1 May 2025

UK HOSPITALITY IN A TURBULENT WORLD

2025 is off to a rowdy start. The deteriorating relationship between the United States and its European allies has sent ripples across the geopolitical order. Simultaneously, major economies are in the midst of a volatile trade war, which is having drastic implications for global growth. These developments cast a shadow over numerous sectors, with international tourism potentially taking a heavy hit.

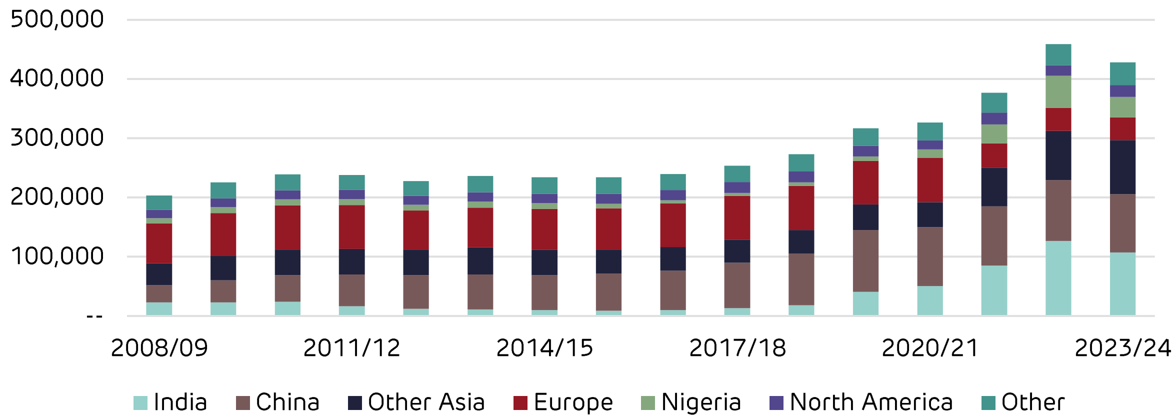
Rising inflation, a consequence of trade barriers, will erode real disposable income worldwide, potentially compelling many to cancel their travel plans. Geopolitical tension may similarly dampen enthusiasm for international travel. This slowdown would come at an unfortunate moment for the tourism industry. The United Nations World Tourism Organization (UNWTO) recently celebrated that international tourism visits finally reached 1.4 billion last year – a level not seen since 2019. A geopolitical fracturing threatens to unravel this progress.

From an investment perspective, the UK's hospitality sector has just emerged from a year of recovery. According to Savills, the UK saw £5.75 billion in hotel transactions in 2024 – a doubling of 2023 levels. While this represents encouraging news, it also highlights how reluctant investors were to engage with the sector in 2023. Any new global economic headwinds could potentially stall this nascent recovery.

Yet despite these challenges, the UK's tourism industry appears well positioned to endure. One critical factor is the remarkable growth of wealthy populations in key source markets for UK tourists. Recent wealth surveys by UBS reveal the astonishing pace of wealth creation in emerging Asian economies. Between 2000 and 2023, the number of dollar millionaires in South Korea, India, and China grew by 13, 23, and a staggering 153 times, respectively. These affluent populations are projected to continue expanding alongside broader growth in the global middle class, creating a robust potential customer base for UK tourism.

Moreover, the increasingly hostile rhetoric and actions emanating from the US may inadvertently benefit British tourism. US Customs and Border Patrol data is already showing a collapse in international arrivals to America relative to the same period last year. Multiple US allies, including Canada and Germany, have issued travel warnings to their citizens. These trends could disproportionately benefit the UK as travellers seek alternative English-speaking destinations.

Figure 1: International student population in the United Kingdom by domicile



Another significant advantage for the UK lies in its substantial population of international students. According to figures from the Higher Education Statistics Agency (HESA), the UK's international student population grew by an impressive 57% between the 2018/19 and 2023/24 academic years. While Brexit did trigger a decline in EU student numbers, this has been more than offset by increases from India, Nigeria, China, and other markets. These international students have become an integral part of the UK's higher education ecosystem, providing universities with essential tuition fee revenue. Though there are indications that international student numbers may have decreased in the 2023/24 academic year, overall populations likely remain significantly elevated compared to pre-Brexit levels.

