GROWTH MARKET SERVICED APARTMENTS

Ciara Walker of **Core Five** and **Neil Davies** of **Neil Davies Architects** discuss the blurring of the lines between residential and hospitality in the emerging serviced apartments segment and examine the design considerations and cost factors that developers should take into account

01 / A GROWING SUBSECTOR WITH GOOD RETURNS

The serviced apartment sector is "the saviour of the commercial use classes", claims Ben Davis, director at property company Saxbury, which specialises in the sector. As commercial and prime residential real estate starts to look less attractive, investors familiar with the benefits of long-term investments in the private rental sector (PRS) are jumping into the wide and varied serviced apartments market. With plenty of room to expand before UK supply levels catch up with mature markets, strong demand and a solid business case for further supply, the sector expects significant growth. Developers and investors would do well to consider the flexibility and profitability of the segment as they search for better uses for planned commercial and residential assets struggling to achieve viability.

Growth has been driven by a few trends, first and foremost the globalisation of work, which has made medium-term stays in gateway cities much more frequent. Combined with the digitalisation of travel and work, this has not only driven an expansion in the demand for serviced apartments from corporates, but has also changed exactly what is being demanded. AirBnB has exposed both business travellers and tourists to a new way of travelling, with the freedom, privacy and flexibility of their own space providing a feeling of home. This familiarisation has driven both categories of traveller towards the serviced apartments market.

However, serviced apartments are not just catering to the hospitality market. The growing co-living and co-working trends are driving changes in the way people want to live, and allowing new, innovative models to be developed to meet this demand. This is mostly evidenced in the blending of traditional PRS provision with the serviced apartments model in co-living properties, whereby services are provided within an ordinary residential development.

The trend for co-living and co-working fits perfectly with the serviced apartments model, which is increasingly seeing reception areas double up as coffee shops, restaurants, or community spaces connecting residents to their environment.

While this kind of rising demand from users has driven the strong growth in supply in recent years, another key driver for the market is a commercial one. Institutional investors are showing increasing interest in the market because it provides a relatively low-risk, high-yield long-term revenue stream, with steady demand from corporate, travel and increasingly, residential markets.

As the regions catch up to London's levels of supply, and the capital continues to show strong demand for serviced apartments from corporate and tourist travellers, we will see traditional serviced apartment concepts such as the aparthotel, branded residences and corporate residences proliferate further. At the same time, innovative concepts are emerging that blur the lines between hospitality and residential and between living and working space – and increasingly also introduce communal living concepts.

Knowing how to target these different models effectively, and understanding the different cost and demand drivers they face, will smooth developers' path to this new asset class, which is expected to see a similar growth curve to that witnessed in recent years in the PRS market.

A BOOST FROM 'BLEISURE'

So-called "bleisure" is a big driver of serviced apartment demand – business travellers are extending business trips into leisure holidays, requiring more space and flexibility from their accommodation. Serviced apartments are ideally placed to soak up this demand, partly driven by millennials in the workforce.

Compact rooms from the Motto brand by Hilton can be interconnected, allowing groups or families to stay together

02 / COST FACTORS

While the approach to financial evaluation of capital costs in serviced apartments tends to be similar to that for traditional residential schemes, the effects of fixed and operational running costs must also be taken into account at the appraisal stage to ascertain viability across the property lifecycle. Longer-term serviced apartment models need to consider the operational running costs such as for concierge services and parcel management, striking a balance between the level of amenity and cost per apartment.

The costing of serviced apartments has notable similarities in this sense to costing traditional PRS development, and the key construction cost drivers of floorplate geometry and core optimisation remain similar to that of PRS and other residential class developments.

In a standard residential development principally intended for private sale, the expected sales value is taken into account to determine the appropriate specification, which can directly influence the targeted capital expenditure. However, for serviced apartments, as for both PRS schemes and hotels, capitalisation of rental revenue is used to evaluate returns on investment. This has significant implications for the cost and design of the asset, with a strong focus on whole lifecycle costs rather than initial capital construction expenditure. This naturally leads to a consideration of minimising running and maintenance costs, rather than just the cost to build.

Once these basic factors are taken into account, major cost drivers will depend on the requirements of the asset being developed and where it sits on the spectrum between budget and luxury. Another important cost driver is location, with the level of amenity found in the local market influencing the provision and specification level needed to attract the target demographic.

Construction costs, and in particular the fit-out, will to an extent be influenced by the target market and associated rental returns. Benchmark data from PRS and aparthotel developments can be used where comparable, but the key differentiators of typical apartment size and density should be taken into consideration when evaluating estimated construction costs. Table 1 (left) gives an indicative range for serviced apartment developments within Greater London, in the budget micro, mid-range and luxury large categories.

