Hotel Investment Outlook 2016

Hotels & Hospitality Group | January 2016

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2016: Strength in unity

2015 marked the second-highest year on record for hotel transactions, posting a confounding growth rate of 50% on the prior year, a figure which far exceeds that seen in other real estate sectors. With global transactions topping $85 billion in 2015, the year saw a number of records: The volume of single-asset transactions, at $47 billion, was the highest ever. Cities such as New York and Hong Kong saw their highest annual transaction volume level. Blackstone's purchase of Strategic Hotels & Resorts in late 2015 marked the largest portfolio transaction in eight years. And the proportion of cross-border purchases reached a new high, signifying the ever-growing dynamism and globalisation of the sector.

Global hotel transaction volumes

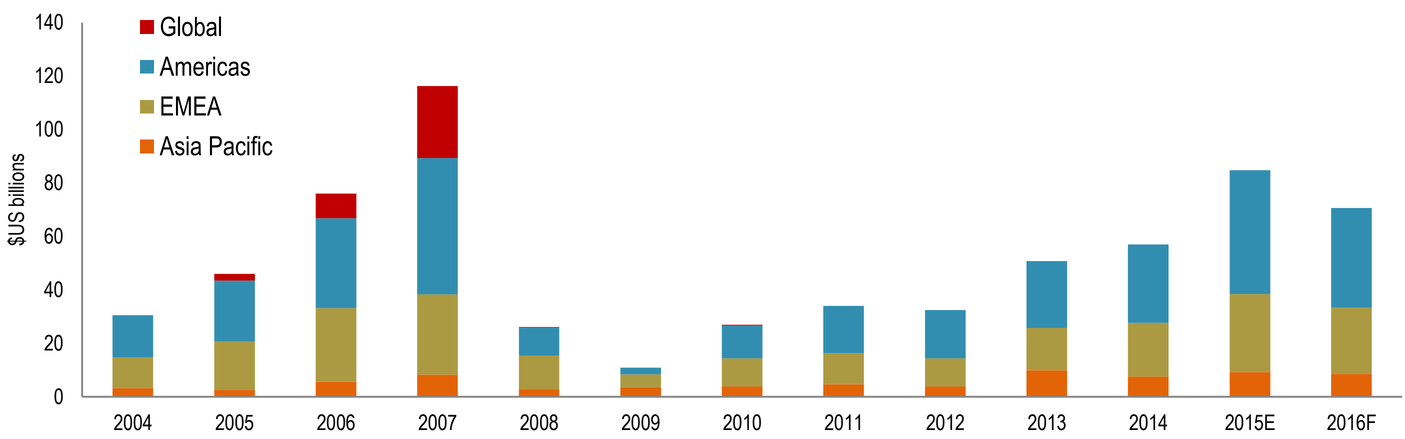
$US billions	Americas	EMEA	Asia Pacific	Global total
2015E	$46.4	$29.2	$9.2	$84.8
2016F	$37.1	$24.8	$8.5	$70.4
% Change	**-20%**	**-15%**	**-8%**	**-17%**

Source: JLL Research

We expect 2016 to be another strong year, although investors' desire to buy is more measured. We project transaction volumes of $70 billion, which would mark 2016 as the second-highest level of the cycle, and is higher than our initial forecast for 2015.

As such, there is positive momentum as we transition into this stage of the expansionary cycle, though investors will take a more cautious approach. Investors are starting to consider what holding assets through a down cycle will look like and making more careful considerations around financing structures.

Global hotel transaction volume



Source: JLL Research

Stock markets across the globe will see volatility, and this will weigh on investor sentiment, but the underlying hotel market fundamentals remain positive. Notwithstanding certain gateway markets where growth is peaking, most markets, and in particular secondary cities, still have room in the tank for continued rises in hotel profits.

Volumes across the Americas to notch $37 billion

The Americas region is forecast to see transactions totalling $37 billion. As in recent years, the United States is expected to be the single most liquid country in terms of transaction volume. 2015 broke a new record in this cycle, boosted in part by Blackstone's $6 billion purchase of Strategic Hotels & Resorts, which was completed in December 2015. Activity across the board is slated to soften by 20% in 2016.

