A Brief Overview of the Serviced Apartment and Extended Stay Market in the United Kingdom

Dated: 7th July, 2020

Over the past few weeks, we have witnessed in various hospitality news bulletins a huge amount of positive publicity on how serviced apartments are outperforming hotels during this covid-19 downturn. Whilst this appears at the moment to ring true in terms of top line figures such as occupancy and revenue per available room (RevPar), one should still be relatively cautious reading too heavily into these key performance indicators. In this article, we set out some of the specific operating nuances of the serviced apartment market in the UK, as well as address a few of issues that we believe are important before investing time and money into this sub-sector.

Category	Extended Stay	Serviced Apartments	Aparthotels
Planning Use	C3 (Residential)	C1 or C1/C3 Sui Generis	C1 (Hotel)
Property Tax	Council Tax	Business Rates or mix thereof	Business Rates
Facilities	Fully furnished residential units ranging from studios to 3+ bedrooms with kitchen and laundry facilities	Similar to aparthotels with mix of studio and multi-bedroom apartments that are fully furnished	Typically, studio and 1-bedroom apartments with a small kitchenette.
Services	Weekly cleaning, maintenance and sometimes serviced reception	Serviced reception, weekly or daily cleaning services	24 hr reception, limited F&B offering, cleaning services
Length of Stay	Minimum stay required	Generally no minimum stay restrictions	No minimum stay restrictions

Source: Jones Lang LaSalle / Safi Capital Research

- **Residential Classification:** In the United Kingdom, many of these serviced apartments are still classified as C3 (residential) units, which means that they cannot be let for less than 90-days. In order to comply with local government regulations, most reputable operators are therefore letting these assets on minimum contract lengths of three months or more, albeit in the UK regions especially, we are seeing more operators list their units for shorter periods which is unfortunately coming under scrutiny now of local government.

- **Council Crack-Downs / Changes to Government Legislation:** There is growing evidence that local councils are cracking down on serviced apartment operators who are breaching planning use regulations, especially given the current housing shortages and also the difference between local council tax and business rates that would normally be payable under a C1 (hotel) license.

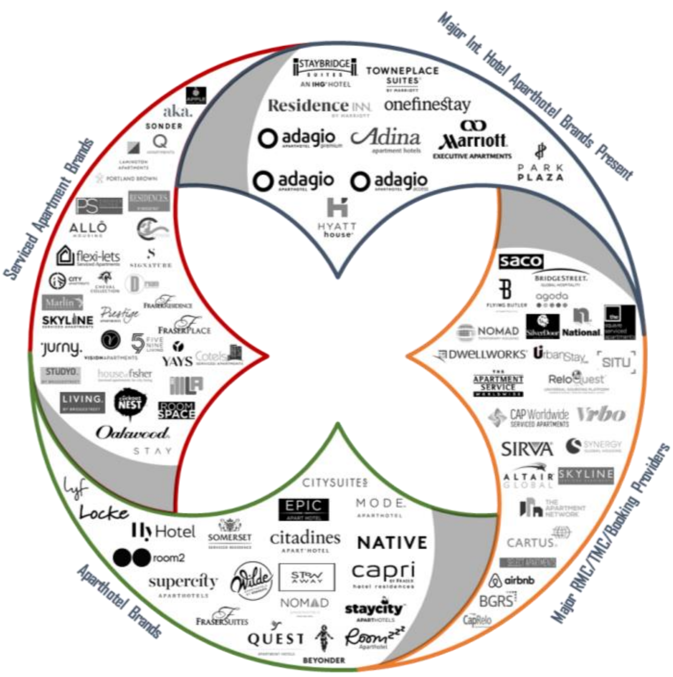
  We believe that local councils will up their investigations and there will be also further tightening of government legislation to endeavour to stop the abuse of use of residential accommodation being used for short-term lets. With time, we are likely to see changes to the serviced apartment sector which has to a certain degree been operating until the arrival of Airbnb, under the radar of local government.

  The likelihood is that many landlords, owners and operators may with changes to government legalisation revert back to PRS accommodation or endeavour to convert their buildings to C1 use to seek more stable income and/or potentially higher returns.

