HOTELS

2010

LONDON AND PARIS LUXURY HOTELS

Market report

Knight Frank

HIGHLIGHTS

- There has been little change in supply within the Paris and London luxury hotel markets over the last decade. However, supply is likely to grow over the next two years with new projects and the reopening of a number of hotels currently undergoing refurbishment.
- The potential new supply comes at a challenging time for the segment, as demand levels have been affected by the recent economic slowdown. The Average Daily Rate (ADR) for luxury hotels in both Paris and London fell during 2009.
- Investment transactions in the segment are relatively rare, though there remains demand for luxury hotel properties, particularly from ultra high net worth individuals, who are often prepared to pay a premium for such trophy assets.

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The Ritz, London

THE LUXURY HOTELS OF LONDON AND PARIS ARE WELL-KNOWN LANDMARKS ABLE TO PROVIDE SOME OF THE MOST OPULENT HOSPITALITY IN THE WORLD

London and Paris

Few cities in the world epitomise traditional luxury hospitality like the two most-visited cities in the world, London and Paris, where luxury hotels are prominent landmarks in the cities' landscapes with centuries-long traditions and globally recognised names.

These cities are political, financial and cultural magnets and Paris and London have long been amongst the world's most desirable hotel property investment markets.

Over the last decade, the scarcity of viable development and conversion opportunities for luxury hotel properties has subdued supply growth in both cities, while demand for luxury accommodation has grown strongly commensurate with the rapid increase in global wealth.

The manifestation of this has been the exceptional performance of the segment and a select group of investors have gone to tremendous efforts to launch new luxury hotel projects, which are expected to open in the next two years.

This likely increase in supply coincides with an exceptionally challenging economic environment, which has led to significant pressure on hotel performance generally as well as greater uncertainty in the wider real estate markets.

A closer look at the underlying characteristics of luxury hotel properties and the fundamentals of the market in Paris and London will help to shed some light on what the future holds for the segment.

Definition

There is no internationally accepted definition for the luxury hotel market.

Whilst there are several possible indicators to define a hotel market segment, the underlying trade and its key determinants – such as location, property features, facilities, services, brand and operator – provide an insight into the segment.

Capturing a property's underlying characteristics and market positioning as perceived by its guests, the Average Daily Rate (ADR) is a first point of reference in defining the segment.

In Paris, the segmentation of the upper end of the market is relatively straightforward. The top performers form a distinctive set with pre-downturn ADRs between €650 and €950, while the followers are further behind with ADRs of between €300 and €400. There are very few properties trading in between.

In London, clear segmentation proves more difficult as the difference in ADR between the top and the following set is less pronounced. While top performers in London reached ADRs from £400 to around £550, there are several properties that directly challenge the top set.

Characteristics

Whilst each luxury hotel property is unique, the hotels in Paris and London share a set of distinct characteristics, which set them apart from the five star segment.

The majority of luxury properties occupy unique historical buildings and are located in prime areas of their respective cities, being the 1st and 8th arrondissements in Paris, and Mayfair and Knightsbridge in London.

The room count of the top performers in the two cities typically ranges from 100 to 200 and rarely exceeds 250. These properties have a wide range of different room and suite types and high suite ratios ranging from 15% to 45% are common.

Although room sizes are often dictated by the historic character of the building, most guest rooms measure between 30 and 45 sq m and the largest suites are often significantly bigger.

Table 1
Property characteristics

	Luxury properties
Location	1st and 8th arrondissements in Paris, Mayfair and Knightsbridge in London
Number of rooms	100-200
Suite ratio	15-45%
F&B facilities	Several outlets, Michelin-starred chefs
Meeting facilities	Limited but exclusive

Source: Knight Frank

The room fit-out is to the highest quality, often combining valuable antiques with the latest technology and state-of-the-art luxury amenities.

Other notable features of the top performers in the two cities are the extravagant food and beverage offerings with fashionable restaurants and bars, often run by Michelin-starred chefs.

