

# UK Hotel Review

2006

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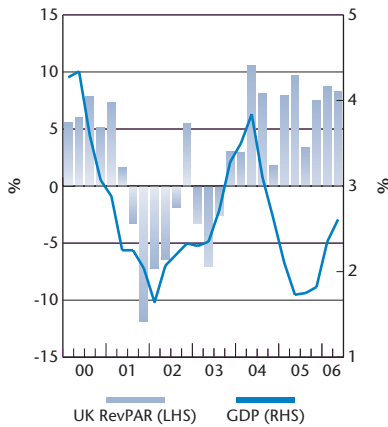


Hanbury Manor Golf and Country Club, Hertfordshire

## Executive summary

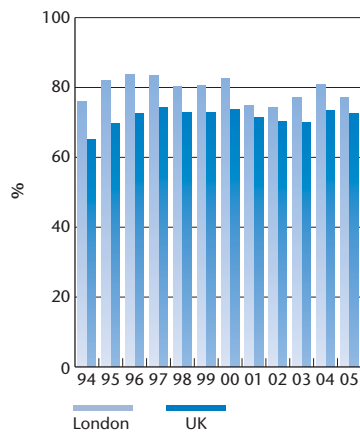
- Hotel performance throughout the UK remains robust with occupancy and average achieved room rate showing year on year growth.
- Corporate operators are continuing to exit ownership of their estates by exploiting a new breed of hotel investor through a tranche of brand sales, manage or lease back deals or straight forward going concern disposals on an unprecedented level.
- Further pressures are being put on yields due to the aggressive nature of new buyers to the sector and the continued low cost of debt.
- Management contracts are becoming more acceptable to investors both large and small.
- The sector has begun to see the impact of over rented leases.

Figure 1  
GDP & RevPAR correlation



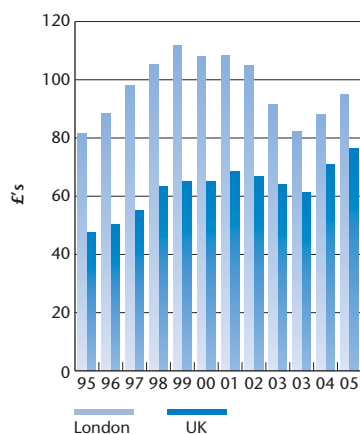
Source: ONS and TRI Hospitality Consulting

Figure 2  
Average annual room occupancy



Source: TRI Hospitality Consulting

Figure 3  
Average annual room rate



Source: TRI Hospitality Consulting

## RBS Group economic overview

Ruth Sutherland, Economist at RBS Group comments:



With a stronger than expected performance in 2006 to date, 2005 would appear to have been the low point of the current economic cycle for the UK economy. UK GDP is on course for 2.7% growth in 2006, slightly above the long-run average and a significant improvement on the 1.9% achieved in 2005. The hotel industry is particularly geared into the economic cycle, as seen by a strong correlation between growth in revenue per available room (RevPAR) and GDP growth (see Figure 1).

Stronger consumer spending has provided most of the additional momentum for the UK economy in 2006. Consumers are anticipated to spend 2.3% more over the course of the year, up from just 1.3% growth in 2005, with the improvement seen most visibly in retail sales. The value of spending on the high street has increased in 2006 with annual growth of over 3% in recent months, compared to the near stagnation witnessed during the same period in 2005. The consumer, therefore, appears to be notably more confident, with a positive effect on demand for hotel rooms in the UK. However, rising utility bills, petrol and food prices continue to increase faster than earnings with the effect of squeezing real household incomes and threatening to undermine consumer confidence. If this risk materialises, hoteliers will have to look to corporate customers and visitors from overseas to bolster performance.

In 2005, overseas visitors spent over £14 bn in the UK. The biggest spenders are visitors from Western Europe who account for two-thirds of the total number of visitors each year. With this in mind, the health of European consumers is hugely important to the demand for UK hotels. Consumer confidence in Western Europe is starting to pick up after several years of weakness. In addition, anticipated favourable moves in the £/€ exchange rate (sterling is set to weaken against the euro) will encourage more Europeans to travel to the UK.

Ongoing geopolitical uncertainty continues to have a negative impact on demand for UK hotels by overseas residents. Evidence from 7/7 is that the impact of specific events is short lived as hotels suffered a drop in occupancy rates immediately after the attacks, but recovered relatively quickly.

Ruth Sutherland, Economist, Group Economics  
Mike Harrison, Senior Manager, Commercial Banking  
Tel: 02380 333 040

## Hotel industry overview

The 2005 year end HotStats figures (for UK chain hotels) prepared by TRI Hospitality Consulting illustrate a stable UK average room occupancy of 72.5%, compared with 73.1% in 2004 (see Figure 2), with a below inflationary increase in average room rate (ARR) to £76.45, up 3.8% from £73.63 in 2004 (see Figure 3). Occupancy reductions in London in the months after 7/7 resulted in a decrease of 1.7 percentage points in 2005 annual occupancy, reducing to 77.1% compared with 78.8% in 2004. Encouragingly, however, London's hoteliers kept their nerve in the second half of 2005 and did not resort to room rate discounting. Effective yield management in the face of reducing occupancies enabled London's chain hotels to achieve a 4.3% increase in ARR, rising to £94.96 compared with £91.08 in 2004.

