European Hotels
Checking in for the Recovery

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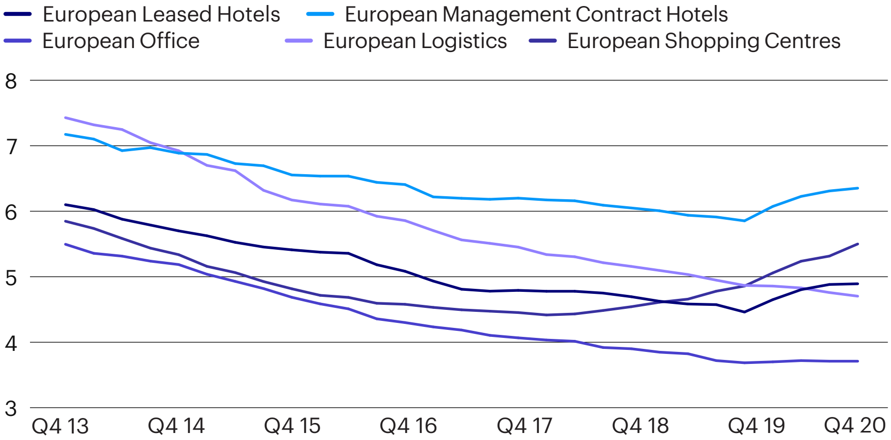
Overview
We believe that the recent repricing in European hotels could represent a good opportunity to acquire either core hotels for a long-term hold or value-add projects following a manage-to-core strategy. Valuations are down 10-15%[1] from the 2019 peak and prime yields have shifted out by 25-50 basis points, in contrast to the office, logistics and residential sectors, further increasing the relative yields from hotels[2] (**Figure 1**).

Although the sector has been hit hard by the COVID-19 pandemic, we believe this is a short-term shock rather than a reversal of long-term positive trends where revenues historically grew by approximately 3% p.a. vs CPI of 2%[3] (between 2000 and 2019).

Figure 1: Prime yields of various real estate asset classes
European average yields



Source: Invesco Real Estate, March 2021

We expect the post-COVID recovery to be led by leisure visitors initially with business travel following. Our strategy remains focused on major cities that have balanced demand drivers and constrained supply, and hence we believe that are positioned to capture early rebound in travel. Within those markets, we like hotels with a clear consumer proposition run by trusted operating partners, avoiding the undifferentiated mid-market.

As such, we see a clear benefit from investing into hotels despite the current uncertainty, but this needs to be balanced with a clear understanding of the risks that were already in place before the pandemic as well as those which have been amplified by it. In this paper, we highlight the key investment themes for the post-pandemic recovery alongside the continued importance of a focused investment strategy.

Hotel investment themes for the post-pandemic recovery

Investing into the hospitality sector today certainly requires conviction that the sector will recover, but it doesn't necessarily need to recover in full or particularly quickly to make investments into the sector potentially attractive and profitable for investors. The uncertainty over the timing and nature of the recovery means that investing into hospitality requires a thorough assessment of the fundamentals behind each investment and the potential risks and rewards that go with it.

Our analysis suggests that cities with a higher share of leisure demand with a limited pipeline of new supply will recover quickly. Within those markets, hotels in micro locations that benefit from the recovery trends combined with a strong brand will be the "first to fill" and rebuild business.

We believe the below markets will remain long-term winners due to:

Supply constraints

as a result of limited land availability and strict development regulations.

An established tourism market

in addition to strong business demand generators, that is proven to be more resilient to economic shocks.

Robust capital market size and liquidity

from core real estate markets with a wider pool of real estate buyers driven by higher confidence in the underlying land value.

We favour major markets such as:

Amsterdam

Barcelona

Berlin

London

Madrid

Paris

Florence

Prague

more leisure-led markets

Within these target markets, we favour the below investment themes:

Core investments

Focused on hybrid leases to leading brands and operators in the strongest micro-locations, avoiding the undifferentiated mass-market. Focus on where the opportunity exists to acquire hotels that wouldn't normally be available from stressed sellers.

