EMEA Hotels, June 2015

Spain – Unlocking Europe's hottest hotel market

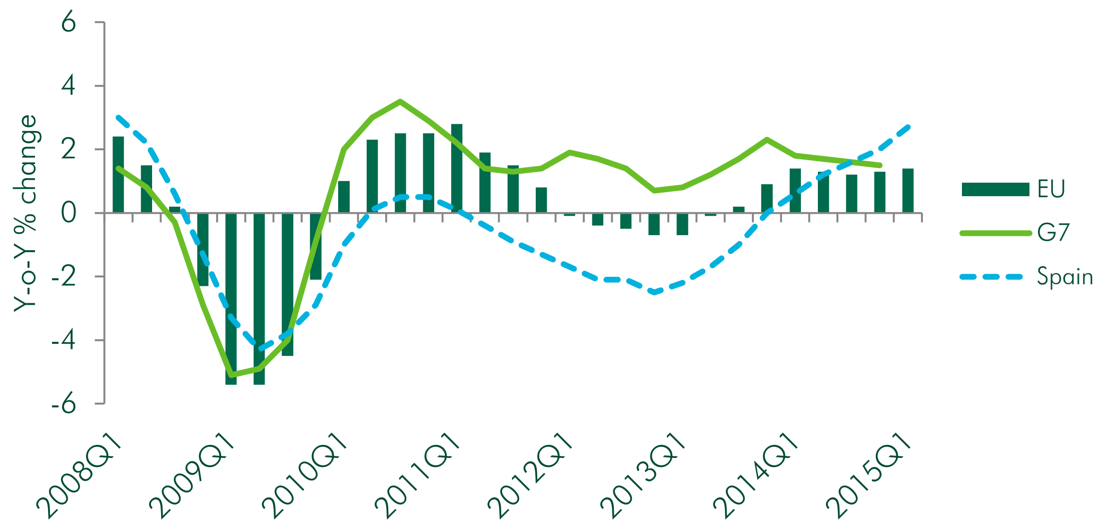
Many consider the Spanish economy to be fixed on a path of recovery; accounting for an extensive uptick in the investment volume of commercial real estate. Despite rising interest, Spain is still regarded as having opportunity for investors seeking large returns, more of which are becoming alert to the ability of hotels to lever on economic growth. Burgeoning international and domestic traveller demand is driving significant hikes in both hotel revenue and profitability.

This paper highlights the expectations for future performance and how this will impact investor returns in the key Spanish markets.

ECONOMIC OVERVIEW

Seven years after the property crash of 2008 and Spain has become Europe's comeback star; economic growth [figure 1] was 18 times greater than the US and three times stronger than the UK in the first quarter of 2015. Many feel that Spain is now reaping the rewards of successful government reforms and is poised to lead the Euro area out of stagnation. Spanish banks have forecast 2015 GDP growth between 3% and 3.3%, whilst the government remains marginally more cautious and estimates that economic output will increase by 2.9%. Nonetheless, this would still put Europe's fourth largest economy amongst the fastest-growing of Ireland, Latvia, Lithuania and Malta.

Figure 1: International GDP growth rates, quarter on same quarter a year ago, seasonally adjusted