Overseas visitor numbers to the UK continue to grow (see Figure 4). A 5% annualised (July 2005 to July 2006) increase in overseas tourists to the UK, rising to 30.9 m from 29 m, contributed to an increase in the London hotel occupancy rate (a rise of 4.8 percentage points) in the 10 months to October 2006. Most importantly, total RevPAR(1) increased in the UK overall by 5.8% and in London by a healthy 10.8%.

The economy's strength and the hotel sector's continued positive performance is creating an exciting and robust investment climate, with yield compression a particular feature at this time.

(1) RevPAR – Revenue per Available Room is the total revenue for the period divided by the total available rooms during the period.

## Corporate overview



Marriott West India Quay Hotel and Executive Apartments, London, E14

Once again, the hotel sector received much attention from the investment market as many of the branded operators continued with their asset disposals, predominantly through a string of sale and leaseback or manage back transactions.

In November 2005, Hilton Group sold 15 UK hotels to the Managed Hotels Unit Trust for £382 m and, in January 2006, The Hilton Group agreed to sell its UK hotel business to the American Hilton Hotel Corporation for £3.3 bn. In June 2006, joint owners Vincent Tchenguiz's Consensus and hotel investment vehicle The Farnsworth Group placed ten Hilton Hotels onto the market for £500 m, which had separately formed a sale and leaseback deal with Hilton Hotels in June 2002 for a reported £336 m. In October 2006, the London and Birmingham Metropole hotels offering over 1,800 bedrooms were sold by Hilton Hotel Corporation for a reported £417 m on sale and manage back deals to Tonstate Property Group. In September 2006, the 251 bed Caledonian in Edinburgh was offered for sale with a guide price of £50 m.

In December 2005, MWB's subsidiary, Alternative Hotels Group (AHG), purchased the Initial Style Group of conference venues comprising 29 properties for £325 m which were re-branded as Verve Venues and then De Vere Venues a short time later. Continuing its foray into the hotel world, AHG agreed to purchase the De Vere group of hotels comprising 19 De Vere core brand hotels, 155 timeshare lodges and 17 Village Hotels which will be rebranded either De Vere Resorts or De Vere Venues depending on their quality.

In February 2006, Folio Hotels, formed by the Landesberg and Rosenberg families continued its expansion programme by purchasing a further 19 hotels from Corus Hotels for around £116 m, taking its hotel count to 27.

In May 2006, Intercontinental Hotels continued the group's strategy of selling 175 properties to return £2.75 bn worth of funds to shareholders, by selling 23 hotels in Continental Europe to Westbridge Hospitality Fund for £242 m along with 15 year franchise agreements. A further seven of its European properties were then sold in July 2006 to Morgan Stanley Real Estate Fund for £440 m with the operations being retained on 30 year management contracts.

City Inn has announced a £300 m expansion plan of its City Inn brand whilst London & Edinburgh Swallow Group, operators of over 150 Swallow Hotels including the Carnoustie golfing hotel, in September 2006 called in administrators Ernst & Young to advise it on possible hotel sales, leaving commentators to wonder whether it had bitten off more than it could chew in terms of rental obligation. The expansion of the Swallow empire had been considerable to say the least, growing to over 150 properties from 33 in 2003.

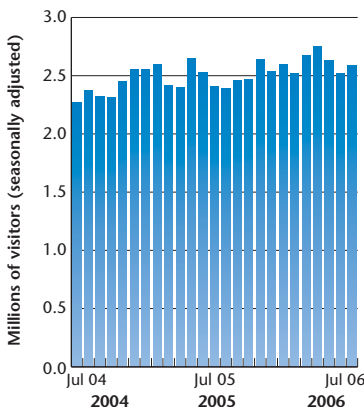
In September 2006, Blackstone Group sold the 236 bedroom Marriott Grosvenor Square Hotel in London for £103 m to Chicago based Strategic Hotels & Resorts whilst MWB relinquished its interest in the Marriott Park Lane for £105 m to Middle Eastern investors and then three months later, its interest in the Marriott West India Quay for £110 m to Yianis Docklands Hotels.

In late 2006, Starwood Capital was rumoured to be looking at the Whitbread portfolio in its entirety for around £3 bn following the earlier sale by Whitbread of its 47 Marriott Hotels in a joint venture to Royal Bank of Scotland for £951.4 m. Marriott continues to run these hotels under management contracts. Meanwhile, Travelodge owners Permira agreed a sale of its 291 strong group to Dubai International Capital for £675m, which plans to continue to grow and develop the Travelodge brand. Permira re-entered the sector in September 2006 with the acquisition of Principal Hotels for a reported £315 m, and, shortly afterwards, placed the group back on the market on a sale and leaseback basis for £265 m.