While this growth in international students has primarily stimulated investor interest in purpose-built student accommodation, it may also hold untapped potential for the hospitality industry as well. The UK's diverse student population may generate demand from around the world as family members travel to attend significant events like graduations. Academic conferences associated with the UK's world-renowned universities could similarly drive demand for hotel space, creating a resilient segment within the broader tourism market. Once again, the hostile rhetoric coming from the US presents upside potential for the UK.

The concept of university-targeted hotel chains has already been tested in the US by the Graduate brand, which Hilton acquired in 2024. Graduate offers boutique hotels, predominantly in small American college towns. The median population of their 31 US locations is approximately 127,000 residents, with some locations like Storrs, Connecticut, and Oxford, Mississippi, being considerably smaller. The brand expanded into the UK market in 2021 with hotels in Oxford[1] and Cambridge. It's possible that a model focusing on college towns could succeed in the UK if executed well.

The UK tourism industry's resilience amid global uncertainty ultimately highlights the importance of diversified international connections in preserving a robust hospitality sector. The growth of wealthy populations in Asia combined with the recent influx of international students creates multiple avenues for sustained demand even as other markets may face disruptions. Regardless of what additional challenges 2025 may present, there is compelling reason for optimism regarding the future growth potential of the UK's hospitality sector.

EUROPEAN PRIVATE CREDIT: OPPORTUNITIES IN A MATURING MARKET

Over the past few years, private credit has become one of the most important topics in finance. The practice of non-bank lenders providing capital loans to private companies has attracted some of the world's largest financial institutions. In December 2024, Blackrock announced that it would acquire HPS Investment Partners, a private credit firm with $126 billion of assets managed under private credit strategies. JP Morgan later announced that it would expand its own private credit and lending services with a commitment of $50 billion. In late February this year, State Street and Apollo released a private credit ETF, demonstrating further market interest in the sector.

According to data from [Preqin and PGIM RE](), the global market for private credit is worth over $1.9 trillion (measured in total AUM), of which $238 billion is made up by real estate lending. Current forecasts for the sector are optimistic, with the total market expected to reach $2.9 trillion AUM by 2028, and real estate lending growing to $400 billion.

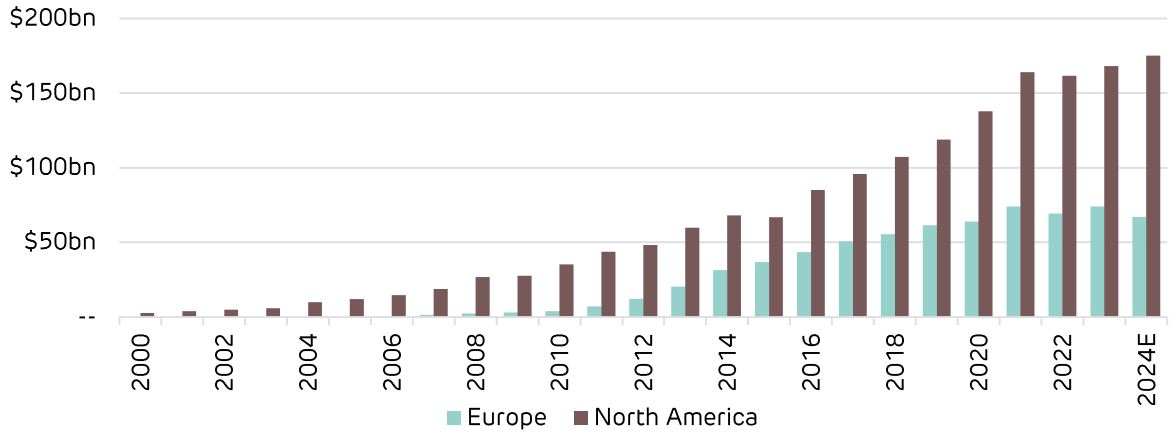
Several factors have spurred the growth of the private credit market in recent years. Traditionally, banks have been the primary lenders to real asset owners needing capital. However, due to regulatory restrictions, particularly increased capital requirements, banks have become increasingly unwilling or

