RESEARCH

UK HOTEL SECTOR 2011 REVIEW

Insight, commentary and the results of the
Knight Frank Hotel Operator Sentiment Survey

Knight Frank

2011

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UK HOTEL SECTOR

Market overview

Knight Frank Hotel Operator Sentiment Survey

The charts featured in this report illustrate the results of the Knight Frank Hotel Operator Sentiment Survey, conducted in Q1 2011. For full details please see page 4.

Figure 1
Regional spread
Which regions do you operate in? (%)

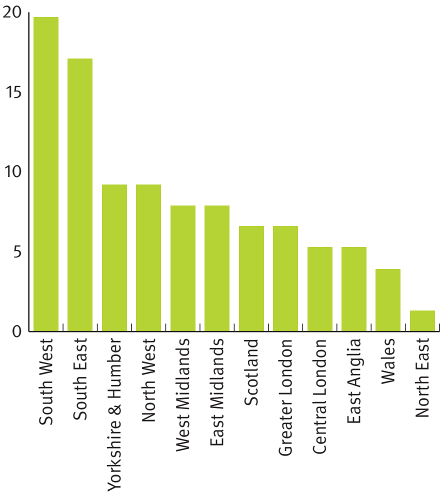


Figure 2
Visitor mix
Which of the following best describes your visitor mix?

Predominantly business	4.3%
Mainly business with some leisure	2.2%
Mixed business and leisure	41.3%
Mainly leisure with some business	21.7%
Predominantly leisure	30.4%

Source: Knight Frank Research

Led by London, the hotel market in 2010 performed reasonably well, surprising many commentators and forecasters along the way. Across the UK occupancy rates, average room rates and revenue per available room (RevPAR) were all up on the previous year, performing more strongly than predicted.

One of the more striking observations during the recent recovery has been the polarisation of the market, with locations in the south of England typically outperforming the other provinces, with London in particular leading the way. Indeed, 2010 RevPAR figures for the UK were up 7% on 2009, with London up 11% and the provinces up a more modest 3%.

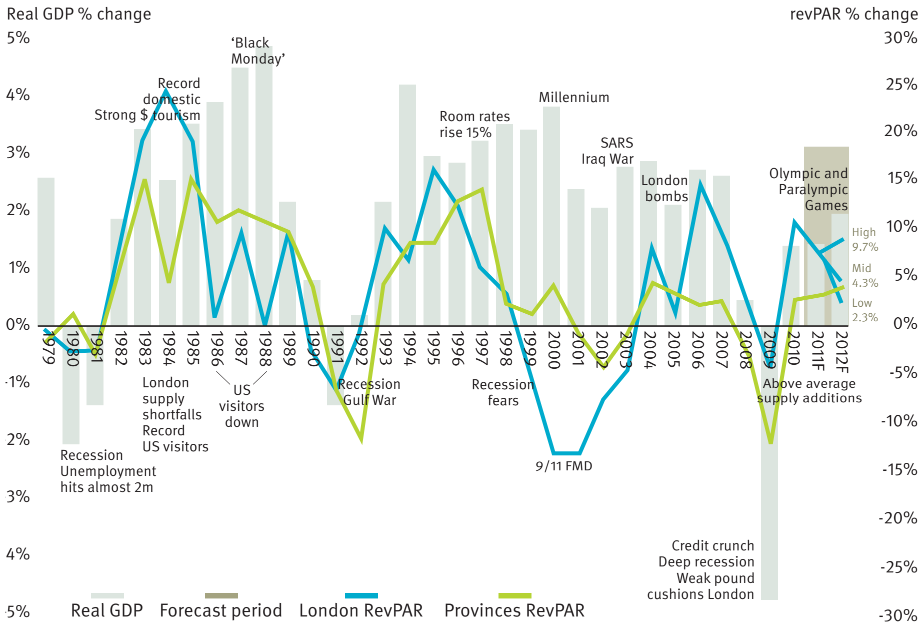
As a key global hub London has become increasingly decoupled from the wider UK market and remains the top performing hotel market in Europe. Over the past year, London's hotels have benefited from the relatively weak pound, both in terms of transactional activity and visitors. The number of high-end hotels in London is also relatively low, which makes the operational environment for existing ones more favourable. There is, however, a good supply of high-end stock in the pipeline, particularly in the City around Trinity Square – an area set to become the new 'dormitory quarter' of the square mile, with a number of top-end operators opening up there.

