Hotels—The fifth food group?

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Abstract

Traditional asset groups — office, retail, residential and industrial — hotels traditionally not regarded as an asset class — high operational costs in running hotels — volatility of income stream — lengthy timescale for development and construction of hotels — new trend emerging — hotel increasingly seen as main asset — wider pool of investors available — negative performance of equity markets and fall in commercial property yields — resilient tourism — sale and manageback transactions — UK REITs — all contribute to boosting the status of hotel into the mainstream.

Keywords:

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Real estate professionals often divide the universe of institutional grade investment opportunities in the sector into four asset classes, or 'food groups' — office, retail, residential and industrial. Well-located properties, leased to quality credits (major corporates or, with residential, high income tenants), have historically provided an optimal mix of locational, leasing and general economic risk. Hotels have historically

not been regarded as an asset class for a variety of reasons: the lack of understanding of the industry by investors and difficulty in having a quick exit strategy coupled with an uncertain level of returns. But in recent years hotels have become more mainstream in the eyes of the investors and this paper examines the reasoning behind the emergence of this 'fifth food group' and the distinguishing features of which an investor ought to be aware of before investing in the hotel industry.

THE OBSTACLES

Hotels, even high profile city centre locations with well-established brand names, have never easily fulfilled stereotypical real estate investment criteria. They are highly leveraged operationally due to their staffing and supply and maintenance needs. A major flag is key to driving rate and occupancy, but many factors such as terrorism and natural disasters are unpredictable and often impact hugely upon travel and thus hotel occupancy. While hotels can raise rates quickly in an upturn, in particular to corporate and premium individual clientele, tenants (or 'guests') can terminate or renegotiate their arrangements virtually overnight, certainly quicker than a typical hotel can adjust its high operational cost base. The volatility of hotel income streams, even for trophy properties, is something many real estate fund managers have difficulty coming to grips with. These are the factors that have in the past suppressed the investors' appetite and are discussed in more detail below.

High operational costs

Running a hotel is a costly business which requires not only the relevant expertise but also capital and a steady stream of income. The unfortunate situation is that, while the supply and demand of hotels fluctuates depending on external and often unpredictable factors, there is no correlation between the supply and demand on one hand and the basic costs in running and maintaining a hotel on the other. The latter remains relatively constant while the volatile nature of the former means that if demand is low, it is feared that returns on the investment of investors will be inadequate. In addition, although the operation of a hotel is usually contracted out to an experienced operator, considerable time and effort needs to be devoted to reviewing and approving operational, budgeting and capital expenditure matters.

Too impatient

On average, a new upscale, full service hotel takes 3–5 years to develop and construct and up to four years to reach operational stabilisation. In terms of the repositioning and stabilisation of an existing hotel, the cycle ranges from three to five years. For investors who are seeking short- to medium-term investment, the above timescale is not exactly appealing. Furthermore, hotel management contracts have traditionally favoured operators of hotels, granting them significant authority to operate and with long-term tenure rights. The combination of these factors acts as a deterrent to investors and makes them think twice before investing a

large amount in a field in which they have little expertise, very little control at an operational level, an uncertain level of return and a difficult exit strategy.

Instability

Natural disasters such as the December 2004 Indian ocean Tsunami, the Asian severe acute respiratory syndrome (SARS) outbreak as well as continued terrorist attacks and rising oil prices in many regions all have a significant impact upon the rise and fall of tourism and the hotel industry as they invariably affect the consumer. These together with seasonal variations evident in occupancy rates have traditionally curbed the investors' appetite from investing in the hotel sector.

TURNING THE CORNER

Despite the above problems, well-branded, well-located and well-managed upscale hotels, which do provide attractive and steady returns, have not escaped the attention of astute fund managers. Hotel assets were a significant component of many successful portfolios assembled in the early 1990s after the real estate crash of that era, and they were a foundation of many Asian property fortunes established prior to the regional crisis there in the late 1990s. Beginning with a few specialist funds and bulge bracket pioneers over a decade ago, today's real estate fund universe includes many established players with significant hotel holdings (eg Lehman Brothers, Morgan Stanley, AIG, Merrill Lynch, Deutsche Bank, Blackstone, Carlyle, GIC) along with a host of specialist funds (Strategic, Colony Capital, Walton Street, Hotel Capital Advisers, Rockbridge, Meristar, Cedar).

