
Virgin Hotels

Scotland's hotel market overview

Avison Young Hotels

September 2022

AVISON YOUNG

Introduction

A year on from our 2021 overview focusing on Covid recovery, Avison Young's Hotels team are pleased to present our latest review of the Scottish hotel sector.

Midway through 2022, hotel performance continues to recover at an incredible pace, thanks to the return of international travel as well as large conferences and events. In most markets year to date average daily rates (ADR) have surpassed pre-Covid levels and we expect demand (occupancy) to follow suit during 2023.

There are however significant headwinds in the form of rising inflation and interest rates, and recession predicted by the Bank of England.

In light of this "double-edged sword", our market overview focuses on:

- A market snapshot of hotel performance in Scotland, looking beyond the key performance indicators to present a more detailed view on the potential impact on the bottom line of various prevailing factors. Whilst room revenues are recovering strongly, the impact of lower demand and higher costs is resulting in lower gross operating profit per available room (GOPPAR), more than 15% below 2019 on average.
- Whilst transaction volumes have not returned to pre-pandemic levels, there is no shortage of interest in Scottish hotel assets, with a large amount of private equity ready to be placed in the sector and a number of deals having completed since late 2021. We provide some insights into the outlook for the transactional market within Scotland which remains positive, albeit with more uncertainty creeping in due to macro-economic factors potentially slowing both buyer and seller appetite, and increasing cost of debt possibly resulting in more distressed sales.
- New development remains difficult even as market performance recovers; as well as the increasing cost of finance, construction costs have increased significantly over the last 12 months. Our experts provide an overview of Development Cost Trends and Forecasts, concluding that there should be some flattening of the inflation curve in the coming months and a move away from the price spikes of recent months.
- Operationally, the hotel sector is facing unprecedented recruitment and operating cost challenges that are impacting profitability, potentially hampering the post-pandemic recovery. Cost Pressures – the operators' perspective gives two of the UK's leading third-party management companies the opportunity to outline their response to these key issues and the actions they are taking to mitigate them. Their actions on the ground are certainly helping to ease the pressure for owners, and both are positive about the future outlook for Scotland's hotel sector.

Avison Young is the leading hospitality advisory team in Scotland with vast experience and a specialist team based between the Glasgow and Edinburgh offices. We have advised on many of the recent and current development projects across Scotland and are actively involved in several hotel transactions.

Please get in touch if you would like to discuss any of the points raised in this overview, or to discuss your hotel project.

Market snapshot – revenues recovering

2022 hotel performance

To present a snapshot of Scotland's key hotel markets performance, we have indexed July 2022 year to date (YTD) performance against that of June 2019 YTD. This shows that both the cities and Scotland as a whole are performing well, with revenue per available room (RevPAR) in line or ahead of 2019 in most cases.

Edinburgh has seen a quicker recovery than Glasgow for two main reasons. The proportion of high-end and luxury hotels in Edinburgh is helping to drive average daily rate (ADR) with the luxury hotels seeing an ADR index of 1.47 compared with 2019. Secondly Glasgow has seen a 9.9% increase in supply since January 2020 whilst Edinburgh supply has increased by only 4.4%, impacting Glasgow's recovery as it absorbs the new supply.

Airport passenger numbers shows demand ramping up towards 2019 levels at Scotland's main airports, highlighting the correlation between improved hotel performance and increased travel.

The hotel recovery is driven by ADR with demand (occupancy) still behind 2019 across the board. Exceptions are Aberdeen Upscale, East Lothian and Renfrewshire where YTD occupancy is equal to or higher than in 2019. The former is driven by the energy sector with Aberdeen's corporate market less affected than in other cities, with the latter two probably benefitting from lower rate overspill demand as the main cities push room rates higher.

