MaxCap
Investment Management

MAXCAP AUSTRALIAN HOTEL MARKET UPDATE

APRIL 2021

AUSTRALIAN HOTEL MARKET UPDATE 2021

OVERVIEW

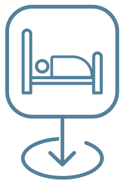
- The Accommodation, Hotel and Tourism sectors experienced a significant decline in 2020, however, positive recovery signs led by increased domestic travel emerged in Q4 2020 and have continued into the new year.
- The success of the vaccine roll out nationwide and internationally is expected to bolster consumer confidence and remains the key catalyst for the recovery of the sector.
- Improved domestic travel is expected to drive the sector in the medium term, partially offsetting the absence of international travel, which is not expected to return to pre-pandemic levels for a number of years.
- Major banks have continued to retreat from the hotel construction funding space, providing opportunity to selectively participate in strong risk-adjusted debt opportunities for transactions offering credit-enhancing operator income support, mixed-use income diversification or opportunistic out performance of investment returns due to credit under supply.

MARKET COMPOSITION

As of June 2020, there were approximately 283,701 accommodation rooms across Australia. This includes hotels, resorts, motels, serviced apartments and holiday parks (Table 1).

283,701 accommodation rooms across Australia

Annual domestic overnight spend valued at **$77.5bn** (pre Covid-19)



Annual domestic visitor nights of **410m** (pre Covid-19)

Source: STR, Tourism Research Australia

In the 2019 financial year (prior to the pandemic), the combined value of total international and domestic overnight visitor spend across Australia was approximately $122.1bn[1]. Notably, domestic overnight spend contributed 63% of this amount, equivalent to $77.5bn[1]. This was particularly evident in markets such as Brisbane and the Gold Coast, which have traditionally been driven by domestic travel.

TABLE 1: AUSTRALIAN ACCOMMODATION BREAKDOWN

ACCOMMODATION TYPE	NO.	%
Hotels and resorts	135,078	48%
Motels/private hotels	61,952	22%
Serviced apartments	73,122	26%
Holiday parks	13,549	5%
TOTAL BY ACCOMMODATION TYPE	**283,701**	
CLASS	**NO.**	**%**
Luxury and upper upscale classes	55,664	20%
Upscale and upper mid classes	119,747	42%
Midscale and economy classes	108,290	38%
TOTAL BY CLASS	**283,701**	

Source: STR

TABLE 2: AUSTRALIAN ACCOMMODATION BREAKDOWN BY STATE AND TERRITORY

STATES AND TERRITORIES	HOTELS/ RESORTS/ MOTELS		SERVICED APARTMENTS AND HOLIDAY PARKS		TOTAL ACCOMMODATION	
Australian Capital Territory	4,803	2%	1,928	2%	6,731	2%
New South Wales	67,761	34%	19,826	23%	87,587	31%
Northern Territory	4,861	2%	2,318	3%	7,179	3%
Queensland	47,876	24	35,917	41%	83,793	30%
South Australia	9,213	5%	4,097	5%	13,310	5%
Tasmania	6,090	3%	1,421	2%	7,511	3%
Victoria	35,055	18%	15,436	18%	50,491	18%
Western Australia	21,371	11%	5,728	7%	27,099	10%
TOTAL BY STATE AND TERRITORY	**197,030**		**86,671**		**283,701**	

Source: STR

New South Wales, being the largest economy and most mature hotel market in Australia, has the highest number of accommodation rooms. The state is popular with both international and domestic tourists, with Sydney identified as the business centre of Australia. The Sydney and Melbourne flight route previously ranked the second busiest route in the world[2] (in 2018).