- **Serviced Apartments:** The UK market is still very opaque in terms of the classification system and we have found many operating companies calling themselves serviced apartment providers while they actually provide more an extended stay product. However, for the purposes of this article, we have amalgamated extended stay and serviced apartments as one segment, given that the market is still very fragmented across the country.

- **Local Players:** The sector currently comprises a large number of local owner/operators who have developed their own brands, more often or not within their own backyard. In each city, one will frequently find one or two dominant local players as well as a swath of smaller operators. Most of the stock we have come across is usually owned or leased and few are managed or franchised which appears at odds with the rest of the hotel industry.

  Major international hotel operators are still not heavily present in this sub-sector, with their focus being on aparthotels which are more closely aligned with their current hotel offering. Accor and Marriott are still by far the largest internationally branded players in this market, albeit we are now seeing Hyatt and IHG also ramp up their development pipeline of aparthotels in the coming years.



Source: Safi Capital Research

- **Varying Degrees of Quality of the Serviced Apartment Product:** At present there is no standard grading system for serviced apartments, although online booking platforms such as Booking.com and Tripadvisor have done much to help consumers gauge the quality of a product. The Association of Serviced Apartment Providers (ASAP) have also an accreditation scheme which was launched in 2014 for serviced apartment providers to meet minimum standards of quality and comfort which is a step in the right direction, albeit this still doesn't assess the varying degrees of quality that one can find between groups and even within each of the brands own portfolio.

  Travel and relocation management companies (TMC and RMCs) which have their own inventory as well as list third-party units also undertake vetting of stock in terms of perceived quality, security and comfort, although again this is in some cases quite subjective and there is a degree of preferential treatment to use their own apartments and/or for those suppliers who pay higher commissions which typically can range between 8% and 15%.

  We would lastly mention that it is still surprising to find many operators have yet to fully standardise or update their serviced apartment product to make them truly suitable for long-stay guests. In the UK, many of the grievances we have found from customer feedback relate still to the lack of air-conditioning, satellite or cable tv, high-speed wifi connectivity and USB port connections as well as a general lack of customer service and after-care which appears at odds with some of the accreditation and ratings. That being said, the growth of aparthotels will likely address going forward the need for a minimum set of brand standards and a uniformity in terms of amenities and services being provided for corporate and leisure consumers.

- **Potential Oversupply:** Over the past five years, the UK has witnessed substantial supply growth of over 35% in serviced apartments, making it one of the most active sub-sectors in the hotel industry with some 25,000 units currently under operation across the country, To date, the cities with the largest supply of serviced apartment accommodation include London (11,500 units), Manchester (1,500 units), Edinburgh (1,500 Units), Liverpool (1,400 units) and Birmingham (950 units).

  We are also seeing strong supply growth in other cities including Reading, Leicester, Aberdeen and Cambridge where there are numerous projects under planning and/or development. When one takes into account the supply growth of hotels as well, there are a large number of cities in the UK where there is a potential of oversupply, with Manchester, Liverpool, Aberdeen, Reading and Cambridge being the five we would perceive most as high-risk, given their demand profiles in the current economic climate.

  What is also been interesting to see is that the size of the serviced apartment blocks has gradually been growing in terms of room count. In the past, the blocks were typically 40 to 50 keys or less, although we are now seeing this slowly increase to around 100 keys or more. As a hotel, one would expect this to produce more operating efficiencies from its scale, although in the case of those we have inspected - the serviced apartment model still being managed under a centralised operating model and this has led to more costs as opposed to efficiencies due to various factors we discuss later in this briefing paper.