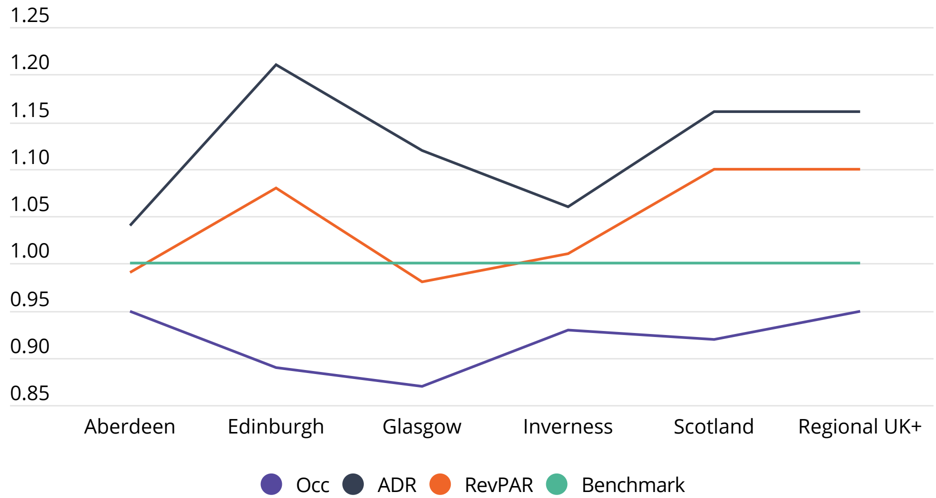
ADR has been increasing due to the staycation boom experienced in the UK; tourists that haven't been able to travel abroad, or prefer not to due to remaining restrictions and well-publicised airport chaos, have been spending their holiday budgets in the UK driving ADR growth.

1.21

Edinburgh 2022 ADR index compared to 2019

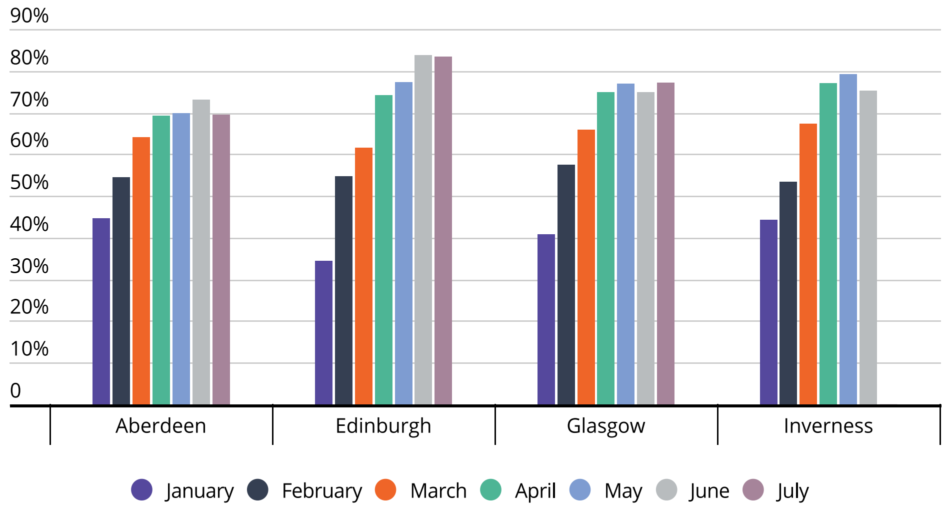
HOTEL PERFORMANCE – JULY 2022 YTD INDEXED AGAINST JULY 2019 YTD

Source: Avison Young / STR Global



2022 SCOTTISH AIRPORT PASSENGER NUMBERS AS A PERCENTAGE OF 2019 LEVELS*

Source: Avison Young / CAA ** July data for Inverness not available at time of publication*



Market snapshot – significant cost pressures

Whilst the increased ADR has supported RevPAR recovery, there are both positive and negative sides to this when considering operators are currently facing serious cost pressures.

Firstly ADR growth converts better to gross operating profit (GOP), so higher ADR in the current cost inflationary environment is very positive and is likely to offset some of the higher costs in utilities, labour and supplies.

Lower occupancy and fewer guests could, however have an impact on food and beverage and other incremental revenues. Whilst this is a negative impact in terms of revenue generation, given increasing operating costs and the challenges of attracting and retaining staff, lower food and beverage activity in the short term may not be such a bad thing for operators and owners.

The main cost pressures currently are coming in two key areas; energy and labour.

Energy costs for most hotel companies is unlikely to impact profitability until later this year or early next year. This is because most hotel companies pre-buy their utilities at reduced rates over an extended period cushioning the blow, but only for a short period. However, hotels by their nature require intensive energy consumption and those without fixed utility contracts have faced the burden of massive increases this year.

There are increasing pressures around labour availability and pay rates. The demand for staff is currently outweighing supply and as a result the labour market is highly competitive. Companies that can move quicker are benefitting from a sleeker recruitment process, but salary expectations are much higher than even a few months ago.