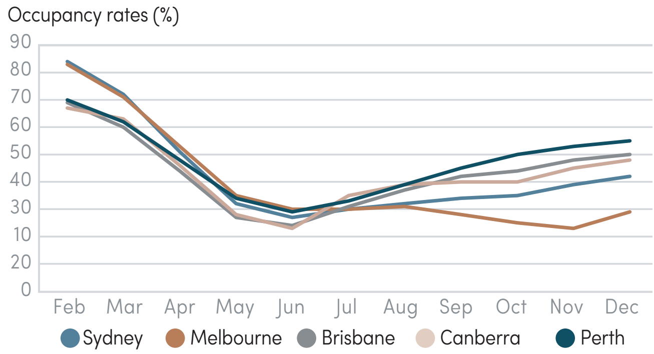
Queensland is widely considered the domestic holiday destination of Australia due to the state's warmer weather and accordingly ranks second in the number of accommodation rooms. Unlike New South Wales and Victoria, a large portion of rooms are located outside of the capital city – 40% are located in the Gold Coast[3] and Tropical North Queensland, compared to 23% in Brisbane[3]. Queensland is also home to the highest number of serviced apartments, with the hotel market not yet as established as NSW.

Victoria ranks third, however does contain the highest number of rooms under construction – 65% of existing accommodation rooms are located in Melbourne[3] with the remainder located in regional areas.

UNDERLYING DEMAND FACTORS AND IMPACT OF COVID-19

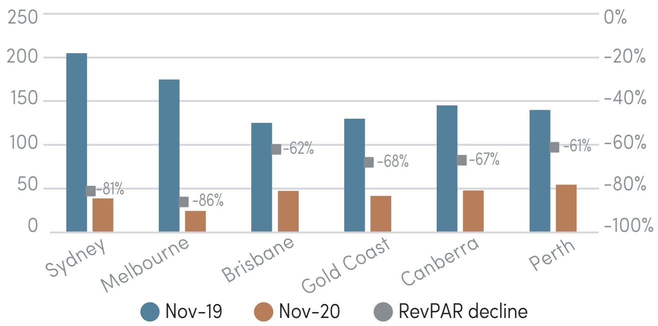
Hotel performance following COVID-19

GRAPH 1: AUSTRALIAN MAJOR HOTEL MARKETS – AVERAGE OCCUPANCY RATES IN 2020



Source: Colliers 2021, Capital Markets Investment Overview – Hotels

GRAPH 2: REVPAR ACROSS AUSTRALIAN MARKETS FOR NOVEMBER (2019 VS 2020)



Source: STR, CBRE Research (Q4 2020)

Prior to the pandemic, major hotel markets were performing strongly with occupancy rates across the country generally above 70% (Graph 2). Notably, Melbourne and Sydney outperformed other cities, achieving occupancy rates well above 80%, driven by a combination of domestic and international travel. This was particularly evident in primary CBD hotel markets and popular regional holiday destinations.

Following the World Health Organisation declaring COVID-19 a pandemic on 11 March 2020, Australia closed its borders to all non-residents and non-citizens. This led to an effective ban on inbound international travel in 2020.

As state border closures were implemented, domestic travel was similarly impacted, resulting in a sharp fall in room occupancies and RevPAR across the sector. In the second half of 2020 as inbound international flights recommenced for Australian citizens, state governments introduced hotel based quarantine facilities, which provided between 10 – 20 per cent of total occupancy per month (source: STR), varying across markets. The Victorian media has recently reported that the Victorian Government is in final stages to contract more hotels to the quarantine program, providing participating hotels and accommodation providers with additional income support.

Positively, as Covid-19 cases across Australia reduced and state borders were progressively reopened, occupancy rates improved to above 50% in most markets (Graph 2), driven by increased domestic leisure and business travel. Victoria was the exception to this improved occupancy, as the second wave resulted in extended lockdowns throughout 2020.

Domestic travel was further supported by state governments introducing subsidies and vouchers for both intrastate and interstate travel in the second half of 2020. This stimulus support has continued through early 2021, with governments indicating further support for the tourism sector, in particular regional domestic travel.

Although, occupancy data is not readily available for early 2021; anecdotally hotel markets have continued to improve in Q1 2021, including Melbourne, which is now largely operating under 'Covid-19 normal' settings, at least with respect to travel. All state borders are currently open, and domestic travel is expected to continue with some momentum whilst international borders remain closed.