While the recovery across the provinces has generally been positive, the picture is mixed. Some of the more 'traditional' locations – those which benefit from strong business and leisure markets and are physically constrained in terms of supply, such as Oxford, Cambridge, Bath, York and Edinburgh – have tended to remain strong, where less popular visitor hotspots have struggled in comparison.

Provincial total revenue per available room (TrevPAR) has historically tracked GDP. With GDP growth marginal against a backdrop of high inflation, pressure will be placed on provincial hotels' profitability.

The sentiment for 2011 and 2012 is one of cautious optimism. Our own survey (see page 4) seems to support the view of other independent surveys and forecasts – while the threat of a weaker economy is certainly on the industry's mind, the outlook for the next two years is relatively optimistic.

The best and worst of times



Economic Forecasts: PricewaterhouseCoopers March 2011 Macroeconomic Data: National Statistics
Benchmarking Data: TRI Hospitality Consulting 1979-2000. STR Global 2001-2010

Industry insider: in times of trouble

Hotel management companies have benefited from a growth in receivership work as banks seek to revitalise failed hotel assets before selling them off. Knight Frank's Vicki Shiel talks to Jim Gordon, group finance director of Legacy Hotels, for his view on where the trend is heading.

VS: How has Legacy Hotels fared during the recession and recent recovery?

JG: Reasonably well. Last year we achieved record sales and profit. Turnover was up 10% and operating profit was up by between 15% and 20%. Having started in 2005 we're still a relatively young company, so we're still growing.

VS: Have you seen an expansion in business due to receivership work?

JG: Yes, absolutely. We didn't target this market until a year ago as our core business is in three- to five-year full-service management contracts. But we have made new contacts and generated new business with banks due to our relationship with agents such as Knight Frank. In the last six months we have been appointed on three hotels in distressed situations, through three separate banks.

VS: How does the process work?

JG: The banks approach insolvency practitioners (IPs) such as Begbies Traynor and Zolfo Cooper and those firms approach sector specialists like us. We are in talks with one of the leading IPs about a further two appointments. So the amount of business we receive in this area has risen dramatically for us and I can see it increasing further this year.

VS: What hotel types have been affected?

JG: Last year banks restructured several hotel groups. But they are now turning their attention to the smaller portfolios, including the single assets. We expect to receive more work as a result of this change in focus.

VS: How sustainable is this source of business – when the banks sell their assets, will you not lose these contracts?

JG: It depends on who buys the assets from the banks. The bank's objective is to sell to the highest bidder. If the bank sells to an operator, it is unlikely that we will be retained. But if the bank sells to an investor, we may be kept on as the operator. We think there is at least another two years' worth of this work left. In the medium to long term, banks will always need support, and there will always be operators that fail to do the job properly. As one door closes another opens.

VS: Where else do you see work coming from?

JG: Once this receivership work dries up, we expect opportunities to arise from the threat posed by the growing number of limited service branded operators – such as Travelodge, Premier Inn and Holiday Inn Express – that are putting a squeeze on the traditional independent hotels. The nature of what we do means we don't tend to get opportunities when things are going well. Struggling independent hotels might approach us for help of their own accord, or their banks might push them to. Services we could offer range from procurement to sales and marketing.

VS: Has the sector changed significantly in recent years?

JG: Yes. There has been a flight towards brands. More new brands have entered the market as lenders increasingly look for the comfort and perceived certainty that they provide. Obtaining funding is difficult enough at the moment, but your chances are greatly improved if you are part of an international brand. This trend arose before the recession, but I think the recession accelerated it and I don't see it reversing when the good times return. We are moving towards the offering available in the US in terms of brand penetration in the market.