The impact of higher costs (along with lower occupancy) is resulting in weaker gross operating profit per available room (GOPPAR). Avison Young data suggests that in the 12 months to summer 2022, Scottish hotel GOPPAR is more than 15% below 2019 on average.

In order to provide an operator's perspective on the impact of employment and cost pressures, Avison Young spoke to two of the UK's leading third party management companies to understand how they are responding to, and mitigating the challenges. Andrew Robb, Chief Financial Operator at RBH Hospitality Management and David J Anderson, Divisional President at Interstate Hotels & Resorts (the international arm of Aimbridge Hospitality) share their experience on the following pages.

We asked Andrew and David about recruitment and staff retention, rising energy costs, the impacts of lower occupancy on food & beverage revenues, where ADR is likely to settle and measures taken to mitigate increasing costs across the board. We also asked them to gaze into their crystal balls to provide their views on the opportunities and challenges that lay ahead in Scotland.

Cost pressures – the operator's perspective

RBH
HOSPITALITY MANAGEMENT

ANDREW ROBB
Chief Financial Officer, RBH Hospitality Management

"We were incredibly proud to be the first hospitality business to be awarded Platinum accreditation from the Mental Health Charter and of being ranked 8th in The Caterer's best place to work in hospitality"

Andrew tells us that, due to a long-term culture of looking after their people, particularly around mental wellbeing, RBH have had encouraging engagement across the team and have experienced strong levels of retention of key staff.

Under difficult circumstances, RBH has found success in recruitment using alternative platforms such as TikTok, particularly for new openings, and recruitment open days driving volume of applicants. They also rely heavily on their reputation which leads to a lot of referrals and RBH has a strong track record of people returning.

The majority of their hotels have not felt the direct impact of the energy cost rise as energy was forward purchased at a low point in the market and the benefits of this will be felt until later this year. However, looking beyond this RBH have implemented a number of energy consumption initiatives and reduction plans across the business as part of their ESG targets. They also track and monitor consumption via a central business intelligence tool to provide a live view of performance to identify issues and benchmark consumption levels across the group.

Generally lower occupancy does put pressure on overall food & beverage volumes, although it varies by location. However, across the industry there has been a necessity to review pricing which is helping to maintain or grow overall food & beverage revenues. A greater challenge just now comes in relation to cost pressures and overall profitability which is difficult with food/beverage/payroll costs increasing significantly. RBH has strong relationships with their suppliers and are working together to mitigate these increases, as well as increasing the frequency of menu reviews to ensure more seasonal products are used.

Andrew does not believe that ADRs will decrease to pre-pandemic levels as the cost base has shifted so dramatically; in the short-term ADR will continue to be held, however, in the medium to long term there is likely to be some form of softening to support occupancy growth.

Overall Andrew tells us that the hotel sector remains strong in Scotland and RBH has some fantastic hotels and people who confirm that the future is bright. Edinburgh has seen one of the strongest recoveries across the UK and remains a strong, attractive market for investors. International leisure guests still have Edinburgh as one of the top markets to visit which is unlikely to change. Glasgow has been slower to recover but is much improved in recent months. With significant supply growth in Glasgow in the last few years, Andrew hopes there will now be a period of low supply growth so that it can get some sustained performance improvements with some large-scale events to support this – maybe even Eurovision!

"Recruitment is tough for everyone and some key areas such as housekeeping are particularly challenging; as an industry we need to continue to lobby government regarding policies to support where possible"

Cost pressures – the operator's perspective

INTERSTATE
HOTELS | RESORTS

DAVID J ANDERSON

Divisional President at Interstate Hotels & Resorts

"By changing mindset and approach to hiring we have been successful in securing some fantastic talent for the future"

Like most hospitality companies, David told us that Interstate had to make decisions during the pandemic that impacted personnel in their hotels. However, they were fortunate in securing a large proportion of exclusive-use business which enabled them to keep job losses to an absolute minimum. Interstate ultimately grew its headcount during the pandemic, creating a number of opportunities in Glasgow and the surrounding areas.

To deal with the current challenges in the recruitment market, Interstate have focused on "hiring for personality", removing the need for experience in the majority front-line roles. In addition, they have launched their second phase of apprentice programmes to address key talent gaps, particularly Chefs and those with sales expertise. By the end of the year Interstate will have more than 100 apprentices in their hotels.