Diane Scott, senior hotels consultant at Katten Law, says: "Serviced apartments can be more cost-efficient to build (no costly restaurant facilities) with lower capex requirements, therefore achieving a greater bottom line income as opposed to full-service hotels, which are typically more expensive to build, along with having higher operating costs.

"Serviced apartments offer a 'home from home' experience that mitigates the need for costly food and beverage facilities, in turn perhaps offering a 'grab and go' cafe-style facility and/or connecting guests with local food delivery options. This gives the owner/operator the opportunity to either outsource the space for additional income or utilise it for guest socialising."

Tall ceiling heights, large windows and a broken plan creates free flowing space in the larger apartments at Whitworth Locke in Manchester

Table 1: Construction costs for serviced apartment schemes in Greater London (gross internal area £/m²)

Category	Cost range
Budget micro	£2,300-£2,700
Mid-range	£2,700-£3,300
Luxury large	£3,300-£3,800

EXCLUDES VAT, PROFESSIONAL FEES AND ABNORMALS

03 / DEFINING SERVICED APARTMENTS

"Serviced apartment" is a broad term covering a diverse range of revenue-based accommodation products that meet a growing demand for flexibility evolving from work and leisure trends.

Officially, the term describes a furnished apartment available for short-term or long-term let, with some level of front-of-house amenity and housekeeping provision. The apartments tend to have private cooking facilities, larger living areas than hotel rooms, and often have access to some hotel-like services. Most taxes and utilities are included in the rental price, meaning a pricing model closer to hotels than the PRS.

This emerging real estate segment has struggled in the past from its broad definition, causing confusion for investors. The Association of Serviced Apartment Providers (ASAP) was formed to define the segment and guarantee levels of quality by certifying suppliers. Due to the breadth of the market some disagreement remains as to what qualifies as a serviced apartment, but ASAP defines the major subcategories as:

- **Serviced apartments** Self-contained apartments within a residential building, bought and let out individually or by a single investor. There may be staff on site or access to keys through a safety deposit box.
- **Aparthotel/branded residences** Serviced apartments within a dedicated building, offering hotel-like services with 24-hour reception. These may also offer additional facilities such as a communal lounge or on-site gym.
- **Corporate housing** A furnished apartment, condo or house made available for rent or lease on a temporary basis, usually 30 days or more.

Serviced apartments can be considered on a spectrum between pure hospitality at one end, such as aparthotels let for short stays to tourists, and a quasi-residential model at the other, such as extended-stay co-living serviced apartment blocks, or branded residences used for longer-term corporate travel. The definition of what is and is not a serviced apartment continues to evolve as trends in demand and innovations by providers mould the sector. »

» 04 / STRONG GROWTH IN SUPPLY SET TO CONTINUE

Within Europe, the UK and Ireland is the biggest market, with a supply of 22,000 serviced apartments in 2017, a 13% increase on two years previously. But this still only represents 4% of room supply, compared with a figure of 8% for the US hospitality market, where the serviced apartments segment is mature. This clearly leaves plenty of room for supply to grow further.

The pipeline in serviced apartments is booming, with 13,000 new units expected to enter the UK market by 2021. This growth is supported by positive performance data: average RevPAR (revenue per available room per night) was up by 0.6% year-on-year to £110.84 in the first half of 2018. This is higher than for the overall UK hotels market. Some cities performed even better (see table 3), with 6.3% growth in RevPAR in Birmingham, for example, although booming supply has pushed RevPAR down in cities with relatively mature markets such as London and Edinburgh. Investment volumes have grown five times since 2010, from £89m, to £486m in May (year to date) 2018, demonstrating an asset class coming into its own.

London has experienced a huge increase in serviced apartment supply over the last decade, and the rest of the country saw supply grow by 23% in 2017 alone. Despite having ample supply, London is still seeing growth in this asset class, forecast to increase by 18% by 2022. The regions are seeing increased interest, driving the past two years' growth in supply in Birmingham (31%) and Edinburgh (24%), and the strong growth forecast to 2022 for Manchester (46%) and Edinburgh (36%) markets. Additionally, the interest of private equity investors and expansion of operator brands both lend themselves to significant growth in the regions, as they move past the mature market of London into those with the higher supply and demand mismatch.