International tourism

Australia's top five international visitor markets (China, New Zealand, USA, UK and India jointly representing 50% of international visitors[4]), experienced substantial losses throughout 2020, with international tourism effectively halting in March 2020. Overall, for the year ending September 2020, international visitors fell 52% to 4.1 million[4] as compared with the year ending September 2019 and International visitor spend reduced 51% to $22.4 billion[4].

New Zealand and Australia have led the world in their management of the pandemic outbreak, however, travel between the two neighbouring countries has been impacted by the border closures and sporadic outbreaks. Sound management of the pandemic by Australia has led to a one-way inbound 'travel bubble' with New Zealand, which is expected to become more flexible later this year. An expansive travel bubble with New Zealand is expected to provide the sector with a much needed boost in confidence and activity, noting New Zealand travellers spent over 12 million nights in Australia and subsequently contributed $2.5bn to the economy, in 2019[5].

Positive discussions recently covered by the Australian media regarding a potential travel bubble with Singapore has also commenced, providing further optimistic signs for the sector. Should a travel bubble with New Zealand and Asian and/ or nearby pacific regions eventuate; in combination with increased domestic travel, occupancy rates across Australian are expected to strongly improve from the unprecedented low base achieved in 2020.

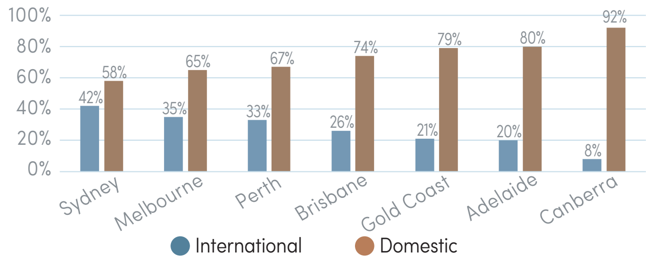
Nonetheless, the gradual roll out of the vaccine nationally and globally remains the key catalyst for improvement of the sector. The Australian government has put in place a priority vaccination rollout, which commenced in February 2021. The roll out of the program is expected to immensely boost consumer confidence and consequently increase domestic travel and to a lesser extent, once some borders reopen, international travel. Qantas is currently expecting international travel to resume more broadly by October 2021, however they do not expect travel to the US and UK to recommence until 2023.

Domestic travel

Domestic Travel for the year ending September 2020, fared better than international travel with overnight stays totalling 300 million and overnight spending contributing $51.9 billion to the tourism / hotel sector[6]. Domestic travel represented 69% of total overnight stays, compared to 60% of overnights stays in 2019.

Since the onset of the pandemic, domestic travel has solely driven the hotel sector recovery, resulting in hotel occupancy rates rebounding to 50% in most major capital city markets (Graph 2) – with Melbourne and Sydney being the exceptions. With all state borders now open enabling freedom of travel, domestic business travel and holiday travel is expected to improve immensely from the lows of 2020.

GRAPH 3: DOMESTIC VS INTERNATIONAL SHARE OF VISITOR NIGHTS IN AUSTRALIAN ACCOMMODATION REPORTED AT MARCH-2020

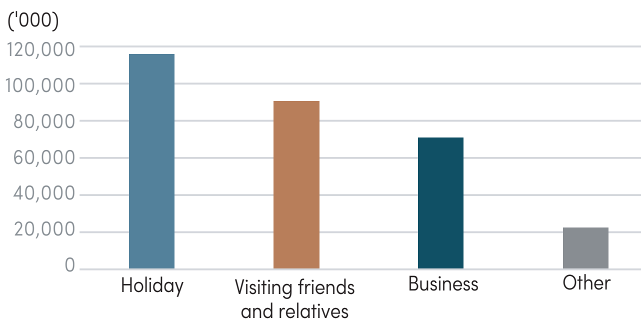


Source: CBRE – Asia Pacific Real Estate Market Outlook 2021 – Australia – Hotels, Tourism Research Australia March 2020

Historically, when compared with other Australian cities, Sydney and Melbourne have predominantly experienced a higher proportion of international travellers as these cities are well recognised as being the gate-way international cities. We do expect domestic travel to increase to these cities, however due to the greater reliance on international travel, we see the hotel market recovery in Sydney and Melbourne lagging behind other cities.