As with RBH, Interstate have been fortunate in that owners have not felt the impacts of rising energy costs, with it being forward purchased last year and secured for winter 2022, with significant savings against the wholesale markets as they stand today. Nonetheless, David is cognisant that the only "lever" to pull is to reduce consumption across the board, and their hotels are focused on this through their ienergy management programme. Across Interstate there is a focus on increasing productivity and maximising efficiencies to ease cost pressures and improve profitability. Initiatives include implementing new technology and multi-skilling across the front-line departments.

Interstate's strategy in combating food cost increases (without increasing prices) has been to "re-engineer" dishes, using alternative products at the same quality, as well as ensuring best price through seasonality and provenance of ingredients. Beverage is managed slightly differently due to the nature of the product and limited opportunities to re-engineer, but they are continuing to ensure that the best sellers are stocked and with a focus on upsell and premium products. Monthly food and beverage cost meetings also drive awareness and planning.

Interstate have experienced very strong growths in ADR in their Scottish hotels and David believes they are well placed to have enjoyed the pent-up domestic leisure demand and latterly the recovering international business supporting major cities. Recovering city-wide events are also driving high rated demand along with strong volumes. However, David expects the ADR growth trajectory to settle as other segments start to recover.

Looking forward, David expects the next 12 months to present many opportunities and challenges for the industry, with recruitment a key area of focus, in terms of attracting the future workforce to our sector. Overall Interstate are positive about Scotland as a market moving forward, with the staycation boom bringing many new people to Scotland that they can build on moving forward, alongside the growth of corporate travel.

"Due to the pandemic, there has been a lot of pent-up demand in the social event space and our Scottish hotels have some excellent facilities to capitalise through this continued demand"

Development cost trends and forecasts – inflation to reduce in mid-term

To provide an overview on rising development costs, Steven Barker, Principal in the Avison Young Building Consultancy team, heading up Cost Management, presents our view on the main issues and forecasts on cost inflation.

The hotel market has not been immune to the current "perfect storm" that has raged through the construction industry here in the UK. A combination of Covid-19, Brexit and more recently the war in Ukraine, triggering hikes in energy pricing has made forecasting tenders almost impossible, resulting in contractors pricing in risk for fixed price tenders that in many cases make development unviable for clients.

The main issues in terms of materials revolve around steel, concrete and timber due to a reduction in manufacturing capability that is exacerbated by global constraints on shipping since Covid, energy costs and importation, where bizarrely, the ensuing volume of delays has caused a reactive measure of bulk buying that has then resulted in price hikes due to the shortage of materials and availability, as is shown in the adjacent graph.

The new immigration rules together with the Government's furlough scheme resulted in an exodus of Eastern Europeans who were the mainstay of the labour force in construction. However, hopefully over time we will see the return of the labour force in line with an increase in "home grown" labour for the industry to reduce the reliance on foreign workers.

So what is Avison Young's view?

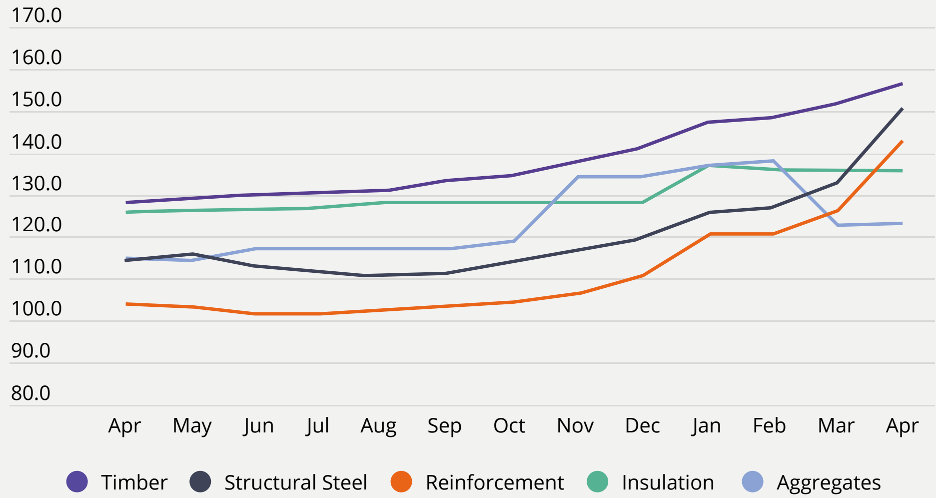
We will not experience any negative inflation for the foreseeable future but we do not expect to see a return of the spikes witnessed in the last two years, rather a flattening out of the inflation cycle as labour returns post the furlough scheme and manufacturing of core materials rises again. These coupled with an increase in shipping levels and locally an increase in the number of HGV (haulage) drivers will provide a positive outcome for the industry and investment as a whole.