[1] The original Oxford.

unable to lend to real estate. This pullback in bank lending comes at a time when the demand for capital is high. In Europe alone, over $700 billion of commercial real estate debt is set to mature by 2028.[2] Some borrowers have faced challenges refinancing due to lower valuations and higher interest rates. Additionally, owners of assets like hotels have had to use cash reserves to survive the pandemic and subsequent inflation, increasing the need for capital for refurbishment today.

The demand drivers point to the continued growth of private credit. A survey conducted by law firm Proskauer Rose also found that 91% of surveyed private credit lenders expect to increase activity in 2025, up 59 percentage points from 2023. The effects of this optimism may not be evenly distributed across markets, however. Measured in AUM, Europe's private debt activity seems to be slowing down relative to America's. From 2020-2024, real estate debt AUM grew by 5% in Europe and by 27% in the United States.

Figure 2: RE debt AUM growth in Europe is slowing relative to America [3]



Proskauer's survey notes that Europe-based respondents' foremost concern was a lack of quality assets in the market. By contrast, the difference between buyer and seller prices was the most commonly cited issue in the United States.

As a result, investors seeking greater exposure to European real estate private debt deals may find it beneficial to work with local partners who can find opportunities and provide operational expertise. For example, we were able to leverage our knowledge of the London office market to provide £24 million in mezzanine lending as part of a financing package to refurbish 1 Portsoken Street (formerly Lloyds Chambers) in 2019. Our ability to quickly develop and execute a financing program was made possible by the fact that we knew about the building beforehand (we had evaluated a potential purchase earlier), and we understood that it fit well with our convictions on London offices. As activity continues to grow in Europe, we expect to see more opportunities to source and execute funding plans for quality assets.

A final factor to consider is the prospect of banking sector deregulation in the US, given the current administration's efforts to reduce regulatory burdens and potentially unleash a wave of financial liberalization. While policy uncertainty is at an all-time high, it is worth considering the potential implications of such a move. If the US banking sector deregulates relative to the UK or EU, it's possible that American banks could be empowered to become more active lenders in the United States, raising competition and compressing margins for alternative lenders such as private credit

[2] AEW
[3] Preqin

funds. Some alternative lenders may therefore consider expanding activity in Europe and the UK, where competition may be lower and policy stability appears higher.

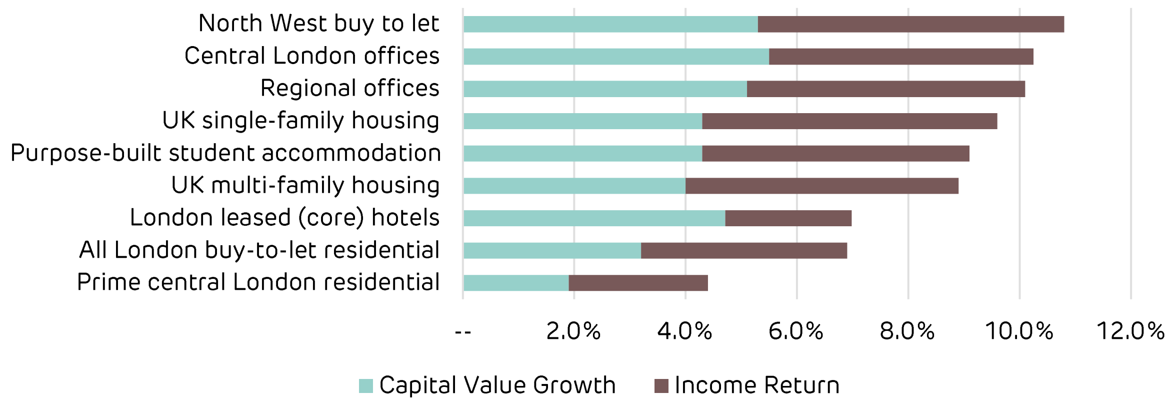
Ultimately, Europe might be relatively underappreciated despite benefitting from many of the same factors that have propelled the US private credit industry forward over the past decade. As the markets continue to mature, this side of the Atlantic could become increasingly attractive. However, lenders seeking opportunities in the UK and nearby economies may find that the best way to efficiently develop viable strategies is to work with partners who have experience in the field.

