THE HOTEL OWNERS'

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Bringing together the interests of hotel owners, real estate investors and hospitality franchisees around the globe

From the Director

Here we go again

SimonAllison
HOFTEL Executive Director

Interest rates remain at record lows. Corporates are cashed up. Airlines are ordering more planes than ever before. The Chinese and Indian markets have started to travel.

It ought to be a fabulous time for the hotel property sector - but, as we all know, it isn't. The effective bankruptcy of most European governments and, in essence, the US too, has left us all in a fix, with fears rising over the balance sheets of banks exposed to the bonds of countries under pressure, which in turn is putting banks off lending to each other and, as in 2008, creating a severe liquidity crisis. This has the potential to push the world into recession on its own, leaving aside the fiscal tightening that most western countries face, which dampens consumer demand on a global level.

This is all potentially disasterous, but the key word is "potentially". As of now most consumers haven't felt the effects of fiscal tightening. The disaster may never happen, though sadly the ineptitude of political leadership on both sides of the Atlantic makes it more likely by the day.

However, in our sector as in so many, the key players have spent the period since 2008 rebuilding their balance sheets and are in far less danger of succumbing to a downturn then they were three years ago. Indeed, in the recent HOFTEL Europe conference in Edinburgh, the mood was of predators looking for bargains, rather than of fully invested players staring into the abyss. Andrew Katz of Axios came to the conference fresh off the back of his acquisition of Mint hotels; Graham Snell at Capital noted that after ten years in the business he finally saw good opportunities to buy in the UK; our guest speaker Chris Stewart waxed lyrical on his extensive development pipeline.

Trading, too, remains solid for the moment for most of our owners, even in Europe, while Asian markets are going gangbusters.

Stock markets, however, are once again disproportionately punishing hotel shares. Out of a basket of 29 hotel stocks tracked by HOFTEL, 13 have fallen by 30% or more from late February to late November 2011, against falls in the Dow of 7% and the FTSE of 12%. Moreover, twelve of the hotel stocks have fallen 70% or more from their 2007/8 peaks, versus declines of 18% and 21% respectively for the indices. As in 2009, the sector appears to be massively oversold.

Yet while stocks may offer some great bargains, the real estate market remains pretty jammed up. In Europe, banks desperate to strengthen their balance sheets may start selling hotels more aggressively and there will be some relatively good deals there – but at the same time, the very same banks can't afford massive write-offs so some of the real basket cases may not come to market. Moreover, with corporates in good shape, few of them are likely to face the sale pressure they did in 2008. Good deals will remain few and far between.

Any recommendations then, from this office? Essentially only this (and you've heard something like it from me before): whether Europe and the US melt down or not, the key travel story of the next ten,

Here we go again

continued

twenty and fifty years will be the descent of Asians, en masse, into European and US destinations. Some of course will be businessmen but they, by and large, will be replacing existing businessmen from countries whose companies can no longer survive in the new competitive environment. The new feature will be tourists; simply and literally millions and millions of them. Where will they go? Fairly clearly, they will head for experiences they can't find at home – which may, for the most part, exclude mountains, rivers, lakes, beaches etc as these are also plentiful in Asia. They will seek cultural/historical experiences and that means the key historic cities of the world – which are usually those with the oldest CBDs and the highest entry barriers – will be top of the list. London, New York, Paris, Rome, San Francisco, Cairo, Jerusalem, Istanbul, and even, eventually, the Avignons, Edinburghs, Florences and Savannahs will all be the beneficiaries. In all likelihood, the former industrial and commercial cities with little or no competitive edge and no leisure potential will be the losers.

In the meantime, at some point – surely – the continued episodes of quantitative easing should unleash at least a modest degree of inflation, while interest rates remain low. For hotels, as for any real estate class, that should be good news.

Opportunities and challenges

Opportunities and Challenges for Strata - Title Hotel Operations

by Malcolm Kerr & Simon Allison

As traditional bank financing for new development remains subdued, where local law permits it, hotel developers are increasingly looking to fund projects through the strata-title selling of individual rooms or villa units.

In theory this should be a win:win:win for all concerned. The developer can secure a premium price for sold units and get equity returned to it quickly; the hotel operator can secure both branding fees and additional management fees; the buyer obtains a property which is fully serviced, a secure holiday home for at least several weeks of the year and potentially some significant value upside in the long-term.

