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Hotel Investment Scene in CEE

Market Evolution and Diversification of Operating Structures

March 2020

Source : Raffles Europejski Warsaw – Courtesy of Accor

Introduction

Welcome to our second edition of the joint Cushman & Wakefield–CMS report on the Hotel Investment scene in CEE: *Market Evolution and Diversification of Operating Structures.*

After years of rapid and turbulent development, the CEE-6* markets were catching up with their western neighbours, in terms of both investment volumes and sophistication. Hotel transaction activity reached record levels in 2019, with indication that there was still room to grow. Our initial expectations for 2020 were bullish, underpinned by several significant deals being in various stage of progress. However, the unprecedented COVID-19 pandemic is impacting this positive trend, making investment predictions for 2020 increasingly challenging. Nevertheless, we have left in this report our initial pre-crisis view, to show the market potential for when the current crisis is resolved and the hospitality sector in the CEE-6 region recovers.

Notwithstanding the current crisis, the CEE-6 region has been experiencing qualitative evolution and diversification in the hotel real estate sector, driven by the changing needs of travellers, as well as increasing competition among operators and investors. In our first edition, we focused on innovation shaping hospitality concepts and issues around shared-accommodation platforms. In this report, we explore the changing nature of operating structures from the investor/owner perspective, and discuss the underlying trends driving this evolution across CEE. We again asked selected international and regional players active in the region, as well as those keen to enter the CEE market, for their brief opinions.

We do hope you will find the report interesting; please do not hesitate to contact us to discuss any of these issues further.

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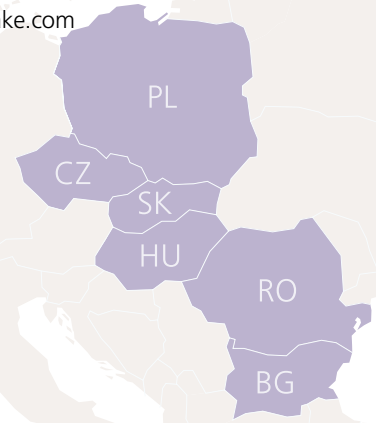


*Bulgaria, the Czech Republic, Hungary, Poland, Romania, and Slovakia

Highlights – hotel investment trends in the CEE-6 region

2015 – 2019

EUR 4.2bn transacted over the last five years with an average deal size at **EUR 25.1m**

EUR 844m average annual volume, **59% up** compared to previous five years (2011 – 15)

67% of volume was transacted in the **Czech Republic and Poland**

50% of volume was by **institutional / listed investors**

Single-asset transactions accounted for **87%** of the volume

Overseas investors accounted for **32%** of transacted volume

2019

The **highest transaction activity** on record, reaching **EUR 1.4bn**

55 hotels with 10,210 rooms were transacted. Average price at **€142,000 per room**.

58% of transacted volume was by **international investors**

56% of volume was by **private investors**

Upper midscale and upscale hotels accounted for **42%** of the volume

12% of transacted volume was spent on **leased hotels**

2020 Outlook (before COVID-19 impact)

EUR 2bn worth of assets were **on the market, 19% already completed**

Leased properties on the market accounted for **18%** of estimated value

Luxury and upper upscale hotels on the market represented **74%** of estimated value

Radisson Blu Hotel, Prague – Courtesy of Radisson Hotel Group

How much and where?

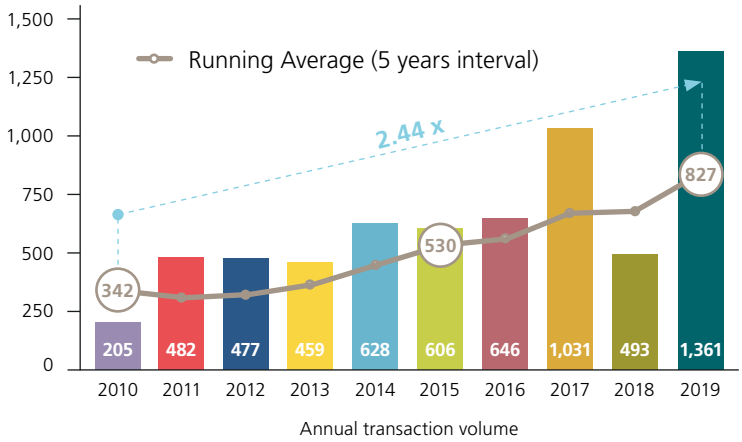
In recent years, hotel transaction activity in the CEE-6 region has reached unprecedent levels. While the total cumulative transaction volume reached EUR 9.4bn over the last 20 years (2000–2019), nearly half of this has been transacted during the last five years, totalling over EUR 4.2bn in 2015–2019. The Czech Republic attracted the highest volume of investment, with Prague already boasting the ninth largest hotel market in Europe in 2019, followed by Poland and Hungary.

72% of transactions in CEE between 2015–2019 are in capital cities

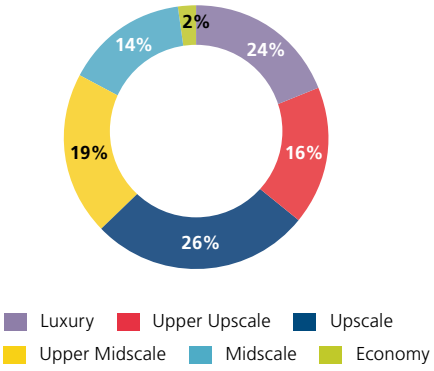
Volatile but more up than down

When looking at annual transaction activity across CEE over the last decade, it might seem that investors' interest has been fairly unstable. Especially during the last three years, the total investment volume dropped from EUR 1bn in 2017 to just under EUR 0.5bn in 2018 before rising again to EUR 1.4bn in 2019. However, the driver behind this volatility has not been on the investors' side, as they continue to show strong interest, but due to inconsistent asset availability and irregular timing of the "big" deals. The number of transactions in CEE and their average size is still relatively small (on average 34 deals per year with EUR 25.1m average deal size over the last five years), thus any major transaction that is completed or conversely delayed, can make a notable impact. A good example is the sale of the InterContinental Hotel in Prague for EUR 225m, expected to close in 2018 but eventually slipping to 2019, making the transaction volume in 2018 over 31% lower than forecasted. Thus, looking at average activity over three to five years is more indicative of changes in investors' appetite. And this has increased significantly. For example, the average transaction volume during the last five years (2015–2019) reached EUR 844m, which is 2.4 times higher than what was achieved during the peak of the previous cycle (EUR 346m in 2003–2007).

CEE-6: Total hotel transaction volume (EUR, m)

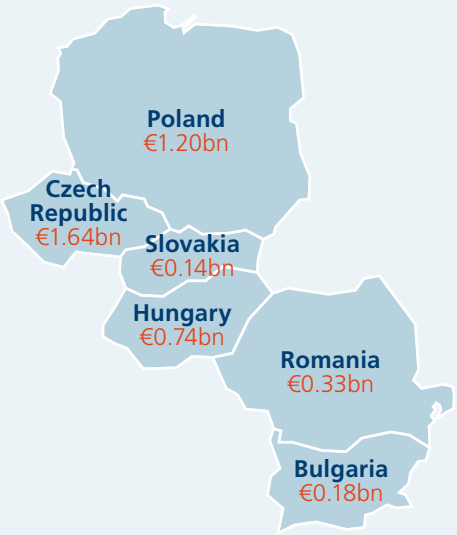


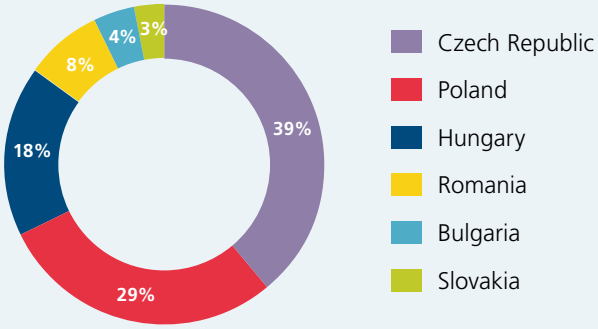
Transaction volume by hotel class in 2019
(share in % based on transaction volume)