VS: What brands do you think will do particularly well in the coming years?

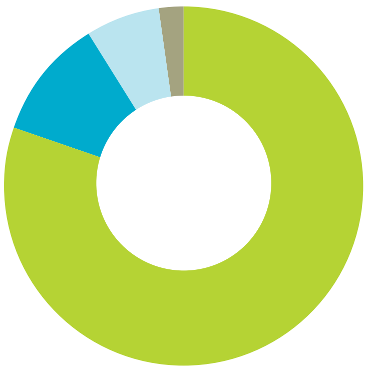
JG: Hampton by Hilton, whose hotels are typically new-build, and Double Tree by Hilton, whose hotels are typically conversions. Until now our focus has tended to be on non-branded hotels, but this trend is a potential growth area for us too.

Figure 3
Sectors
Which sector definitions are applicable to your offering?

Budget	7.0%
Mid-market full-service	33.3%
Conference	17.5%
Luxury	42.1%

Source: Knight Frank Research

Figure 4
Size of operation
How many hotels do you operate?



1 - 5	80.4%
6 - 10	10.9%
11 - 25	6.5%
25+	2.2%

Source: Knight Frank Research

For more on brands go to our trends feature on page 6

The Knight Frank Hotel Operator Sentiment Survey 2011

The results of Knight Frank's 2011 Hotel Operator Survey – presented throughout this report– confirm a picture of a sector which has weathered the recent economic storm and which is now looking forward to sustainable, if measured, growth.

Our survey was conducted in Q1 2011 and the panel included a wide range of operators, jointly responsible for managing more than 280 hotels. The panel had strong representation across the UK (figure 1), with a particularly strong presence in the South West and South East – reflective of recent stronger economic performance.

In terms of operation type, figure 2 confirms a bias towards leisure visitors, but with a healthy proportion of business visitors, allowing our panel to provide a holistic view of the sector. Figure 3 points to a good balance between luxury and budget segment operators, as well as representation from operators with full service and conference facilities.

While our panel was dominated by smaller independent operators, more than 40% of the hotels in our sample belonged to businesses operating 10 or more units (figure 4).

Performance

In figure 5 we have pulled together a snapshot of key performance measures from across our panel. We asked our panel to consider how their average daily rates (ADR), average room occupancy (ARO) and revenue per available room (RevPAR) had performed over the previous 12 months and, again, how they believed they would perform over the following 12 months.

Only ADR was felt, on balance, to have declined and the balance of opinion on this measure was relatively close. The most positive sign on this measure was the consensus that growth will return in 2011/12.

With a view that ADR would improve over the coming year, and a belief that ARO was likely to keep improving, there was a noticeable improvement in the expectation for RevPAR for the year ahead.

In terms of regional performance – there was little surprise that the strongest regions were those in the south, especially central London and the South East. Of the northern regions Yorkshire & Humber presented the most positive response looking forward.

Risks

When it comes to perceived risks to business performance, there is a very clear pattern among the responses in figure 6. Economic issues present the biggest concern to hotel operators at the current time.

Non-wage cost inflation is the biggest single concern, followed by weak economic growth. Energy costs are a particular worry for a majority of operators – partially explaining the relatively strong take-up of green technologies we explore below.

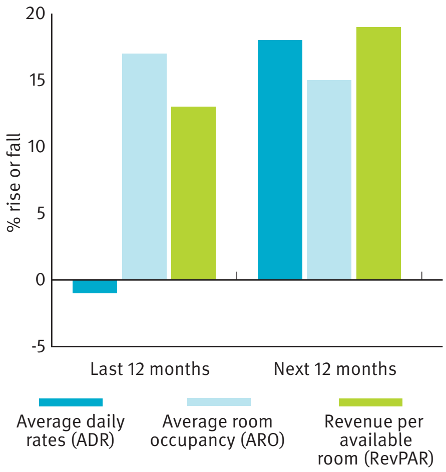
There is limited concern surrounding security and regulatory impacts, the former being of high concern only to central London operators.