Having witnessed the impact of failed strata developments in previous market cycles, many major operators have recently avoided new projects due to the complications and liabilities of dealing with multiple owners. However, now encouraged by the rapid growth, especially in Asian markets, several groups are once again dipping their branded toes into the (rental) pool.

According to Bill Barnett of C9 Hotelworks, who works extensively with developers and operators of strata projects across Asia, sales pace is substantially higher for hotel managed strata-title units than for unbranded residential real estate, and the branded product can also attract a premium of 30-60% over comparable non-branded properties.

This potential upside in the sales price is clearly recognized by developers; however, reaching mutually acceptable terms between major brand operators and developers can be difficult.

Owner-Operator issues in Strata Title deals

Operators will usually want a branding fee which can

Opportunities and challenges

continued

be a straight percentage of the gross sale price of the condo or villa, or can be a larger slice of an imputed premium over comparable non-branded product. Operators may also seek to have a very significant degree of control over:

1. Sales collateral and the promises made therein
2. Eventual exit of the original developer i.e. they tend to want an ongoing partner to deal with, except in markets like Australia where a 100% strata sale model is more normal
3. The way buyers can behave following the sales (in terms of maintain physical product, letting it out, funding its ongoing servicing etc)

While there are no hard and fast rules here, owners do need to exercise some caution:

a) Operators can ask for a whole plethora of controls over the sale process, largely through fear of (i) standards not meeting their brands or (ii) being accused of underwriting a deal over which they do not have control but which carries their name eg. if a guarantee is given. While operator concerns are understandable, owners need to be careful of what they are signing away. If an operator insists on reviewing all sales collateral, then the question arises whether they actually have the in-house expertise to add value to it and also whether they are obliged to come back on it quickly - no owner will want to lose a sale or worse, a launch, because the operator is slow to react or raises unreasonable objections.

b) There may be an inherent contradiction between the termination clauses within the management agreement and the implied brand promise to unit buyers - a clash which gets potentially more serious the higher up the quality spectrum you go. Owner need to ensure that wording in the sales contracts makes it clear if they have the right to let the operator go, and they also need to ensure that the broker's sales team doesn't make promises that undermine that legal position, either vis-à-vis unit buyers or the operator.

c) Operators may demand a vast range of restrictions on what unit buyers can do. While many of these are sensible (for example, to keep the integrity of the appearance of the property, or to prevent noisy or other anti-social behavior), owners need to be willing to push back if required. Owners also need to think through what services they (and potential buyers) actually want the operator to perform. Do they want the manager, for example, to provide estate management (i.e. to act as the local juristic person) or merely to be subcontracted for certain services? Will buyers want to deal with the hotel manager for issues like service charge collection, or would they prefer to deal with a professional property management firm? Will they pay a premium for a property where the branded operator provides regular cleans (they may, for a luxury brand), or will they prefer the flexibility of hiring maids themselves? Will they be happier knowing they (and all their neighbours) can only let out rooms via the official letting pool, or would they prefer to be able to use outside agents (maybe cheaper, but less control of quality)? Owners need to work out their position on these types of issues early because many of them will be contained in the hotel management agreement or supplementary documents.

In this short article we summarize the common pitfalls for owners to avoid and present some key elements common to successful projects.

Where it goes wrong

There are numerous cases where strata-title projects have gone awry before construction or once the realities of operation set in.
Failed projects typically demonstrate the following

(former Westin Auckland Lighter Quay - de-flagged amidst unit owners/developers disputes) continued

problems:

Unrealistic expectations of sales demand and operating performance of the property undermine many strata-title projects. Careful and realistic analysis of the property and hotel operation market is critical. In many cases, especially in the Australian strata market, buyers were supplied with blue-sky forecasts that over-estimated their revenues and woefully under-estimated ongoing costs and maintenance requirements.

Too much debt. Excessive debt puts heavy pressure on the developer to discount units and to sweeten purchase terms for short term cashflow. Far too many developers prior to the financial crisis relied upon pre-sales of units as a cornerstone of their financial model - and then got stuck with a half-completed project which they couldn't fund.