In the U.S., investors are re-trading assets purchased earlier in the recovery cycle, and momentum is further fuelled by the weight of private equity raising funds and pursuing large single assets and portfolios. With historically low cap rates in primary markets, we expect to see robust activity in secondary regions, such as the Midwest. Given their lower share prices, real estate investment trusts (REITs) are expected to be net sellers, with dispositions often accretive in that they can buy back shares at discounted prices. We expect to see additional privatisations of REITs, given that in many cases the entity as a whole is trading for less than the individual asset values.

With REITs less active buyers, offshore investors stand to become the second-largest buyer type after private equity. The ownership composition of hotels remains fragmented and there is opportunity for fewer larger owners to own more stock. We expect the industry to head into a cycle where hotels will transact more like office buildings, with investors trading in and out on a consistent basis. Given the healthy macro-economic environment in the U.S., capital will continue to flow and we see a normalised asset trading environment ahead.

The year for single-asset transactions in Europe's secondary markets

Europe, the Middle East and Africa (EMEA) will continue its stride with a projected $25 billion in hotel trades in 2016, down about 15% on last year. Sales will be driven by single-asset transactions, with an increasing share in secondary markets. 2015 saw remarkable portfolios, and portfolio purchases are now set to return to more normalised levels. Given the culling of portfolios and prime single-asset properties coming to market this year, we expect single-asset transactions to increase by 35%. The relative weakness of the Euro against the U.S. dollar will help inbound tourism, notwithstanding some reticence among travellers given recent terrorist acts.

To find yield, investors will look beyond the mainstay markets, with provincial UK, secondary German cities, Spain – both the major cities and resort markets, Italy and Portugal receiving more attention. Lenders are increasingly active across non-gateway cities as well.

On the buy-side, private equity and sovereign wealth funds will be active, and Mainland Chinese investors will continue to purchase hotels. Sellers will include investment funds and private equity investors who made early-cycle buys. Europe is expected to remain the largest destination for offshore capital in 2016, as it is the recipient of inflows from U.S.-based private equity funds, Middle Eastern investors and capital from Asia.

In the Middle East the outlook for hotel operating fundamentals remains tepid, in part given economic weakness in big tourism source markets such as Russia. At the same time, given governments' support for development, the new hotel pipeline is staying robust.

Japan and Australia to be the standout in Asia Pacific

On the back of one of the strongest years for Asia Pacific, the region is slated to see volume of $8.5 billion, a 5% to 10% decline on 2015. Japan saw its second-highest amount of transactions ever in 2015 and the market will continue to see a strong bench of domestic investors in addition to interest from U.S. private equity funds. We are also seeing early trends of Chinese investors evaluating purchases in secondary Japanese locations.

Australia will remain active as well, in particular with regard to portfolios. Given the large number of prime single assets having traded to long-term holders of late, the amount of product on the market will be lower. Mainland China has started to see in excess of $1 billion in hotel trades annually, and this level is expected to continue if not increase in 2016.

The tightly-held hotel stock in Singapore leads to deals being few and far between. Investors will take more of a wait-and-see approach in Hong Kong, which saw its highest year for deals ever in 2015, with hotel performance largely having peaked. Pockets of liquidity will also be seen across Southeast Asia and the Indian Ocean.

India's hotel landscape is changing – from being development-driven to becoming more transaction-based. Improved hotel operating performance is providing the impetus for acquisition and consolidation in some markets.

Lastly, in Asia, there remains opportunity for the formation of more hotel REITs if entity-level tax structures change to offer similar benefits to those seen in the U.S.