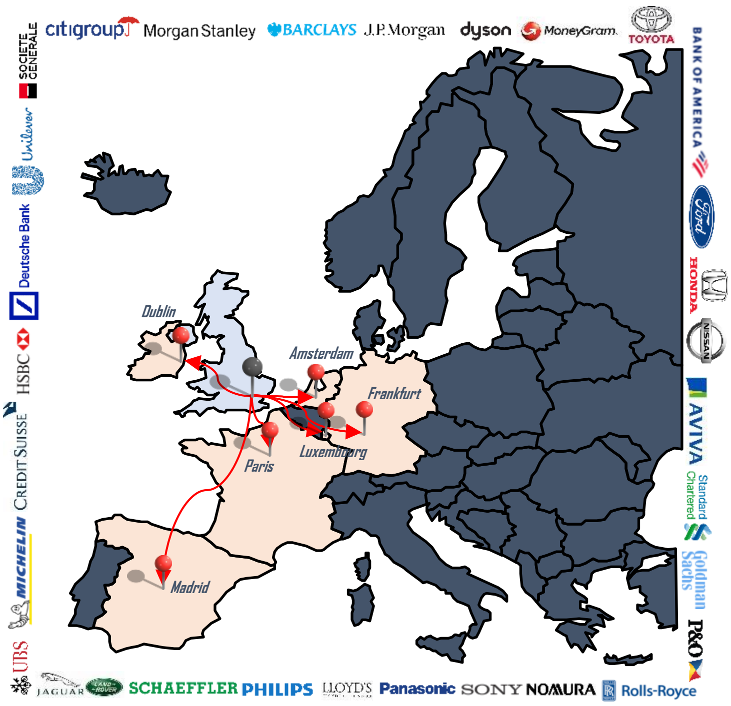
- **Corporate Long-Stay Demand:** The long-term impact of Covid-19 has yet to be fully understood. Based upon our empirical research, we have found that many of the large relocation management companies were already struggling somewhat with maintaining the same levels of long-stay corporate demand even prior to Covid-19, and it was felt that this long-stay corporate demand was in a relative decline due to faltering economic conditions, especially with the uneasiness surrounding Brexit. Indeed, several companies were seeing less demand flowing into the UK and more into cities such as Amsterdam, Dublin, Paris, Luxembourg and Frankfurt (what we label the "Brexit Alternatives").

  Pricing for long-stay has also been impacted over a number of years with companies continuing to push for discounts or flat-lined rates which haven't increased at the same level as rental costs. This has diminished profit margins and led to a number of companies such as Oakwood spinning off or reducing their supply chain business to concentrate more on short stay demand as well as developing aparthotels which are more adaptable in this ever-changing market.

  It is still difficult to predict whether post Covid-19 lock-down, corporate demand will ever resume back to peak 2018 levels. In our more pessimistic opinion, we feel that the market for long-stay corporate accommodation will continue to deteriorate somewhat in the near future as companies reduce their lodging and relocation requirements and evaluate their operating structures and modus operandi. We will likely see spikes in shorter term relocation requests, but overall, less sustained long-stay demand, as companies continue to find ways to prune back financial overheads.

The Brexit Alternatives

Companies reviewing options to downsize and/or relocate overseas



Source: Safi Capital Research / UK Broadsheet Newspapers

- **Resilient Performance?:** Much has been discussed in the various hospitality bulletins on the resilience of the serviced apartment market to Covid-19. While it appears on the face of it that serviced apartments have weathered the crisis far better than hotels due to their typical guest profile and apartment configuration which serves better social distancing and minimal contact in this Covid-19 world we live in– not everything is as good as it seems and there are a large number of serviced apartment companies now struggling to survive due to the changes that are happening in the industry as well as a result of the Covid-19 pressures on demand, resources and cashflow.

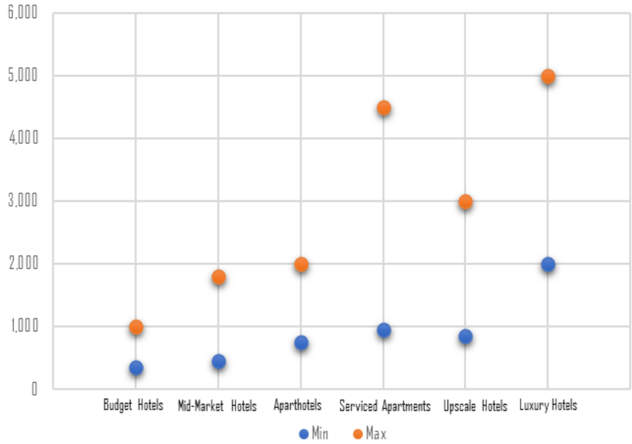
  The serviced apartment market has traditionally thrived on servicing long-stay corporate customers which have fed in demand over the year, reducing vacancy periods. Increased demand from short stay guests has also helped, filling in periods of low demand which fall between mid-November unto the end of January, as well as increasing ADR, as these are usually provided at a premium over long-stay corporate rates. As a result of longer average length of stays, these companies have also been able to reduce operating overheads, with less turnarounds and housekeeping costs. With many having no other staff on-property, additional corporate services from maintenance and sales could thus be centralised, increasing profitability. The other operating costs such as electricity, water, energy, TV licensing, and council tax are relatively stable and fixed which means that on a GOP basis, margins appear quite high – in many cases between 60 and 65% or above.