Poor legal structure. Traditional residential developers will have an established process for the marketing and contracting of residential sales which do not adequately address the complexities of long term branded management. It is vital that the developer engages an advisory team with relevant experience and knowledge of the product, and ideally one which can balance the competing demands of the real estate brokers, buyers, operator and developer.

Bearing these concerns in mind while recognizing the potential commercial value, major brand Operators are refining their pre-requisites for projects which they are prepared to put their name to.

Key Attributes for Successful Strata-title Hotel Operations

The location can attract a premium daily rate and sales price.
The economics of the development and ongoing operation will depend on sufficient occupancy and ongoing revenue to support the operating costs and provide a reasonable return to all stakeholders. Developers need to look closely at the returns that buyers can expect and price the units accordingly.

The project team understand the type of buyer they are seeking. The developer needs to understand whether it is selling to (i) buyers who may live in the project, currently or upon retirement, (ii) weekenders who will want the property 20-30 times pa and are unlikely to be willing to let it out, (iii) "sunbirds", who will use it for several months in the local dry/high season but will be happy to let it out at other times, and (iv) financial investors which are happy to take it back for 3-4 weeks per annum, but are otherwise happy to let it out. Attracting each of these buyers will require a materially different strata structure. Investment-led buyers may want a guaranteed return and may also be OK with a compulsory poolback arrangement; live-in buyers will not only be unwilling to rent their properties out (obviously) but may also want to have a section of the resort secluded away from holidaymakers, with their noise and frequent comings and goings.

Project finance is not dependent (or at least not heavily so) on pre-opening residential sales. The developer needs to be able to ensure full finance for the construction, at least to the opening of a fully financed first phase, without reliance on the success of off-plan sales. Developers should also note that sales of units that take place after the project (and accompanying hotel/resort) is completed tend to attract a large premium. While there may be short-term IRR benefits to pre-sales, the overall cash returns may well be harmed; especially if units have to be sold off at a discount to bridge a funding gap.

The Developer shows long term commitment to ensure the future high-quality operation and maintenance of the project. Essentially, projects where the original backers only want to "take their money and run" quickly fall into disrepute, as there is no interested party with an equity stake in the overall project to ensure high standards. Generally, developments where the owner retains control of the public areas and a meaningful number of accommodation units are the best run and create a good track record for repeat projects.

Commercial agreements are tailored to the project to ensure a fair and sustainable relationship between the parties and sufficient tenure for the operator over the entire hotel.

Common areas ownership is separate from the ownership of the individual units. As noted above, it is important to keep control, if legally possible, of the public areas. In many jurisdictions, as soon as a project has been sold off, it falls under the jurisdiction of a condominium juristic person (or some similar body) and this can play havoc with the collection of charges and the quality of maintenance. In most jurisdictions, however, an experienced law firm can find a way to mitigate this risk.

Management Fee Structure is proportionate to the value of the business. Regardless of the market

Opportunities and challenges

continued

positioning of the hotel, non-rooms revenue may be constrained by limited F&B outlets and revenue available to the operation reduced due to the share of income paid directly to owners. The management structure and fees must reflect this relatively lean operating model. We certainly recommend that base fees should be calculated from net, not gross, room revenue, even if the percentage ends up being higher (i.e. 4% of net room revenue after a 50% share is given to unit buyers is cheaper than 2.5% of the gross!)

A couple of successful global examples of strata titling (or sale poolback) are:

Pan Pacific Whistler

Opened in 1999 in a prime ski resort location with 121 units all sold within days of launch. Developer took a fairly modest 20% profit upon completion of the project.

Pan Pacific Whistler

Property values appreciated 75% within 3 years and unit owners received a strong annual return. Relationship with operator is a simple management agreement.

Banyan Tree Phuket

Banyan Tree Phuket

Banyan Tree Phuket opened in 1994 and built a reputation as one of Thailand's best resort hotels

before introducing high end 1,2 and 3 bedroom villas,"Banyan Tree Residences", for sale and lease back to the resort operation. The resort has a total of 150 units.

Summary

With sufficient planning and operator involvement we consider that there is considerable potential for developers to profitably deliver high quality strata-title hotels which offer long term value to unit buyers and the operators.

However the operators, advisors and developers we work with all recommend a measured approach. Sales and operating projections should be conservative; the project should be designed to be operated profitably from ongoing cashflows and agreements tailored to protect the long term interests of the stakeholders. Ownership of common facilities and some room inventory should be retained by the developer and, ideally, financed independently from the strata-title portion of the development.