Wildcards

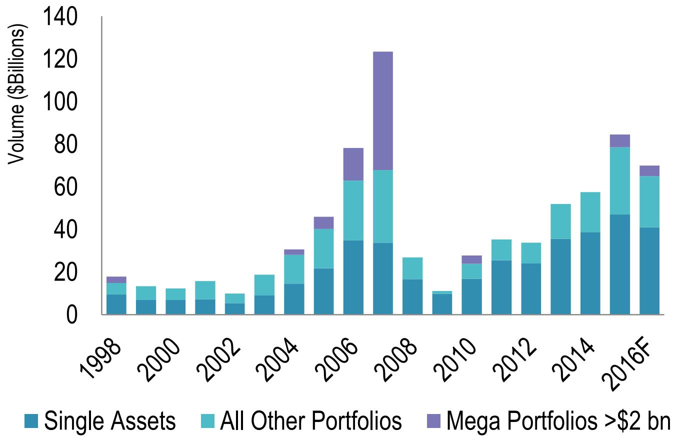
While volatility is challenging some investors – for example the impact of low oil prices on Middle East economies; unpredictability in equity markets; a prolonged slowdown in China; economic malaise in emerging markets such as Brazil and Russia – there will be plenty of ways to profit from property over the next 12 months.

A number of factors could impact our hotel transaction volume. On the upside, a higher than expected push from capital exporters in China and the Middle East would put an upward pressure on deal flow. The U.S. just signed into law a measure easing a 35-year-old tax on foreign investment in U.S. real estate, potentially opening the door to greater purchases by overseas investors. Any large corporate-level real estate mergers and public-to-private acquisitions – of which a few are expected – would create a further spike in volumes.

And on the downside, terrorism, political conflict, natural disaster, a pandemic or other demand shocks have the potential to impact travel and tourism. While fears about terrorism are not derailing travel globally, certain markets will see pressures. Even Paris has not been immune to a slowdown in visitor arrivals, but based on the precedent in other cities which have faced attacks, the travel disruption should be short-term.

Expect more M&A and consolidation

Global hotel transaction volume by deal type



Source: JLL Research

Hotel companies made headlines in 2015 announcing purchases of competitors. Many of these large deals, such as Marriott International's merger with Starwood Hotels & Resorts, are expected to be completed in 2016, and more consolidation is on deck.

Even with the mergers and acquisitions announced in 2015, the lodging industry remains considerably more fragmented than other large consumer industries in terms of the market share controlled by the top brands. We expect to see more consolidation among operators and real estate owners alike, whether portfolio optimisations or public-to-private trades.

The case for hotel brand consolidation is that public markets reward growth. Hotel brands are on a never-ending quest to bolster their pipeline. With the natural attrition in properties and limits to new supply growth, the surest way to grow is often by acquiring operators with strategic management or franchise contracts. Equity analysts favour those that have a full range of offerings, in terms of service levels and geography. Furthermore, with revenue per available room (RevPAR) growth slowing across mature markets, brands and management companies are looking to boost EBITDA and garner efficiencies by adding properties.

Lastly, a larger size is expected to give hotel companies more power to respond to broader matters taking place in the industry. Prevalent examples here are the growing market share of disruptors such as home sharing sites and alternative accommodations services, and the increasing clout of online travel agencies. In addition, it is simply too expensive and inefficient for there to be so many brands and smaller parent companies, each with their own corporate overhead, sales and marketing teams, digital architecture and booking platforms.

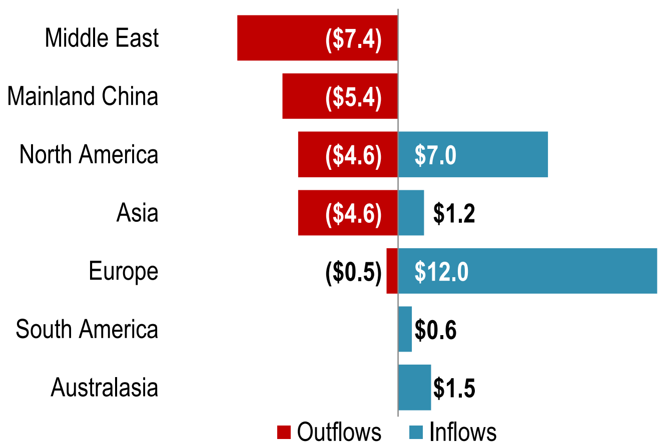
Consolidation appears to offer the greatest opportunity and benefit among brands with 5,000 to 15,000 rooms globally. There are approximately 100 such brand parent companies, and opportunity to consolidate abounds, from the economy sector all the way to the luxury space.

A lot of cross-border activity on deck

Cross-border interest is expected to remain heady: Some $30 billion in capital acquiring hotels crossed national borders in 2015. While overall volume will temper in 2016, we expect to see a significant proportion of cross-border activity.