UNREASONABLE HOSPITALITY IN THE FLEX OFFICE MARKET

In *The Winning Bookends of the Office Market*, we outlined our survey of the office sector as it appeared to us in mid-2022. To summarise, we argued that the market was bifurcating, with large HQ-style buildings and flexible offices appearing best positioned for success given shifting patterns of work.

Two and a half years on, we remain confident in our assertions. A lack of supply and an ever-increasing list of occupier demands has pushed up rents for prime offices in gateway cities like London. Flexible offices, meanwhile, continue to attract interest from large investors and occupiers alike. Last April, for example, Grosvenor announced a 300,000 flexible office drive in London and other major UK cities and, annual UK flexible office take-up in 2024 grew to its highest level since 2019.[4] These positive tailwinds have pushed the outlook for office returns upwards relative to other UK real estate in the next four years.

Figure 3: Comparative returns per annum for UK real estate by sector, 2025-2029[5]



One trend that has emerged since our 2022 letter is the rise of managed offices, which offer a middle ground between workspaces with flexible leases and traditional longer-term lease transactions. While terms differ from deal to deal, a managed office contract generally provides tenants with a fully fitted and customised space. Rents are inclusive of most services such as business rates, service charges, IT, and cleaning. Unlike a typical coworking setup, the occupier has a fixed area and private amenities (such as a kitchen or phonebooths) for themselves.

Some smaller office landlords who don't fit neatly into the bookends we described earlier have started pivoting toward managed operating models by offering fitted spaces for SMEs with lease terms of around two years. While the trend is most pronounced in London, it's likely that regional cities will begin to see smaller landlords convert office spaces soon, too. For example, Savills notes that nearly

4 Green Street
5 Savills

a quarter of all lettings below 5,000 square feet in Manchester from Q1-Q3 2024 were for fully fitted suites.[6]

Smaller landlords shifting to managed offerings could reduce rental growth in the flexible office segment if supply growth outpaces demand. However, it's crucial to note that not all serviced office offerings are the same, and operators have many ways of differentiating their products.

One way is through the structure of the buildings themselves. Flexible offices need to be, well, *flexible*. That means being able to create new offerings based on what the market demands. For example, a startup boom could create demand for hot desks or suites for ten or fewer workers. Alternatively, a large company setting up a regional presence might drive demand for larger offerings at a given location. In our time running our flexible office platform Clockwise, we have prioritised buildings that have the potential in response to the market, allowing us to capture a wide array of tenants.

When it comes to keeping tenants, there are additional opportunities for differentiation. Chiefly, flexible office providers can convince tenants to stay beyond their lease terms through effective relationship management. Over the course of a flexible contract, startups and SMEs can see their office demands change significantly as their operations grow. Office providers, therefore, have opportunities to proactively engage with their tenants to extend the relationship even as the needs of the tenant change over time, generating stable income. Once again, the role of adaptable floorplans plays a role here, as they allow providers to accommodate evolving tenant needs without requiring a full relocation.

The ultimate objective is to reduce the impact of switching and void costs, which emerge when a tenant decides not to renew a lease. As we described in *Only the Paranoid (Office Investors) Survive*, the costs incurred by new tenant incentives such as custom fit-outs and rent-free periods can dramatically reduce NOI for an asset, making it paramount for office investors to have tenants to stay for as long as possible.

To accomplish this goal, flexible office operators might be able to steal a few pages from the hospitality industry's playbook, which has always focused on the experience of tenants. In his book *Unreasonable Hospitality*, for example, author/restaurateur Will Guidara, explains how taking creative approaches to improving customer experience leads to positive outcomes for operators, guests, and businesses alike. In one notable example, he recalls when his team at Eleven Madison Park filled a dining room with sand and beach chairs to surprise guests who missed their beach vacation.