Along with other major QS firms, Avison Young tracks inflation and whilst over the last two years we have all had to increase our predictions sharply upward on a quarterly basis due to the volatility of the market, we are seeing forecasting being more consistent between us for the next three years with compounded figures of between 6-8%.

CORE MATERIAL PRICE INCREASES 2021/22*

Source: Avison Young

**This sample table and graph showing the high-level indication of core material price increases being experienced across the industry, as identified by a market leading construction firm and their supply chain.*



It is possible in the short term that a return of fluctuating contracts may arise to provide a more consistent and real time understanding of inflationary pressures, rather than the current high levels being incorporated by sub-contractors whose work on a project may be several months from the contract start on site. The impact of this would be a flattening of out- turn costs as the level of risk a sub-contractor will place on projects will be higher than inflation over the equivalent period. This will continue to place owners/developers in a difficult position in regards to risk which not all will be comfortable with.

Transaction volumes – returning strongly

Hotel investment in Scotland has increased in recent months, with Edinburgh continuing to be a sought-after destination and investors seeking to profit from the market's post-pandemic recovery by acquiring high quality city centre assets.

In December, Pandox acquired the 146-room Adagio Aparthotel Edinburgh for approximately £40.5 million (£277,000 per room); the resilience of apart-hotels during Covid and their appeal to both leisure and corporate segments makes this type of asset particularly attractive to investors. In September, Castleforge Partners acquired the Crowne Plaza Edinburgh Royal Terrace (97 rooms) for an undisclosed sum. The hotel is currently undergoing a full refurbishment and is expected to be relaunched as a voco by IHG later this year. Whilst some uncertainties remain, investment appetite for hotels in the city is likely to remain strong, with the luxury Waldorf Astoria Edinburgh – The Caledonian (241 rooms) recently placed onto the market.

In Glasgow, hotel investment has picked up pace with portfolio sales at the forefront as investors seek value-add opportunities and growth potential. In February, Atlas Hotels acquired the Chardon Group portfolio comprising six hotels (569 rooms) across Scotland including two assets in Glasgow city centre; the Holiday Inn and Holiday Inn Express Theatreland. In November 2021, Henderson Park purchased the 12 Hilton-branded hotel estate, including one large asset in Glasgow; the DoubleTree by Hilton Glasgow Central (304 rooms). This provided the real estate investment firm the opportunity to step into strategic locations across the UK, whilst the assets offer a variety of value-add opportunities through renovations, extensions and other alternative uses.

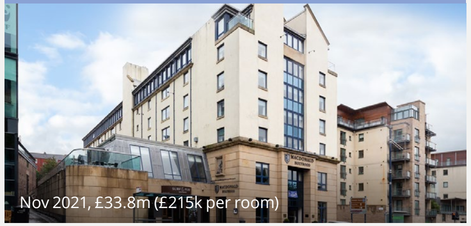
The upcoming months are more uncertain however, with reports of a recession looming as interest rates and inflation continue to rise which may deter buyers from the market, while owners may decide to hold assets until the economy starts to show some signs of improvement. Meanwhile, distress is likely to increase as struggling and underperforming assets are set to feel the squeeze to bottom lines while financial obligations, such as debt service payments, may also push owners to sell at a discount.

The Scotland Regional submarkets have been performing above the normal rate over the past year in what is an actively traded submarket. Scotland North has recorded 25 hotel trades over the past year whereas Scotland South saw 11 transactions.