The big movers will be U.S.-based private equity funds scouring the globe for higher-yielding opportunities. Secondary markets across Western Europe will be a big target, along with hotels in Japan. There is no doubt that there is more capital to place; the challenge is finding the right-priced opportunities.

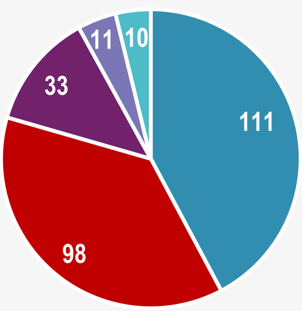
Hotel transactions: Capital outflows and inflows (USD billions)



Data pertains to 2015
Source: JLL Research

Even with oil prices depressed and local economies burdened, Middle Eastern investors have not been given an official mandate to rein in spending. Given the relatively smaller investment grade market at home they will continue to have an outbound focus. Middle Eastern investors pumped nearly $7.5 billion into hotels globally last year, and even with some decline, 2016 could mark the second or third highest year on record. Even if large institutional funds slow their buying spree, we expect an increase in high-net-worth-tied family offices placing capital in safe havens abroad.

Number of brand parent companies by room count:



- 2,500-5,000 rooms [PURSUIT COSTS DISPORPORTIONATELY HIGH VS. DISTRIBUTION GAINED]
- 5,001-15,000 rooms [SWEET SPOT AND MAIN AREA OF OPPORTUNITY TO GAIN SCALE]
- 15,001-50,000 rooms
- 50,001-125,000 rooms [TOO BIG AND TOO EXPENSIVE FOR MOST]
- Top 10 global parent companies [TOO BIG AND TOO EXPENSIVE FOR MOST]

Source: JLL Research, Smith Travel Research

As we forecasted, mainland Chinese investors exported over $5 billion into hotel real estate across the globe in 2015, and the country accounted for nearly half of all cross-border investment out of the Asia region. Chinese investors have brought a new perspective to deal selection and 2015 was China's breakout year in terms of transactions.

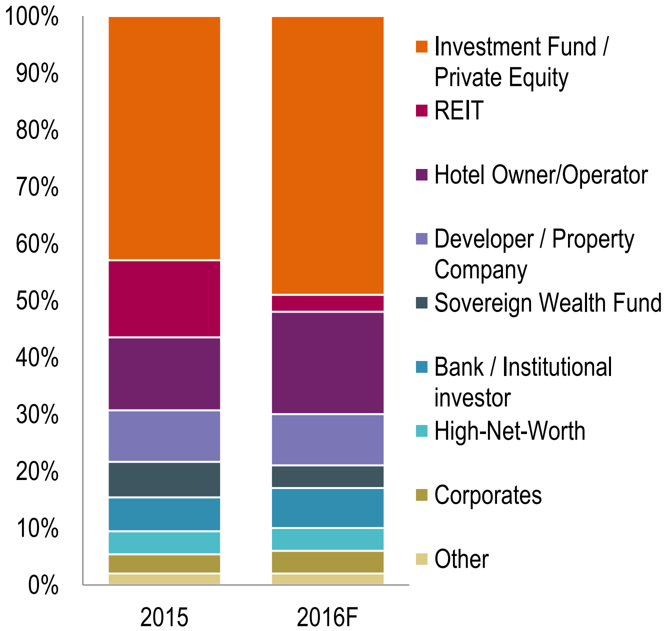
But given volatility and government pressures at home, a short-term pullback is anticipated among the insurance companies and larger funds. However, wealthy family conglomerates will continue to have strong appetite to invest outside the country. Chinese investors are also starting to pursue secondary markets. Mainland China outbound capital, and Asian capital as a whole, are expected to target not only individual assets and portfolios but brands, platforms, operating companies – opportunities to gain scale and control broader companies across the leisure and travel sectors.

Who's buying in 2016?

Private equity funds are still flush with cash and have a need to deploy capital, motivating them to push forward with deals. For funds raised earlier in the cycle, there will be increasing pressure for the money to be placed during the funds' investment horizon. Private equity groups based in the U.S. and Western Europe will lead the charge here, with secondary markets in the U.S., UK, Germany, Spain and Japan the biggest targets.