Value-add investments

Adopting a "manage-to-core" mindset, working with a selected group of specialised operating partners to reposition assets over the next one to two years ready for the recovery.

Focus on co-invest and work on flexible structures designed to maximise value for all stakeholders at exit.

Opportunistic and debt investments

Structured to enable good businesses to be funded for the recovery.

Strategic implementation

These investment themes frame an approach and strategy for investing in the hotel real estate market. The overall goal should be to select investments that provide the optimal combination of market, micro location, brand and operator to drive above market, compounding, revenue growth which has the potential to create long-term and sustainable value.

In practice, this means following a rigorous and disciplined approach to any transactions, guided by a strategic framework, such as the example below, which guides our hotel investment strategies.

To support strategy and decision making, having bespoke research tools that allow for the detailed analysis of markets and draw insights that help deal theses and investment decisions are key. In addition, being able to verify these insights with locally based investment management teams, comprehensive market visits and asset tours adds significant value to the process.

Overall, we believe that the combination of a clear strategy, supported by rigorous analysis and local market insight will allow us to make compounding investments that create long-term, sustainable value.

High barrier markets and micro locations

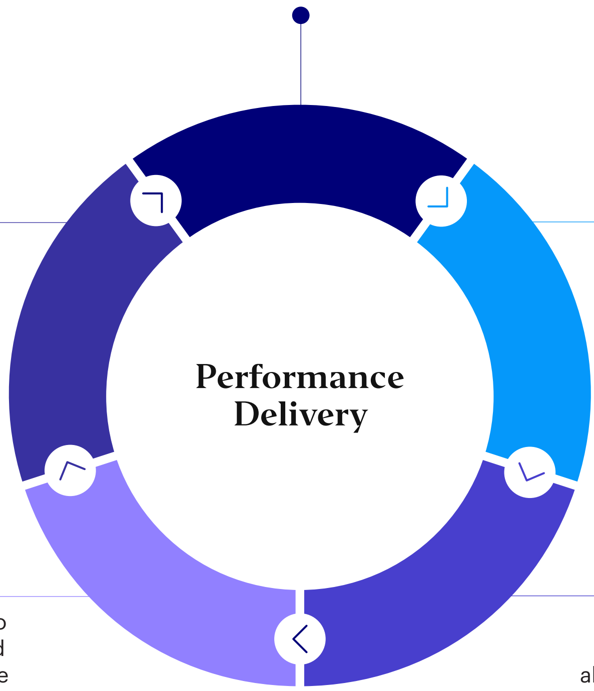
Well-located hotels in high barrier to entry markets: Micro location is paramount in all our investment decisions. We look for a balance of business and leisure demand drivers in markets with high overall market occupancy, presence of compression nights (occupancy > 90%), and a favourable supply/demand outlook.

Active capital investment

Implementation of major capex (refurbishing, repositioning, rebranding) and ESG+R initiatives is key to driving long-term performance.

Proven operators and brands

We work closely with operators and brands that have a strong track record of operational delivery and reputation through the pandemic, helping add value for our investors and their portfolios.



ESG+R[4]