Future plans

When we asked our panel about their business plans for the next 12 months, the response regarding positive steps being taken to improve business performance was promising (figure 7).

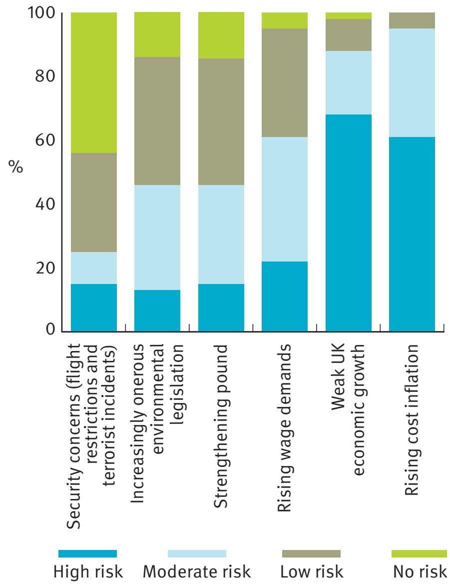
Half of the respondents have definite plans to refurbish their hotels, and nearly 40% have actual or potential plans to add additional

Figure 5
Sector performance
How have ADR, ARO and RevPAR performed over the past 12 months, and how do you expect them to perform over the next 12 months? (%), balance of opinion



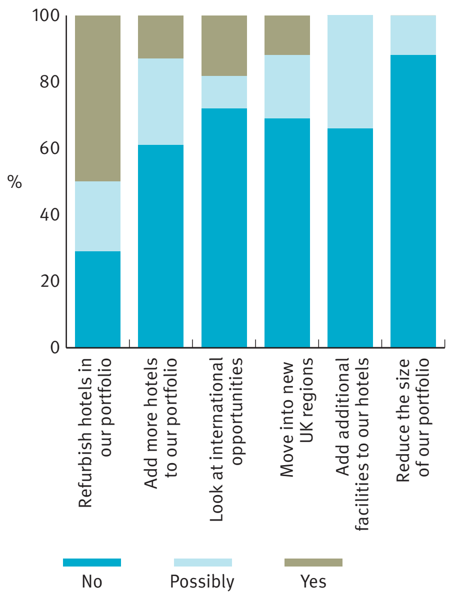
Source: Knight Frank Research

Figure 6
Risks
Rank the following in order of their risk to the performance of your sector over the next 12 months



Source: Knight Frank Research

Figure 7
Future plans
Over the course of the next 12 months I expect to...



Source: Knight Frank Research

hotels to their portfolios. The strongest response regarding expansion plans came from businesses that already have a strong presence in the South West.

International opportunities are being considered by 28% of respondents, generally those already active in London. But a higher proportion (31%) are planning geographical expansion within the UK.

Figure 8
Online issues
The internet is facilitating transparent hotel pricing. This will increase competition and drive down profit margins in the sector

Strongly agree	29%
Agree	29%
Disagree	39%
Strongly disagree	2%

Reassuringly only 12% of our panel are considering a reduction of their portfolio over the next 12 months, with the majority of these being based in the Midlands and the north of England.

Figure 9 confirms a sector with at least tentative experience of green technology. The main driver from the comments we received was a desire to minimise energy costs which, as we noted above, were a contributory factor to the biggest business risk observed by the panel.

At the moment this experience has been largely limited to the benchmarking of environmental performance (61% of respondents either have or plan to implement this), and developing carbon compliance strategies (50% either have done so or plan to do so).

In terms of green technologies in action, the most popular is Passivhaus standard insulation levels and thermal efficiency – with 14% of panellists having active schemes. Solar is the most popular energy generation technology.

We closed our survey by asking our panel to consider how the sector would perform over the next 12 months with regard to investment and development activity (figure 10).

There was a generally neutral response to the four measures we put to our panel.

Investment activity was thought likely to expand this year by 28% of respondents, against 26% who thought it would contract. Similarly the volume of planning applications was closely balanced, with 40% growth to 35% contraction.