Source: Office for National Statistics, CBRE Q1 2015

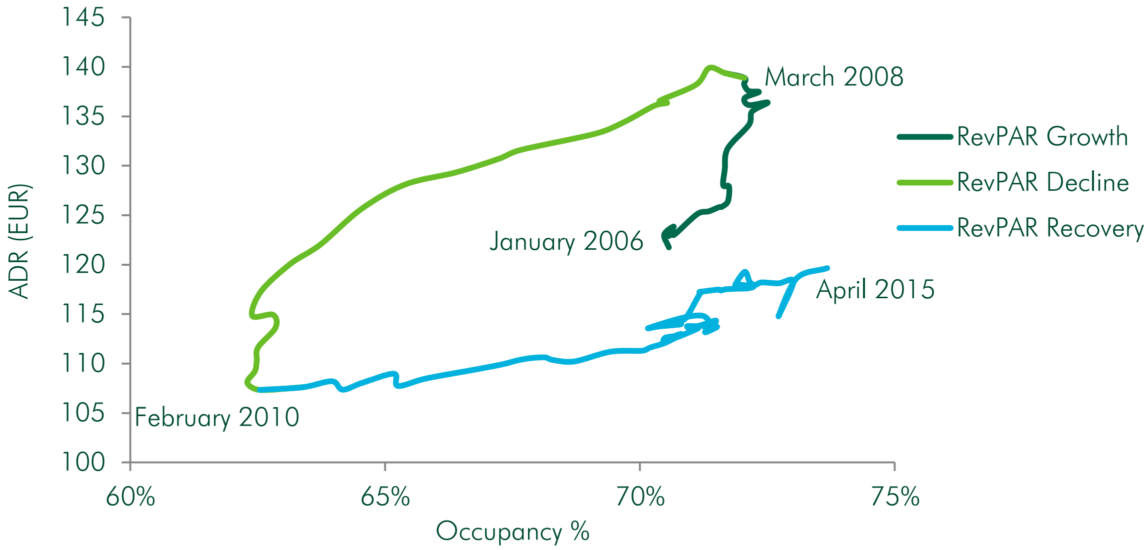
'[Spain] is poised to lead the Euro area out of stagnation.'

Whilst Spain looks set to be triumphant in recovery, pragmatists continue to express concern about the 4.5 million (Q1 23.8%) people that find themselves out of work. The Spanish unemployment rate has been dropping and it is hoped that recent cuts in income tax will further bolster the economy; acting as a catalyst to increase the availability of work and thwart underemployment. Higher rates of employment would undoubtedly drive further growth in consumer spending which is the current key driver of Spain's increasing economic output and be particularly favourable to the hotel sector.

HOTEL MARKET PERFORMANCE

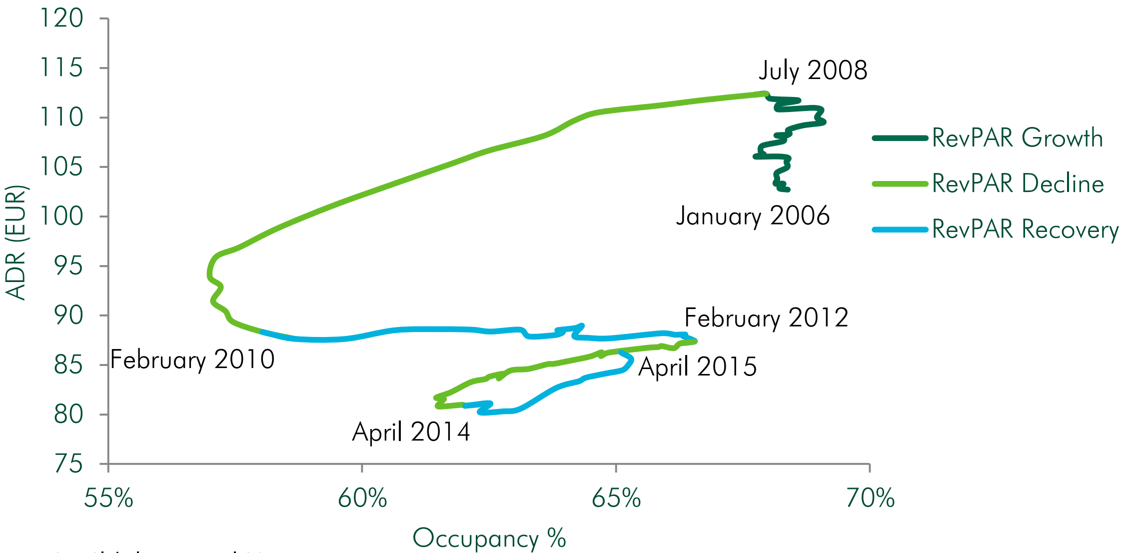
Economic growth has been categorically welcomed across the Spanish hotel markets, non-more so than in the city of Madrid. Fluctuations in hotel demand for the capital show a strong, positive correlation of 0.81 with the relative annual movement of Spanish GDP indicating the markets' reliance on corporate and domestic demand. Barcelona hotel performance shows a much weaker relationship with Spanish GDP, but displays a strong, positive correlation of 0.86 with EU GDP highlighting the international travel driving hotel performance on Spain's north-east coast.