  At this stage, the operational outlook of servicing such asset types sounds like a great deal. The problem we have encountered when reviewing this asset class is that there are several factors that need to be taken into account including the cost of leases/financing and centralised overheads.

- **Lease Agreements:** The market has until recently been heavily focussed around the lease model and unlike hotel groups who have managed to negotiate reasonable lease amounts of around 20 to 30% of turnover, serviced apartment operators are still paying on the whole far above this at residential market rents. In some cases, this can reach over £3,000/month/unit which can exceed 45% of turnover. In comparison with hotels, one would normally expect only upper-upscale and luxury hotels to be paying this amount per key. What we have seen is that in any downturn, the performance only needs to drop marginally before operators start to suffer heavy losses as the net profit margins are swept aside by the heavy fixed lease costs.

  A large number of the serviced apartment companies have endeavoured during Covid-19 to negotiate with landlords to reduce their lease obligations and many have been able to shave off 30% or more of their rental costs as well as have rent free periods of up to three months. While this has surely helped preserve cashflow in the interim period, the main concern is what will happen once this period comes to an end. With no real sight of an upsurge in long stay demand following lock-down and the likelihood of travel restrictions being in place until 2021/22, the impact this will have in terms of cashflow will likely not be sustainable for many of these serviced apartment providers who need high occupancy levels to survive and cannot push their RMC and TMC partners as well as b2b customers to raise their rates for fear of losing more custom.

Average Lease Amounts in UKP / Month / Unit



Source: Safi Capital Research

- **Management Agreements:** Management agreements in the serviced apartment sector are still quite few and far between and in many cases are atypical to hotel management models ranging from cost plus models, to fees based on a percentage of net profit, to fixed amounts per key or a hybrid thereof. The main reason for this is that staff are usually located offsite as there is limited or no space at the serviced apartments. The operators have therefore found ways to offset their own head office costs through re-charging for centralised overheads, as opposed to the owners being responsible for on-property employee costs. This includes sales and marketing, finance department overheads and general operations, although housekeeping is by and large still outsourced to third-party providers.

  As more and more hotel operators come into the market, we do foresee contracts evolving into more normalised hotel management models where there is a base, sales and marketing and incentive fee. We also anticipate that the way in which the apartments are managed will also evolve as companies look into gaining greater efficiencies. This might be through servicing the apartments from nearby hotels as opposed from one centralised office location, as well bringing back housekeeping in order to improve controls on quality and hygiene, especially given the added emphasis now on cleaning and disinfection.

  We lastly understand from our recent research that the impact of Covid-19 has changed the way consultants and brokers are dealing with operator selection processes and are now more open to management agreements which from an operator's perspective is more interesting. Nonetheless, financing is still an issue and especially as many of the operators don't have sufficient covenant strength, having grown primarily through leasing which has impacted their balance sheets. Owners and developers are at the same time still seeking some form of financial guarantee or key money to obtain debt financing. While banks and lenders have been more willing in the past to provide financial backing for lease agreements, it is questionable whether the same will be said when lending to projects where there is no financial guarantees or where the operator's covenant and financial strength is circumspect, even under a management agreement.

- **Centralised Overheads**: While centralising overheads to manage a portfolio of assets across a destination should normally make strong commercial sense, it is not without its own challenges, Maintaining quality, control and servicing client's needs still have a heavy price to pay and unfortunately still also require a minimum level of staff to manage, especially if one is undertaking meet and greet services as well.