Other Australian cities, especially those in Queensland, are largely driven by domestic travel. With the current restrictions on international travel, the Brisbane and Gold Coast markets are expected to receive an influx of domestic travellers and perform strongly throughout 2021, with evidence of this already being seen in Q4 2020 and early 2021, as occupancies in Brisbane returned to above 50%.

GRAPH 4: NUMBER OF NIGHTS BY STOPOVER REASON FOR YEAR ENDING SEPTEMBER 2020



Source: Tourism Research Australia (Sep-20)

Holidays (39%) remained the most common reason for domestic travel throughout the year ending September 2020, followed by visiting friends or relatives (30%) and business travel (24%) – Graph 4.

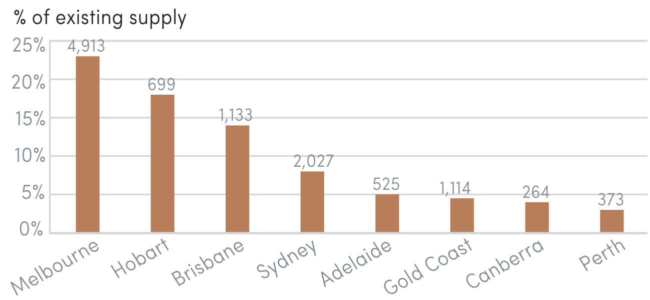
We expect 'visiting friends and relatives' to pick up as borders have now opened, with domestic holidays to also rebound well. Business travel is expected to improve, however, it is anticipated that this will be dampened by the increasing popularity of online conference calls, that have become more commonplace following the pandemic.

Intrastate travel over the past year represented 65% of all domestic travel, reflecting increasing regional travel by Australians, subsidised by the state governments and lack of available international travel. These incentives have continued through early 2021, providing a boost to regional tourism across Australia.

Overall, interstate visitors travelled to NSW (30%) most frequently, followed by Queensland (24%) and Victoria (18%)[7].

Hotel supply pipeline

GRAPH 5: NEW SUPPLY PIPELINE (UNDER CONSTRUCTION) INCREASE RELATIVE TO EXISTING INVENTORY

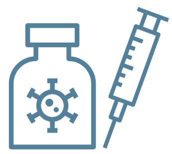


Source: CBRE Research (Q4 2020)

New supply in Melbourne and Hobart, based on a percentage of existing available rooms, is the highest of all states, with confidence in these markets prior to the pandemic having been particularly strong.

Once the pandemic impacts have eased in the near term, absorption rates and occupancy levels will be tested as new hotels progressively start trading in the next 12 – 24 months. The majority of new Melbourne hotels are centrally located with the majority earmarked to have a five star rating. This is likely to place pressure on average daily rates and occupancies of existing older secondary stock, which may be less desirable due to the quality or location of the accommodation.

SECTOR OUTLOOK



Vaccine roll out is a key catalyst for the sector

Domestic travel to drive sector recovery in the medium term, partially offsetting foreign tourism

New Zealand and Asia/Pacific travel bubble to assist recovery, mostly eastern seaboard

Overall, on the back of the vaccine roll out in Australia, state borders opening and the possibility of international travel bubbles, the Hotel and Tourism sector is expected to continue improving in 2021.

From an economic standpoint, growth was positive in the second half of 2020, with GDP per capita in the third quarter increasing by more than 3%[8]. Unemployment rates were better than initially predicted by the Reserve Bank of Australia, decreasing to 6.6% in December 2020[9]. Average household savings to income ratios increased across households to 18.7% in the September 2020 quarter, compared to 6.2% in the previous year[10]. Domestic travel is expected to be buoyed by these savings, leading to higher overall consumer consumption in 2021.

Whilst international travel is not expected to return to pre-covid levels for a number of years, local domestic travel is expected to increase, partially offsetting the reduction in foreign tourism.

Domestic overnight trips in December 2020, were only down 19% compared to December 2019 Domestic overnight trips[11], demonstrating an early recovery and continued resilience in the domestic travel market.