Real estate investment trusts, which are more prevalent in the United States, will take a backseat on acquisitions until their share prices rebound. Thus, in the U.S., offshore investors will become ever dominant.

Hotel acquisition volume by buyer



Source: JLL Research

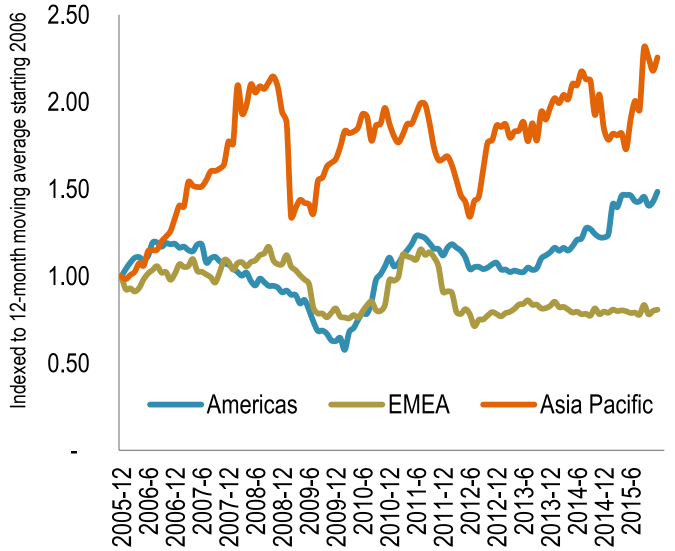
Discretionary investors, on the other hand, have fewer deployment requirements or market timing pressure. This group includes sovereign wealth funds, institutions, developers and high net worth investors who will deploy capital only if they are attracted to a property and a deal. These investors are expected to continue to concentrate on primary markets in 2016, and given their long-term hold horizon, will be less focused on timing the market cycle and more on the opportunity and asset quality.

We expect 2016 to be another strong year but investors’ desire to buy is more measured now and volumes will be closer to 2014 levels than the 2015 outcomes. Our projection of $70 billion would mark 2016 as the second-highest level of the cycle, and higher than what was initially forecast for 2015.

Europe to offer the greatest value

Europe still offers more upside on the recovery curve with per-key values of assets – outside of London and Paris – still below the previous peak in both Western and emerging Europe. Indexing single-asset transaction values on a per-room basis to the trailing 12-month average going back ten years suggests that EMEA still has more value plays.

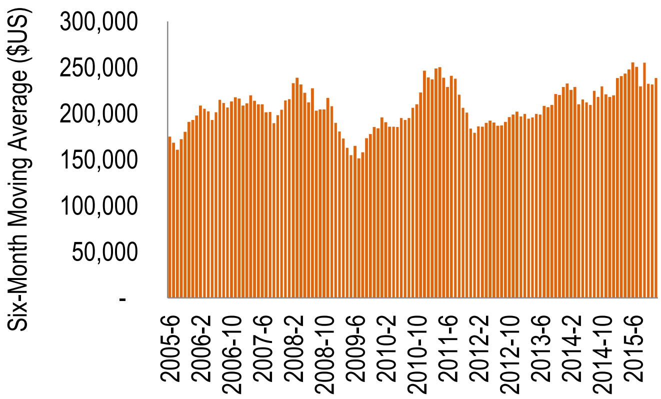
Single-asset hotel transaction values



Source: JLL Research

In the U.S. and Canada, hotel values have climbed above the previous peak, marking significant recovery milestones – but also pricier purchases. Hotel valuations across Asia Pacific have generally eclipsed the previous peak levels seen before the global economic downturn – in part because the region did not fall as deeply. The trend line for Asia Pacific is more volatile due to the lower transaction volume overall.

