel assets. Aviva Investors acquired the freehold of the Grange Tower Bridge, whilst Alpha Real Capital acquired the ground rents of the three remaining hotels, all of which have since rebranded under the Leonardo and NYX brands, following the Israeli-based Fattal Hotel Group acquiring the long-leasehold interest of all four properties.

Overall, across the UK market, the net initial yield for a ground lease transaction averaged 2.6%, with certain deals reflecting a NIY as low as 2.0%.

Commercial ground rents are now a well-established asset class for investors and an attractive funding source for owners of hotels. We envisage a strong pipeline of transactions entering due diligence, with the greatest flexibility offered to tenants with the strongest covenants. Investors need to have confidence in the long term income generating capabilities and value of the asset.

SHAUN ROY, HEAD OF HOTELS, KNIGHT FRANK

GROUND LEASE TRANSACTIONS 2019

DATE	TENURE	PROPERTY	CITY	PRICE (£)	ROOMS	PRICE PER ROOM	NIY%	PURCHASER
Jan-19	Freehold	Holiday Inn Cardiff	Cardiff	3,700,000	95	38,000	2.7%	CBRE Global Investors
Jan-19	Freehold	Crewe Hall, Crewe	Crewe	7,000,000	117	60,000	2.5%	Aberdeen Standard Investment
Feb-19	Long Leasehold	Q Hotel, Slaley Hall	Hexham	5,000,000	141	36,000	2.5%	Aberdeen Standard Investment
Apr-19	Freehold	Leonardo Royal City & St Paul's & NYX Holborn	London	Confidential	947	–	2.0%	Alpha Real Capital
Apr-19	Freehold	Leonardo Royal Hotel London Tower Bridge	London	Confidential	370	–	2.0%	Aviva Investors
May-19	Freehold	Oulton Hall Hotel	Leeds	12,100,000	152	80,000	2.6%	Aberdeen Standard Investment
May-19	Freehold	Village Hotel Walsall	Walsall	8,600,000	125	69,000	2.5%	La Salle Investment Management
Jun-19	Freehold	De Vere Beaumont Estate	Windsor	38,100,000	429	89,000	3.2%	Alpha Real Capital
Sep-19	Freehold	Tides Reach Hotel, Salcombe	Salcombe	5,300,000	67	80,000	2.8%	Aviva Investors Real Estate
Oct-19	Freehold	Holiday Inn Piccadilly, Manchester	Manchester	28,900,000	298	97,000	N/A	BBC Pension Fund Ltd / CBRE Global Investors
Oct-19	Freehold	Days Inn by Wyndham Sandy	Sandy	2,800,000	57	50,000	N/A	Central Bedfordshire Council
Dec-19	Freehold	London & Regional 43 Hotel Portfolio	Various	Confidential	5,972	–	3.5%	M&G Real Estate

Source: Knight Frank Research

INNOVATIVE FUNDING OF HOTEL DEVELOPMENTS

As outlined in our latest UK Hotel Development Opportunities publication, the positive momentum and record amounts of development capital targeting the UK hotel sector has translated into a strong pipeline of hotel development coming to fruition.

Our latest research reveals approximately 15,000 new hotel rooms opened in 2019, with UK hotel supply growing by 2.2%. Whilst the continuing dominance of the branded budget sector continues, a plethora of new hotel openings from an extended range of brands is further driving development activity.

Whilst scarcity of existing hotels coming to the market has almost certainly steered some investors towards investing in hotel development, the underlying growth in hotel development has stemmed from the prolific sources of capital now available, in terms of both debt and equity financing. These channels include: insurance companies, pension funds, opportunity funds, traditional banks, challenger and international banks, private equity and private wealth funds, family offices, mezzanine lenders, offshore capital and many more.

Our research reveals a total of 35 hotel development transactions took place in the UK during 2019, in the form of the acquisition of hotel sites or innovative structures geared towards the forward funding of hotel projects. Development transactions totalled over £1 billion of investment, with 57% of the transaction volume targeting London sites.

Institutional investors have been instrumental in the provision of funds and are having a profound positive impact on the changing shape and size of the UK hotel sector, accounting for 85% of the transaction volume. In 2019, development funding represented 35% of total institutional investment into the UK hotel sector, with this figure rising to 43% in London, an indication of the insatiable demand to add value through development.