Macdonald Hotels continues to rationalise its portfolio by offering 23 hotels for a figure in the region of £400 m, whilst the Aurora Family Trust purchased nine hotels from The Airport Hotels Unit Trust for over £300 m to add to its existing estate of airport hotels. In October 2006, the 16 strong Menzies Hotels chain was sold to Piccadilly Hotels for £180 m and, in November 2006, QHotels in partnership with Alchemy Partners also paid £180 m for the 12 strong Marston Hotel Group, adding 1,200 rooms to its existing estate.

**“Once again, the hotel sector has received much attention from the investment market.”**

Figure 4  
**Overseas visitors to the United Kingdom**  
July 2004 – July 2006



Source: National Statistics

## Regional overviews

### London



The Cranley Hotel, London, SW5

**“London hotel property remains in very high demand, with overseas buyers leading those who want to enter the market across all levels.”**



Royal Park Hotel, London, W2

The first half of 2006 saw positive growth in revenue for London hotels, and the majority of industry commentators predict that the full-year numbers are likely to exceed those achieved in the year 2000, the previous high point for the domestic hotel market.

Occupancy levels and room rates have both improved compared to 2005. Ironically, the transatlantic flights terrorism threat in August provided a short-term boost to London hotels, as cancelled and postponed flights left thousands stranded at Heathrow. This bookings anomaly was, however, atypical and a stark reminder of the ever present threat of terrorism and its indirect implications for London’s hotel industry.

London hotel property remains in very high demand, with overseas buyers leading those who want to enter the market across all levels. Private Middle Eastern buyers entered the London hotel market with the acquisition of the 157 bedroom Marriott Park Lane Hotel for £105 m and ‘London’s favourite country club’, the 161 bedroom Hanbury Manor Golf and Country Club in Hertfordshire for a figure in excess of the guide price of £40 m, through Knight Frank.

Knight Frank also represented the private buyer of the Marriott West India Quay in August 2006 who paid approximately £110 m for the landmark building comprising 301 bedrooms, 47 serviced apartments and 158 private apartments. In a separate deal, Lawrence Geller of Strategic Hotels and Resorts added to his portfolio with the purchase of the 236 bedroom Marriott Grosvenor Square for £103 m from Blackstone Group. In Docklands, the 210 bedroom Crowne Plaza was purchased in September 2006 by a private investor for a reported £35 m.

De Vere sold its only London hotel, the 230 bed Cavendish in St James’s for a figure slightly in excess of £100 m to the Barclay Brothers, owners of the Ritz, Piccadilly. Also in St James’s, the 90 bed Dukes Hotel was sold in September 2006 to Middle Eastern investors for a figure in the region of £40 m.

Boutique hotels in London remain highly sought after, particularly with overseas investors. Private Irish buyers have acquired several high profile properties during 2006, including the 39 bedroom Cranley Hotel in South Kensington, the 48 bedroom Royal Park Hotel close to Hyde Park and the 42 bedroom Elizabeth Hotel in Pimlico off a combined guide price of £30 m. In a separate transaction, the 50 bedroom Gore Hotel on Queens Gate was sold from a guide price of £20 m in August 2006. The 47 bedroom Franklin Hotel in Knightsbridge was sold in February 2006 for approximately £13.5 m. Knight Frank represented the vendor in all these cases.

The development pipeline in the capital remains strong. Leicester Square’s Swiss Centre is expected to be redeveloped into a mixed-use scheme incorporating a 100,000 sq ft, 230 bedroom, four star hotel. US hotel and leisure development firm Thomas Enterprises has purchased the former Willis headquarters building at 10 Trinity Square EC3, for £110 m, and has plans to convert it into one of London’s leading hotels. Elsewhere, included in the second phase of Paddington Central is the proposed 206 bedroom Accor operated hotel which will add much needed new bedroom stock to the area. Within the City of London is the planned Rezidor SAS operated Missoni brand hotel at Cutlers Gardens, which will provide flair to the currently limited stock of rooms available within the Square Mile. City Inn seems likely to add to its London presence with a proposed 591 bedroom hotel in the City of London.

Finally, Sinclair Beecham, founder of Pret A Manger has launched his latest venture under the Willow Hotels name with its Hoxton brand. The 205 bedroom hotel opened in September 2006 and is reportedly trading well, prompting the group to talk about rolling the brand out in key cities throughout the UK.



Beechfield House Hotel, Wiltshire

## Central Southern England

The hotel sector within Central Southern England has remained robust. After a period of stagnation, both occupancy and average achieved room rates have shown positive growth which has translated through to improvement in hotel performance and values.

Many hotel groups continue to consolidate their portfolios, by disposing of either their underperforming units or operations which no longer represent their core brand ethos, as is evidenced by several transactions being concluded in recent months.