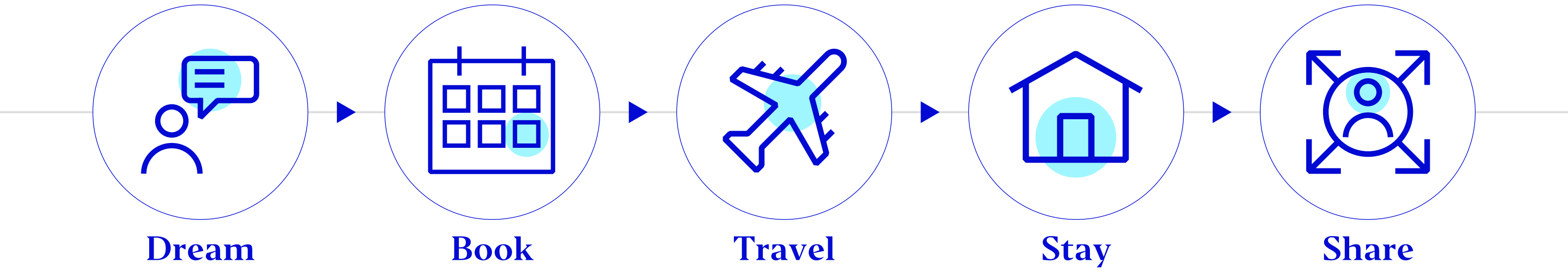
Sustainability credentials and resilience to both climate and "transition" risks created by a lower carbon economy, have become central to our asset selection criteria.

Aligned deal structures

We structure deals that suit both the real estate investor and the hotel operator, aligning the interests of both parties usually through a hybrid lease structure.

Changing consumer trends – technology, disruption, and the democratisation of travel

Over time, changing consumer trends and demands combined with the impact of technology have increased the level of disruption in the wider travel sector. This impact is perhaps best thought of by considering the guest journey[5] as shown below:



Habits have changed over the last decade and more of this journey is enabled by technology, typically via mobile devices. This includes travel booking websites and apps, and the sharing of experiences on social media. The stay experience is, of course, a physical one and cannot move online, but technology is having a greater impact here too, such as mobile check-in and keys, in-app communications, and hotel hosts acting as virtual city tour guides.

More importantly though, technology has driven a democratisation of the travel experience – guest reviews provide comfort for unbranded hotels and home rentals via platforms such as AirBnB, allowing for a greater degree of personalisation to specific guest needs.

However, some cities have pushed back on AirBnB's presence, particularly to enforce compliance with local laws and regulations to ensure there is a level playing field on taxes and guest safety with all accommodation providers, and therefore, growth in hotel performance has been maintained despite growth in AirBnB; this change was already well absorbed. We think this will remain complementary and a manageable influence on future hotel demand.

COVID-19 has seen a sharp reduction in air travel and is likely to lead to a consumer reappraisal of volume and frequency of international travel for both personal and sustainability reasons. Notably, it is estimated that 1% of the global population created half of the airline industry's carbon emissions in 2018.[6]

It remains too early to tell how quickly travellers will return post-pandemic, however, we note that historically travel has rebounded.

Whilst sustainability trends are growing with consumers, technology disruption and the push to more sustainability-focused behaviour will not, in our view, remove the need for hotels. However, the sector must ensure hotels remain truly relevant to the needs of their guests and provide them with a clear and differentiated value proposition.

Brands and operators

The largest global hotel companies have become increasingly focused on the growth of both their portfolios of brands, loyalty programmes, and system size (number of hotels/rooms) over the last decade: the five major global brand companies (Hilton, Marriot, IHG, Accor and Hyatt) have added almost 60 brands to their portfolios in this time either organically or via M&A, doubling the number of brands these companies own since 2010.[7]

This shift has happened alongside a move away from hotel operations by these companies, particularly for midscale brands, and the growth of independent hotel operators. Meanwhile, regional branded operators (e.g., NH, Scandic, Motel One) and specialist lifestyle operators (e.g., Ruby, 25hours) have continued to focus on operational excellence alongside the growth of their brands and continue to lease hotels in their target markets.

As the major hotel companies continue to deal with the pandemic and pursue asset-light growth we believe that niche operators and specialist brands will be attractive targets, and that further consolidation remains likely.

Where new brands meet a clearly identified consumer need, ideally with the benefit of a global loyalty programme, then there can be success in our view, but we are cautious of investing in new brands and those without relevant scale. Two areas to consider are lifestyle and extended stay hotels – we believe there are brands and operators in each sub-segment that have strong consumer appeal and the proven ability to grow revenues and profits above market rates.