Global single-asset hotel transactions average price per room



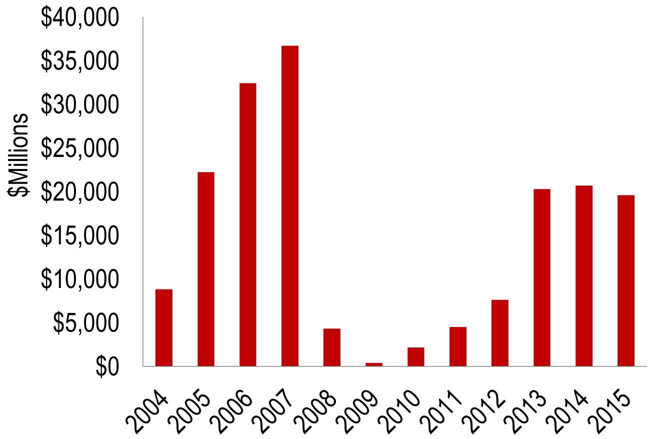
Source: JLL Research

While 2015 broke the cycle's record in terms of deal volume overall, the asset value increases on a per-room basis remained supportable, and in no way represented a period of excesses. In general, hotel values will continue to rise in 2016, with the highest value increases expected across secondary markets where the incoming supply pipeline remains manageable. However, an uptick in cap rates is all but certain.

Lenders accommodative, but some caveats

Debt markets are open, active and liquid, but lenders' sentiment has retracted a bit from 2014 and 2015. Debt is accommodating to the hotel sector, notwithstanding certain caveats. As the cycle matures, lenders are becoming more cautious with regard to future underwriting, and given that banks' hotel exposure has been on the rise again, they will slowly become more selective in 2016 unless the global economy sees a considerable uplift.

U.S. hotel CMBS issuance



Source: Commercial Mortgage Alert

In terms of commercial mortgage-backed securities (CMBS), rating agencies are taking a slightly more cautious view and pricing is seeing some upward pressure while loan-to-value rates may see downward pressure outside of the strongest markets. That said, lenders can underwrite the strongest and longest growth trajectory, optimistic sentiment prevails and secondary markets that are not as advanced on the recovery curve stand to benefit.

Interest rate environment manageable

The U.S. Federal Reserve's decision to raise interest rates marks a new era in global monetary policy. But when the Fed took its first step, the market expected it and this first gradual uptick had already been priced into investments for the most part. This first move is as much psychological as it is financial, and was largely seen as a sign of strength and confidence in the U.S. economy.

The interest rate environment in the U.S. will remain benign in 2016 and the rates' impact on asset pricing in 2016 is expected to remain minimal, and investors will not alter major investment decisions as a result. While monetary policy will shape investors attitudes, it should not shape their strategies.

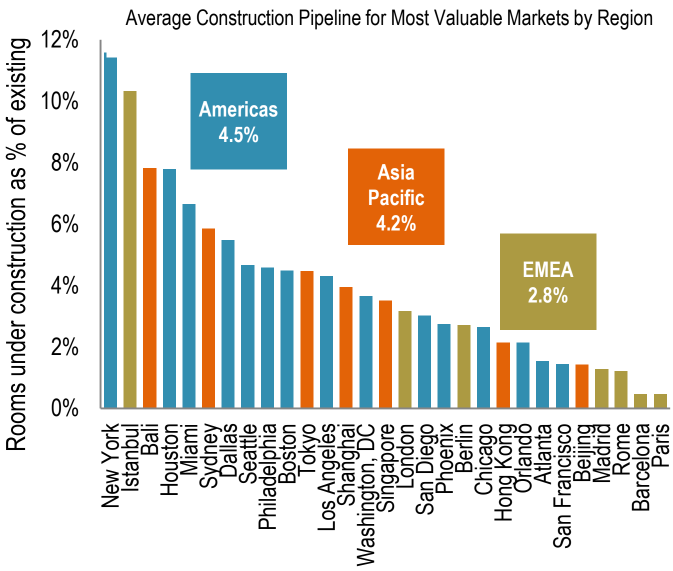
Although investors will no doubt keep a keen eye on other markets, whose central banks are tipped to follow suit and raise rates in 2016, the UK, Japan or Australia will likely wait for subsequent increases in the U.S. before they alter their own monetary policies.

When will the RevPAR growth cycle end?

RevPAR is projected to grow by 4-5% globally in 2016, notwithstanding regional variances. In many mature economies, 2016 will mark the seventh consecutive year of growth, leading investors to ask how much runway there is ahead. Based on previous expansionary cycles, which have lasted as long as ten years in the hotel space, the market still has some good times ahead, notwithstanding demand shocks.