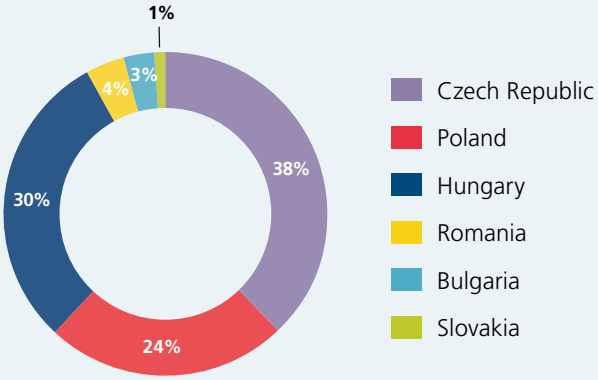
Source: Cushman & Wakefield / RCA

Hotel transactions 2015–2019

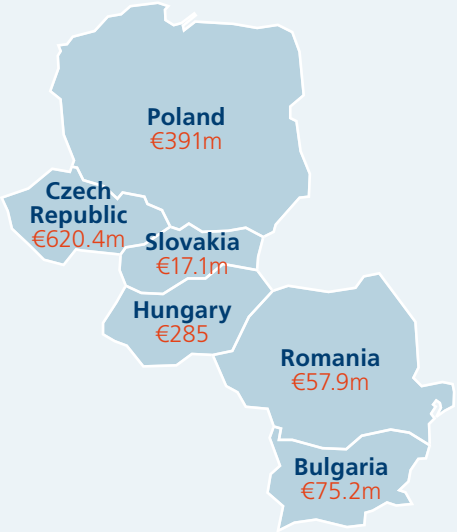


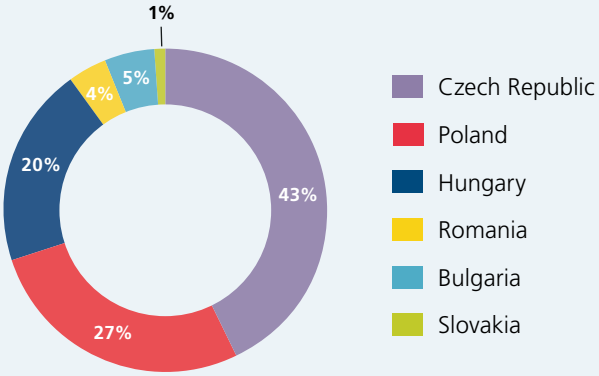


Hotel transactions 2018



Hotel transactions 2019





Source: Cushman & Wakefield / RCA

Courtyard Bucharest Floreasca – Courtesy of Apex Alliance Hotel Management

Key recent transactions

In 2018, one of the largest deals was the acquisition of the Sofitel Budapest Chain Bridge for EUR 75m by Starwood Capital from the USA, and the purchase of the Sheraton Prague by the Norwegian company Wenaasgruppen. Other notable transactions included the acquisition of Sugar Palace in Prague by Austria fund UBM, for conversion to a luxury hotel under the Andaz brand by Hyatt, and the purchase of the 102-room Buddha Bar Hotel in Budapest by Ali Bin Alin.

Looking at 2019, by far the largest transaction in the CEE region was the Fairmont brand purchase of the InterContinental Prague for EUR 225m by the family office and wealth management R2G from the Czech Republic. The hotel is to be repositioned under Fairmont brand by Accor. Other notable deals included the acquisition of the Sheraton Warsaw by Patron Capital, a UK private equity real estate fund, the purchase of the 440-room Panorama Hotel in Prague by Austrian S+B Gruppe, and the acquisitions of the Radisson Collection Warsaw and the Hotel Don Giovanni by Wenaasgruppen, extending its CEE portfolio.

Selected major hotel transactions 2019, 6-CEE

Property	Market	Keys	Buyer	Buyer Origin	Seller	Seller Origin
InterContinental Prague	Prague	372	R2G	CZ	Best Hotel Properties	SK
Sheraton Warsaw	Warsaw	350	Patron Capital	UK	Walton Street Capital	UK
Sofitel Budapest Chain Bridge	Budapest	357	Indotek Group	HU	Starwood Capital	US
Panorama Hotel	Prague	440	S+B Gruppe	AT	Corinthia Hotels International/ Legner Holding	MT
Radisson Collection Warsaw	Warsaw	311	Wenaasgruppen	NO	Europa Capital	UK
Hotel Don Giovanni	Prague	412	Wenaasgruppen	NO	Mornington Capital	UK
Penta Hotel Prague	Prague	227	Aroundtown	DE	CTF Development	UK
Buddha Bar Hotel Budapest Klotild Palace	Budapest	102	Ali Bin Ali	QA	Beghelli Family	IT
Danubius Hotel Gellert	Budapest	234	Indotek Group	HU	CP Holdings	UK
UII European[M] Portfolio	Kraków Katowice	527	Union Investment	DE	UBM Realitaetenentwicklung AG	AT

Source: Cushman & Wakefield / RCA

Convergence among buyers and sellers

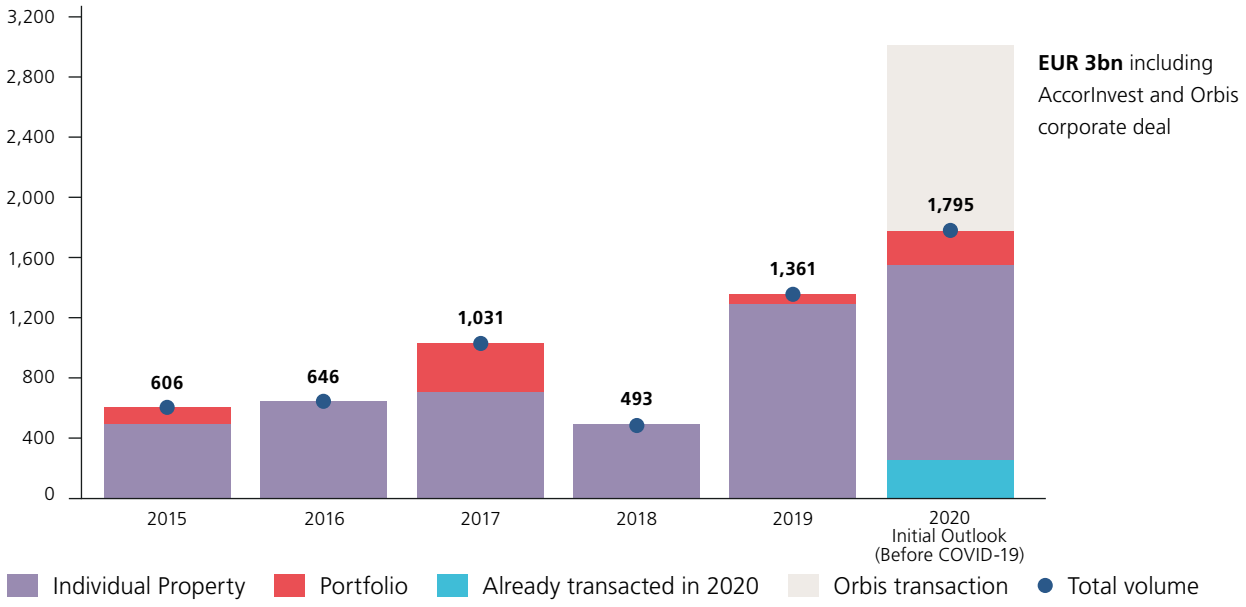
The growing hotel transaction activity in the CEE region has been driven by the improving convergence of demand and supply. On the demand side, investors have been increasingly attracted to hotel real estate as well as the CEE region due to the superior returns relative to most other major asset classes, especially in western Europe where yields are more compressed. This trend has been observed for several years, driven by the long-term growth prospects of the travel industry and maturing status of CEE countries. However, until recently transaction activity in the region was constrained by the lack of assets available for sale. This started to change, especially in 2019, with sellers being enticed by strong pricing and the maturing of the market attracting a new investor base. Even before the current COVID-19 pandemic, there was already a recognition that strong growth rates experienced in the past will eventually start to moderate, coupled with some potential headwinds, such as rising global geopolitical and economic concerns and the increasing supply pipeline in selected markets such as Warsaw. As a result, many owners started to think that it might be the right time to sell, and the current pandemic will reinforce this.

Due to the ongoing COVID-19 crisis, several deals that were expected to close in 2020 are being put on hold. Nevertheless, there are investors that see beyond the current issues and continue with their acquisitions and due-diligence process. There is also a number of deals that were already completed in the beginning of this year, totalling approximately **EUR 297m across 6 assets**, primarily located in Budapest.

With the large amounts of capital raised for real estate investments, interest rates remaining low and potential for healthy profitability levels of hotels within the CEE-6 area, the number of buyers scouting for deals in the region is likely to grow, once the current crisis is resolved. Accordingly, the medium and long-term prospects for transaction activity in the region remain very positive.

Aside from the current COVID-19 crisis, we have been experiencing strong interest from investors in the CEE hotel sector, attracted by healthy yields and long-term capital appreciation potential. This was despite some emerging headwinds such as the rising pipeline in selected markets and growing labour costs. We expect this strong appetite from investors to quickly return once the ongoing pandemic is contained.

Annual transaction volumes (2015–2020*, EUR, m)



Source: Cushman & Wakefield / RCA

Sofitel Grand Sopot – Courtesy of Orbis

Orbis SA

Dominik Sołtysik
Board Member and Chief Investment and Development Officer

(Note: this interview was completed before COVID-19 impact)

What is your presence in the CEE region? What are your plans going forward?
2019 was a transition year for Orbis, until then an owner, operator, manager and franchisor at the same time. Following the asset-light strategy of Accor Group, Orbis decided to dispose of its asset-light business line to Accor. Consequently, since 31 October 2019, Orbis and Accor have been two completely separated entities; Orbis owns or leases 73 hotels throughout CEE, and Accor remains manager of these hotels under a long-term management agreement. This creates two unique companies, each of them the regional leader in its core business.

The final stage of this transformation is the sale of Accor's stake in Orbis to AccorInvest, which was announced in December and will be completed in March 2020. This transaction, with a value of over EUR 1bn, is a record-high in the CEE hotel industry.

What is your preferred business model in CEE? In your opinion, what structure offers the best ratio between return and risk?
Further to the transformation of Orbis, it is obvious that we are no longer looking for management or franchises, which is the field of expertise of our partner Accor.

Orbis has now fully reconnected with its roots as an investor, and consequently we aim to focus on the ownership of land and buildings. Due to the attractiveness of CEE, expected returns for investors have lowered, however we still see some long-term growth potential, therefore we believe that it is possible to build long-term value with a smart and careful asset management strategy. We currently have four hotel projects under development, and we are reviewing other opportunities that are in the pipeline, mostly in Poland. Most importantly, we are steadily investing in our existing portfolio to improve, transform, renovate and upgrade existing assets.

Finally, we still have some hotels under lease, which we will pursue for the most strategic ones, but it is not an axis of our development.

What trends/changes do you see in terms of business models adopted in the region?
In recent years, we have seen significant expansion in the lease model (mostly imported from Germany and Austria), with three parties involved: investors and real estate owners, lease operators and international chains acting as manager or franchisor.

In this context, we have seen the following consequences:

— institutional and financial investors have increased their presence and are ready to accept low but stable investment yields;
— operational risk has shifted to be entirely borne by operators that have the leasehold, which is often made up of a fixed rent or at least has significant minimum guarantees.

