21 February 2023

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For the attention of [redacted]

Dear Sir,

RE: The proposed Palace Hotel Development, Torquay

I am writing to summarise the current situation in respect of the proposed development of the Palace Hotel in Torquay. Savills are well acquainted with the site and the scheme.

In summary, we do not consider that the hotel development is viable. Furthermore, we are of the opinion that there is no market appetite to deliver a hotel on the site of the former Palace Hotel due to changes in the local market as well as the current economic climate. This is explored in more detail in the following sections.

1. Viability

[redacted]

Due to recent inflationary pressure the build cost will have increased in the region of at least 20% - 25% versus the appraisal undertaken in 2019. Fragrance and their advisors have shared with us that the contract costs for the two Paignton hotels (Mercure and Ibis Styles) have increased by 45%. The Corbyn Head has gone up by 25% from initial concept to contractor contract. If we adopt the same inflationary figures to the Palace it derives a negative viability [redacted]. The Council are aware of this we know from their own hotel project on The Terrace.

Furthermore, due to interest rate rises, the cost of development finance will also have increased.

At the same time, as a result of cost of living crisis and softening consumer demand, the anticipated trading performance of the asset will have reduced, thereby reducing the Gross Development Value of the scheme.

This is in effect a perfect storm, with the cost of delivery going up and the value realised going down.

[redacted]

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2. Local Pipeline

Local Authority research, detailed in 'The English Riviera Destination Management Plan' assesses that Torbay has 31,000 bed spaces. Although half of it is non serviced, in Torbay Council's own words, 'the remaining 15,000 spaces represents an oversupply'.

The current pipeline of new hotel developments (excluding extensions) is provided below:

Project	Bedrooms	Type	Stage	Grade
Corbyn Head Hotel	151	New build	In construction	4-star
Park Hotel	161	New build	In construction	4-star
Lighthouse	120	New build	In construction	3-star
Premier Inn Torquay	120	New build	In construction	Budget
TOTAL	**552**			

Since 2019, a further 128 new branded bedrooms have opened in Torquay due to the new Hampton by Hilton on Torwood Street.

In addition to these bedrooms, the construction of the hotels on the site of the former Park Hotel and Lighthouse in Paignton are nearing completion (with opening dates set for March and July 2023 respectively). The completion of these projects will see 281 bedrooms enter the Torbay bedroom inventory.

On top of these, the Premier Inn Torquay will see a further 120 bedrooms added to the local supply.

Whilst the Corbyn Head Hotel is in the early stages of construction, we anticipate this will be completed by September 2024, adding another 151 bedrooms at a 4-star standard.

As such, within 24 months, a further 552 bedrooms will have been added to the local supply, an increase of 11%. To contextualise this, the entire UK's development pipeline in construction represents a 4.3% increase in terms of bedroom increase. Torbay is therefore seeing an unprecedented increase in bedrooms.

There are two main impacts to this increase in supply:

- The ability of the demand for the local market to absorb these new bedrooms and maintain occupancy and rate in the face of increased supply;
- The perception, by investors, of the risk involved in investing in a market which will be subject to a significant increase in supply in the short and medium term.

3. Consumer Demand and Operational Challenges

Consumer demand during and since Covid in the UK's leisure led destinations, outside of periods of government mandated closure, has been robust. This was driven by consumer desire to travel but due to restrictions, overseas travel was limited. This benefitted the UK's leisure market as well as consumers choosing to deploy Covid savings on travel spending after limited options to do so in lockdowns.

More recently, the cost of living crisis, driven by rampant inflation has been well publicised. As such, PWC's consumer sentiment survey for Autumn 2022 shows that consumer sentiment is worse than pre-pandemic and worse that at any point during austerity measures. In fact, it has only been lower once – immediately following

the collapse of Lehmann Brothers at the start of the Global Financial Crisis. Across all categories, consumer intentions are to reduce spending. In relation to holidays specifically the net spending intention was -41%.

What this means for hotel businesses is starting to show in the data. A review of the UK market snapshot, provided by STR, shows that occupancy in the UK's hotels is softening (for the summer period Jun, Jul, Aug 2022 saw occupancy -3.1%, -2.2% and -3.8% lower than the corresponding periods in 2019) and whilst some of the rate growth seen in 2021 and 2022 has been retained, meaning average room rates are higher than in 2019, the overall effect of inflation means that true average room rate is actually flat or in some cases, below that achieved in 2019.

In short, the hospitality sector is starting to see what is likely to be a significant softening in consumer demand as a result of inflationary pressure.

Separately, on the operational side, hotels and hospitality businesses are facing a perfect storm of challenges with cost increases being seen throughout their operations:

- Worker shortages and increasing wage costs mean that staffing is an acute issue with cost increases being reported in the region of 15% - 20% versus pre-Covid.

- Procurement costs, as a result of supply chain issues and increased energy costs, have also seen significant increases, in some cases approaching 20%.

- Utility costs have spiralled. Our clients have seen anywhere between 150% and 350% increases in energy costs, dependent on when these were fixed. To contextualise this in terms of actual performance, based on what we are seeing in the energy market, a business which previously had energy costs of £150,000 could now be paying £525,000. For many operators, this will be the difference between the business being profitable or loss making.

The result of softening of consumer demand and increasing operational costs will see profitability eroded and some business are likely to fail. Those that are able to sustain their profits will see profit margins reduce and in doing so, will reduce the attractiveness of hotels as an asset class to investors.

4. Conclusions on Operator / Developer Demand

Synthesising the points discussed in sections 1., 2., and 3., underlines that there will not be a hotel solution deliverable on The Palace Hotel site. The project was always challenged from a viability perspective. The local market will see significant supply increases with the bedrooms currently in construction. The consumer demand outlook is poor with operational viability facing significant headwinds. Torbay should be grateful that Fragrance have decided to build three branded hotels, contributing 432 quality bedrooms, when they did as economic and viability challenges would mean that these schemes would have not be progressed today.

In addition to these points, the cost of financing this type of project has significantly increased. SONIA is currently sitting around 3.93% versus the highest rate achieved in 2019 which was 0.71%. Loan to value ratios adopted by banks have been reduced and in addition, they are seeking higher levels of debt servicing coverage. In short, there is less debt available and it is significantly more expensive.

Therefore, in the context of spiralling costs to deliver a scheme which was already unviable, in a local market which is seeing significant increases in high quality bedrooms, in an operational landscape which will see a softening of consumer demand combined with increasing operational costs, with debt less available but costing more, there will be no appetite in the Palace Hotel site from a prospective purchaser, developer or operator.

I trust that this letter covers the salient points however if anything further is required please do not hesitate to contact me.

Yours sincerely

[redacted]

On behalf of Savills (UK) Limited