Table 3: Supply of serviced apartments in selected UK cities

City	Supply (2018)	Two-year growth history	Three-year growth forecast	RevPAR (growth) H1 2018
London	12,630	8%	18%	£146.73 (-3.3%)
Edinburgh	1,782	24%	36%	£77.86 (-11.8%)
Manchester	1,788	53%	46%	£77.44 (2.7%)
Birmingham	886	31%	0%	£72.13 (6.3%)

SOURCE: JLL 2018, GSAIR 2018/19

The small details are designed into the ingenious repurposed shipping containers at the Stowaway aparthotel in Waterloo

05 / DESIGNING FOR THE TARGET DEMOGRAPHIC

One of the most important things to get right with the design of a serviced apartment is effective targeting for the desired demographic or subsector. This can be anything from luxury aparthotels designed for wealthy foreign visitors, to a hybrid hotel, professional accommodation, budget aparthotels and a whole host of innovative co-living and co-working concepts. Different target markets have different expectations, in particular in terms of the level of amenity provision required, which will also be influenced by what is already available within the local neighbourhood. The extent of amenity provision to match tenants' requirements, together with design and cost considerations, should be factored in as part of initial proposals and ongoing operational assumptions.

Designing with flexibility in mind is also essential, because serviced apartment market conditions will change over each development's lifecycle. Leases and designs should be flexible enough to allow for future changes in co-living and co-working trends. The building design needs to take account of the growing influence of technology on tenant needs and changing consumer patterns - for example, adding more storage for delivery services.

Serviced apartments in town centres are invariably located on tight or constrained sites. With space in short supply, the challenge is how to create a sense of wellbeing for guests and provide internal environments with the feel of generosity of volume and attention to detail reminiscent of a real home. This has driven a trend towards serviced apartments becoming more compact, partly driven by maximisation of rooms (and therefore revenue), but also using intelligent design to give customers what they expect from a larger apartment in a smaller space. This design challenge has created a segmentation of the serviced apartments market offering into different categories, designed to target their chosen market, outlined in the table.

There are also elements of commonality across the spectrum:

- **Internal environmental control** Most of the brands share a common approach to how the room technology works. Simplicity is key to how the guest can control their internal environment within the apartment.
- **Fit-out lifecycle** Most operators work on the basis of a fit-out lifecycle of five years. There is a trend currently for brands to specify finishes that add to the materiality of the room, be it exposed brick, concrete, natural timber and metal.
- **Finish and detail** Due to the high occupancy rates, all the apartments are more robustly finished than residential stock but detailed expertly so that they do not feel generic or low-quality.

Table 2: Design specification across the serviced apartments spectrum

Category	Size and layout	Lighting, heating/cooling	Fit-out	Facilities
Budget micro	Rooms less than 18m². incorporating ingeniously designed storage solutions and small kitchenettes. Shower rooms are designed to be semi-open to the room, with sliding screen or door to close off if required	Artificially lit, a combination of downlights and lit walls. Space heating and cooling provided by a fan coil unit and controlled by a room thermostat, with openable windows	Collapsible furniture that can be stored away when not in use. Finishes tend to be spray lacquered or veneered MDF and with moulded surfaces in the showers	Communal laundry rooms available in lieu of washer-dryers. Shared communal space at street level that can double as co-working area. Passes to nearby amenities, such as yoga classes, offered
Mid-range	Rooms 18-25m². Concealed storage units hide away clutter to maximise the feeling of internal volume. Shower rooms are closed off from the main sleeping area. Kitchenettes are larger with a hob, small combi-oven, sink and fridge	Greater ratio of glazing to floor area so that rooms are flooded with natural light, which blends well with a mixture of feature and task lighting	Greater emphasis on materiality to the fit-out, engineered floors, mood lighting and good-quality fixtures and fittings in the shower rooms. Occasional tables that double as a surface for both work and dining	Depends on proximity to a city centre. If central, communal facilities would still be limited to a shared cafe/workspace on the ground floor with the ability to use nearby amenities
Luxury large	Semi-open plan layouts, with much more generous space and greater ceiling heights. Bathrooms often in a broken plan arrangement. Interconnecting rooms in suites are often available. Judicious use of movable screens and wardrobes allowing the sleeping areas to be subdivided from the living spaces	Apartments that are fully serviced, with whole house ventilation including heat recovery providing both heating and cooling and digital TV	Finishes akin to a high-end residential fit-out, with high-quality materials specified and rooms dressed. Lighting that is a combination of recessed, pendant and freestanding lighting. Rooms that have a styled feel to be distinguishable from one another	Much more extensive communal facilities, such as on-site gym, cafe, restaurant and lounge area for relaxation, with these spaces tending to be increasingly flexible in terms of use. Biophillic design becoming more prevalent in newer developments

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» 06 / PLANNING AND REGULATORY CHALLENGES OF SITTING ACROSS USE CLASSES

In the absence of a dedicated use class, serviced apartments can operate under a number of use classes – hotel (C1), residential (C3), or sui generis. It may be possible to convert existing residential buildings into serviced apartments without the need for a change in use. Existing hotels and hostels may operate as serviced apartments under their current use class (C1) and specific serviced apartment or short-term let consents (sui generis) can be applied for as standalone consents, or added onto C3 consents to provide a dual use permission to give maximum flexibility. Some operators hold a mix of C1 and C3 uses to maximise the benefits of both, and provide a diverse offering at different rates to travellers, covering extended stay and shorter stays. Remaining closer to apartment than hotel in approach allows flexibility of end use and conversion to residential if desired.