Filling an office with sand might be a bit overkill, but the point is that furnishings and short contracts alone cannot guarantee success for a flexible office anymore. Operators need to consider how their offerings – from floorplans to community events to food and beverage options – keep tenants happy. Simply offering a fitted space and keeping the coffeemaker full is unlikely to do much to attract or retain potential occupiers, who increasingly demand more from their workspaces in terms of both furnishings and service. New entrants may find that they need to adjust to the norms set by the rest of the industry.

FRACTAL DIMENSION ANALYSIS

There are many ways to analyse asset price movements, but one that struck our interest comes from Dhaval Joshi at BCA Research. Joshi's work uses the fact that the asset prices tend to move in a fractal pattern, meaning that trends in movement are reproduced at different time scales. The fractal

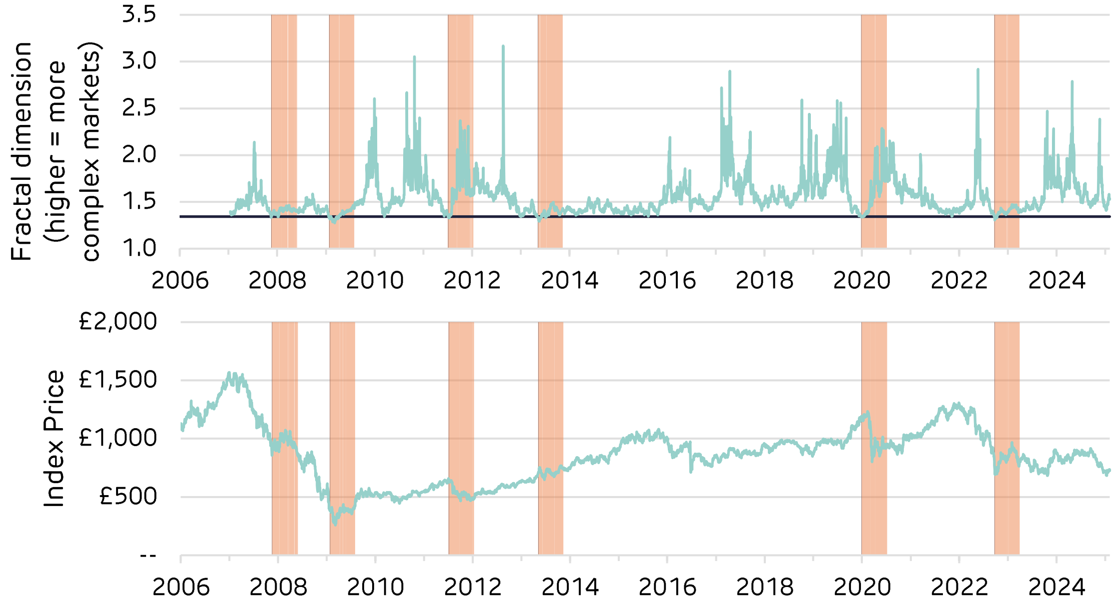
[6] Savills UK | Spotlight: UK Flexible Offices – 2024

dimension of a price trend measures how complex its movements are over a given period (referred to as a scaling factor). Joshi posits that fractal complexity is correlated with the amount of information in a market. Higher complexity means the market is comprised of actors with different time horizons, ultimately creating a liquid environment.[7] A collapse in complexity, however, means price movements are being caused by a single type of investor, which reduces liquidity. Most importantly, the work by BCA argues that collapsing complexity is a signal that ongoing price trends may reverse, and investors can use such data to time a market entry or exit.

We've yet to see the method applied to UK real estate markets, so we decided to give it a try. We started by creating an index based on the share prices of five major public UK real estate companies: British Land, Derwent London, Great Portland Estates, Land Securities, and Segro, with fixed weights based on relative market capitalisations in mid-February 2025. Then, we used the formulas provided by BCA Research to compute the fractal dimension of the index's price movements.