If yields continue to compress, we do not anticipate a shift in this trend, because it will always require more capital to invest and become an owner, which the operators cannot afford.

In this new landscape, Orbis remains a special case, because we still think it is possible to capture at the same time the long-term value of the real estate and the potential upside from operating hotels. This requires the operational risk to be accepted, but ultimately results in higher investment returns

> Due to attractiveness of CEE, expected returns for investors have lowered, however we still see some long-term growth potential.

» Orbis SA is the largest group investing in hotel assets in Poland and Eastern Europe. It comprises 73 hotels, including 63 own and ten in lease (total of over 14,000 rooms), in six countries of the region: in the Czech Republic, Lithuania, Poland, Romania, Slovakia and Hungary.

Where is the money coming from?

Growing diversity of buyers

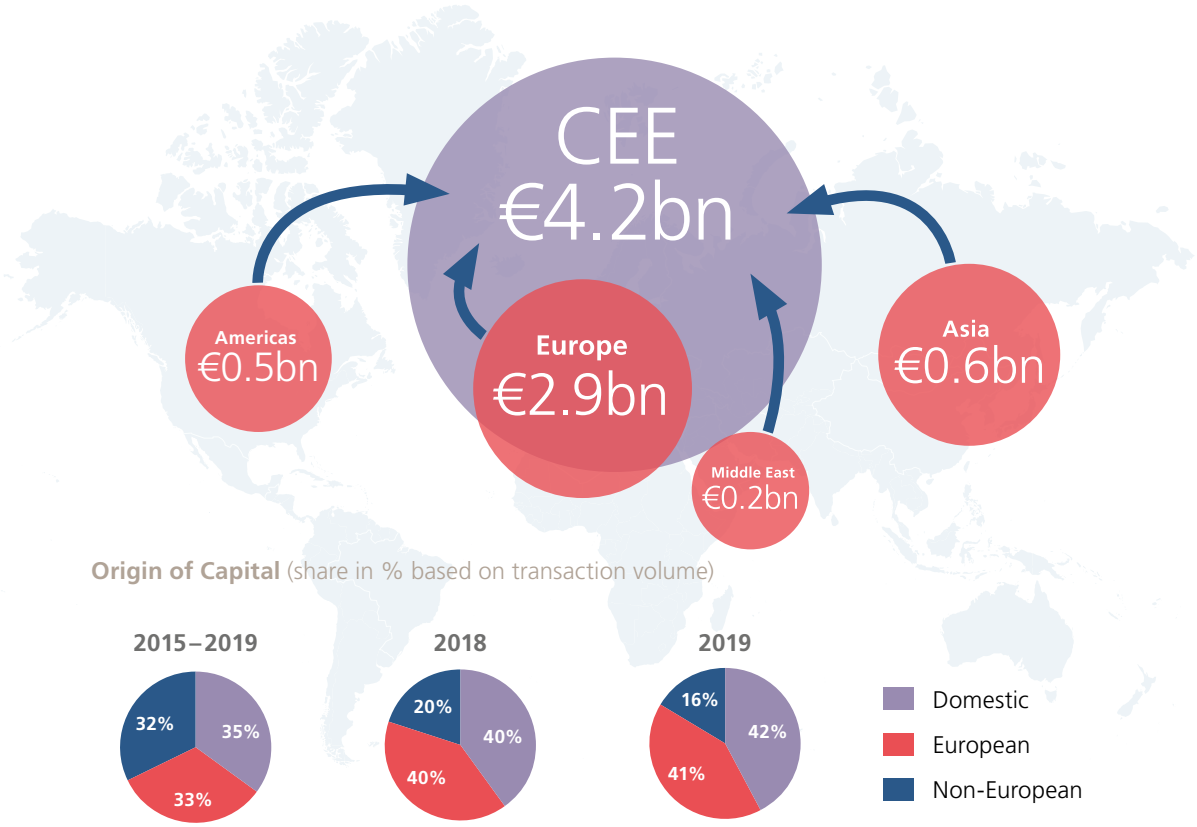
The increasing volumes transacted across the CEE-6 region have also been accompanied by a growing diversity among buyers in terms of origin and type. This trend was especially apparent in 2017 when investment volumes reached a record level with a healthy mix of institutional, listed and private investors from Europe, the Americas, Asia Pacific and the Middle East.

However, the geographical diversity of investors somewhat reversed in 2018 and 2019, when the majority of transacted volume in CEE was executed by European investors such as R2G from the Czech Republic, Norwegian Wenaasgruppen, German Union Investment and Austrian S+B Gruppe, and UBM. These investors are close to the market and were frequently able to secure the assets on an off-market basis or get to the tender process very early. Confidence grounded in a good understanding of the region, strong relationships and an established network of trusted advisors, allows these players to perform appropriate due diligence and make superior offers quickly, which is increasingly important in this highly competitive environment.

However, this does not mean that non-European investors were not keen to acquire hotels in the CEE region. Their interest has been growing, especially when it comes to buyers from Israel, South Korea and South Asia. Examples of recent major acquisitions include the K+K portfolio by the Indian fund InterGlobe Enterprises and the Lindner Hotel Gallery Central in Bratislava acquired by Rotana an UAE Hotel Group.

While European investors dominated the CEE market in 2019, securing hotels worth 83% of the total transacted volume, overseas players have been showing strong interest in the region

Total transaction volume invested in CEE hotels; 2015–2019 (in EUR, cumulative)



Source: Cushman & Wakefield / RCA

Institutional investors are here to stay

The presence of institutional and listed investors is important for market liquidity, especially at the late stage of the cycle. These investors typically have a lower cost of financing and need to deploy capital and, therefore, are more likely to continue investing even in an environment with compressed yields, which has been the case across most markets in Europe including CEE, albeit to a lesser extent.

Furthermore, many institutional investors such as pension and insurance funds invest for the long term, have low leverage and, therefore, are less concerned with the temporary headwinds. A good example has been the Warsaw market where institutional investors see long-term growth potential and continued to scout for new deals, despite the declining RevPAR in 2019, driven by a supply influx.

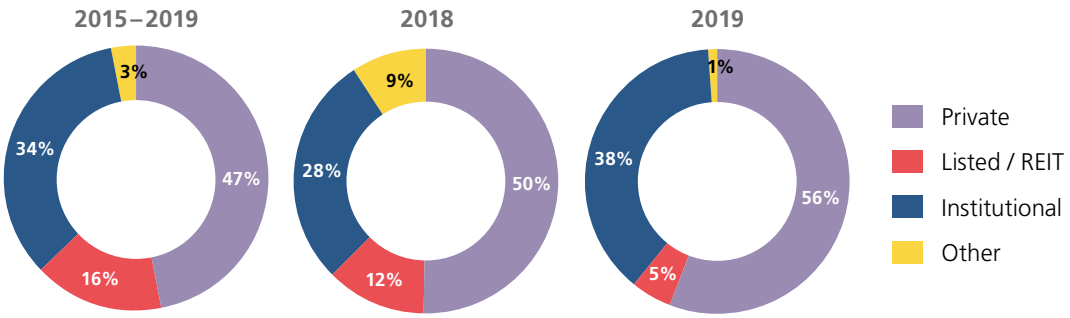
All of this makes institutional investors active buyers even in the later stage of the cycle, hence they represents a critical exit consideration for hotel owners. A growing number of these investors that were seeking and acquiring assets across the CEE region, is therefore good news for the market. During the last five years alone (2015–2019), institutional and listed investors acquired hotels worth over EUR 2bn, representing 50% of total volume transacted. The examples of key players in the region include Union Investment and U-City.

While in 2018 and 2019 the share of institutional and listed investors in total transaction volume in CEE declined compared to the peak in 2017, it was not for the lack of interest. The primary reason was that regional private investors were somewhat more aggressive, being closer to the market, and also because of the relatively moderate deal sizes that are too small for institutional players. For example, in 2019 the average price per transaction was EUR 31m.

Institutional and listed investors typically look for big-ticket single transactions or portfolio deals, and these are still rare in CEE. Nevertheless, several institutional investors acquired hotels in CEE either via smaller portfolios or as part of larger pan-European portfolio acquisitions. Examples include Covivio, one of the largest European REITs active in hotel sector, acquiring three B&B hotels in Poland in 2019 for EUR 24m, and a JV of InterGlobe Enterprises and Even Hotel Group acquiring three hotels in Prague and Budapest as part of a ten-property portfolio under the K+K brand operating across Europe. This trend has continued in early 2020, evidenced by Covivio's pending acquisition of three hotels in CEE; part of pan-European portfolio deal including eight hotels under the Dedica Anthology brand in Budapest, Prague, Rome, Nice, Florence and Venice for a total of EUR 573m. Another notable transaction in CEE that closed in March 2020 by an institutional investor was AccorInvest's acquisition of an 85.8% stake in the Polish Orbis S.A. from Accor for PLN 115 per share, corresponding to proceeds for Accor of EUR 1.06bn. This added 14,000 rooms across 73 hotels to AccorInvest's portfolio, spread over six countries in the CEE region.

While private investors dominated CEE transactions in 2019, the Institutional and listed investors still managed to acquire hotels worth EUR 620m, representing 43% of the total volume.

Structure of 6-CEE Hotel investment by Investor type (share in % based on transaction volume)



Source: Cushman & Wakefield / RCA

Sheraton Grand Warsaw – Courtesy of Schroders

Schroder Real Estate Hotels

Frédéric De Brem
Head of Schroder Real Estate Hotels

(Note: this interview was completed before COVID-19 impact)

What is your presence in the CEE region? What are your plans going forward?
We have been an active investor in the region since 2013. Our first investment was the acquisition of the Sheraton Krakow, which we bought out of administration. We were drawn to Krakow by its compelling demand and supply growth dynamic, an attraction we see in many CEE markets, and relative value compared to other Western European markets, both in terms of hotel average rates as well as investment yield. Over the course of our ownership, we have carried out a renovation of the hotel, re-structured the debt, and re-positioned it as the Sheraton Grand Krakow.