Hôtel Plaza Athénée

Leisure facilities are large in size, high-end and often branded, whilst meeting facilities are generally limited in size and cater only to small but exclusive events.

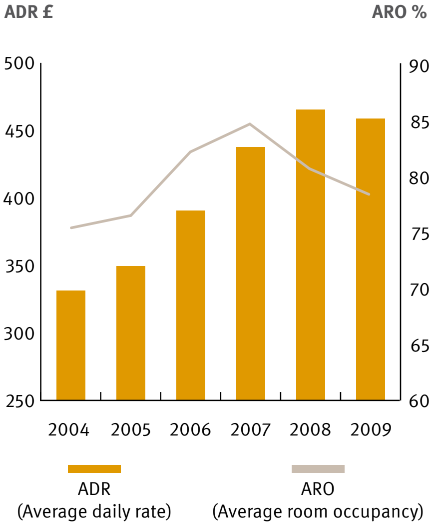
Apart from these property-related characteristics, it is the exceptionally high service delivery and wide array of personalised services that distinguish a true luxury hotel from a five star hotel.

Although many luxury properties are only discreetly affiliated to their group or collection and operate under their individual name, operators and brands ensure that the range and standard of facilities, the quality of the room fit-out as well as the service delivery, are of the same high quality across their global portfolio.

To a certain extent, luxury hotels in Paris and London share the same exclusive clientele, with the majority of demand coming from affluent individual leisure travellers, largely from non-European countries with a high proportion of North American, Far and Middle Eastern guests, as well as an increasing number from the so-called BRIC countries (Brazil, Russia, India and China).

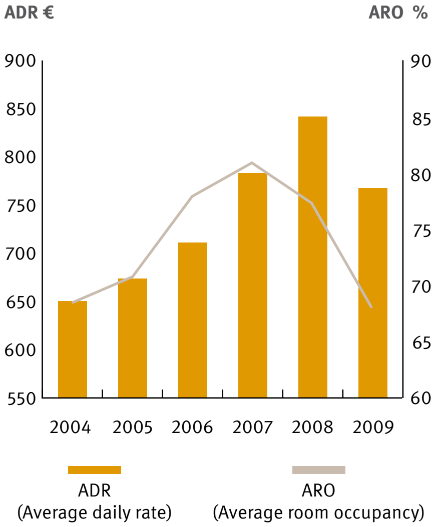
The luxury hotel markets in Paris and London are dominated by companies that operate in the luxury market exclusively, such as Mandarin Oriental, Dorchester and Four Seasons. Only some of the major international hotel companies have true luxury offerings, such as Starwood's St. Regis brand.

Figure 1
London luxury segment performance[1]



Source: STR Global
[1] Includes The Lanesborough, The Dorchester, Claridges, Mandarin Oriental, Brown's, The Berkeley and The Ritz. Does not include The Connaught, The Savoy and the Four Seasons London as they were/are closed for refurbishment.

Figure 2
Paris luxury segment performance[2]



Source: STR Global
[2] Includes the Four Seasons George V, Le Bristol, Le Meurice, Le Plaza Athénée, Le Ritz and Le Crillon.

Operational Market

London

In London, the luxury segment has seen limited change over the past decade with no new supply coming to the market other than that which has been removed and refurbished prior to returning to the market. This was principally the removal of Brown's Hotel in 2004 before it re-opened in 2006.

A significant change to supply occurred during 2008 when the Four Seasons London closed for renovation and refurbishment. Together with the closing of The Savoy at the end of 2007 this was a major contributing factor to the continued strong performance of the luxury set in 2008 and the limitation to the downturn in 2009.

The recent weakness in Sterling has been pivotal in sustaining a relatively strong performance across all sectors of the London hotel market. This has particularly been the case with a significant uplift in leisure business. In the luxury segment, the fall in ADR in 2009 was a mere 1.7% compared with the same period in the previous year, while Average Room Occupancy (ARO) dropped by only 2.9%.