Below are two graphs depicting our results. The top graph shows the complexity of price movements in our index over a rolling 260-day period, and the bottom shows the actual price of the index. A highlight appears whenever the fractal complexity collapses below 1.3425, with the following 130 trading days highlighted as well to show the trading window.[8]

Figure 4: Fractal complexity analysis of UK public real estate stocks



The results of our experiment show some interesting results. As calibrated, strategy calls for six trades over 18 years with an average return of 9.05% per trade. The method would have worked for short positions in 2012 and 2020, as prices reversed trend. In 2013, however, the price trend did not reverse, and investors would have lost 5.12% if they had taken a short position.

After talking with Dhaval Joshi, we've since learned that there are more ways to tune our model. Modifications to our trigger or the duration of our trades could have yielded drastically different

[7] Joshi's work can be sampled on BCA's website.
For additional information on the topic of fractals in finance, see *Fractal Market Analysis: Applying Chaos Theory to Investment and Economics* by Edgar Peters and *The Misbehavior of Markets: A Fractal View of Financial Turbulence* by Benoit Mandelbrot and Richard Hudson.
[8] If complexity falls below 1.3425 multiple times within a 130-day window, only the first instance will be counted, as this model focuses on when complexity collapses to determine market entries and exits.

results. It turns out that analysing complexity is... complex. Overall, the results show us that the fractal trading strategy is promising, but its best use might be as a complement to fundamental analysis and wider macroeconomic understandings.

Even though we primarily deal with private real estate transactions, we think that fractal dimension analysis of public assets could still have some interesting use cases for us. The different timeframes of activity between public and private markets have contribute to a valuation gap in real estate investing. Aberdeen estimates that total returns for UK direct real estate lag publicly listed REITs by six to nine months. While the public-private gap can make it challenging to determine the true health of the real estate market, it provides opportunities as well. Analysing the price of publicly traded assets to gauge changes in market sentiment could give investors valuable time to reassess their strategies in the private markets. Looking forward, fractal dimensions analysis could be a way to help private investors time entries and exits with a substantial horizon.

GAME ON: BLACKSTONE CALLS THE BOTTOM OF THE OFFICE MARKET

In late January, Blackstone's president shared his views on office investment, and in doing so he revealed a change of heart. During an interview with *Bloomberg*, Jon Gray argued that the office market had reached the bottom, stating that Blackstone was optimistic for growth, especially in stronger markets and better quality buildings.

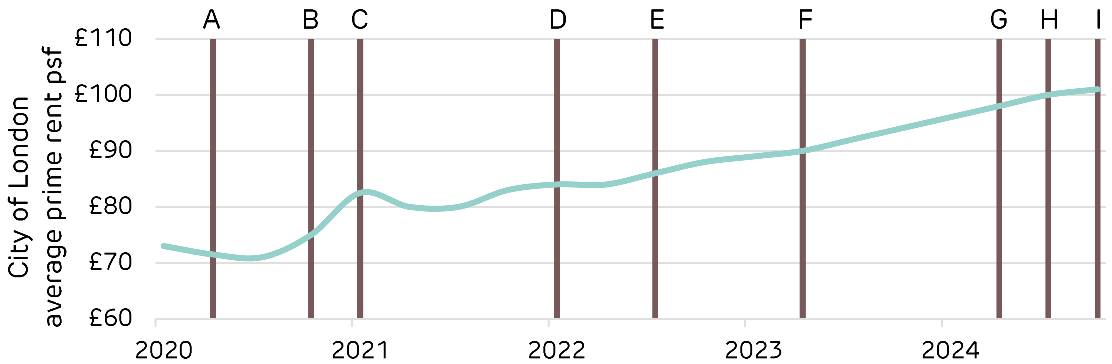
It's no secret that we've been quite confident about the potential of prime offices in gateway cities like London, so it was refreshing to see our predictions from November 2024 coming true:

> *"The recovery in offices has been slow, but we're starting to see evidence that some investors are(re)discovering the potential of the sector's best assets ... we expect the market to heat up significantly, and for institutional investors to get the message soon."*

Mike was glad to see his former employer get more bullish on the asset class, even if the road has been winding. It's difficult to fault anyone for feeling uncertain about the future of office investment: over the past five years, the actions of large institutions pushing for more in-office work, the opinions of commentators, and the actual operational data from offices have all shared conflicting narratives for both rents and cap rates. And even if the former turned out empirically positive as organisations realise that while hybrid work is here to stay, some degree of in-person time will always be necessary, the latter matters perhaps even more.