Of major economies, the U.S. has among the most robust outlooks for RevPAR, driven by growth in group and leisure travel and low new supply. Many European countries have reached their occupancy ceiling with average rates driving RevPAR growth. Secondary locations in the UK and Germany, along with Spain and Italy are poised for the highest increases. Among the world's 30 most valuable hotel markets, rooms under construction average 4% in the Americas and Asia Pacific markets on the list, and just under 3% in EMEA.

Supply pipeline for world's 30 most valuable markets



Note: Pertains to metropolitan area; excludes Dubai where rooms under construction represent 27% of existing stock
Source: JLL Research, Smith Travel Research

Investors have a more tempered outlook for hotel trading performance growth in the Middle East, whereas hotels in Africa will at times experience double-digit RevPAR growth. Growth is expected to moderate across Asia, but still notch single-digit RevPAR increases across a number of markets with Japan and Australia among the bright spots in terms of demand fundamentals.

Opportunity on the horizon

Africa is increasingly finding a place on the global hotel investment radar with its emerging economies, increasing global corporate entry and favourable demographics. Investment in the region continues to be dominated by local and regional investors, who are well placed to capitalise on opportunities.

There is an increasing appetite from global real estate capital for the region, with a number of private equity-style hotel development platforms and income funds in formative stages. The further maturation of the sector and introduction of new investment platforms should result in local investors exiting their investments and increasing liquidity in the markets. This will reduce risk premiums sought by global capital, and enable investors to achieve suitable scale in their regional portfolios.

Sub-Saharan Africa, representing 43% of room count, has seen acceleration in investment in the past decade, with South Africa, Kenya, Nigeria and Mauritius representing the most mature hotel investment markets. Resources-focused economies such as Nigeria and Angola are slowing, while other markets in East and Southern Africa are continuing on their strong growth path.

Developing and investing in Africa has its challenges, due to the emerging nature of the sector, the lack of transparency in the real estate markets, and a shortage of critical development skills and expertise in many markets. This delivery risk should improve in the medium term, as the sector sees an increase in experience and expertise.

Due to the emerging nature of the region, transaction volumes in Africa remain below $1 billion, and mostly off-market, and investment into new developments was in the order of $2.1 billion in 2015.

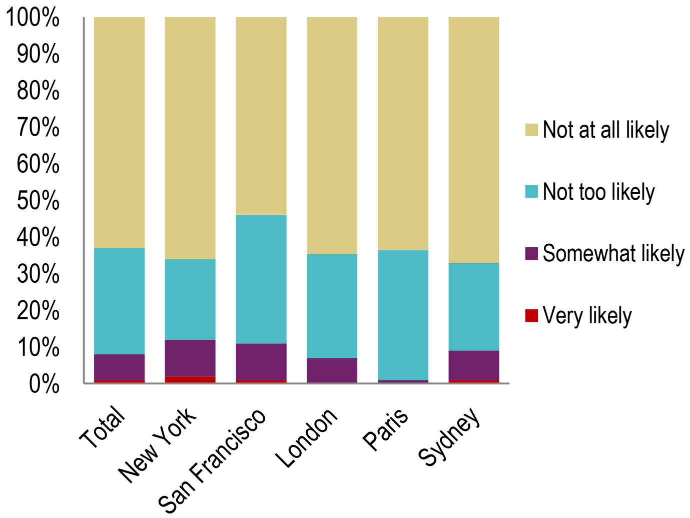
Disruptive forces

Lodging companies and hotel real estate investors have typically not been at the forefront of technology investment. Industry stakeholders have embraced that disruption from the technology sector and new business models are here to stay. While the bread and butter of the industry, namely the business of accommodating guests in hotel rooms, remains largely intact, new players have entered the foray in meaningful ways, with one of the most notable business models being home-sharing sites such as Airbnb and Homeaway.

Disruption from home rental sites and alternative accommodations remains relatively small in the grand scheme of global lodging sector. Home rental sites and the alternative accommodations market account for approximately 10% of hotel room bookings in the top global gateway markets such as New York and London. Across the world as a whole, room nights booked through Airbnb and other similar outfits are estimated at around 2% of hotel occupied room nights.