Adagio Aparthotel, Edinburgh

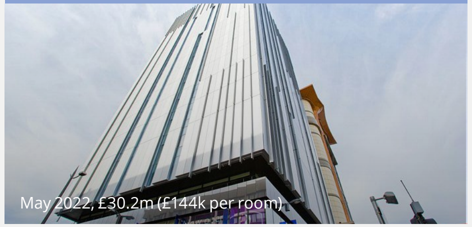
Dec 2021, £40.5m (£277k per room)

Macdonald Hotel, Edinburgh



Nov 2021, £33.8m (£215k per room)

Premier Inn Buchanan Galleries, Glasgow



May 2022, £30.2m (£144k per room)

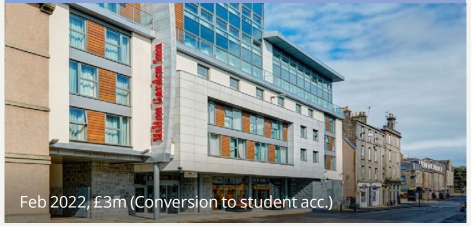
The Roxburghe Hotel & Golf, Kelso

Dec 2021, £36.2m, (£1.8m per room)

Fonab Castle Hotel & Spa, Pitlochry

Feb 2022, 8m (£191k per room)

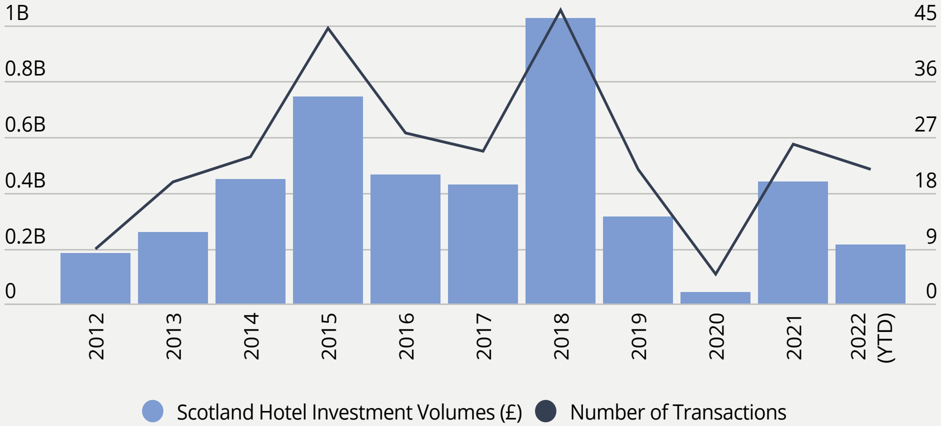
Hilton Garden Inn (City Centre), Aberdeen



Feb 2022, £3m (Conversion to student acc.)

SCOTLAND HOTEL INVESTMENT VOLUMES 2012 – 2022 (AUGUST YTD)

Source: Avison Young



How can Avison Young assist

AVISON YOUNG HOTELS TEAM CAN ADVISE AND SUPPORT CLIENTS IN A NUMBER OF WAYS:

Detailed financial projections and sensitivity analysis

Procurement of development partners, brands and operators

Advising on the appropriate and most relevant hotel products that fit the overall master plan of a regeneration project, matching the demand drivers

Advice around the structure of any support or financial subvention including financial performance, investment returns and risk profile

Investment advice, negotiation of commercial terms and analysis of long-term returns

AVISON YOUNG HOTELS TEAM CAPABILITIES

- Agency and Investment
- Valuation
- Building Consultancy
- Project Management
- Planning
- Business Rates
- Consultancy Advice (Feasibility Studies, Branding, Re-Positioning, Operator Selection, Performance Monitoring, Acquisition Due Diligence)

Carried out valuations totalling £5bn in the last two years

Advised on £310m+ of hotel transactions in the last year

UK-WIDE COVERAGE – AVISON YOUNG OFFICES

Should you wish to discuss any details within this update please get in touch

Andrew Renouf
Principal,
Hotels and Leisure
andrew.renouf@avisonyoung.com
+44 (0)131 469 6026

Ian Derrick
Director,
Hotels and Leisure
ian.derrick@avisonyoung.com
+44 (0)131 469 6028

Tracey Gribble
Consultant,
Hotels and Leisure
tracey.gribble@avisonyoung.com
+44 (0)131 469 6025

Richard Gaunt
Principal,
Head of Consultancy, Hotels and Leisure
richard.gaunt@avisonyoung.com
+44 (0)7979 111 021

Ian Elliott
Principal,
Head of Hotel Valuation & Investment
ian.elliott@avisonyoung.com
+44 (0)7920 138 482

Pippa Harrison
Principal,
Head of Hotel Capital Markets
pippa.harrison@avisonyoung.com
+44 (0)7584 185 013

Visit us online
avisonyoung.com