It is clear, in any event, that Blackstone's views on offices appear to have shifted over the past year as confidence grew. In January 2024, Gray argued that real estate markets had hit the bottom, and he encouraged investment in the residential and data centre sectors – though subsequent letters to shareholders affirmed that the firm was not yet investing in offices. In fact, Blackstone was paring its office holdings to 2% of its total real estate portfolio. As recently as September 2024, Gray cautioned that structural vacancy in key markets would continue to weigh down the office sector. But the reported purchases of Tokyo Garden Terrace in central Tokyo and 1345 6th Ave in Midtown Manhattan suggest that the mood music is shifting.

Figure 5: Rumours of the office market's death have been greatly exaggerated[9]



Ref.	*Quote*	*Source*
A	"The office, for the foreseeable future is dead."	NYT
B	"[The] success of remote working during pandemic raises prospect that many workers will not return to offices."	FT
C	"As office vacancies climb to their highest levels in decades with businesses giving up office space and embracing remote work, the real estate industry in many American cities faces a potentially grave threat."	NYT
D	Regarding Google's new HQ at King's Cross: "We believe in the value of coming together in person to collaborate, which is why we're continuing to invest in our offices around the world."	Google
E	"Structural change is biting and wishful thinking will not make UK remote workers return to their offices"	FT
F	"Companies continue to downsize during the pandemic, creating a major challenge for the city over what to do with so many empty buildings"	NYT
G	"[RXR and Ares Management] are convinced that a prolonged paralysis in an office market frozen by uncertainty about interest rates and the threat of remote working is now breaking."	FT
H	"This year's findings reveal that CEOs are hardening their stance on returning to pre-pandemic ways of working, with 83 percent expecting a full return to the office within the next three years — a notable increase from 64 percent in 2023."	KPMG
I	"[HSBC's] potential up-sizing is the latest sign that pandemic-era projections about shrinking office footprints are being challenged by the gradual return of a majority of workers to offices and the increasing need for companies to provide top quality amenities for their staff."	Bloomberg

There's a scene in the 1992 comedy classic *Wayne's World* that encapsulates what it feels like to see the narrative oscillate back and forth. For the uninitiated, here's the rub: In one scene, Wayne and his buddy Garth are trying to play street hockey in an idyllic American suburb. Unfortunately, their efforts are repeatedly interrupted by the arrival of cars and other passersby, causing them to repeatedly set up and dismantle their equipment. Undeterred, they yell "game on!" every time they're ready to play

[9] Rental data from Savills

again. The narratives around offices have been somewhat similar, with commentators crying out at every datapoint.

Perhaps Gray's statement is just another instance of the office market setting up its net in the middle of the street. But when the world's largest owner of commercial property says that offices are back on the menu, the rest of the market tends to take note. We expect that this vote of confidence will convince sceptical investors to critically evaluate how the office market still provides promising opportunities for flexible spaces as well as prime offices in gateway cities. As we described in a previous letter, narratives tend to multiply in the wake of major market events, as everyone with a megaphone tries to figure out what to make of a new world order. After years of violent swings, we hope that headlines will continue to calm down in the near term.

In the meanwhile, those who choose to re-enter the office sector may find that the market has changed significantly in the past few years. The demands of occupiers, rules regarding conversions, and the construction landscape have all changed markedly since 2020, which would make it difficult for any investor who has turned a blind eye to get back in. As such, we expect that large institutional investors that leverage local expertise – either by bringing experts in-house or working with operating partners – will be the best equipped to achieve high net returns.[10]

Michael Kovacs Adam MacLeod Mathew Chemplayil

[10] That's a hockey pun.