New member profile - Foncière des Murs

continued

Mercure, Boulogne - Billandcourt, France

Foncière des Murs is a French property investment company (SIIC) specialising in the ownership and development of service-sector property. Its business model is based on sale and leaseback operations, with tenants who are, respectively, leaders in their markets, in the hotel, leisure, restaurant and health sectors. Foncière des Murs has built its success on a solid and long-term partnership approach which combines a focus on regular rates of return over the long term with dynamic management of a portfolio which is diversified in terms of signatures, business sectors and geographical locations.

As at mid-2011, the group had a Total Asset Value of €3.18 billion with a Net Asset Value of €1.464 billion. It owned 196 hospitality properties, of which 193 were hotels, and three were thalassotherapy institutes. The hospitality portfolio's total value as €1.8 billion and the annual rental income was €118 million.

The portfolio has essentially been an Accor-operated one, with the largest brands being Ibis, Mercure and Novotel. However, in the first half of 2011, the group acquired 18 B&B hotels in Germany and took a 20% stake in a partnership with Prédica to acquire 32 Campanile properties.

The company is also actively managing its portfolio, with several portfolio sales underway. At the end of these, hotels are expected to remain at over 50% of the total assets.

Novotel Brussels Centre Tour Noire, Belgium

Edinburgh and Pattaya Conference Review

Given HOFTEL's expansion, in 2011 we launched a policy of having two regional conferences, one in Europe and one in Asia.

Edinburgh

The first was held on 29th and 30th September in Edinburgh, sponsored by Scottish Development International. It began with members being piped into cocktails on the terrace of Edinburgh Castle on a wonderful late summer evening, and continued with an excellent dinner addressed (very briefly) by the Scottish Minister for Tourism, Mr Fergus Ewing. Events continued with the Conference proper the next day, held at the offices of the Scotch Malt Whisky Society. The keynote session was a very open discussion with Iain Corstorphine, the head of Real Estate at Lloyds TSB (which of course acquired HBOS with all of its problem hotel loans in the UK and across Europe). Iain was frank about the problems facing lenders – on the one hand, pressure to extend loans to new and existing clients, while on the other hand, also needing to raise the capital base, not least by disposing of assets. He noted that the period of "extend and pretend" was coming to an end and said he expected more sales of bank-controlled hotels to be rolled out in the coming months. He agreed with the view of the audience that the current market could offer banks very lucrative lending opportunities, but pointed out that while hotel lending teams might wish to go down that route, the top-level credit committees were not ready to support such a strategy.

Edinburgh and Pattaya Conference Review

continued

Members also benefitted from another debate about the unique nature of the Scandinavian hotel ownership sector led by Henrik Bartl of Host Hoteleiendom and Pirjo Ojanperä of CapMan/Dividum, with the (not wholly unexpected) conclusion that Scandinavian hotel property companies will expand out of their home base quite cautiously and also that their lease-based system is unlikely to be expanded to countries where it does not already prevail.

Members were treated to presentations of two live projects, one in Glasgow and one in Edinburgh, details of which can be forwarded to any member who may have an interest in these exciting cities. We also heard from Dr. Joachim Modlich of Mayer Brown about how to avoid the pitfalls in JV relationships and enjoyed a round-up of the European markets from Tim Smith of HVS International.

Pattaya

In a rather different setting, the Asian conference took place at the beachside Sheraton hotel in the Thai resort in Pattaya, kindly being sponsored by the property's owner, Amburaya.

Following a general introduction, the conference kicked off with cocktails and a superb dinner and resumed the next morning with a feisty exposé of the costs of using online travel agents ("OTAs") by Prab Thakral of Boutique Asset Management. He explained that OTAs will be charging hotels (and their owners) anything from 8% - 30% commissions for their bookings and proposed that owners and operators should get together to form their own OTA which could impose price discipline on the existing players.

We heard from David Mallinson of Mayer Brown JSM about the hot issues currently impacting owners in management agreements – including an outline of an amazing menu of 37 different types of centralised services fees that the various Asian branded operators levy – and about the risks and rewards of branded residences and condo hotels. Malcolm Kerr from KerrWood followed up with an analysis of how to structure contracts to incentivise operators to assist in turning around and repositioning underperforming assets. Stephane Baldanoff gave an extensive overview of insurance issues that impact owners, which is obviously an investor responsibility and something often overlooked.