While home sharing sites are posting phenomenal growth in the number of listings, we expect that the number of willing renters in gateway markets will eventually reach a cap. Currently, approximately 7% of households in the world's main gateways say they have rented their living units out on alternative accommodations sites, with a further 8% say they would consider it in the future. So our data suggests that this will remain a somewhat niche activity. Where the home sharing market has the most runway ahead is across smaller cities and markets across Asia.

Surveyed individuals' likelihood to rent out living unit on home sharing sites over next year



Note: Pertains to individuals who have not previously rented out their units
Source: JLL Research

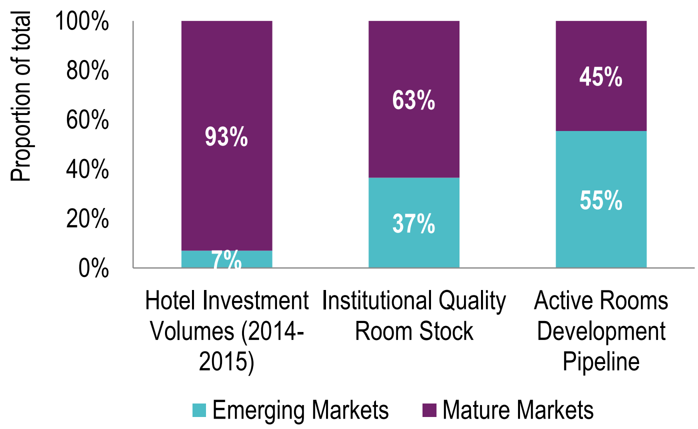
All eyes are on home sharing sites' yearning to more significantly accommodate business travellers going forward. Given the prominence and prevalence of new ideas in the digital world, we expect to see more and more creative partnerships going forward. While there is risk and trial and error involved, we believe some of the most interesting matchups will be where hotel companies partner with these newer entrants – an example being Hyatt Hotels Corporation making an investment in London-based Onefinestay.

Other consumer industries are far more immersed in the jungle of social media, digital communications and big data analysis. These elements are both defining and responding to guest demand, which requires owners and operators to engage on these issues to ensure that the generator of RevPAR – the guest – continues to favour their brand. Hotel companies need to recognise and adapt to a changing world, becoming more mobile-friendly and shifting focus to building, enhancing and extending their brand through digital platforms.

A call for increased capital allocations

Emerging markets now are home to 35% of hotel rooms worldwide. However fewer than 10% of the world's hotel real estate deals are happening in these markets. This lop-sidedness will continue to swell because hotel supply growth in emerging markets is more than twice that of mature markets. The increasing prevalence of a liquidity gap in emerging markets is creating an imbalance that can play to the favour of first movers.

The growing liquidity gap



Source: JLL Research, Smith Travel Research

Private equity funds seem like the most logical group to re-shape their mandates and be more aggressive in emerging markets. They account for 45% of deals in mature markets, but represent only roughly 25% of transactions in emerging markets. They are thus far less active in emerging markets, where yield potential is strong and competition is lower. Investing in these markets would address both their need to deploy capital as well as their requirement to achieve meaningful upside.

At the same time, the news is buzzing with announcements of funds increasing their allocations to real estate. For instance, Norway's sovereign wealth fund, the world's largest, is evaluating a considerable increase to its current commercial real estate allocation of 5%. While it will take some time for the real estate allocations to trickle into hotels, this represents good news for the sector, especially to the extent the funds are focusing on emerging regions. Another group to watch here are Canadian pension funds.

During the past three years, two-thirds of hotel investment was funded by cross-sector investors, as opposed to investors who focus solely on the hotel sector; thus, there is a strong precedent for broader funds to invest in the sector, which should set the stage for increased capital allocations.

Incremental new allocations into the hotel sector are paramount in order for the hotel investment market in emerging countries to start to even inch towards liquidity levels seen in the U.S., Western Europe, Australia and Japan.

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Whether you are looking for a hotel or you're ready to sell, we'll use our capital markets expertise, hospitality industry knowledge and global relationships to put the right parties together and execute a bespoke deal that exceeds your objectives.

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