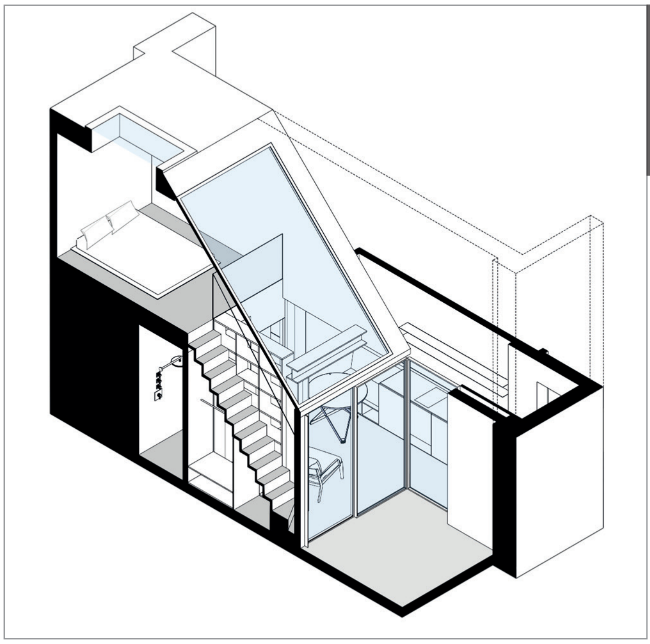
Given that the serviced apartment sector straddles the travel and property rental use classes, unique legislation for either does not tend to fully match the serviced apartment offerings available. For example, if classed as a hotel, a serviced apartment property usually attracts business tax rather than council tax on its units, which is considerably more expensive. In the UK, due to the shortage of housing, significant restrictions are also imposed by the Draft London Plan as to size, energy efficiency and living conditions of new-build residential development, which would not apply to the hospitality use class. This is a challenge worth consideration when deciding what planning use class to go for: it is essential to select the right class for the specific type of serviced apartment to be provided.

07 / RISING INVESTOR DEMAND

With more high-profile operators entering the market, as well as better availability of operating data, investors are becoming more familiar and comfortable investing in the serviced apartment sector. Asset classes such as offices and residential have struggled with low yields, while serviced apartments are achieving 4%-5%. Given the current political and economic uncertainty, developers and investors are seeking new ways to generate income from existing developments. Serviced apartments can be adapted for the short term and remodelled in future, allowing the flexibility developers are seeking to maximise the returns from their land/assets.

Recent experiences with the now mature PRS model, and the benefits of the long-term, relatively low-risk income streams such assets provide, have allowed institutional investors to identify an opportunity in this emerging segment. As investors have become more knowledgeable, we have seen increased interest from institutional investors such as pension funds, signalling a level of market maturity previously unseen in this sector in the UK. Brookfield's acquisition of SACO's portfolio and pipeline in May 2018 is symbolic of this newfound confidence in the sector, and is the largest serviced apartment deal in the UK to date.

This growing investor interest appears to be justified, not only by the market fundamentals, but also by the solid business case underlying the model. Aparthotels seem attractive to investors for a very simple reason, according to Richard Gaunt, head of consultancy at Avison Young: they are slightly cheaper to build than similar asset classes such as hotels, and get a much better cash return. When building in an attractive location with both corporate and tourist demand, developers often have a choice between hotels or aparthotels. Gaunt highlights that a typical aparthotel build cost per bedroom is similar to a typical four-star hotel, but with lower fit-out costs, and would allow roughly the same room price and demand levels due to demand from corporates. Not only are they less expensive to build, they are also less expensive to run than a hotel, with fewer staff and lower fixed costs to manage. Gaunt estimates profit conversion on an aparthotel model in London would be 45%-50%, compared with 35%-40% on an upscale four-star hotel.



A split-level room in a serviced apartment scheme by Neil Davies Architects in London's south Kensington that floods the room with natural light and opens out into a private external courtyard

Greater ceiling heights permit additional bed decks in the larger rooms at Room2 in Southampton, making the rooms more flexible for guests