Our next investment was the Sheraton Warsaw; again we were drawn by the attractive long-term demand outlook for the city, and relative value against other Western European cities. We are carrying out a full repositioning of the hotel and recently re-opened as the Sheraton Grand.

Solid levels of infrastructure investment in the CEE region coupled with solid economic growth should underpin hotel demand in the future. As such, we remain committed to the region and are actively seeking further investment opportunities in major cities.

What is your preferred business model in CEE? In your opinion, what structure offers the best ratio between return and risk?
Both of our existing investments in the CEE region are operating assets subject to long-term management contracts with the Marriott. Exposure to the operating business allows us to apply our expertise in hotel operations and asset management in order to improve performance and add value to our investments.

> Aligning the interest of owner and operator, whether under a fixed lease, variable lease, or HMA, is an essential tool to ensure the long-term sustainability.

Our approach to any hotel is first to consider the underlying fundamentals of the investment: the quality of the location, quality of the real estate, and quality of the management. From then, it is the long-term sustainability of the structure that determines the overall success of the investment. Aligning the interest of owner and operator, whether under a fixed lease, variable lease, or HMA, is an essential tool to ensuring this long-term sustainability.

What trends/changes do you see in terms of business models adopted in the region?
Future change in hotel investment business models is likely to be driven by the type of capital that is investing in the region. In CEE there has been a growth of institutional investors who seek exposure to the sector through a predominantly fixed leased structure. The lease structure still makes sense as a result of the attractive macro-economic fundamentals of the region, and if the interests of the landlord and tenant are well aligned in a well structured lease.

Equally, this attractive economic backdrop creates operationally driven opportunities with savvy local operators and hotel concepts, bringing in more varied types of capital from around the globe to the region.

» Schroders has managed real estate since 1971 and is one of Europe's largest managers of real estate. Our investment range allows our clients to access real estate through open ended funds, listed REITs, specialist funds, joint ventures, separate accounts and global real estate securities. As at 30 June 2019, Schroder Real Estate manages GBP 16.2bn of real estate on behalf of a wide range of institutions.

Covivio

Dominique Ozanne
Deputy CEO

(Note: this interview was completed before COVID-19 impact)

What is your presence in the CEE region? What are your plans going forward?
Today Covivio Hotels is present in 12 countries across Europe and intends to strengthen its position to reach critical size in each of them in the coming years. We will be keen on pursuing further development in Eastern Europe and Italy, which both currently show strong growth and high potential in the hospitality industry. As for the CEE region, in 2019 Covivio Hotels entered Poland, the Czech Republic and Hungary in prime locations in capital cities through long-term partnerships with renowned hotel operators.

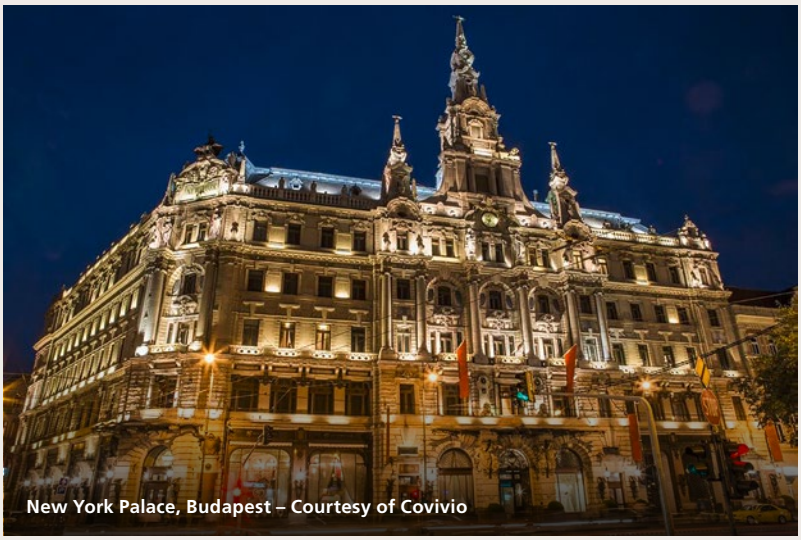
What is your preferred business model in CEE? In your opinion, what structure offers the best ratio between return and risk?
Covivio Hotels is a flexible player with a strong track record on all types of contracts in order to make the most of each opportunity and catch value creation. Our preferred structures are leases and management contracts, including a minimum guaranteed and a variable component to allow us to benefit from further growth. Where we identify strong potential, we seek to maximise the variable income while still securing our investment.

> Hotel operators tend to be more pragmatic to adapt to investors' needs, managing hybrid structures or variable income in order to catch the best opportunities in prime locations.

Beyond financial metrics, Covivio Hotels' strategy focuses on top locations in major capital cities in targeted European countries along with leading hotel operators.

What trends/changes do you see in terms of business models adopted in the region?
Hotel operators seem to be currently looking for partners who can support them in their organic growth through capitalistic participations or long-term agreements, especially when it comes to significant investments in an environment where flexibility and swiftness are key. They tend to be more pragmatic in adapting to investors' needs, managing hybrid structures or variable income in order to catch the best opportunities in prime locations. This is how Covivio Hotels entered the UK in 2018 with IHG and more recently Italy and CEE in 2019 with NH, signing long-term hybrid leases including a fixed and a variable component.

» Covivio Hotels specialises in the ownership of leased properties in the hotel industry, acting as a subsidiary of Covivio, a leading European operator with a portfolio valued at EUR 24bn. Being a listed property investment company (SIIC) and the real estate partner of large players in the hotel industry, Covivio Hotels holds a portfolio valued at EUR 6.7bn (as at 31 December 2019).



New York Palace, Budapest – Courtesy of Covivio

Carlo IV, Prague

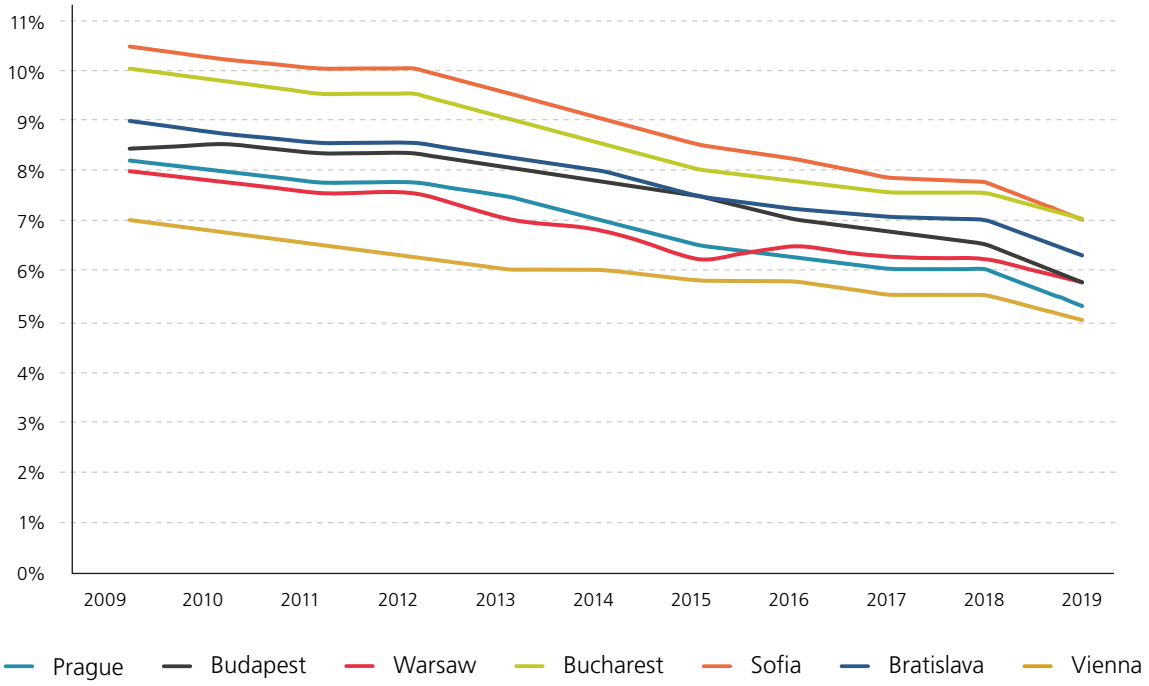
Where are the yields?

The growing interest of investors and the presence of institutional and listed players shows the growing maturity of the markets. This contributed to compressing transaction yields across the region.

Since the global financial crisis, hotel yields for a typical deal with a management contract structure across the capital cities of the CEE-6 region compressed and narrowed from an 8–11% range depending on the market, down to a 5.25–7.00% range. Hotels in Prague, Budapest and Warsaw are being transacted with the lowest yields. In terms of lease structures, the yield spread has compressed by between 50 and 75 basis points.

Yields have been getting closer to those seen in Western Europe in recent years. However, in 2019 there was still gap of about 50 to 100 basis points between the top cities in the CEE countries and their close western neighbours, such as Vienna and Berlin.