Figure 2: Barcelona performance evolution, January 2006 to April 2015, 12MMA



Source: STR Global, CBRE April 2015

Figure 3: Madrid performance evolution, January 2006 to April 2015, 12MMA



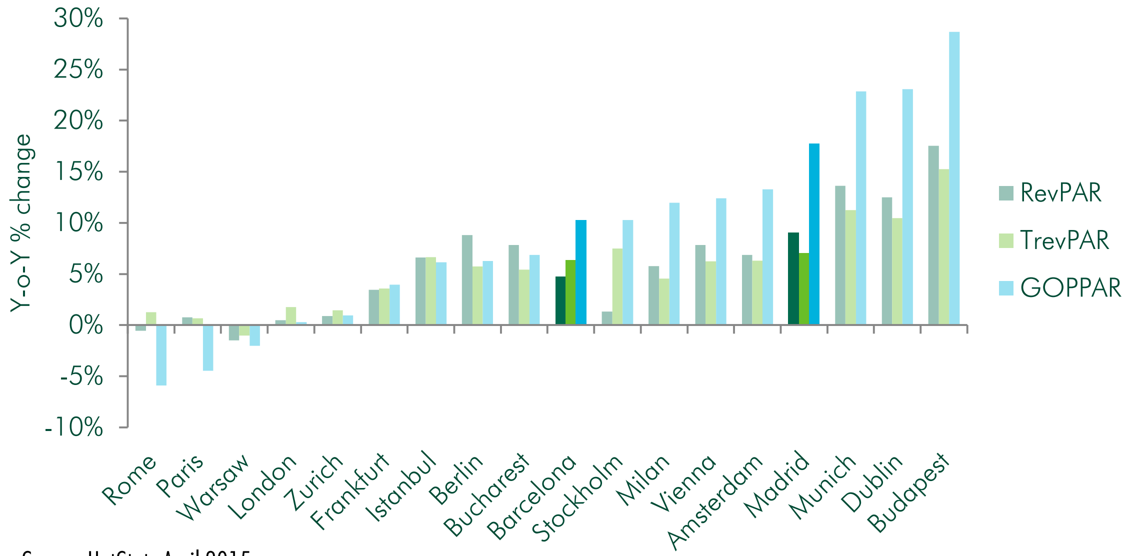
Source: STR Global, CBRE April 2015

As a result, the evolution of revenue per available room (RevPAR) through the course of the current cycle has differed tremendously for the two cities. Both experienced declines from 2008 to 2010, consistent with most European hotel markets; however, Barcelona has since experienced a consistent, balanced recovery, whereas Madrid was blighted heavily by the second plunge of Spain's double-dip recession and significant levels of new supply entering the market.

'…Barcelona's [anticipated] increase in rate will aid the continuation of profit growth, which is up 10.3%…'

Barcelona is unsurprisingly some way ahead in terms of RevPAR recovery, and rate (ADR) growth is likely to be the key driver of future performance improvement [figure 2]. Operators are expected to leverage off of the high occupancy base and capitalise on the uptick in consumer spending in the key source markets of Northern and Western Europe, to take advantage of the €20.25 headroom in ADR that exists based on the pre-recession peak. Such increases in rate are also advantageous to the bottom line and will aid the continuation of gross operating profit (GOPPAR) growth, which is up +10.3% in the 12 months to April. Other factors acting in favour of Barcelona's continued recovery and that of Spain's other leisure destinations, include a displacement of tourists from alternative markets in North Africa, Turkey and Greece which are experiencing political issues and also a reduction in the price of air travel following a fall in the cost of oil.