Development projects are complex and detailed in nature, thus balancing the competing levels of interest between an investor and the developer is critical. Undertaking a high level of due diligence from the outset and building long-lasting, trusted and seamless relationships with experienced partners with a credible track record, is critical

Clayton Hotel Bristol, acquired by Aberdeen Standard Investment, NIY 4.25% Knight Frank advised the seller.

UK HOTEL CAPITAL MARKETS 2020

for mitigating the development risk. However, a key objective of an institutional investor is to de-risk the investment from the outset, thereby creating stable, low-risk, long-term returns to match future liabilities. As such, increasingly innovative forward funding structures in the form of income strips are becoming more prominent in the structuring of a development transaction.

The weight of local authority covenants help fund hotel developments

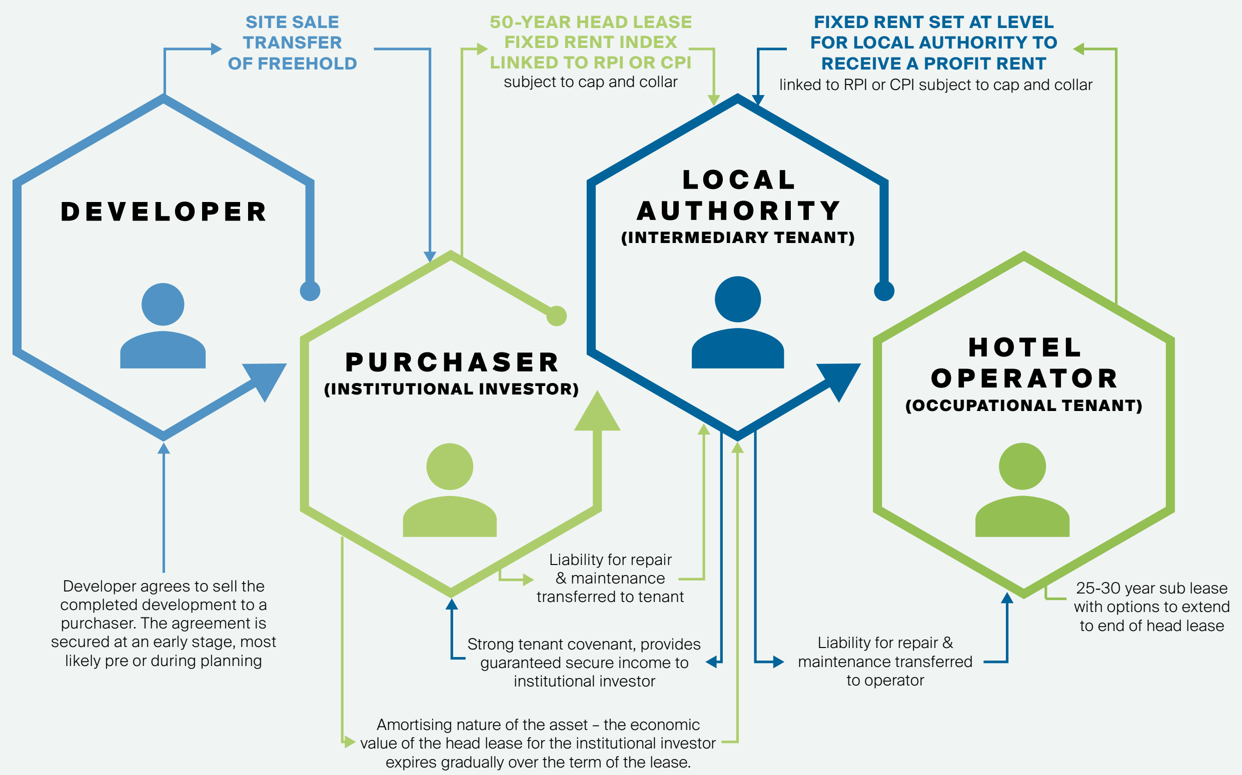
Local authorities and other public institutions are increasingly being sought after to act as intermediary tenants, entering into a 30 to 50 year lease agreement with an institutional investor. In doing so, local authorities, with their strong tenant covenant, provide a guaranteed income stream (similar to a bond) to the institutional investor, while subleasing the building at a profit, to a hotel operator. The deal provides a mechanism to ensure that the freehold title transfers to the authority for a nominal value at the expiry of lease, typically a buy back option in favour of the tenant or to enter into another income strip agreement.