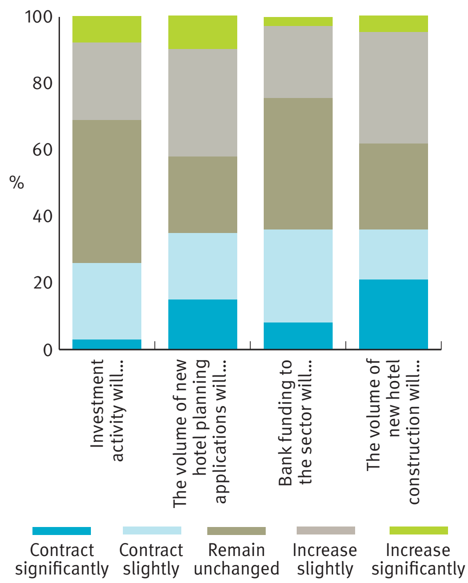
There was a more negative view on the future of bank funding to the sector and the prospective volume of hotel construction.

Summary

The view provided by our panel was relatively positive and upbeat. There is no doubt that the sector has issues to resolve, especially in some of the main regional cities, where business segment accommodation is in relatively strong supply. But two years on, from the depths of the recession, the sector overall has been performing as well as could be expected.

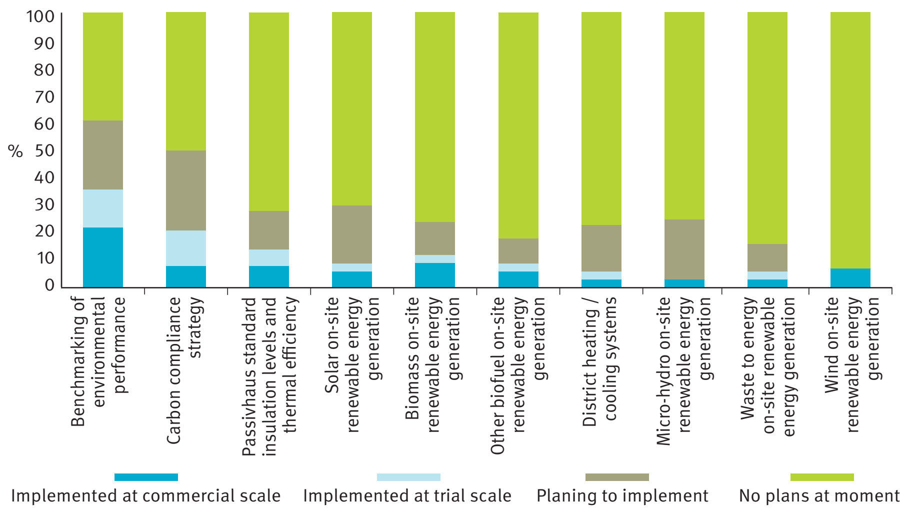
The regional view provided by our respondents is distorted by several operators being active in multiple regions but, unsurprisingly, a key split between more active and positive trading conditions in southern England and more difficult conditions further north came through.

Figure 10
Future activity
Over the next 12 months:



Source: Knight Frank Research

Figure 9
Green ambition
How is your business responding to rising energy costs and ever tighter environmental legislation?



Source: Knight Frank Research

Trends to watch in 2011

Henry Jackson
Knight Frank
Hotels UK

Andrew Theobold
Knight Frank
Hotels UK

Alistair Bell
Knight Frank
Hotels Australia

The hotel industry has a reputation for being one of the most innovative within the property sector. This innovation is felt from design to business models, and provides a constant reference point for the residential and retail sectors in particular. For this year's review we asked Knight Frank's hotel experts to share their insight on four issues set to shape the sector this year.

Budget hotels

Are we hitting saturation with budget hotels?

HJ: Branded budget hotels are still achieving good prices and this market is not yet saturated. When corporate and leisure travellers are once again willing to stay at upscale full-service hotels, the budget brands may have to become much more competitive on price. The rise of 'super budgets' – hotels with very small but well-designed and high-spec rooms with TV screens rather than windows – means the budget sector is feeling the squeeze from both above and below.

Which locations still offer good opportunities for budget hotel development?