Figure 4: GOP, total revenue and rooms revenue, Y-o-Y % change, 12 months to April 2015, EUR, London in GBP



Source: HotStats April 2015

Madrid, on the other hand, has more work to do in regaining its performance of old [figure 3]. Both occupancy and rate still fall short of their former recovery to February 2012 before performance unravelled for the second time. However, the rate of RevPAR growth in the last 12 months to April 2015 has been at a greater pace than that of Barcelona and eclipsed most key European markets [figure 4]. Improving domestic leisure demand has nudged rate up by 3ppts, whilst corporate activity is the key driver of a €6.03EUR uplift in rate. Improving occupancy has improved the operational efficiency of hotels in Madrid, also aided by a global reduction in the price of commodities and therefore profit is up 17% in the past 12 months. If considering the 2008 high-RevPAR mark as the target for Madrid's recovery, the capacity for further growth is substantial.

INVESTMENT OVERVIEW

The Spanish hotel investment volume for 2014 reflected the aforementioned uplift in trading performance and economic fortunes; increasing by 63.4% on the previous year to €1.1bn. This is the highest annual volume recorded since 2008 and with Q1 2015 volumes up 283% Y-o-Y at €703m this year the Spanish market could surpass the €1.6bn of hotel investment recorded for 2006. There was also a shift in the hotel share of all commercial real estate investment, increasing from 5.7% in 2013 to 8% in 2014 and underlining the recognition from investors that hotels can effectively lever GDP and consumer spending growth into improved returns.

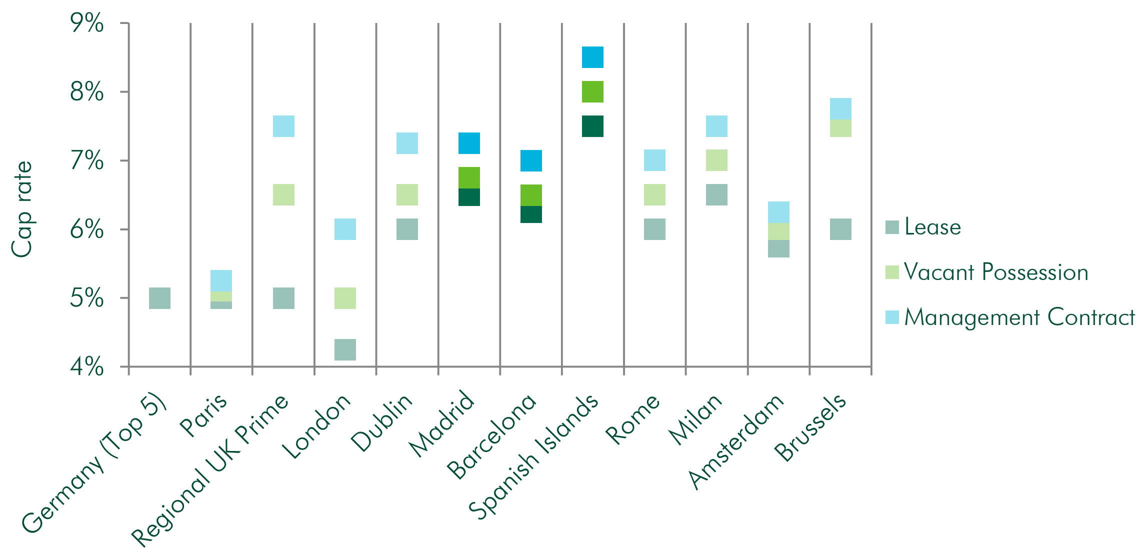
Excluded from the above transaction volume is over 100 hotel debt trades which took place in 2014 and this trend is expected to continue throughout the course of this year. SAREB (a corporate structure created by the Bank of Spain to isolate non-performing assets) and other banks, both Spanish and international, have begun divesting hotel debt as they come under increasing pressure to clean up their balance sheets in compliance with European regulation. Many of the trades have therefore offered substantial discounting and appealed to the opportunistic investors; with confidence in potential trading performance and their ability to buy-fix-sell, or build a hotel platform and benefit from the associated synergies should they pursue a loan-to-own strategy. Under both circumstances there is evidence of re-structuring and re-branding in a bid to meet high return expectations. Predictably, loan book sales have been wholly dominated by private equity funds, the North American based capital also having the benefit of favourable FOREX.

