HARVESTING OPPORTUNITIES IN THE AUSTRALIAN HOTEL MARKET

- Ronald Stephen Barrott, Pro-invest Group

Given the active management hotel assets tend to require, traditionally this 'niche' real estate sector is overlooked or declared as 'non-mainstream' by the majority of real estate investors.

However, given the attractive yields of skilfully acquired hotel assets – in particular those that can be found within the Quality Select Service hotel segment which show cash-on-cash returns to investors in the early teens – more attention has been paid to this sector in various parts of the world, with some prominent US and Asian REITs becoming increasingly active in the sector.

DEMAND IS OUTSTRIPPING SUPPLY

One of the latest geographies where this sector is experiencing substantial growth is Australia, a continent which – up until recent years – has been known for lacking hotel room supply. Demand, measured by room nights occupied, has been growing at almost double the rate of supply (rooms nights available) leading to a lack of hotel rooms available for guests, in particular in the Quality Select Service segment. Given the lack of additions to supply, key hotel metrics such as occupancy, average daily rate, RevPAR (revenue per available room) and revenue have experienced strong growth.

Most of Australia's key markets are experiencing occupancies in excess of 80%, with country-wide RevPAR following an annual growth rate of over 3%. Demand growth is forecast to continue to outstrip growth in supply, which is leading to a positive outlook for the sector. Also, New Zealand hotels collectively recorded their best results in five years in FY 2015-16 on the back of limited additions to supply and very strong demand growth from international arrivals.

In regards to investment activity, yields significantly tightened since 2010, with the average initial yield achieved on investment grade sales now around 6.0%.

WHY INVEST IN HOTELS NOW?

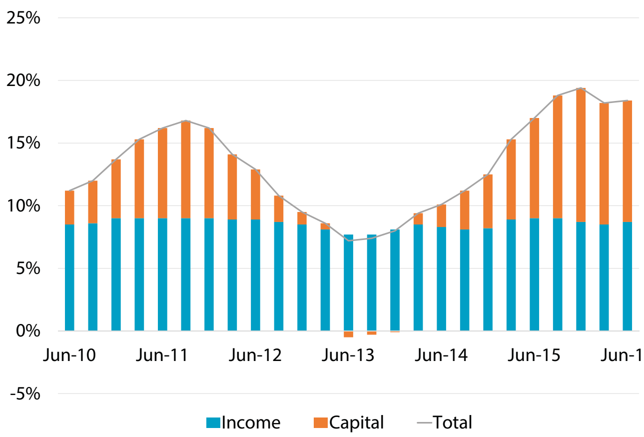
Interestingly, the risk-adjusted return of Quality Select Service hotels in Australia has been found to outperform that of core office buildings (see Fig. 2, Quality Select Service hotels fall into the 3 & 4 star hotel category).

Corporate clients (such as Siemens and Google) are demanding dependable, consistent, quality accommodation facilities at a competitive rate per night at a scale. Hotel products that satisfy the corporate and millennial markets' expectations can help ensure occupancy exceeds its fair share against its competitors and also reduce the likelihood of guests using alternative accommodation such as Airbnb, as corporate travellers are not as willing to accept staying at somebody's home given the lack of service consistency and grey areas around insurance policies and potential tax avoidance (which corporates are not able to expose themselves to).

The income returns of Australian institutional-grade hotels have demonstrated low volatility over past years, with running yields around 7-8% per annum before leverage. This is noticeable in buoyant as well as particularly challenging economic environments. Hotels that target a range of business segments, including both corporate and leisure, as well as hotels such as Quality Select Service hotels, which have a large proportion of variable costs versus fixed costs, are significantly more resilient to market downturns.

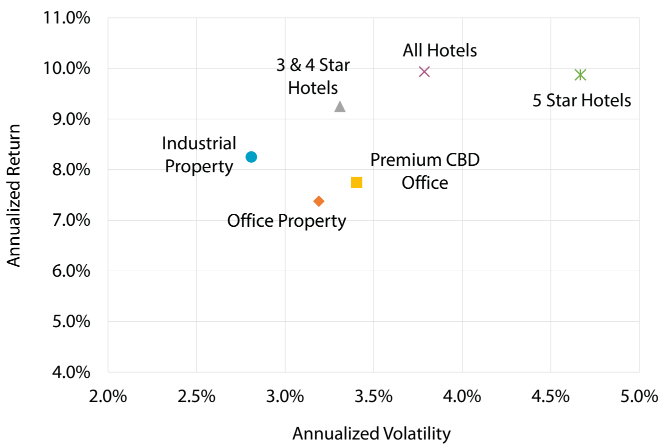
The relatively stable income returns and running cash-on-cash yields in the early teens are of particular interest to institutions such as pension funds, superannuation funds, insurance companies and – indeed – the majority of investors looking for a higher yield in our current low interest rate environment.