In terms of group disposals, Forestdale Hotels opted to dispose of its 47 bedroom Boship Farm Hotel near Hailsham off a guide price of £1.75 m to a local hotelier in January 2006, whilst Fine Southern Hotels sold the Brighton Best Western Hotel off a guide price of £3 m to an investor who leased it to operators Vienna Group in October 2005. Further west, several private sales were concluded including the sale of the Beechfield House Hotel near Melksham off a guide of £1.9 m in May 2006 and The Brookfield Hotel in Emsworth, after 34 years in the same ownership, off a guide of £3 m in June 2006.

Knight Frank anticipates that the trend for groups releasing part of their non core businesses will continue as they seek to capitalise on a buoyant market where demand for hotels offering the capabilities for operating under management are realising strong prices. It also appears that this message is filtering through to owners of privately operated businesses where the prospect of retirement may be a highly attractive option in the current strong climate.

## West Country

Hotel sales in the West Country through the latter part of 2005 and during 2006 have remained strong. Confidence throughout the region is greater than in 2005 and the decline in visitor numbers appears to have now levelled out. The excellent weather of early and mid summer helped to attract last minute bookings to Devon and Cornwall.

Investor demand for hotels in the region has increased by 30% on the same period in 2005, with the majority of activity noted within the three and four star sectors. Investment in the West Country has increased with corporate activity also strong. In Plymouth, construction of a 250 bedroom Jurys Inn Hotel has commenced, whilst Weymouth and Portland are already starting to feel the positive impact of the decision to host the 2012 Olympic sailing events in the West Dorset waters.

Knight Frank's Exeter office concluded the sale of The Lugger Hotel at Portloe in Cornwall to Swallow Hotels in April 2006 for £3 m and the Walnut Tree Hotel at North Petherton in Somerset to Acorn Hotels in February 2006 off a guide price of £2 m. Demand for small country house hotels throughout the region is strong with several hotel sales at record prices, including the 53 bedroom Marine Hotel in Salcombe which was sold by Menzies Hotels in September 2006 for a reported £10.5 m to a private Irish investor.

Knight Frank estimates that over 28% of the region's resort bedstock has been lost over the last three years to alternative use, resulting in increased demand for those hotels that remain. Approximately 10% of the existing bedstock may be acquired by residential developers during the next twelve months. Many of the new developments in the region are being purchased as second or holiday homes. Typically owners seek to let the unit – treating it as an investment vehicle which in turn attracts more visitors into the non-serviced sector.

**“Investor demand for hotels in the West Country has increased by 30% on the same period in 2005.”**



The Lugger, Cornwall



Chateau Impney, Worcestershire

## Cotswolds and Midlands

Birmingham's commercial and leisure profile continued to rise in 2006. Focus on the city grows stronger as high profile and prestigious developments reach fruition. The 211 bedroom Radisson SAS at Beetham Tower, which opened early in 2006, represents a new level of quality and greater commitment by hoteliers to the UK's second city.

The building of a new boutique hotel, to be developed at The Mailbox, is eagerly anticipated, and it is envisaged that the hotel will provide facilities for the residential accommodation to be developed in the same futuristic block. The landmark Fort Dunlop site, being redeveloped by Urban Splash as a 100 bedroom Travelodge and office accommodation at junction 5 of the M6, has also become a talking point. The trend for developing hotels in conjunction with either retail, office or residential accommodation is helping to bolster the number of bedrooms in the city whilst creating landmark buildings in the process.

Hotel development opportunities in neighbouring West Midlands conurbation cities, Walsall and Wolverhampton, include the Wolverhampton Interchange site and the proposed redevelopment of the city's mainline railway station to include retail, office, restaurant and hotel opportunities. In Walsall, Travelodge has acquired and redeveloped the 100 bedroom Quality Boundary Hotel, which benefits from close proximity to the M6 and the NEC.

The Cotswolds and Peak District areas continue to be a hotspot for purchasers of both lifestyle businesses and country house hotels with demand outstripping supply. The focus of demand is based around the 'honey pot' villages in these high volume tourist destination areas. A recent Knight Frank instruction, the Old Lock-Up, at Wirksworth in Derbyshire, is a character example of the lifestyle businesses available. The sale of The Lygon Arms, Billesley Manor and Combe Grove hotels to Paramount Hotels off a guide of £40 m, now forms part of the company's Signature hotels brand.

The imminent sale of the 122 bedroom Chateau Impney Hotel and Conference Centre close to Droitwich, and the 72 bedroom Raven Hotel in Droitwich from guide prices of £20 m and £7.5 m respectively through Knight Frank seems likely to attract considerable interest from the market.

## The Northern Home Counties and East Anglia

The general market overview is promising, with continuing strong demand for the more commercial hotels that benefit from high levels of occupancy from Monday to Thursday, in particular, hotels situated close to the main motorway arterial routes. There has been a steady increase in the number of hotel development sites coming to the market. Demand is strong for suitable sites across the Home Counties, particularly so as the 2012 Olympics draws closer.