Globally recognised capital cities, Sydney and Melbourne, which have a greater reliance on international travellers, are expected to lag in the recovery, whereas regional areas, and destinations such as Brisbane and the Gold Coast are forecast to perform better. These larger cities may seek some relief from the ongoing quarantine hotel program for returning travellers for additional income support.

Serviced apartments and Airbnb offerings are expected to under perform compared to well-managed and operated hotels due to the lower level of hygiene and overall service standards, which are currently of higher priority than in pre-pandemic times.

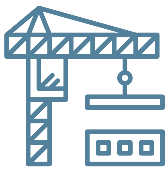
Accordingly, we expect new hotels to perform well across Australia and especially in Queensland which has a strong existing supply of serviced apartments and Airbnbs for holiday rentals.

Pent up demand from locals unable to travel overseas is expected to drive both intrastate and interstate tourism. Accommodation in regional centres, especially those within driving distance of major capital cities, is expected to continue to outperform most CBD hotels. Federal and state travel grants are also expected to continue through 2021, providing further incentive for domestic travel.

As confidence in the handling of the pandemic continues to increase, domestic business travel is also expected to improve. This improvement will however be moderated due to the ability for video meetings via online platforms.

International travel is not expected to return in any meaningful way in 2021, except for the New Zealand and Asia/Pacific travel bubble which is expected to commence this year. Commencement of this travel bubble and the likely expansion allowing for greater flexibility, will provide both nations with a new influx of accommodation demand, boosting hotel and tourism performance, and overall consumer confidence. Traditionally, New Zealand and Asian visitors have mostly travelled to the eastern seaboard of Australia (mainly capital cities); accordingly, we expect these markets to benefit the most from this bubble arrangement.

CRE DEBT OPPORTUNITIES



Construction periods of 18 – 24 months, expected to alleviate immediate occupancy risk

Strong risk-adjusted opportunities for well-structured debt

MaxCap will continue to conduct thorough due diligence on potential hotel deals

Despite the challenges of 2020, MaxCap remains cautiously optimistic regarding commercial real estate debt opportunities within the hotel sector.

In particular, MaxCap continues to observe the retreat of the major banks from property construction lending generally and for hotels specifically, and accordingly sees an increasing number of attractive risk-adjusted opportunities.

Selective participation in these transactions continues to be carefully considered, with preference for those transactions benefiting from the following favourable risk-return characteristics:

1. Lease or income support

Hotel assets where the hotel managers provide a minimum EBITDA guarantee to the asset owner, or alternatively a long term lease arrangement, are considered more favourable than a standard arrangement, reducing the level of trading uncertainty in the current environment and providing financiers with greater confidence in the performance of completed assets.

2. Mixed use income diversification

In line with pre-pandemic times, MaxCap views mixed use hotel projects (that comprise other components such as residential apartments or commercial tenancies) more favourably than standalone hotels.

The variety of assets within the project provides natural diversity, leading to reduced investment risk. Moreover, the non-hotel components of the project provides the developer with the ability to obtain presale and/or pre-lease commitments, which further de-risks the project. Additionally, should the project be partially presold (if for example there is a residential component), settlements from pre-sales would reduce the residual LVR, enhancing the exit position of the overall project/asset.

3. Opportunistic return out-performance

Transactions where, as a result of dislocation of the banking sector reducing the supply of credit, MaxCap is able to generate significant out-performance in returns for a given level of risk.

Consistent with this thematic, MaxCap is aware of several earmarked hotel developments which are expected to commence construction in the next 12 months. These developments are predominantly underpinned by long term hotel management agreements with global hotel operators, who remain heavily invested in the Australian market and who appear to be confident in Australia's handling of the pandemic to date.

As construction periods are typically 18 to 24 months for a major hotel project, the near term risks are also expected to be largely alleviated by the time construction completes and domestic travel resumes and some international travel bubbles open.

Accordingly, MaxCap expects to see strong risk-adjusted opportunities appear in the non-bank space, for well-structured debt investments.

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