AT: Cities such as Oxford, Bath and York, where opportunities are restricted due to a lack of sites, and other centres where alternative use land values have fallen to a point where it becomes more economically viable to consider hotel development.

HJ: Secondary towns and leisure destinations for cost-conscious travellers who would otherwise stay at B&Bs.

Where are the biggest risks of oversupply?

HJ: City centres where there are three- and four-star hotels as well as budget offers. Demand for full-service hotels may be suffering now, but this will change as economic conditions improve.

AT: A fall in corporate demand mid-week can have a big impact in non-leisure destinations and secondary towns such as Reading and Swindon.

What new trends are we seeing in the development of budget hotels?

HJ: Much higher design standards, with small rooms, boutique-style interiors, good bathrooms and plenty of technology. Pod-style bedrooms with no natural light are increasingly acceptable and more are likely to be developed as it is relatively inexpensive to convert existing office properties for this use.

AT: Growth in franchising, with Accor and Hilton in particular.

The brand factor

Which brands are most successful?

HJ: The obvious names are the global players such as Hilton, Marriott and Intercontinental Hotel Group (IHG). Accor is very successful but in a more limited geographical market – mainly Europe – due to their strategy for separating the brands from the parent. While Hilton has Hilton, Hampton by Hilton and Hilton Garden Inn, Accor has Mercure, Novotel and Ibis, which are not necessarily connected in the minds of the traveller.

What makes them successful?

HJ and AT: Market awareness, brand consistency and offering value for money in their respective markets. Utilising a mix of business formats – owned, management contract and franchise – and a range of brands also helps to fit different markets and properties.

What brands do you think will do well over the next few years?

AT: Citizen M offers a refreshing alternative to existing budget hotel operations. Hilton is rolling out three new brands in the UK – Hampton, Garden Inn and Double Tree. Hilton developed these in the US but has been unable to roll them out in the UK until now due to the historic ownership structure of Hilton. Now that structure has changed, this rollout provides them with huge expansion potential, enabling them to compete with the likes of IHG, which operates Holiday Inn and Holiday Inn Express.

HJ: As well as the high-design super budgets such as Citizen M, I think the big brands will move in on the design-led boutique concept, such as Indigo by IHG.

The rise of franchises

How important will franchising be in the future?

HJ: It is hard to tell. It would appear to be a growth area as it is a mechanism for independent hoteliers to buy into a brand. But this can compromise the brand if the franchisee does not maintain standards. It is certainly a useful way for a brand to expand with relatively little investment. But franchisees are likely to expect reduced fees, with a greater choice of brands becoming available.

AT: The importance of the internet continues to grow and it will become increasingly difficult to place your business at the top of the search engine results without having a strong brand. Franchising enables you to tap into a brand and utilise the power it can deliver through its central reservations function. Accor (owners of brands such as All Seasons, Etap and Ibis) and IHG are actively franchising their brands as it gives them more representation without incurring costs. It also generates income via the franchise fees and brand loyalty programmes.

How does the current economic climate affect the franchise model?

HJ: It puts pressure on independent hotel property owners to join a brand – to benefit from an external business delivery system – but it also pressurises the franchiser to deliver. The model is likely to become much more competitive in the future. However the cost of the franchise needs to be justified by reference to an improvement in turnover. A brand association may give additional comfort to a lender.

The Olympic impact

With next year's London Olympics looming on the horizon, we asked Alistair Bell, Knight Frank Sydney, to share his thoughts on the Sydney hotel sector's Olympic experience in 2000.

"The 2000 Olympic Games in Sydney were widely recognised as the best example of how to leverage an event for the benefit of the tourism industry. In the period leading up to the games there was a significant increase in hotel development. According to the Australian Bureau of Statistics, around 7,000 new hotel rooms were added to the city's stock between December 1996 and 2000 – an increase of 51%, peaking at 21,378 in December 2001.