Oxford and Cambridge remain amongst the most desired locations with demand from both business and leisure style operators. Cambridge is awaiting completion of a new 42 bedroom Hotel du Vin which will increase the luxury stock in the city, although there still remains a void in the four and five star market.

A slight increase in demand has been noted for small hotels from both the private and corporate investor sector, as is evidenced by the sale of the privately owned 16 bedroom Black Lion Hotel in St Albans in March 2006 for £1.35 m and the 18 bedroom Stanwell Hall near Staines in April 2006 for £1.4 m. At the other end of the spectrum, the sale was concluded this year on the 161 bedroom Hanbury Manor Golf and Country Club, Hertfordshire for a figure in excess of the £40 m guide price. The 33 bedroom Taplow House in Buckinghamshire was sold in October 2006 to a private overseas investor, for a figure in the region of £6.5 m. Oakley Court Hotel in Windsor was placed on the market by Queens Moat House in August 2006 and reputedly sold for a figure in excess of £50 m.

A significant number of new beds are being added to key towns and cities across the area including Milton Keynes, Norwich and Reading. Norwich currently has approximately 230 beds planned, whilst Reading is anticipating an extra 500 beds in a number of developments and extensions to existing hotels. Milton Keynes has seen the recent development of a new Juras Inn with other developments amassing some 450 beds.

The upgrading of infrastructure across the region is making East Anglia more accessible and, consequently, popular as a leisure and commercial destination. The planned development of the east coast ports at Harwich, Felixstowe and Lowestoft will stimulate further demand for hotel businesses around those areas.

**"The Cotswolds and Peak District areas continue to be a hotspot for purchasers of both lifestyle businesses and country house hotels."**



Taplow House, Buckinghamshire

**“The split of ‘bricks and brains’ has now started to be applied to smaller hotels, previously the preserve of the owner operator.”**



Haley's Hotel, West Yorkshire

The future potential for hotel business in the region is further enhanced through the planned government housing development schemes in the sub-regions of Cambridgeshire, Hertfordshire and Essex. This will lead to an increase in demand for bed-nights during construction and thereafter through the subsequent increase in population and business investment.

## Northern England

The North of England hotels market has experienced another 12 months of strong activity with a number of private sales driven by the favourable economic climate. The North of England remains less affected by extraneous factors such as the strength of the pound and overseas visitor numbers – being less reliant than the South on the overseas market.

The yardstick measures of occupancy and, in particular, achieved room rates are showing improvements over prior years throughout the region. The major cities such as Manchester, Leeds, Sheffield, Liverpool and Newcastle are all experiencing frantic hotel development with developers and operators competing for the prime sites, and maximum bedroom capacity still deemed to be some years away yet.

As a result of the hot early summer of 2006, tourist numbers were appreciably higher than in 2005 both for the key coastal resorts and rural areas. In particular, the national parks have enjoyed record levels of business.

Values are continuing to rise; with high profitability, low interest rates and further inflation of residential prices resulting in higher values for hotel properties. High quality, well located businesses showing healthy net profits are now consistently achieving in excess of ten times annual adjusted operating profit.

A notable trend during 2005 was the increasing differentiation of property ownership and operation. This split of “bricks and brains” was established in the corporate sector but has now started to be applied to smaller hotels, previously the preserve of the owner operator. For example, Haley's Hotel in Headingley, Leeds was sold in December 2005 off a guide price of £2m to a private investor with no prior hotel experience and little interest in direct involvement in the business. The investor has engaged Signature Hotels to operate the 29 bedroom hotel on a management contract.

The short-term outlook is optimistic for the Northern England hotels market. The August and November interest rate increases appear to have had a minimal impact as increases can often be offset by the aggressive terms that many lenders are prepared to offer hoteliers to secure business, in what is now perceived by the financial industry as a reliable sector. After some doubts during 2005, all the major economic and market indicators remain positive and Knight Frank is anticipating the current level of activity in the region to carry through to 2007.

## Scotland

Hotel sales across all levels in Scotland have continued the recent trend for increasing values driven by a lack of supply of quality businesses and an influx of purchasers into the market.

At the corporate end, the traditional business model of hotels owned and operated by the same company has continued to diminish with a large number of investors, both commercial and private equity, entering the sector for the first time. The level of yields now being accepted by these investors has added to the upward pressure on freehold prices to a point that is difficult to justify using traditional hotel valuation principles.

With the residential market throughout the country reaching new heights (for example, Scottish country house properties saw prices rise by over 8% in the first half of 2006) the market for small to medium-sized hotels has also felt the inflationary pressure, with businesses regularly achieving significantly above asking price. Notwithstanding this, private hotel values in Scotland are still comparatively lower than south of the border, resulting in a significant number of English purchasers moving north in search of better value.