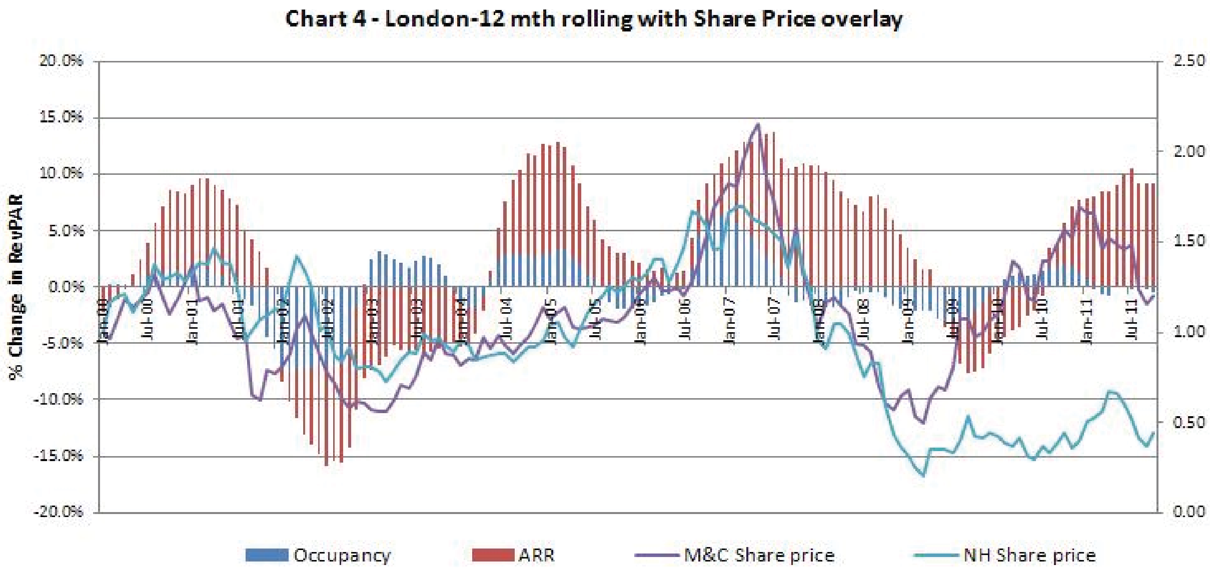
In the afternoon, Peter Meacock from Legend Tec talked about ways to improve the project management process and ended up in a long conversation about toilet plumbing in prefabricated units! Ricco de Blanc and Brian Williams, two heavyweights of the Hong Kong hotel industry then led an engaging debate about the best places in the world to invest, with everyone around the table having slightly different ideas and the conference was rounded off by Rohit Sachdev of Soho Hospitality showcasing his rooftop Bangkok bar and restaurant, which is currently under construction.

A big thank you to the participants and sponsors of both events. We look forward to the 2012 Conferences, which will hopefully continue to expand our range of activities and a new and wider membership base.

September saw a staggering 11.3% jump in ADR year-on-year but this appears to have been simply be a blip in an otherwise gloomy picture, with October showing a 1.8% ADR increase. Occupancy growth which was 1.7% YOY in June, fell to 1.2% in July, 0.3% in August, 0.1% in September and -1.9% in October. On a 12-month rolling basis, the occupancy change has averaged -0.2% throughout YTD 2011. In other words, we are flatlining at best. On the other hand, the 12-month rolling trend in ADR has averaged 8.4%.

This all suggests a late cycle pattern – in other words, the end of a recovery and the start of a downturn.
If share prices are also a leading indicator, then both NH and M&C have been pointing us towards a recession for months.

So, the LIP paints a pretty gloomy picture all round – which is unlikely to change unless the European and US authorities give us all a powerful dose of monetary easing, which should help hotel real estate investors by boosting short-term demand and also stoking up inflation on which our property values depend. However, there may well be a lag and, in terms of trading on the ground, the indicators suggest that the next six months won't be too great – which can hardly be surprise given the overall economic background.



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