Fig. 1: Total Returns for Australia Hotel Property Index: Annualized Returns Ending to June 2016



Source: MSCI

Fig. 2: 3 & 4 Star Hotels: Better Risk-Adjusted Returns than Core Offices



Source: IPD, RBA

Pro-invest is in the unique position of having built up a platform with a very detailed pipeline for sites and hotel assets and – as such – is able to provide the level of scalability institutional investors are looking for. With an ever-growing pressure on institutional investors to see their funds put to work, given our exclusive arrangements with hotel brands, we are able to assist in deploying funds in a sensible manner over a fairly short period of time.

Given that the supply of Quality Select Service accommodation falls significantly short of demand in Australia, there is presently the opportunity for investors to create a secure, growing income stream through the development of new, purpose-built, efficient hotel assets in areas where under-supply is particularly acute.

As a result, Pro-invest Group has embarked on developing a portfolio of around A$1bn of Quality Select Service hotels in major cities throughout Australia and New Zealand with a focus initially on a geographically diversified portfolio in CBD locations and hence following a "Build-to-Core" strategy. By developing new, efficient, Grade A buildings, "Build-to-Core" investors can ensure that their assets meet the latest guest expectations, with a portfolio of modern, future-proof hotel properties well positioned to generate long-term, stable cash flows.

In an environment in which development finance remains constrained, investors that are willing and able to fund new hotel developments can access attractive returns, suitably compensating them for the associated development and letting risk. Our track record proves that we are able to mitigate most of these risks by a) acquiring sites for development that have undergone a thorough assessment of the local environment, market and planning authority constraints and b) partnering with the largest international hotel management companies in order to leverage room nights from their corporate accounts and large reservation system, which drive high occupancy rates once the hotel is opened.

HOTEL ASSET MANAGEMENT

The separation of hotel ownership and management as well as the increasing complexity of the industry have created a growing need for dedicated, specialist hotel asset management (HAM) services, which are able to effectively monitor the performance of hotel assets and ensure ownership interests are protected.

This has been accentuated by the institutionalization of hotel ownership and the rise of ownership groups (such as hotel funds) over the past two decades. The need for asset managers arises from the fact that hotel operators and hotel owners typically have diverging goals. This lack of alignment is especially acute with branded operators for which growth and protection of the brand trumps the individual needs of a given asset. Given the nature of their role, hotel operators are for the most part focused on the 'hotel business'. A good hotel asset manager will however be focused on the 'business of hotels', taking more of a strategic view towards the asset and ensuring that operating modalities are balanced with the owner's financial objectives.

In order to be successful, a hotel asset manager should understand, articulate and be capable of fulfilling the owner's investment objectives. Thus, the best asset managers combine practical hotel operations experience with solid financial and analytical skills. Having hands-on experience allows them to understand the granularity of the business and adds credibility when dealing with the hotel's operational team. On the flip side, having the financial and analytical capacity to understand the nuances of hotels' income statements and valuations is also critical. Combined, a good asset manager can enhance department profits in the order of 3-5% and 5-15% of Gross Operating Profit margins.

OUTLOOK

Given the low interest rate environment we are exposed to in all global markets combined with low bond yields, there is no doubt that real estate will remain an important part of investors' overall asset allocation.

When looking at the 'classical' geographies institutional investors like to 'tap into', there is a growing level of concern and uncertainty owing to BREXIT, the EU's political disengagement, the US election etc.; most Asian markets – despite their fundamentally strong and healthy economies – are perceived to be on the higher spectrum of country risk.

However, Australia (and New Zealand) stand out given their diversified economic fundamentals which have proven to be more resilient to the commodity bust than expected (as the world is generating less substitutes for iron ore than for oil & gas these days), and there is a growing demand from an Asian middle class that looks at Australia as a desirable place to live that is opening up a diverse range of opportunities for growth.

In order to maximize risk-adjusted returns, investors should consider looking beyond traditional core strategies and standing office buildings in Sydney or Melbourne and team up with managers that can secure/develop the right assets in the right locations and implement a rigorous active management approach to align investor and fund manager interests.

This is the 'value-add' philosophy Pro-invest is following and by offering either funds with a tailored investment strategy or select joint ventures and separate accounts that are designed to best meet investors' customized strategies, we can cater to investors' own risk and return preferences.

Looking at all of the uncertainty in the global markets, now seems a good time to take advantage of the opportunities that exist in the Australasian real estate markets for attractive, long-term income returns.

PRO-INVEST GROUP
Pro-invest Group is a leading international private equity real estate firm specialized in investing into hospitality-, retail- as well as office assets with an active management approach. The Group has a long track record in developing as well as operating hotels in Europe, Middle East and Asia and is managing the Pro-invest Australian Hospitality Opportunity I which owns, develops and operates a portfolio of select service hotels across Australia and New Zealand and has a development portfolio in excess of A$1bn.

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