Yield trends 2009–2019: CEE-6 capitals and Vienna



Note: *The yields are based on actual transactions where available as well as the sentiment indicated by the investors. The initial yield may vary widely in the region particularly depending on the location, hotel quality/type, deal type, operating structure and upside potential (applicable to the Management Contract operating structure).*

Source: Cushman & Wakefield

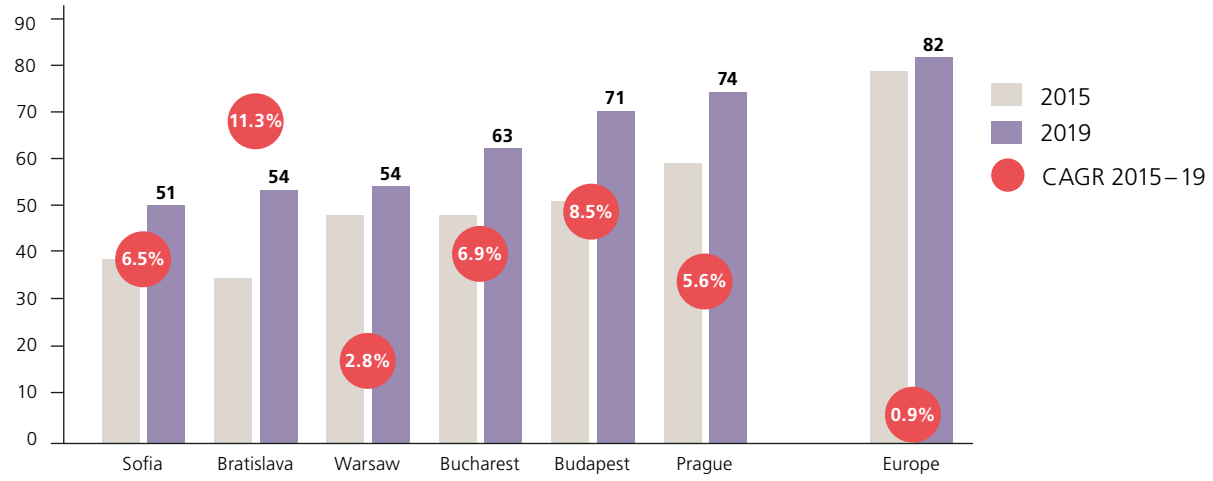
The large amount of dry powder looking for placement should help to keep the yields low, once the COVID-19 crisis is contained. However, further compression might be challenging, due to slowing RevPAR growth combined with economic and geopolitical uncertainty and concerns caused by the coronavirus outbreak.

Holiday Inn Gdansk – Courtesy of UBM

What were the key investment drivers?

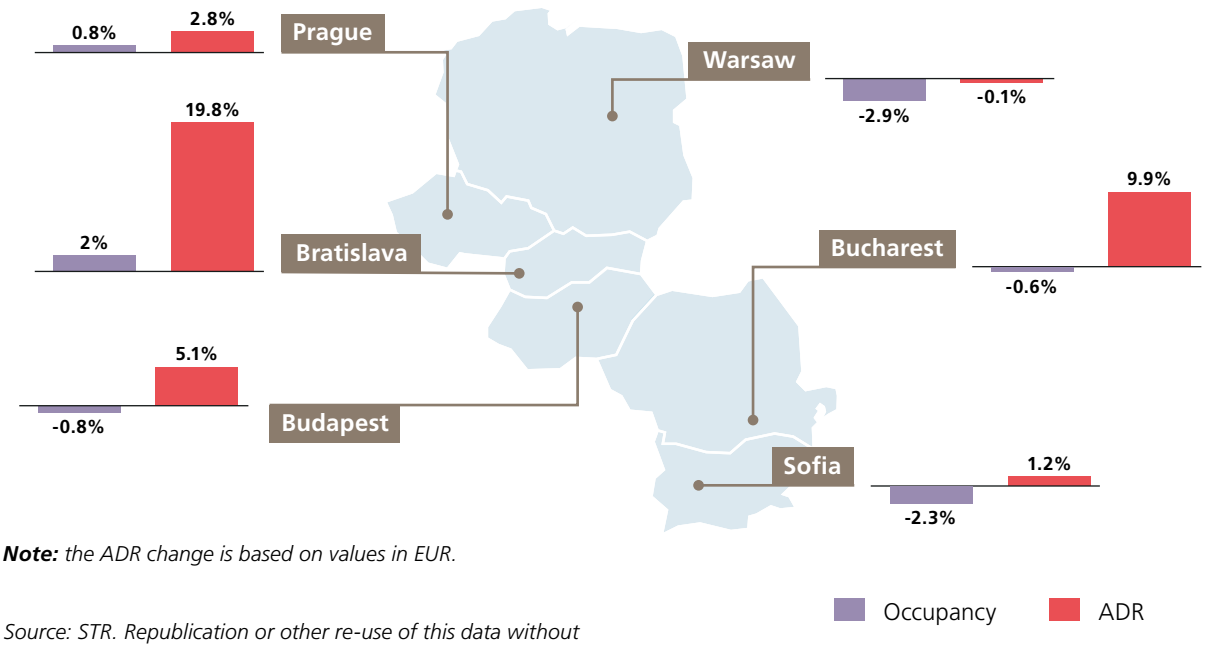
- **Healthy market performance** in recent years and attractive profitability levels, despite rising labour costs
- **Unique market characteristics** such as a very limited supply pipeline in Bratislava and Prague, robust commercial development in Warsaw or decreased VAT rate for hotel accommodation in Hungary and Slovakia
- **Higher yields** relative to many established markets in Western Europe and other asset classes, combined with long-term growth potential
- **Low brand penetration** compared to Western Europe, which creates opportunities for branding and repositioning
- Expansion of global branded operators, professional third-party management companies and specialist hotel asset managers across the region allowing institutional investors to enter the sector, thus **increasing overall transaction activity and liquidity**.

Performance trends in key CEE-6 markets vs Europe (RevPAR in EUR)



Source: STR

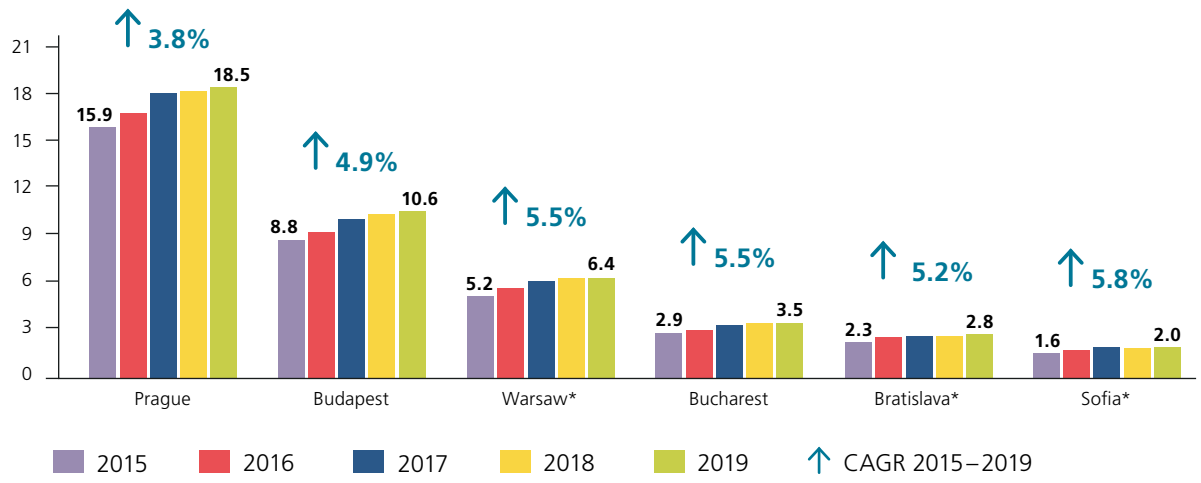
Performance trends of 2019 (% change vs 2018)



Note: *the ADR change is based on values in EUR.*

Source: STR. Republication or other re-use of this data without the express written permission of STR is strictly prohibited.

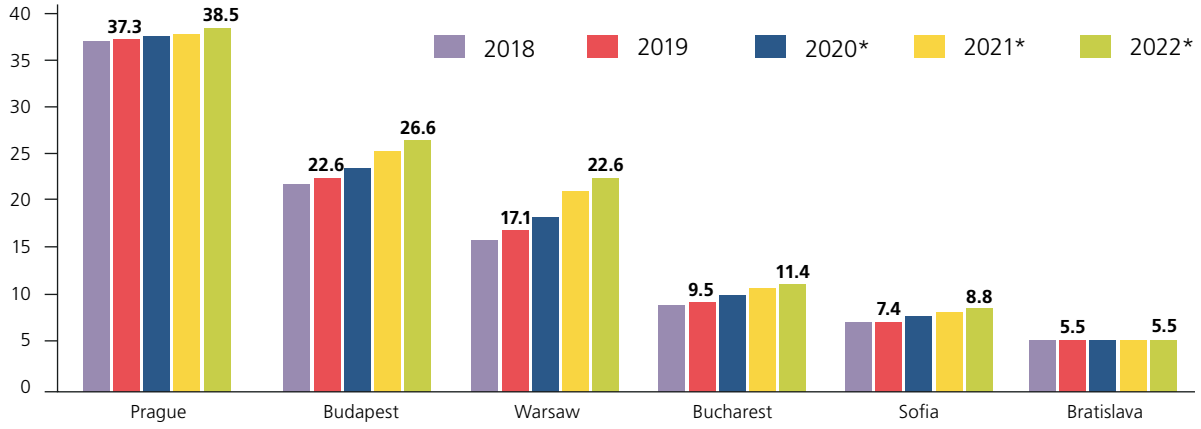
Overnight Stays (millions) – CEE-6 Capitals (2015–2019)