**“The level of yields now being accepted by these investors has added to the upward pressure on freehold prices to a point that is difficult to justify using traditional hotel valuation principles.”**

## REITs finally arrive



Following clearance approval in the Budget in March 2006, UK REITs are currently expected to go live on the 1st January 2007. This will enable the UK to catch up with the US, Australia and other Continental countries, such as the Netherlands and France, which already have a statutory REIT structure in place and enjoy the 'benefits' which include amongst others, tax breaks; transparency; and heightened liquidity. In the US, where legislation has been in place since the 1960s, there are a number of dedicated REITs, including hotel REITs and this has led to the emergence of newly narrowly defined, property holding asset classes. This is now the dominant listed form in the US. The emergence of REITs in the UK will have significant consequences for the future evolution of UK property investment, although it is not for everyone as the vast amount of still privately owned property testifies, which is more than 90% globally.

The main driver behind the launch of REITs in the UK appears to have been a need to re-energize the listed UK property sector by offering investors a small tax benefit and the scope to participate in the UK property market. Historically, this was not available except through convoluted fund structures and institutionalised investment. The UK listed property sector market capitalisation is expected to grow, according to City analysts, from some £39 bn to £80 bn in the next five years through the advent of new money, M&A and the transfer of unlisted businesses into REITs. REITs will, according to the US model, be able to manage their assets with a greater focus on cash flow optimisation rather than balance sheet management. This will, it is hoped, banish the notion of decision making solely for tax purposes from the corporate boardroom in time. Furthermore, as the asset class gains better understanding among the investor community, differentiated property strategies and sector focus are expected to favour those REITs able to generate growing profits and demonstrate future growth with their shares trading at a premium.

A number of the London listed property companies including British Land, Land Securities and Hammerson have already stated that they will become a REIT and others, such as Great Portland are currently examining the merits of doing so. Share prices of a number of the major potential beneficiaries already jumped back in March after the Budget by approximately 10% reflecting investors' expectations.

It is important to remember that the REIT corporate form requires a listing on a 'recognised stock exchange'. The London Stock Exchange has now published its requirements for listing and ongoing obligations.

Clearly, hotel REITs would be considered very attractive for inward investment in terms of cash flow generation and growth, particularly for inner-city based chains or those with a differentiated business formula. The continuing trend to separate assets from their operators will strengthen the REIT model fit for hotels but there may well be some tax issues surrounding the appropriateness of assets subject to a management agreement versus a lease for REITs in the hotel sector. A number of private hotel funds might achieve their exits by becoming REITs.

## Branding – not the only route to success

Branding, says Bob Cotton, Chief Executive, British Hospitality Association, has become an important factor in the hotel industry, but it is not the only route to success.

A century ago, Cesar Ritz built his hotel in London. Although not many more Ritz Hotels followed, the name became a brand. Why? Because, to this day, the name Ritz came to represent classic five star luxury and service.

When Conrad Hilton entered the industry in the 1950s, Hilton Hotels was born – and would go on to become the first worldwide and, perhaps, the world's best known hotel brand. Other brands, including Holiday Inn, InterContinental, Sheraton, Hyatt and Marriott followed, and have become powerful brands in their own right.

Why are they so powerful? Because, like Ritz, their name has meaning. A brand name instills expectations of a certain standard. It also provides familiarity for the traveller who may know what facilities are available, what standard of safety and comfort to expect and, importantly, at what approximate cost.

**“The continuing trend to separate assets from their operators will strengthen the REIT model fit for hotels.”**



However, hotel branding is not limited to the high end of the market. Accor's Ibis, Premier Travel Inn and Travelodge have become familiar budget hotel brands. Best Western, a consortium of 4,200 independent hotels worldwide is an example of an established brand within the mid-market – arguably dominated by Holiday Inn. The everyday familiarity and confidence that mid-budget leisure and business travellers alike hold in such brands demonstrates the importance of hotel branding.

Amidst strong competition, maintaining customer loyalty and market share will be the challenge faced by established brands at all price levels in the short and long-term. As hotels become better equipped across the board, the emphasis on subtle differences and unique selling points is likely to become increasingly important.

Yet branded hotels are not the only route to success. Many travellers look for something different to the branded product which is, by its very nature, standardised. Individually run and operated hotels, with individual names, have thrived for centuries and will continue to do so. A market exists for individuality and the "personal touch".

Independent hoteliers exploit the difference between themselves and the branded operator, emphasising their more personal and individual level of service. The challenge for the independent market will be to successfully access the market at a time when branded hotels employ ever more sophisticated marketing and merchandising systems which often have a global reach.

At both a national and international level, the trend for separating the ownership of hotels from the actual operation will have an added influence on branding. Hotel owners – often property or investment companies – require a predictable revenue stream and will not hesitate to turn to another brand if one fails, although the length of management contract limits how frequently this can happen. However, this does not prevent hotels changing names. When this happens, new brand values have to be introduced often with extensive refurbishment and alteration. A hotel remains just a building. It is the brand – whether it is recognisable or unique – that gives it identity.