ESG+R[8]

The construction and operation of real estate is estimated to contribute approximately 40% of global greenhouse gas emissions. Of all commercial buildings, hotels are one of the largest energy and water users per m^2, accounting for 2% of the 5% global CO^2 emitted by the tourism sector.

Invesco Real Estate has committed to a 3% annual reduction in energy and emissions from our global portfolio by 2030, from a 2018 baseline, and to become net zero by 2050.[9] To achieve this, we are working hard with our operating partners to monitor consumption parameters for energy, water, and waste with a strong focus on driving further improvements.

There is significant scope for the tourism industry to create a positive impact across many of the United Nations Sustainable Development Goals (UNSDG), particularly those connected to real estate, cities, broader social communities, and hotel supply chains.

From a social standpoint, hotels operate 24/7 with many employees on low wages and are often well-located in the inner city where affordable housing remains a wider problem. In our view, social sustainability is a key element when investing in the hotel sector, and these issues will become increasingly prominent. We work closely with our operating partners to improve the sustainability of our hotels, hosting regular roundtable events since 2016, bringing together all stakeholders while implementing clear and actionable ESG+R targets.

Within Invesco Real Estate's hotel portfolio, we proactively improve the environmental aspect of our assets, and we are currently considering sustainable improvements as part of significant capex programmes in nine hotels in Germany. We monitor our ESG performance and our improvements by endorsing green building certifications (e.g. BREEAM and LEED), and the fund rating system GRESB.

90% of our hotel portfolio achieved BREEAM scores between Good and Excellent, and the 13 portfolios that were submitted to GRESB in 2020 received a score of 29.6 out of 30 in the management component, reflecting our strong ESG leadership and practices. Our European Hotel Fund scored five stars in GRESB in 2020, outperforming its peer group average.[10]

Looking forward, we are seeking to invest only in assets that either already meet high ESG+R standards or where there is clear scope for improvement, and we assess this both at acquisition and on an on-going basis.

Net Zero

Carbon emissions by **2050**

3%

Annual reduction in energy and emissions by **2030** from a 2018 baseline

Market recovery and forecasting: Invesco Real Estate's House View

Demand

Travel and tourism was a key component of the global economy before the COVID-19 pandemic, generating 10% of global GDP and providing 1 in 10 global jobs.[11] The impact of the COVID-19 pandemic on the travel and tourism sector is clear to us all. Indications from Oxford Economics are that demand will recover back to previous levels by 2024[12] and we note that travel has historically been resilient to crises and has come back stronger – international travel grew by 117% between 2000 and 2019, despite setbacks including 9/11, SARS and the global financial crisis. In our view, the pace of recovery will be driven by the vaccine rollout and key themes that we have seen before:

Leisure will recover faster than business travel

But we believe both will recover. The key risk is to regular business travel demand where mid-level executive travel could be cut back following the success of video conferencing during lockdowns.

Domestic will recover faster than international

However this trend will be short-lived and revert to long-term trends when airline routes are re-established.

Luxury and budget will recover faster than the mid-market

Luxury guests have historically stopped traveling first in a crisis, but then started again first. The budget market benefits from travel that is absolutely necessary – from domestic travelling salespeople to people visiting friends and family and needing a room for a night.

Conference and events business will be the last to recover

However, we expect a greater resilience here if there are wider business travel reductions, leading to a greater intent to attend fewer, but larger conferences and events.