Statistics provided by the industry predict a continual growth in the hotel sector both in terms of single asset transactions and portfolio transactions. The hotel industry in the US witnessed more than \$21bn in transactions in 2005. In the UK, single asset transactions in 2006 thus far have reached £570m, already ahead of the 2005 figure of £526m. High profile single asset transactions include the sale of 263 Savoy rooms for £250m from Quinlan Private to a joint venture between Fairmont Hotels, Kingdom Hotels International and the Bank of Scotland, and the acquisition of Hilton Prague by Ireland's Quinn Group for €130m. High profile portfolio transactions include the £670-m acquisition of 46 UK 4 and 5-star Marriott hotels by Condor Overseas Holding and the sale of Société de Louvre to Starwood Capital for €1.69bn.

Bored of conventions

Low performance of the equity markets coupled with an era of low inflation and interest rates have driven capital towards real estate. With a paucity of conventional real estate such as traditional office, residential, multifamily and industrial assets available at attractive yields, most investors have needed to test the boundaries of their historical investment criteria to meet return goals. They are forced to look at a much broader range of assets.

Wider pool of investors

Long gone is the traditional concept of direct or passive investment in hotels by only those trade buyers with expertise. In the past, the main two options were owner-occupation, whereby the owner controls both the property and the business risk or passive investment, whereby the ownership and operation of the hotel is split. The past decade has, however, witnessed a growth of different sources of investment capital and the trend towards indirect property investment has become increasingly prominent with institutional investors and private equity groups both setting their eyes on this unconventional fifth food group. In particular, specific private equity real estate funds have been formed to take advantage of the trend, and the favourable conditions for investment in the hotel sector, such as the strong residual values of hotels as an asset, the steady stream of income from well branded and located hotels and greater access to debt at favourable lending terms, have all contributed to this changing attitude.

Tourism and hotels

The world of tourism has seen its fair share of misfortunes in recent years. Hotel occupancy was low and the market was generally sluggish. But these events do not always halt tourism but redirect travel flows instead. According to the World Tourism Organisation, an estimated 460 m tourist arrivals were recorded worldwide in the first seven months of 2005, a 25-m growth on the same period from the previous year. On a global scale, travel and tourism continues to be resilient and remains a growth market. Against this backdrop, investors will continue to be pouring capital in the hotel sector.

Sale and manageback transactions

In recent years, there has been a growing trend for hotel owner-operators to split the bricks and mortar from the operation of a hotel business by means of sale-and-lease/manageback arrangements. The reasoning behind this is threefold. First, in the increasingly globalised world, hotel brands are striving and competing against each other for a dominant global presence, asset disposals can free up capital which can then be used for the purpose of further acquisitions, development or refurbishment activities. Secondly, with most of the major hotel operators publicly listed, the return on capital is low and asset disposals are considered as earnings enhancing, thus creating value for shareholders. Thirdly, real estate, unlike equity, has proven to be much more of a robust investment with strong residual value.

In terms of the lease or management agreement itself, they have traditionally been more operator friendly, however, as mentioned above, due to the increased competition among hotel operators to establish a more prominent global presence, the balance of power has shifted and they have conceded to more flexible terms with respect to the operating agreements. With regard to lease structures, they have moved away from the traditional fixed-based rental payments to turnover-based leases, which comprise a guaranteed component and a variable rent component,

thus offering a rental income linked to the hotel's trading performance. As to management agreements, they are often structured so that incentives are available to operators depending on trading performance. Although owners were initially reluctant to opt for this sort of payment structure, the financial benefits achievable in strong trading conditions outweigh the incentives that they pay out to operators.