Room occupancy and average room rates peaked in 2000, with the latter enjoying a spike of some 50% around the time the games were taking place. But in the following year both declined. The number of hotel rooms declined sharply reaching a low of 18,173 rooms in 2003. From 2002 around 3,200 rooms were converted for residential use. Many of the hotels had

Meetings, incentives, conferences and exhibitions

Services in the meetings, incentives, conferences and exhibitions (MICE) sector were in high demand before the global recession hit, after which companies either became increasingly rate driven or cut back completely on this expenditure. These cutbacks have led to some interesting changes in the sector.

According to Ian Jones, director of group sales at De Vere Hotels, one element of the sector that has weathered the storm better than others is regulatory training. "The fact that we live in a world of increasing legislation has led professions such as law, accountancy and financial planning to continue to run training courses and conferences in this area," he says. Training courses in 'softer skills' such as communication happen less frequently now as companies consider this less of a priority, he adds.

The incentives market is proving more challenging, as Mr Jones explains: "Scaremongers had a field day when they found out that RBS rewarded star employees with a trip to Sardinia. The market has since gone underground and companies are looking at other, less conspicuous ways to reward employees, such as high street vouchers."

According to Graham Dodd, a development director at Hilton Worldwide, MICE customers are also more sustainability conscious than ever before and check that venues meet their own criteria before booking. "Hilton Worldwide has excellent credentials, led by its industry leading LightStay proprietary system that calculates and analyses environmental impact. This includes a meeting calculator that measures the impact of any meeting or conference held at a Hilton Worldwide property. Corporate customers can also use the impact data from the Meeting Calculator to use in their own sustainability reporting," he adds.

Perhaps the most obvious threat to MICE services is that posed by the increasing quality and take-up of video conferencing services. Where a company might have flown its employees to a three-hour conference in New York a few years ago, now it might use services provided by companies such as Skype or Polycom instead, at a significant saving.

But Mr Jones points out that research on the topic has suggested that, while video conferencing is a suitable alternative for some meetings and events, there are many that benefit significantly from those involved being able to sit together and develop relationships by communicating in person. "We are a service- and people-based economy and sustaining this would be difficult without face-to-face meetings."

"The economic climate has made companies apply a broad brush of common sense. We have even substituted video conferencing for some of our weekly sales meetings and get together once a quarter instead of more frequently," he adds.

While he believes that the top-end of the sector may never see a return to the extravagant three-day conferences common of the pre-recession era, Mr Jones is positive about the future. "Experiencing such difficult economic circumstances changes a company's outlook. Having said that, many companies that previously opted for lower-end hotels have benefitted from mid-market hotels offering better value and have come to appreciate the benefits that better quality facilities can bring to such events." He therefore expects the market to grow in this middle range, but less so at the top and bottom ends.

"Scaremongers had a field day when they found out that RBS rewarded star employees with a trip to Sardinia. The market has since gone underground and companies are looking at other, less conspicuous ways to reward employees, such as high street vouchers."

exceeded planning controls and converting them to residential apartments was an attractive choice for developers and landowners.

This reversal of fortune for the hotel sector was caused in part by a series of external factors that adversely affected travel to Australia in the three years following the games, such as the growing threat of global terrorist activity, the Iraq war and the severe acute respiratory syndrome (SARS) outbreak. While Sydney's room occupancy rate responded positively to the contraction in supply from the end of 2001, the average room rate took some five years to exceed its Olympic Games peak.

The degree to which other cities are able to achieve the initial success seen in Sydney will depend on a number of factors. The competitiveness of the business environment will determine how many corporate occupiers are attracted, the amount and quality of tourist attractions and infrastructure will determine the long-term tourism appeal, and the ability to attract other major world events will determine the re-use of facilities."

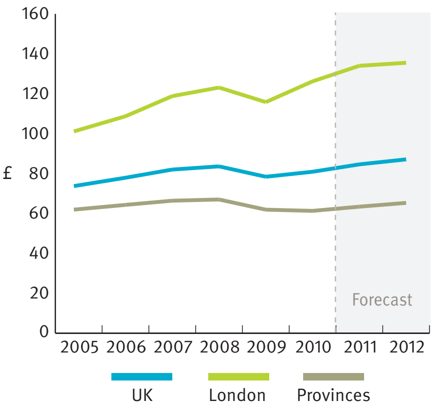
RESEARCH

Statistical analysis and digest

Knight Frank's Hotels team has access to a comprehensive range of market-leading data and analytical tools. This page provides an overview of the key metrics influencing hotel operator performance at the current time.