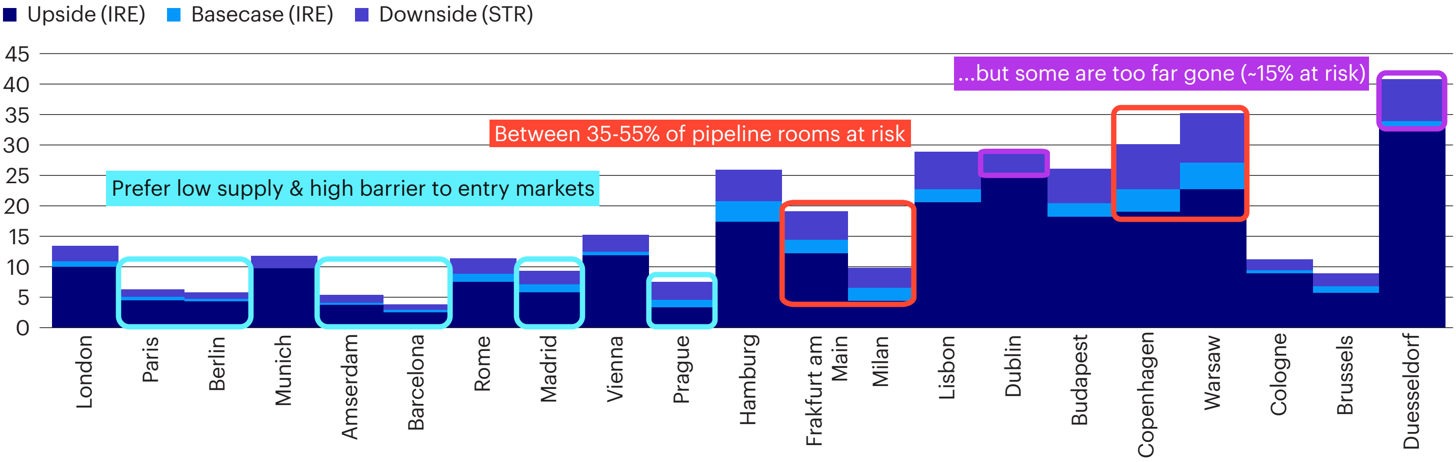
Supply

New supply growth was one of our major investment risks prior to the pandemic, and it will remain so during the recovery. Following the financial crisis, supply growth in Europe was particularly muted (averaging around 1% p.a. vs a long-term trend of 2% p.a.[13]), but it accelerated before the pandemic, and several cities now have significant supply pipelines as a proportion of existing stock. In and of itself new supply is not necessarily a bad thing – new product will improve standards and drive competition, and on a long-term view can provide an opportunity to buy high-quality, new-build hotels. However, short-term performance does come under pressure, which will be exacerbated by the pandemic.

Following the pandemic, we expect a significant rise in the cancellation of pipeline projects given the difficulty of securing funding and challenged business plans. For comparison, after the global financial crisis supply pipelines decreased by approximately 20%. This could be positive for the performance outlook of some markets that were at risk of being oversupplied and could provide a further opportunity for investment in markets where the supply pipeline could contract materially (**Figure 2**).

Figure 2: Supply pipeline in major European cities

Pipeline – risk-adjusted (2020-2025, % of supply)