It should be mentioned, however, that seemingly robust Sterling performance in London is somewhat devalued in Euro and US Dollar terms.

With both the Four Seasons (November) and The Savoy (September) scheduled to reopen in the second half of this year, the impact on the market is likely to be minimal in 2010 and we will only be able to measure the impact more precisely as we move into 2011.

Paris

Paris has seen little supply change in the luxury market since 2000, when the Four Seasons George V and Le Meurice reopened after extensive refurbishment works. However, in the third quarter of 2006, the Fouquet's Barrière opened as the seventh and smallest luxury hotel, which had a direct effect on the ARO of the luxury set. However, this did not prevent ADR levels increasing further throughout 2007 and 2008.

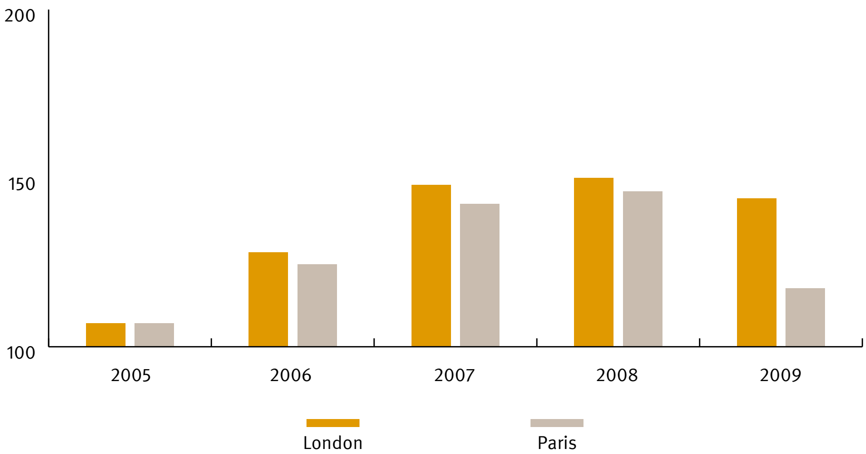
After a dismal start in 2009, the Paris set recorded better results in July and August but the year as a whole still saw ADR fall by 8.8% while ARO dropped significantly by 11.9% to 68.2%. These movements must however, be considered against the exceptional market performance in 2008, when both ADR and ARO increased strongly on the same period in 2007.

Interestingly, Revenue per Available Room (RevPAR) in London and Paris show a very similar growth pattern for the period from 2004 to 2008, with compound annual RevPAR growth rates of 10% and 10.7% respectively.

The Dorchester


Le Meurice

Figure 3
RevPAR indexation, base year 2004
2004=100



Source: STR Global

Comparison

There is a considerable difference between the level of RevPAR in the Paris and London luxury hotel markets, with Paris achieving significantly higher ADRs than London. This was already evident before Sterling started to weaken against the Euro in mid 2007 and the impact of the recent downturn in ADR and ARO in Paris is illustrated by Figure 3.

There is, of course, more to hotel properties than headline performance. Behind the scenes, high ancillary income of sometimes 50% of total sales, extensive but sometimes moderately profitable food and beverage facilities and significant human resources of up to three employees per bedroom, result in a very distinctive business profile.

Payroll is the biggest cost issue, particularly in Paris, where it is significantly higher than comparable hotels in London. Overall the higher cost ratios result in a considerable difference in Gross Operating Profit margins.

Having analysed the supply side on the basis of what we interpret to be the full luxury set, we have included the Fouquet's Barrière in Paris and The Connaught in London, which were not included in the operational survey.

Including the recent extensions of the Oetker Hotel Collection's Le Bristol in Paris and the Maybourne Hotel Group's Connaught in London, there are currently 1,170 rooms in Paris and 1,334 rooms in London with 357 suites on sale in Paris and 369 in London. This results in an average suite ratio of 31% in Paris and 28% in London.