In 2019, development funding represented 35% of total institutional investment into the UK hotel sector, with this figure rising to 46% in London.

Local authorities are increasingly turning to hotel investment as a means to boost their financial strength to support the funding of vital services, in a climate of increasing reducing resources. However, local authorities themselves need to undertake sound due diligence to ensure commercial terms are in their best interest. In 2019, direct investment by local councils totalled around £55 million, with all deals involving a high quality tenant such as Travelodge.

However, indirect investment, via income strip deals are likely to continue to evolve, similar to the £150 million acquisition by Aviva Investors for The Gate development in London Aldgate, where the London Borough of Barking & Dagenham entered into an out-of-borough 50-year lease agreement, featuring an apart-hotel with 189 suites. Set-up costs and stamp duty, incurred by the council, are to be funded by the institutional investor, up to a pre-agreed amount.

Fig 13: Income strip



HOTEL INVESTMENT OUTLOOK 2020

London's position as one of the world's most liquid and transparent real estate markets is expected to drive continued new pools of opportunistic investors to the UK, including emerging Japanese institutions and growing private wealth in Asia, with hotel real estate a prime investment target.

HENRY JACKSON,
PARTNER, HEAD OF HOTEL AGENCY

The Long Leasehold interest of the Sofitel London Gatwick was acquired by Schroders Hotel Real Estate for £150 million.

Following a confused and turbulent year in the commercial property markets, resulting from the political chaos and economic uncertainty of Brexit, the resilient £6.0 billion of investment into UK hotel real estate should not come as a surprise to some. The sector is the largest and most mature of the specialist property sectors.

This past year, the sector has clearly benefitted from those investors seeking to invest and benefit from current hotel income, whilst seeking out opportunities which offer the greatest scope for income growth through value-added upside potential. Significant opportunity exists for investors to take advantage of long-lease ground strip deals which continue to evolve and further strengthen the investment market.

Investors will increasingly look to invest in markets with strong demand generators, and seek out well located assets benefiting from strong covenants and experienced management teams. Furthermore, by undertaking proactive asset management and a willingness to take on selective development risk, the rewards and opportunities exist for a wide range of investor types, with different risk profiles. Despite the ongoing uncertainty surrounding Brexit, there remains a sizeable weight of capital continuing to target the UK, with compelling factors such as transparency, liquidity, language, corporate governance and currency plays enticing investors.

Margin pressures will certainly put pressures on operators to improve efficiencies, particularly assets held on management agreements and this in turn is expected to churn investment opportunities. Equally, a focus on leaner business models is likely to further support investment.

AC Marriott Hotel Salford Quays, Manchester. The hotel transacted as part of the Marathon Asset Management portfolio, a collection of 17 hotels for £450 million, acquired by DTGO Corporation.

In 2020, we can expect investors to become more confident following the Conservative party's recent victory, albeit caution is likely to grow if no extension to the end date of the transition period on 31 December 2020 is sought. Nevertheless, we anticipate that 2020 will see an increase in stock becoming available, with hotel investment volumes having the potential to extend beyond the 3-year average of £6.3 billion.

Key to achieving this goal is the UK remaining attractive to overseas investors who we would expect to capitalise on the opportunities presented, with increased investment likely from Thailand, Japan and the Middle East.

However, we remain alert to the risks of the current outbreak of the Corona Virus and its potential to cause a global slowdown in travel to all destinations.

PREDICTIONS 2020

1 UK hotel investment to rise above £6.5 billion

2 Overseas investment rebounds to 2018 levels

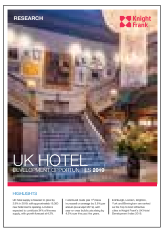
3 Greater volume of portfolios and higher value assets for sale

4 Continued growth in institutional investment

Note: For assets which form part of a portfolio transaction, on the occasion where an asset's value is not reported or it has not been possible to verify an individual asset's value, an allocated amount of the total portfolio transaction will have been apportioned to each asset included in the transaction. Knight Frank's uses this information in order to undertake further analysis, such as to determine the attractiveness and liquidity of a hotel market.

Front cover photo: **Fairmont Hotel St. Andrews.** Knight Frank advised the seller. The hotel transacted off an asking price of £55 million.

Recent Publications



UK Hotel Development Opportunities 2019

UK Hotel Trading Performance Review

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