* 2019 forecasts

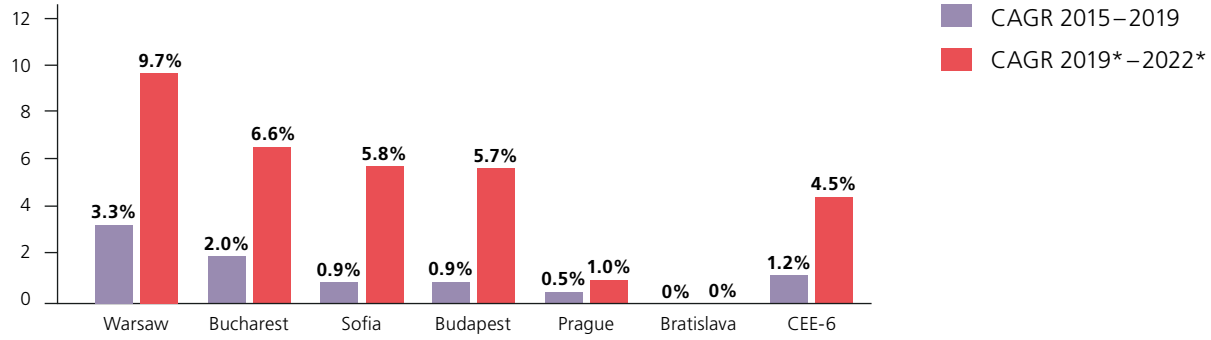
Source: Respective statistical offices and Cushman & Wakefield

CEE6-Capitals – Supply Growth Forecast (000's rooms available)



Source: Cushman & Wakefield

CEE6-Capitals – Supply Growth Forecast (% change, based on number of rooms)



Source: Cushman & Wakefield

2019 Hotel performance in CEE-6 capitals

Thomas Emanuel
Director, STR

(Note: this interview was completed before COVID-19 impact)

Four of the six major Central and Eastern European (CEE) capitals continued to enjoy growth in revenue per available room (RevPAR) in 2019. The region as a whole also continued to improve from a hotel performance perspective, due to growing economies, political stability, perception as safe destinations, expanded airlift, demand-driving events, and relatively low supply increases (in most markets).

Looking at each of the capitals in turn, starting with the furthest north, we see the dynamic city of **Warsaw**. The city saw a decline of 2.4% in revenue per available room (RevPAR) in 2019, the market's second consecutive year with a RevPAR decline. However, that performance was solely supply-driven. Supply increased 6.8% in 2019, following an increase of 7.0 in 2018 – significant amounts for any market to absorb. With supply outpacing demand, occupancy dragged down RevPAR despite an increase in average daily rate (ADR) increases. The pipeline in Warsaw remains strong, with an additional 4,156 rooms due to open, so supply will need to be closely monitored in the years ahead.

Moving to **Prague**, 2019 produced a steady RevPAR increase of 3.6%, mostly driven by ADR. The market benefits from multiple demand drivers, and enjoyed the strongest occupancy of the six capitals – 79.3%. Supply growth has been low, less than 1% per annum since 2011, which naturally benefits hoteliers in the market.

Of the markets analysed for this article, **Bratislava** saw the greatest ADR and RevPAR increases, 22.1% and 19.8%, respectively. The outstanding growth shown by the Slovakian capital was driven by two major factors; firstly the decline in VAT from 20% to 10%, which came into effect on 1 January 2019 and helped an increase in net rooms' revenue. Secondly, events played a big part, the highlight being the World Ice Hockey Championships in May, which helped boost ADR 32.8% for the month.

Budapest has seen significant RevPAR increases over recent years – 11% per annum since 2014. This past year was also impressive with RevPAR growing 6.3%, but this was all due to ADR increases, as, similar to Warsaw, supply growth outpaced demand and led to a small occupancy decline of 0.8%. Again, events played a major part in the market's success – the best of which was the Hungarian Grand Prix which drove 101.7% RevPAR growth from 2–4 August.

Romania held the EU Presidency during the first half of 2019, which was the key driver in a positive year for **Bucharest**, with RevPAR increasing 11.6%. Supply in the city grew 3.4%, which again was faster than demand, leading to a small occupancy decline. The city is still a heavy corporate destination with wide variances in occupancy between the weekends and weekdays. In 2019, Sunday night average occupancy was 57.1% versus a far stronger Wednesday night, which averaged 84.3%.

In **Sofia**, the market experienced a slight RevPAR decline of 1.1%. This was due to demand falling 1.8%. The key reason for this decline would be the comparison with the EU presidency host time, which Bulgaria held in the first half of 2018. Much like Bucharest, the market is still dominated by corporate business, with occupancies below 60% on Friday and Saturday nights, and less than 50% on a Sunday. This, however, does also give the market a good opportunity to focus on driving more leisure business to the city.

In summary, despite a mixed picture, and supply challenging occupancy in a number of cities, demand grew in 2019. More people were travelling to this growing region, and it has all the fundamental demand drivers to ensure that continues into the future.

» STR provides premium data benchmarking, analytics and marketplace insights for global hospitality sectors. Founded in 1985, STR maintains a presence in 15 countries with a corporate North American headquarters in Hendersonville, Tennessee, an international headquarters in London, and an Asia Pacific headquarters in Singapore. STR was acquired in October 2019 by CoStar Group, Inc. (NASDAQ: CSGP), the leading provider of commercial real estate information, analytics and online marketplaces.

> The CEE region as a whole also continued to improve from a hotel performance perspective, due to growing economies, political stability, perception as safe destinations, expanded airlift, demand-driving events, and relatively low supply increases (in most markets).

Raffles Europejski Warsaw – Courtesy of Accor

Hotel Operating Models

Proliferation across CEE

A unique feature of hotel real estate is that it offers a wide spectrum of risk-and-return investment profiles. The nature of income can range from being very stable and secure, in the case of traditional fixed leases, or fluctuate on a daily basis, if the investor decides to operate a hotel directly, engage an operator under a management contract, or lease the property with a variable rent structure. This provides investors with interesting opportunities to diversify the risk profile of the assets in their portfolios and widens the pool of buyers, making hotels a very attractive asset class for investment.

However, in the CEE region the availability of various operating models was until recently somewhat limited, with the predominant structure being owner-operated hotels, followed by properties under management agreements. The main reason behind this lack of fixed income options was the hesitance of major operators to sign leases and the absence of third-party management companies to fill the void. This started to change in recent years, driven by the increased popularity of, and confidence in, the CEE markets. Selected examples of major branded international operators signing leases in the region include Motel One, the Radisson Group, Barceló, Hotusa, A&O, Louvre Hotels Group and B&B hotels. This trend is likely to grow with a number of other major operators already having deals in progress and actively looking for more opportunities across the region. Nevertheless, this typically applies only to prime projects in prime locations and within a limited number of key cities such Prague, Budapest and Warsaw.

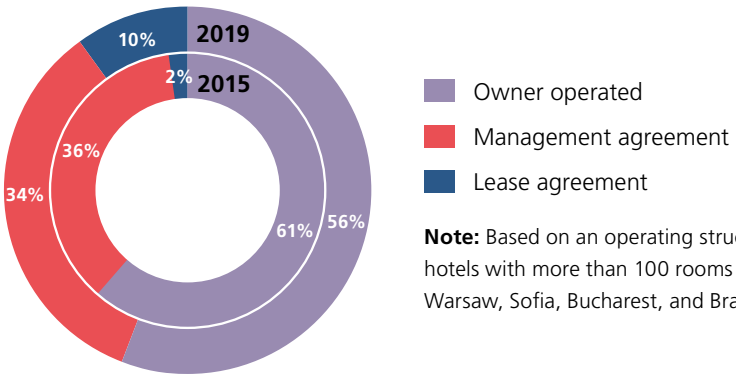
The share of hotel supply operated under lease agreements in the capitals of the CEE-6 countries has increased five times over the last five years, from only 2% in 2015 to 10% in 2019.

Everybody likes the sandwich

The increasing array of third-party management companies active in CEE has led to a growing number of so called "sandwich deals" where a hotel is leased by a third-party management company (also called "white-label" operator) and there is also a franchise agreement with a hotel brand provider such as Marriott, Accor, IHG, Wyndham or Hilton. This business model has expanded particularly well in Poland, where there are several white-label operators willing to enter lease contracts, such as Focus and VHM Hotel Management. However, there are also third-party management companies increasingly active in other countries across the CEE region, such as Apex Alliance in Romania and the Baltics, Mogotel in the Baltics, Accent Hotel Management in Hungary, and the Borealis Hotel Group entering the CEE region with its first project in Budapest.

The "sandwich" model has been further boosted by the increasing number of sale-and-lease-back transactions, with UBM and Orbis being examples of the key players utilising these structures. Furthermore, even major branded operating companies support this model as it allows them to focus on their asset-light franchise business and expand their footprint across the CEE region more rapidly.