Additional inbound capital has included purchases by Qatari and Chinese investors; generally targeting trophy assets. This includes the recent trade of the Hotel Ritz in Madrid, purchased by Mandarin Oriental and the Saudi Arabian multinational; Olayan Group in a JV. Demand is such to own luxury hotels in Spain that there is even evidence of office and residential assets being converted into 5-star accommodation.

With a rising economic tide and ensuing uptick in business confidence, domestic investment in hotels rose by 82% Y-o-Y in 2014 to represent 54% of the total deal volume. Many domestic investors have utilised the recently created SOCIMIs (equivalent to REITs) in order to invest their capital alongside a burgeoning number of international shareholders. An example is Bay, a hotel SOCIMI focussed exclusively on resort properties in Spain and formed between Hispania and Barceló Hotels & Resorts.

Private investors and family offices remain ever-present within the hotel space; looking to maximise their returns at a time when low inflation has paved the way for an assumed period of lower-for-longer interest rates, thus returns from holding money in the bank bears little reward. The only decrease in investor activity comes from the hotel operators as they seek to realise asset-light strategies and increase their market share through franchise agreements and management contracts. Melia's recent sale of a majority stake in seven key Spanish resort hotels to Starwood Capital is evidence of this trend, whereby Melia will continue to manage the hotels under their Sol Hotels brand and enhance their position as hotel operators.

Figure 5: Q1 2015 CBRE House Yields, key European markets



Source: CBRE Q1 2015

"Hotels located in the traditional Spanish leisure markets such as the Canary & Balearic Islands and the Costa del Sol are currently benefiting from strong international demand. The outlook is positive with a further increase in demand anticipated from the domestic leisure segment as the labour market continues to recover in Spain. As a result, we are seeing significant transactional activity in these destinations as investors look to capitalise on softer pricing and a generous yield profile when compared to the major cities."

– Jorge Ruiz, Head of Hotels – Spain

Given the strong trading growth, relatively benign supply risk and high investor appetite; sharpening of yield is likely. The most significant movement over the last 12 months has been a -50bps reduction in yields for unencumbered (VP/Franchise) assets, highlighting the demand from value-add investors to take full operational control. Management contract yields, on the other hand, remain the highest [figure 5] due to the reduced operational flexibility and associated lack of opportunity to add maximum value under mounting market profitability. Even lease yields, which have remained the most consistent through-the-cycle, have sharpened by 25bps in Madrid and Barcelona in the last 12 months; suggesting an increasingly strong interest from institutional seekers of fixed-income, core assets at a time of low bond yields.

It must be acknowledged that the strength of economic recovery in Spain and the rest of Europe is likely to result in increasing interest rates. Whilst the speed of the increase is likely to be relatively slow, it will have an impact on consumer spending, the price of debt and is likely to trigger a rise in the yields offered on government bonds. Quality assets in core locations will be less sensitive to any change, however there is more risk associated with value-add and opportunistic investments.

Despite substantial downward pressure on hotel yields, the comparison to other key European markets (particularly markets in Northern and Western Europe which are further along in the economic cycle) would suggest that there remains value in Spanish hotel real estate and scope for continued yield compression.

CONTACTS

Jorge Ruiz Andres
Director
Head of Hotels – Spain
+34 93 444 7700
jorge.ruiz@cbrehotels.com

Miguel Casas
Director
Hotel Brokerage
+34 91 678 2074
miguel.casas@cbrehotels.com

Blanca Martin
Associate Director
Hotel Valuation
+34 91 514 3907
blanca.martin@cbrehotels.com

Joe Stather
Manager – EMEA
Hotels Intelligence
+44 207 182 2523
joe.stather@cbrehotels.com

Lola Martinez
Director
Research – Spain
+34 91 598 1900
lola.martinez@cbre.com

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