## Alternative use

Over the past few years, many hotel owners, property investors and developers have realised additional value by recognising that potential exists when considering the alternative uses of their property asset. There is no specific ideal property type when it comes to considering a property's alternative use, with suitable buildings varying greatly in terms of size and location.

A plot of land may have the potential for residential development, therefore that land value, with the necessary planning consent in place, will be worth a proportion of the Gross Development Value (GDV) and this is determined on a case by case basis. Indeed, the old benchmark of land value being 30-40% of GDV is now inaccurate and out of date. In the current property development climate, we have seen growth in land values slow due to the increase in supply of opportunities and a better understanding of the risks attached by the developer.

Each Local Planning Authority has the ability to grant or reject a change of use planning application. The nature of that decision-making process varies and, in most cases, is the "cornerstone" to establishing value. The sensitivity of each decision undertaken by the planning authority lies within the potential benefits and disruptions that may impact from an alteration of property use. The Unitary Development Plan (UDP) sets down the framework for each planning decision and is in place to protect current legislation. There have been instances when local authorities have been known to impose moratoriums on residential development planning applications. Additionally, small hotel properties, located within sizeable plots, have been turned down for residential conversion due to the potential loss of amenity value.

Although residential use may be identified as being a suitable alternative to the existing hotel use class, the requirements for affordable and key worker housing might make such conversion prohibitively expensive. This is relevant as some local authorities now impose Section 106 legal agreements, meaning that up to 50% of the housing stock must be sold as affordable housing. There are additional factors and risks associated to the end values of these potential developments, such as restrictions on car-parking ratios.

**"Amidst strong competition, maintaining customer loyalty and market share will be the challenge faced by established brands."**

**"The old benchmark of land value being 30-40% of GDV is now inaccurate and out of date."**



27/35 Poultry, London, EC2

There are alternatives to a change of use to residential, which can also provide a premium on resale over and above existing use value. For example, conversion from a hotel property to a healthcare facility may be a viable option due to the typical size and layout of an existing hotel building, subject to obtaining the necessary planning consents. However, complications exist as legislation pertaining to such a use has become increasingly prohibitive due to the room requirements and facilities stipulated by the Commission of Social Care Inspectorate (CSCI).

These restrictive regulations imposed on what are predominantly residentially based uses have in many cases worked in favour of changing the use of a building to hotel use. There are many examples of instances where premium prices have been achieved for properties where the change of use to hotel has proved financially more attractive when compared to existing or alternative uses.

These include Citibank House, an office building on The Strand in London, acquired in June 2004 by the Spanish hotel developer and operator Group Urvasco for a reported £83 m. The property is being converted into a 166 bedroom hotel and 92 apartments.

The Grade II listed Northumberland House, close to Leicester Square in London, was sold in December 2004 for approximately £30 m to a private US hotel firm, Masterworks Development Corporation, founded by Club Quarters hotelier Ralph Bahna. The property was bought unconditionally with no planning applications applied for or granted at the time of the purchase. There are plans to return the building to its former glory as an exclusive hotel.

In June 2005, The Barclay brothers, owners of the Ritz Hotel in London, acquired the 18th Century Grade I Listed William Kent House and 22 Arlington Street, an office building adjoining the hotel. The property has been largely converted to provide additional hotel accommodation.

In September 2006, US hotel and redevelopment firm Thomas Enterprises purchased the European Headquarters of Willis in the City of London for redevelopment as a luxury hotel, 10 Trinity Square, London EC3, overlooking Tower Bridge, at a price reputed to be in excess of £110 m.

The former HSBC headquarters at 27/35 Poultry, London EC2 was sold in October 2006 through Knight Frank for a figure in excess of £60 m. The cellular nature of the office space means the property may well be converted into a landmark hotel.

Outside the Capital, smaller scale hotel transactions where alternative use opportunities have existed are also evident, including the sale of The Stanwell Hall Hotel near Staines in Surrey in 2006. This property was sold on behalf of clients in April 2006 by Knight Frank for £1.4 m. The best price for this property was ultimately paid by an hotelier, despite full exposure to both residential developers and hoteliers. In this case the value of the hotel sale was marginally better than its alternative use value as residential, but this could only be demonstrated by a comprehensive marketing campaign to both target markets.

## Fractional ownership

Fractional ownership of property has been hugely successful in North America and Europe over the past 15 years, and is now beginning to emerge within the UK. Based on the simple principle of friends and family collectives pooling resources for the purchase of luxury yachts and aircraft, such arrangements have also been applied to the purchase of holiday homes. This has now developed into one of the fastest growing sectors of the global leisure real estate market, supported by the underlying ethos that leisure time is often the most precious commodity for individuals and families within the target market groups.

Purchaser profiling reveals that, unlike the traditional timeshare market, many fractional ownership buyers are in a financial position to be able to purchase whole ownership, but choose not to do so. By owning a part share of a property combined with strong back-up and support services, buyers are able to maximise their leisure time and minimise the attendant costs, worry and responsibilities of second home ownership.