Hotel Supply Distribution by Operating Models in the CEE-6 capital cities
(share in %, based on number of rooms)

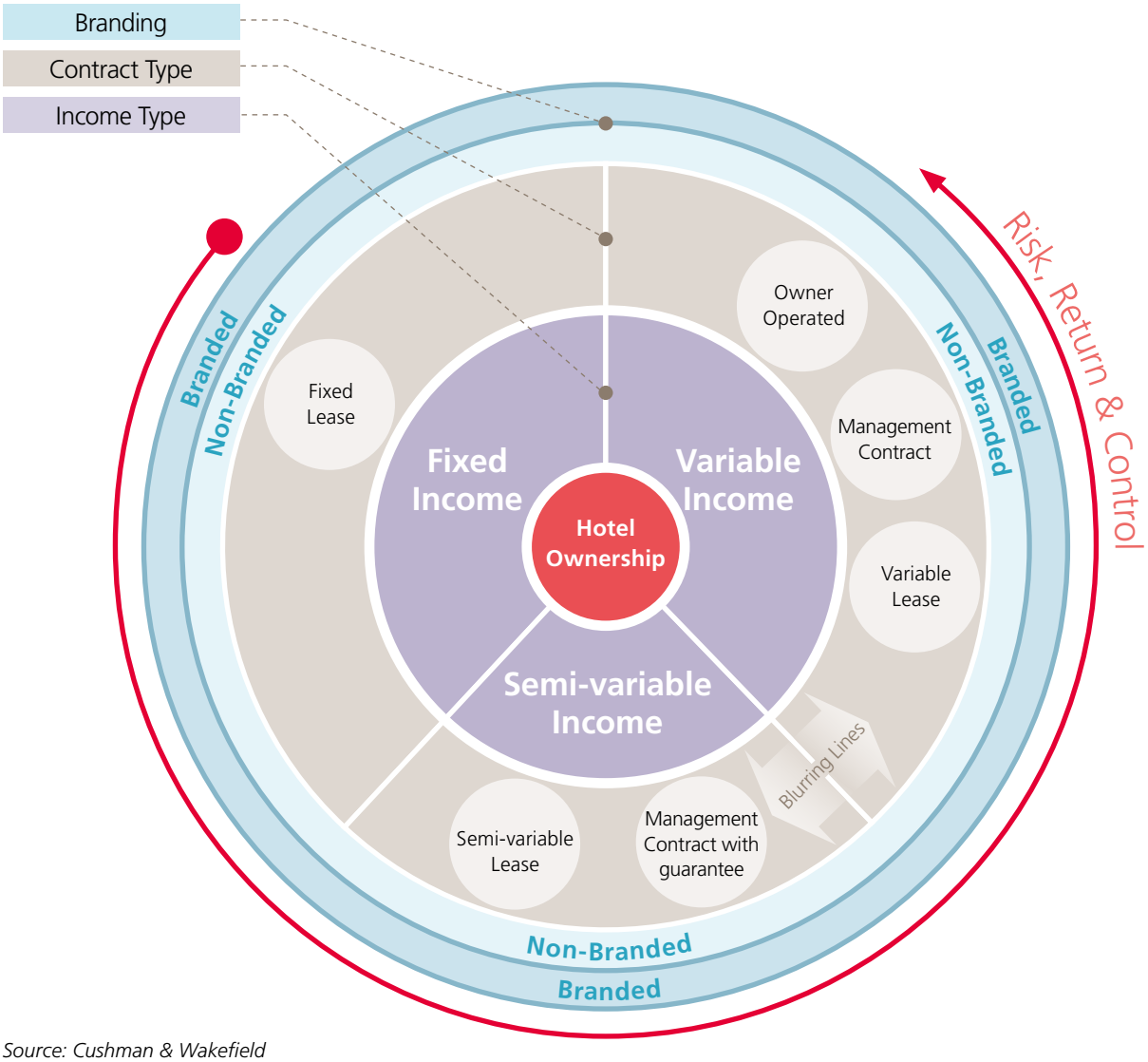


Note: Based on an operating structure analysis of hotels with more than 100 rooms in Prague, Budapest, Warsaw, Sofia, Bucharest, and Bratislava.

Source: Cushman & Wakefield / RCA

Hilton Prague Old Town - Courtesy of M&L Hospitality

Universe of Hotel Operating Models



Source: Cushman & Wakefield

Borealis Hotel Group

Pieter Moll
Director Corporate Finance / Development

(Note: this interview was completed before COVID-19 impact)

What is your presence in CEE? What are your plans going forward?
Next to Western Europe we have been actively targeting the CEE region and are currently looking at multiple opportunities in Germany, Austria, Hungary and Poland, whereby we have been able to secure our first deal in Budapest, Hungary in 2019. Our aim is to significantly increase our foothold in the CEE region, whereby Germany is our key priority, as we still see many opportunities for branded hotels in this region.

What is your preferred business model in CEE?
Our business model is in essence asset-light as our aim is to operate hotels for the long run, under long-term leases (> 25 years), a franchise agreement of one of the large hotel chains and potentially a management contract with our preferred management companies or our own management. Given our strong relationship with the brands, we are able to select the right brand for the specific location, in order to create long-term value for all stakeholders. Even though we aren't developing outside Benelux, we have a strong track record in development and can assist landlords developing hotels in the most efficient and cost beneficial way, and according to specific brand standards. Our leases have proven to be tradable amongst (institutional) international investors and we have access to a set of investors with whom we can team up to secure sites.

> With increased competition and sometimes short-term views, we see parties taking on high risk by offering fixed lease levels, which in the long-run might not be sustainable.

What are the key opportunities and threats going forward?
In the current climate we see the hotel asset class becoming more attractive and having an increasing number of branded hotels; brand consistency, presence and location as well as the right franchise partners, in our view, will be key elements for the long-term success of brands as well as owners. With increased competition and sometimes short-term views, we see parties taking on high risk by offering fixed lease levels, which in the long-run might not be sustainable and which will not create the most value for all stakeholders. We believe this can harm the overall hotel business and feel it is therefore important that we are not carried away by certain market dynamics. Borealis stands for reliable partnerships with a long-term strategic understanding that adds value for owners, neighbourhoods and brands.

» Founded in 1997, Borealis Hotel Group has developed into a market leader in the sector, with a successful track record of developing hotel projects across the Netherlands and Belgium. Following the sale of The Vincent Hotel Group in late 2015, we began building a new portfolio of hotels focusing on primary and secondary cities and key airport locations, where we can target a healthy mix of leisure and corporate guests. We currently have eight hotels open and an even larger secured pipeline under development based on preferred partnerships with Intercontinental Hotels Group, Hilton, Accor or Marriott.

Staybridge, The Hague – Courtesy of Borealis Hotel Group

Hilton Garden Inn, Bucharest Airport – Courtesy of Apex Alliance Hotel Management

Apex Alliance Hotel Management

Vytautas Drumelis
Member of the Board

(Note: this interview was completed before COVID-19 impact)

What is your presence in the CEE region and plans going forward?
Apex Alliance Hotel Management is currently operating six hotels with a total of 1,202 rooms (three in Romania, two in Lithuania and one in Latvia). Together with the properties in pipeline, we will operate 16 hotels with 2,997 rooms across six countries by 2022 whereas this includes seven owned hotels representing EUR 118m of investment (five in Bucharest, one in Riga and one in Venice). Our aim is to become the largest and the most recommended independent hotel operator in CEE, thanks to our creative and attentive approach, focus on efficiency, fast decision-making and flexibility. We intend to expand through our own investments as well as via the management agreements as a third-party hotel operator. Our goal is to reach a 100-hotel portfolio in ten years, and, I believe, this is the right time and we are in the right place to do so.

What is your preferred business model in CEE and where do you expand?
Apex Alliance Hotel Management prefers management agreements, although leases can be considered for extraordinary projects as well. There are pros and cons associated with both models, therefore it is very important to understand the strategy and further intentions of the owners and our partners. For example, is this an institutional investor or a private equity fund and do they plan to sell the property in the short-term or do they see it as a lifetime investment? Depending on the answers, there are different milestones and attention given to different critical points and financial metrics, such as a quick ramp-up or long-term stable cash-flow as well as growth in the property's value. The majority of hotels in our portfolio are operated under the management agreements and the owners also have franchise agreements with an international brands franchisor in place, such as Hilton, Marriott or others. The recipe for success is closely related to the fact that we act both, as an investor and developer; thus, we understand well the challenges the for owners undertake, starting from the development, pre-opening period and operations. In terms of regions, we are currently analyzing the projects in Poland, Estonia, Romania, Hungary, Ukraine, Turkey, Italy and Germany.'

What trends do you see going forward?
The underlying changes in the hospitality industry, such as bank requirements, taxes, constructions costs and tourism trends, are driving the evolution of hotel business models. For example, banks prefer fixed leases as they provide stable cash-flows. However, we are now seeing greater trust from banks due to the strong performance of our hotels, thus management agreements are being increasingly considered. Similarly, as western European Institutional investors have started looking eastwards to countries like Poland, Romania, Hungary and the Czech Republic, they too are more open to management agreements that offer higher returns. This model is more balanced for both the parties than a lease, as it offers a market-upside to owners, while the operators receive their fees and are protected against the downside. In leases, there can be tension between the parties every time the market moves up or down. The alternative could be a lease with a variable component. However, if the fixed component is too large, the entire model no longer fulfils its purpose.

To sum up, when choosing the best possible model, it is important to consider all possible advantages and disadvantages, understand the needs of the owner and evaluate the capabilities of the management company.

> In leases, there can be tension between the parties every time the market moves up or down.

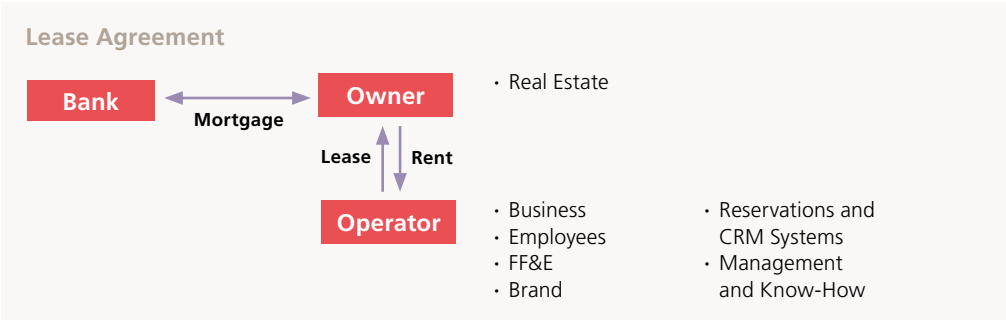
» Apex Alliance Hotel Management is an independent operator which focuses on establishing and developing long-standing partnership with institutional investor, property owner or private equity fund while providing the management services to their existing or future hotels with a committed team of passionate hoteliers.