  What we noted in our time reviewing this sector, is that many of these companies have been overstaffed as they have endeavoured to expedite growth over efficiency. It's a typical approach that we have found in small growing hotel companies and one which is difficult to change quickly – as in many cases they haven't built up effectively proper processes, policies and procedures, nor have they been on top of financial matters. While this does mean that for any incoming investor – there is a huge opportunity to turn around the fortunes of some of these companies – the process can be very time consuming and more often or not needs deep pockets to manage the company through any transformation, including upgrading the information technology platforms which on the whole have been neglected over the years.

  In good times, one can potentially hide operating inefficiencies through adding more stock and scale to their portfolio to increase revenue, but this doesn't solve the underlying issues at stake and the flow-through of revenue to bottom line more often or not doesn't improve at the same rate. Based on hearsay, we have noted that some of the serviced apartment companies in the past have looked primarily at cutting costs in terms of housekeeping, maintenance and staffing levels as opposed to undertaking more difficult improvements to their processes and procedures or releasing and recycling leased properties before the lease amounts increase to unsustainable levels. These shift some costs down the road but do nothing to improve profitability and productivity.

- **Benchmarking and Segmentation:** When analysing benchmarking data, one needs to be relatively careful regarding the statistics. Many of the benchmarking companies are still averaging ADR across all room categories for serviced apartments which can skew performance of the sector considerably, especially against competitive hotel companies. The other issue we have found is that the benchmarks often contain aparthotels which are more often or not classified under C1 (Hotel use) and therefore are able to sell on a short-stay basis, which is where they are achieving typically a premium on the achieved daily rate – irrespective of the room type.

  When one looks more at the segmentation analysis - the long stay rates that we have studied over the past two to 3 years haven't actually moved considerably and indeed are pretty much flatlined, given that the major corporates are more price sensitive and resistant to rate increases. It is still also quite true that one can find a 30 to 50% discount against hotels by staying in a serviced apartment, and in some markets, this is even more stark.

  Our advice therefore is to not take benchmarking data as the only bell weather of the industry or when reviewing a serviced apartment investment opportunity. One should really build-up an understanding of the segmentation of the demand, the price points between each of the segments and average length of stay, utilisation rates by room category to build the revenue streams. As an example, it is highly unlikely that long-stay demand of more than three months would want to stay in a studio apartment which is more suited to short stay demand. In addition, one should also take note that the more short-stay business one drives to the property, the higher the operating costs as cleaning especially will increase due to the difference between the time it takes to do a weekly spring clean versus a full deep clean on turnaround.

- **Corporate Social and Environmental Responsibility:** Unlike many of the branded hotel companies, we have found that by-and-large, relocation and serviced apartment providers have yet to fully enact what they preach in terms of social and environmental policies within their own portfolio or supply chain. This is still far behind the rest of the hotel industry and in most cases, one will struggle to find in their collateral or annual accounts any reports and data analysis on waste management, green initiatives and social responsibility.

  Going forward, we believe that this will be ever more important and especially when it comes to operators endeavouring to secure new buildings to operate under a lease, management or franchise agreement. We have seen first-hand, developers and owners in Europe questioning operators on their CSR and environmental policies and seeking clarity in terms of data and information to verify their credentials. Its only a matter of time before the UK catches up.

  We also foresee potentially larger corporate clients taking more of an active interest going forward to ensure that they place their customers and associates in properties that are compliant, as many are already focussing heavily on HSSE compliance as part of their CSR and this would be an extension of their duty of care.

- **An Opinion on the future of the Serviced Apartment Sector:** Serviced apartments have in the past been considered a good investment opportunity because of their high profit margins, stable cash flow, high space efficiency and conversion flexibility and potentially lower development costs. Whether this holds true in the future remains to be seen. The competitive landscape is changing with the move to more standardised aparthotels. This together with changes to the legislation and use of C3 assets, and less long-stay corporate demand could trigger a downturn in interest in this alternative asset class going forward.

  In the short term, we believe that the main challenge many operators will face is cashflow. It is extremely likely that a few more will go either into administration or be swallowed up by competitive firms as they struggle with a mountain of debt and/or pay down the high cost of their lease commitments. We also foresee more relocation and travel management companies spin off their solutions side of the business to focus more developing their own branded aparthotels to diversify risk and capture more short stay demand.