Hotel real estate investment trusts ('REITs')

As of January 2007, companies in the UK will be able to enter the REIT regime. Other European countries such as Netherlands and Belgium, already have REIT regimes in place, although the regimes vary from country to country, essentially, they are modelled on the structure adopted in the US.

Provided certain conditions are met, once a company obtains REIT status, the trust itself is generally a tax-exempt vehicle and tax is only payable at investors' level on the dividend income they receive. One of the main conditions for qualifying as a REIT is the distribution requirement: most of the trust earnings in a given financial year must be distributed to investors within a period of time. Secondly, all REIT regimes have investment and income restrictions covering qualifying investments and activities. Some other regimes also require companies to be listed on a recognised stock exchange.

In the context of hotel investment, and in particular in the UK, concerns were raised as to whether there will be restrictions which prevent the possibility of establishing a hotel REIT. Although it remains the case that income in a REIT will not be tax exempt if it derives from property occupied by a member of the group, hotel REITs are still possible provided that the REIT itself does not operate the business of running the hotel.

HOTEL-SPECIFIC FACTORS

In the context of hotel investments, determining the path to ownership is an element that an investor must contemplate. There are various ways to ownership ranging from developing a new hotel to acquiring existing hotels of various profiles or converting existing buildings into hotels. The path an investor is inclined to choose would largely depend on the funding available and the anticipated holding period. Developing a brand new hotel would obviously be a lot more time-consuming than acquiring an existing one. Furthermore, other issues to be considered include the hotel type, size, cost, location and more importantly the required return.

Exit strategy is also an aspect that must be borne in mind if investors wish to maximise the potential returns on their investments. In terms of short-term investments, property appreciation and the ability to negotiate a desirable sale consideration upon exit are the key drivers to securing more favourable returns. Understanding of the cyclical nature of the industry and the ability to both enter and exit at an optimal time dictates the level of profitability. For long-term investors, time is less important, instead they seek a secure and sound investment which can generate strong, steady cash flows over the longer term. The ability to achieve this

depends on various issues such as the quality of the brand, the location, economic and social trends, and last but not least the efficiency of the management. Structuring the lease or management agreement in such a way that return is linked to the performance of the operator is likely to lead to bigger rewards being reaped by both operators and owners. Periodic valuations are also essential in ensuring that returns remain on target.

MAINSTREAM

Once grasped, real estate fund managers who have become comfortable with hotels value them as a core component of a successful portfolio. The typical fund's 5–7-year hold period has caused most to focus on existing assets and shy away from development or long-term repositioning situations. Depending on the fund and the brand, the presence of a long-term operator contract can be both an incentive and a deterrent to investors. In contrast with even the most high profile office and retail buildings, well-established upscale city centre hotels have market staying power that is unique, and are functionally adaptable to changing occupier taste in a way that other buildings are not.

In addition to the inherent stability of residual values for prime city centre hotels (particularly in older cities where large hotel sites are limited), other changes in the investment marketplace have fostered deeper liquidity for investment grade hotels.

After years of struggling to replicate the ability of other real estate assets to tap the securitisation capital markets, hotels seem to have finally turned the corner. The growing popularity of splitting operations from ownership continues to spur a wave of sell offs by major hotel chains of quality hotel portfolios to eager institutional funds. There have also been a number of sales of significant hotel loan portfolios, and many individual hotel acquisition loans are now being underwritten with the expectation that they will be placed into commercial mortgage backed securities (CMBS) pools.

In the case of portfolio sell offs, many of these have been done with a leaseback of the properties by the selling operator, to respond to the traditional fund preference for a corporate credit standing behind an asset. Increasingly, many funds will consider sale and managebacks, as they grow comfortable with analysing the operational risks of the hotel business. These funds, often together with related corporate private equity funds, are also buying into lodging corporates.

CONCLUSION

While the jury is still out on many of these lodging investments insofar as measuring their return over a fund hold period, hotels look likely to be a familiar asset class for real estate fund managers for many years to come.