Hotel Operating Models – Legal Overview

When considering the allocation of risk and responsibility between the owner and operator of a hotel from the legal perspective, there are three basic operating models: lease agreement, management agreement and franchise agreement. Let's take a look at the three models in their pure form, as well as various hybrid forms that are appearing on the market.

Lease agreement

A hotel lease agreement is an agreement under which the owner of a hotel property leases the hotel property to an operator who then runs its hotel business in such property and pays rent to the owner. The owner bears a very little risk and responsibility under this operating model, as the hotel business, with all its related risks and liabilities, is owned by the operator, and the rent would typically be an agreed fixed amount. However, the owner does not have much control over the hotel's operation and does not benefit from increased profits if the hotel performs well.

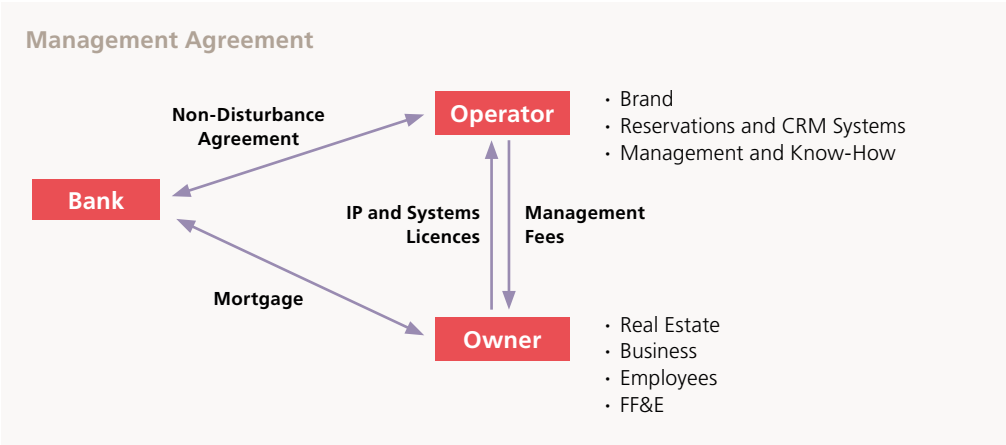


Management agreement

Under a hotel management agreement, the hotel owner mandates a hotel operator to manage the hotel's business on the owner's behalf. The operator provides hotel management services and allows the owner to use the operator's brand and to access its central reservation system, loyalty programmes and sales and marketing programmes. In return, the owner pays the operator certain fees primarily based on turnover and profit of the hotel business.

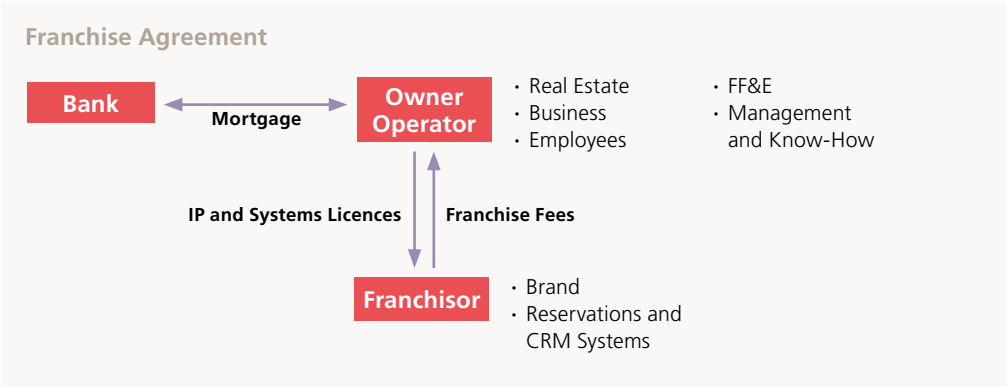
Unlike under the lease agreement model, under a management agreement the hotel owner takes all the risk and liabilities of the hotel business. For example, the owner will usually be the employer of the hotel's personnel and therefore liable for all employee claims. The owner is also responsible for the hotel's assets, including maintaining the property, furnishings, fittings, equipment and inventory, and funding the hotel's bank accounts.

However, when the hotel is performing well the owner enjoys the benefit of the hotel's success under the management agreement model. After paying the operator its fees, the owner is entitled to retain the hotel's profits, so it benefits from the hotel's better performance far more than under a typical lease.



Franchise agreement

The franchise agreement is a suitable operating model where the hotel owner has the skills and expertise to operate and manage the hotel itself and only needs the brand and distribution channels of a major hotel operator. The owner owns and bears the risk of the hotel business similarly as in the management agreement model, but has more control over the hotel's operation and pays lower fees to the franchisor than to the operator under a management agreement.



Hybrid forms

The changing market and the demands made by its players mean that these operating models are subject to pressure and various hybrid operating models have appeared.

Variable Lease Agreement

Under hotel lease agreements, the rent is often not agreed as a fixed amount but is based on turnover or a combination of both. The rent mechanism can be set to allow the owner to benefit from the hotel's successful performance, to allow the owner's rent receipts to fall if trading levels fall, or a combination of both.

Modified Management Agreement

Operators have become more willing to share some of the owner's risk to provide more comfort that the hotel business will perform. This can be achieved in a number of ways, including:

— Reduced Fees. If the operators' projections show a strong enough performance by the hotel, the operators might accept a mechanism to reduce or scale down their fees in the early years of the hotel's operation.
— Key Money. With newly built or converted hotels, operators are sometimes willing to pay "key money", an upfront payment to the owner for entering into a management agreement, to ease the owner's burden of the financial investment in the hotel.
— Owner's Priority Return. Operators may agree to defer their incentive fees to the owner's debt service, so that they do not receive their incentive fee if there is insufficient profit to fund the owner's loan interest.
— Profit Guarantees. Operators may also guarantee a minimum level of profits, compensating any shortfall to the owner. When guarantees are given, they are always capped, both annually and in aggregate, and sometimes subject to clawback when the profits rise again.

White Label Franchise Agreement

This is a combination of a lease agreement or a management agreement with unbranded, "white label" operator which has a franchise agreement with an international hotel brand. This combination can overcome unwillingness from an international hotel brand to enter into a lease agreement and lead to the owner paying lower fees.

Manchise Agreement

"Manchise agreement" refers to an arrangement where the agreement starts off as a management agreement but contains an option to convert into a franchise agreement once the hotel owner has developed sufficient skill and knowledge to take over the hotel's operations itself. Manchise agreements are an interesting concept to hotel owners who seek to reduce their fees payable to the operator at a later stage of the operating term.

What's next

With many institutional investors focusing primarily on leased assets, especially those who are new to the hospitality sector, it is expected that this model will continue to grow in the CEE-6 region. However, the current COVID-19 pandemic is likely to result in higher caution among tenants. Nevertheless, the share of hotels under lease is anticipated to rise far beyond the current 10%, especially in capital cities across the CEE-6 region. An analysis of the latest transaction activity confirms this, with 13% of deals in 2019 involving hotels with a tenant in place at the time of sale, while in 2020 this was initially expected to increase to 17%. Furthermore, as properties that are being sold on a 'vacant possession' basis may subsequently be leased, with buyers frequently having a preferred tenant already lined up, the final share of leased hotels is likely to be even higher. A good example is Covivio's pending acquisition of the Dedica Antalogy portfolio, where the properties will be rented to NH Hotel Group (owned by Minor Hotels) and rebranded under NH Collection and Anantara brands.

Growing complexity and blurring lines

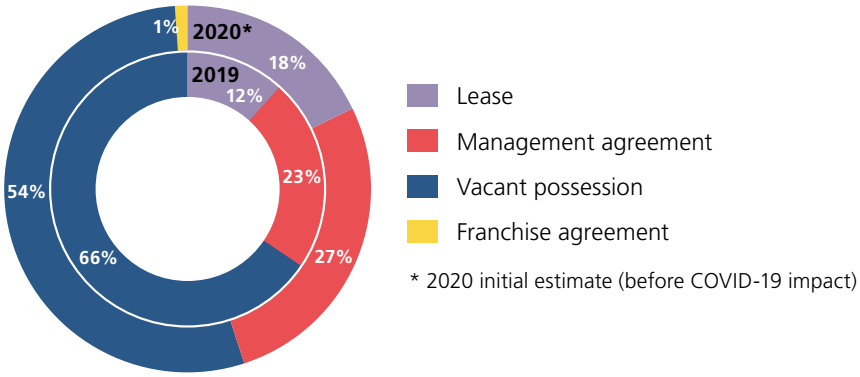
In an environment with compressed yields and rising uncertainties, parties to deals need to be creative to make it work. In terms of leases, this means increasingly including variable components, which is driven by the owners' as well as tenants' preferences. Investors want to boost their returns and participate on the upside, while the tenants are using hybrid structures to offer attractive rent proposals while managing the risk via combinations of minimum and variable rents with various shortage caps and exit clauses.

Furthermore, as an alternative to semi-variable leases, many branded operators are increasingly offering management agreements with minimum income guarantees and occasionally even willing to take on employees, thus blurring further the lines between operating models.

While these hybrid structures are not necessarily new, they are becoming more sophisticated and more frequent across the CEE region. This has been pushed by strong competitive pressures on one side while on the other side it has been being pulled by the rising uncertainties such as economic and geopolitical concerns and supply influx in selected markets. The unexpected and unprecedented international pandemic that is currently causing major challenges for hotel sector globally will undoubtedly further enhance the need for the flexibility and risk mitigating terms in contracts.

The game must go on but the deals need to be smart and incorporate flexibility to handle the unexpected.

Breakdown of recent and pending transactions by operating structures (2019–2020*)
(Share in %, based on transaction volume)



Source: Cushman & Wakefield

Moxy Warsaw Praga - Courtesy of Marriott

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