Figure 11

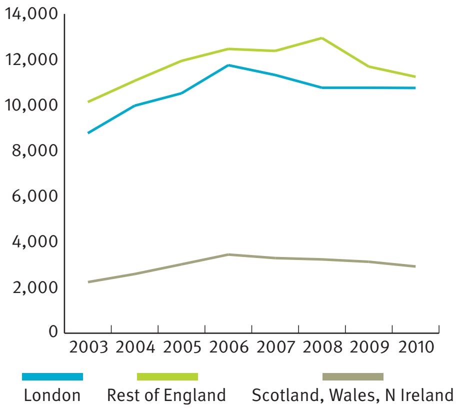
Average daily rate (ADR)



Source: PwC

Figure 12

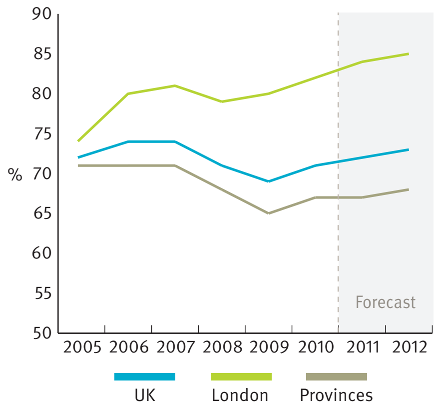
International visitors (000s)



Source: International Passenger Survey

Figure 13

Occupancy

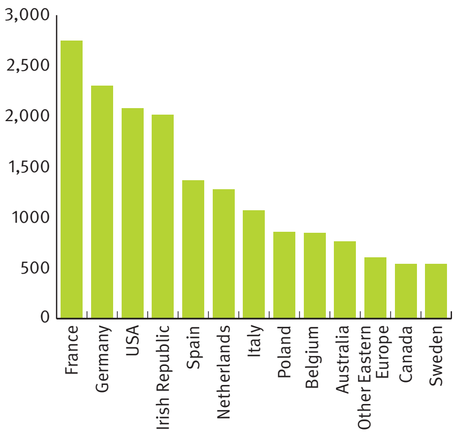


Source: PwC

Figure 14

International arrivals 2010

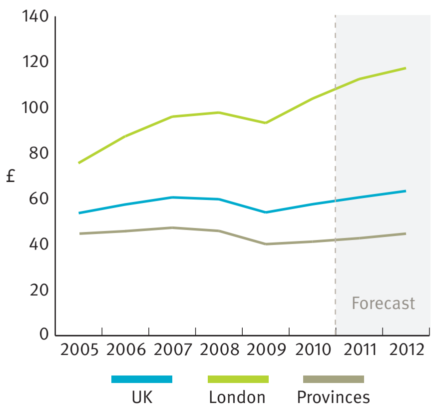
(Q1 - Q3), 000s



Source: International Passenger Survey

Figure 15

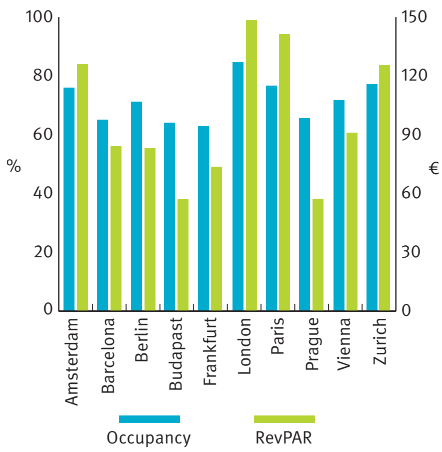
Revenue per available room



Source: PwC

Figure 16

Leading European locations, 2010



Source: TRI Hospitality, HOTSTATS

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