As outlined earlier, properties in the two cities share the main basic characteristics. However, certain differences between the markets are apparent.

On the basis of the full set, the properties in Paris have larger average room and suite sizes, with balconies and terraces more common in Paris than in London. Several of the properties in London have single rooms of less than 25 sq m, while in Paris the minimum room size is 30 sq m across the board.

Also, many of the properties in Paris have extensive signature suites in excess of 300 sq m, while most signature suites in London are less than 200 sq m. However, the largest suite is The Dorchester's Royal Penthouse in London, which is in excess of 750 sq m.

General real estate values which are clearly amongst the highest in the two cities ensure that the Gross Internal Area (GIA) of a property plays a key role when appraising a luxury hotel property.

The GIA of luxury properties in both cities varies between 100 and 180 sq m per key and an assessment on the basis of profit per sq m of GIA is recommended for a thorough review of an asset's performance.

Table 2
Currently operating luxury hotels

	Total number of rooms	Average room count	Average suite ratio	Guest rooms	Junior suites	One bedroom suites
Paris	1,170	167	31%	30-60 sq m	45-75 sq m	55-110 sq m
London	1,334	167	29%	20-55 sq m	40-63 sq m	56-124 sq m

Source: Knight Frank

Investment market

Although luxury hotels are a highly sought-after asset class, the luxury hotel property market is characterised by few going-concern transactions. Where they do take place, they are often sold at significant premiums to their net book values or commercial investment values.

Most luxury hotel properties are conversions of five star hotels or landmark buildings in alternative uses, which are subject to strict planning controls. These conversions can consume several hundred millions of Euros or Pounds and take several years to complete. Nowhere is this more evident than the renovation of The Savoy in London which has seen a significant cost overrun and a delay in reopening that will stretch to almost 18 months.

The majority of luxury hotel properties are backed by prestigious owner operators who also own the corresponding luxury hotel brands. Hotel groups that want to secure a management agreement on a property usually have to take a share in the investment or offer significant financial incentives to secure a strategic entry into the market place.

Investors in luxury hotel properties are mostly sovereign wealth funds or ultra high net worth individuals with long investment horizons and deep pockets for vital and continual renovation and improvement. Often from the Middle and Far East, these equity investors generally prefer freehold properties and may be willing to pay premiums to acquire trophy assets. The dearth of available debt in the market will continue to highlight this buyer profile.

After a quiet 2008 and 2009, current investor interest is improving, mainly from buyers looking for opportunistic acquisitions in London where overseas investors see attractive capital values based on the currency arbitrage. The Stafford Hotel in London, which recently sold to an Egyptian investor for a reported £77.5 million, is one example and several groups are showing interest in the In and Out Club on Piccadilly. The latter has the potential, with significant investment, to become a luxury hotel.

In Paris, Starwood Capital's marketing of the Crillon, the Louvre and Lutetia hotels has resulted in the Lutetia being recently sold to Alrov Properties for c. €145m. This is the first sale in the segment since 2008, when the former Le Majestic was taken over and the Prince des Galles was sold.

Developments

There is considerable development activity in London and Paris which will impact the luxury market segment. We elaborate on the most prominent projects below.

In London, the Four Seasons London is currently closed for extension and redevelopment. Guest rooms, suites and public areas are to be reconfigured and the property will feature a new spa and fitness suite on the top floor of the building when it reopens in late 2010 with 200 rooms and suites.

The Savoy will reopen in 2010 with 268 rooms and suites, after a complete and somewhat delayed renovation with a reputed total investment of c. £200m. The property will be operated under the Fairmont brand and have a suite ratio of more than 20%. It will also feature one of London's largest suites at 300 sq m.

The Dorchester Collection will open a second property in London under the name of 45 Park Lane with 50 guest rooms and suites. It is expected to operate as a sister hotel to the Dorchester, albeit with a more contemporary feel.

The only new development in the luxury market segment that is currently in the early stages of construction is the Knightsbridge Palace scheme. This is expected to comprise 85 rooms and suites and to be operated as a Bulgari branded hotel.