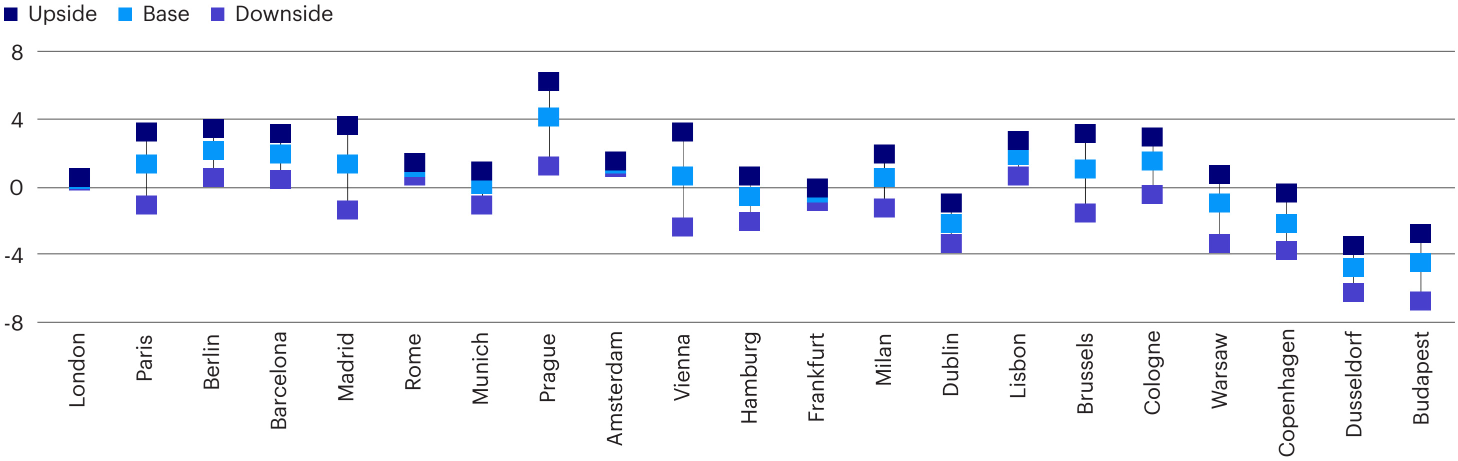
Source: IRE Research using STR data as of April 2021

Hotel revenues

An assessment of these supply and demand trends blending historical and forward-looking data has resulted in our updated market forecasts for revenue per available room (RevPAR), where we have adopted a range of scenarios based on the speed and nature of the recovery. Overall, our base case forecasts a return to 2019 performance levels in 2024, with an upside based on a fast vaccine roll-out and quick consumer response bringing this forward one year to 2023. Our downside assumes that the pandemic results in a major economic contraction and the continued loss of business demand which doesn't fully recover.

At a city level, we expect destinations that are exposed to a combination of regional demand and a high share of leisure guests to perform best. Similarly, a limited pipeline of new hotels entering the market will allow existing hotels to recover faster. In this respect, markets such as Amsterdam, Barcelona, and Berlin remain favoured. Certainty of recovery reduces, however, as the exposure to business travel, conference and international demand increases and we expect markets such as Frankfurt and Dusseldorf to take far longer to recover fully (**Figure 3**).

Figure 3: RevPAR forecast growth by city (2019-24 CAGR) (%)



Source: Invesco Real Estate, March 2021

Conclusions: Checking in for the Recovery

We believe that COVID-19 has been a shock to the previously strong growth trajectory in the travel and tourism market rather than a reversal of a thematic trend. We continue to believe in the recovery and growth, while in the short-term see an opportunity to access the sector at a reduced value and realise short-term value gains as well as access to long-term income. In our view, hotel real estate investment potentially offers investors with a yield premium to most other real estate asset classes on long-term, sustainable leases with further upside potential in the recovery.

However, investing into hotels today requires a clear understanding of the risks and potential rewards of a sector that has been severely impacted by the pandemic. We believe that tackling this starts with a clear investment strategy at the asset level that we then use to determine portfolio strategies for our clients. We follow this approach rigorously, supported by our bespoke research and industry-trained investment and asset management teams.

1 Source: HVS, Invesco Real Estate
2 Source: CBRE, Invesco Real Estate
3 Source: Oxford Economics
4 Source: ESG+R = Environmental, Social, Governance and Resilience
5 Source: BCG
6 Source: Linnaeus University
7 Source: hotel company websites
8 Whilst the fund manager considers ESG aspects they are not bound by any specific ESG criteria and have the flexibility to invest across the ESG spectrum from best to worst in class.
9 There is no guarantee a target can be achieved
10 Any reference to a ranking, a rating or an award provides no guarantee for future performance results and is not constant over time.
11 Source: WTTC
12 Source: Oxford Economics
13 Source: STR

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