**“Fractional ownership is one of the fastest growing sectors of the global leisure real estate market.”**

**“Whilst it is evident that fractional ownership is an offshoot of the timeshare industry, there are significant differences.”**

Fractional ownership schemes can offer the freedom of a luxury second home but with the back up and facilities normally associated with a five star resort hotel. In addition to the back up typically provided by a maintenance company (insurance, security, refurbishment etc), property owners invariably benefit from a concierge service, a stocked fridge, and even personal items placed about the property on arrival.

There are numerous operational variables that require agreement when a fractional scheme is set up, with the principle factor being the actual size of fraction being sold. This is typically dependent upon the perceived length of the high season. Fractional real estate developments are thought to have originated from the US luxury ski resorts which typically have two seasons – winter and summer. However, schemes have now spread to include golfing and waterside venues worldwide. In the UK market, a typical development might be based on a ten week high season. It therefore follows that the most logical fractions to offer would be either fifth or tenth shares – ten or five weeks use. (This is based on a 50 week year with two weeks being taken out for annual refurbishment and maintenance). Unlike traditional timeshare which tends to offer a fixed period of occupancy, fractional ownership occupancy tends to be allocated on a rolling basis. Typically, the year will be divided into sections corresponding to prime, shoulder and quiet periods with a number of weeks allocated in each on a rotating basis so that the weeks available for each part owner are distributed fairly.

Whilst it is evident that fractional ownership is an offshoot of the timeshare industry, there are significant differences. Timeshare offers a licence to use a property for a fairly short period of time whilst fractional ownership offers a form of property ownership over a longer period (subject to the way in which the fractions are set up). Timeshare may be perceived as downmarket and ‘affordable’ – RCI research shows the typical cost of a timeshare week to be £8,000 whilst fractional ownership costs range from at least twice this amount and can quite easily exceed £200,000. The size and quality of fractional ownership properties are generally larger, better equipped and furnished, and have access to greater facilities and services than those of timeshare.

Over the past few years, the majority of the major corporate hotel chains (Marriott, Ritz-Carlton, Four Seasons, Disney) have realised the financial benefits associated with fractional ownership schemes and have diversified into this sector of the industry. Some of the more significant benefits include:

- Resort hotel developments may be easy to fund where there is a significant fractional ownership element, as this part of the development can be pre-sold.
- Fractional ownership can provide a rental income to an owner if they desire, which can provide a further income stream to the operator.
- Fractional ownership in a resort hotel can assist the overall developments ability to include significant facilities (more than those normally found at a resort hotel).
- Very high occupancy levels in the fractional units which has a knock-on effect on hotel occupancy.
- Greater use of the hotel facilities – particularly food and beverage.
- EBITDA\* percentages will be high in a fractional resort, primarily because of the increased occupancy and also because of the high capital spend.
- Inclusion of fractionals will mean hotel companies and developers can compete with residential land values.
- Uplift in values on both the hotel and fractional developments.
- Considerably lower marketing costs as a % of the Gross Development Value than timeshare developments. Typically around 20% as opposed to up to 40%.



Holwell Farm Cottages, Dartmoor – a fractional ownership scheme

Although fractional ownership is thriving outside the UK there are signs that it is a concept that is about to take the UK leisure market by storm. Aware of this, Knight Frank is currently advising a number of developers with fractional schemes in various stages of planning and implementation. Knight Frank Hotels perceives that fractional ownership will emerge as the hospitality industry ‘buzzword’ in the first quarter of the 21st century.

\* Earnings before interest, tax, depreciation and amortisation

# Research

## London

**Dominic Mayes** Partner  
Department Head  
+44 (0) 207 861 1086  
dominic.mayes@knightfrank.com

## Southampton

**Andrew Theobald** Partner  
+44 (0) 238 048 8757  
andrew.theobald@knightfrank.com

## Exeter

**Martin Rogers** Partner  
+44 (0) 1392 848848  
martin.rogers@knightfrank.com

## Birmingham

**Mark Jones** Senior Negotiator  
+44 (0) 121 200 2220  
mark.jones@knightfrank.com

## Leeds

**Leigh Parsons** Associate  
+44 (0) 113 297 2430  
leigh.parsons@knightfrank.com

## Edinburgh

**John Coleman** Partner  
+44 (0) 131 225 4151  
john.coleman@knightfrank.com

## Professional

**Christopher George** Partner  
+44 (0) 207 861 1084  
chris.george@knightfrank.com

## Cottage Complexes

**Colette Charsley** Partner  
+44 (0) 1392 848848  
colette.charsley@knightfrank.com

## Golf

**Martin Rogers** Partner  
+44 (0) 1392 848848  
martin.rogers@knightfrank.com

## Hotel Finance

**Jason Briggs** Associate  
+44 (0) 207 861 1388  
jason.briggs@knightfrank.com

## General Enquiries

**Joe Simpson** Associate  
+44 (0) 207 861 1728  
joe.simpson@knightfrank.com

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