In Paris, the former 236 bedroom Royal Monceau on Avenue Hoche in the 8th arrondissement is currently being redeveloped and will open under the Raffles brand with a significantly reduced room count of around 150, including 42 suites. The largest suite will be 400 sq m and the spa will be 1,500 sq m in size.

The former hotel Le Majestic on Avenue Kléber in the 16th arrondissement will be home to Peninsula's first hotel in Europe. The property is being redeveloped, to include 200 rooms and suites. The renovation cost alone is expected to be in the region of €250m.

The Paris Shangri-La will be in a building dating from 1896 on Avenue d'Iéna in the 16th arrondissement. The minimum room size is 37 sq m and suite sizes range from 50 sq m to 235 sq m. The total suite ratio will be in the region of 40% and the property will feature a 1,000 sq m spa.

A Mandarin Oriental is set to open in 2011 with 150 rooms and suites on Rue Saint-Honoré in the 1st arrondissement, situated in a 1930s building. Amongst its main features will be a substantial swimming pool.


Brown's

Table 3
Developments in London

Property	Operator	Type of work	Total rooms upon opening	Opening date
Four Seasons London	Four Seasons	Extension and redevelopment	200	2010
The Savoy	Fairmont	Redevelopment	268	2010
45 Park Lane	Dorchester Group	Conversion	50	2010
Bulgari Knightsbridge	Ritz Carlton/Marriott	Development	85	2012

Source: Knight Frank

Table 4
Developments in Paris

Property	Operator	Type of work	Total rooms upon opening	Opening date
Royal Monceau	Raffles	Redevelopment	152	2010
Palais d'Iéna	Shangri-La	Conversion	109	2010
Mandarin Oriental	Mandarin Oriental	Conversion	150	2011
Le Majestic	Peninsula	Redevelopment	200	2012

Source: Knight Frank

Outlook

The luxury hotel market had an exceptionally successful up-cycle until the beginning of the fourth quarter of 2008, subsequent to which, the economic crisis has placed significant pressure on this segment.

At a time when demand for luxury accommodation is subdued, supply is likely to increase substantially in Paris. With the market segment's relative sensitivity to changes in supply, this may lead to continued pressure on ADRs and AROs.

However, as two of the world's leading gateway cities with diverse source markets and business mixes, we should see a gentle but sustained recovery in demand for luxury hotel accommodation in the short term.

Several operators are reaching out to distinguish themselves through a superior quality of service, increased room sizes and superior fit-out and facilities in their properties.

Whilst new brands might generate demand from markets that do not already have significant exposure in the two cities, it remains to be seen how new names and concepts are received in the market place.

The prevailing financial restrictions on new developments and the top prices paid at the peak of the last cycle, lead us to believe that some projects might be considered at risk or will be postponed.

Also, the general scarcity of suitable buildings and land and the prevailing high real estate values of surrounding properties and competing uses, resulting in exceptionally high capital requirements, will continue to restrict supply as has been the case historically.

If we see any increase in supply, the luxury hotel markets in Paris and London may sub-divide into a leader group and a follower group. Whilst in Paris the current trading level is unlikely to be exceeded in the near future, the London market may be ready for a new performance benchmark.

In particular, some of the Far Eastern brands still desire a presence in London and The Savoy and Four Seasons will re-enter the market with essentially brand new products. A new group of properties together with the existing top performers may form a distinctive set, enhancing London's reputation as a true luxury hotel destination.

This is one of the most interesting but at the same time challenging hotel market segments. Increased competition, the push for larger rooms, improved services and better efficiency of flows in the hotels will, as ever, require continued investment in the future.

Luxury hotel properties will rarely attract mainstream commercial property investors with their strict investment return requirements. Even for the trophy hunters, it is absolutely essential to understand the underlying market dynamics and property characteristics in order to generate the maximum return on an investment in this segment.

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