Global Hospitality Insights

Top thoughts for 2012

Ernst & Young
Quality In Everything We Do

2011 started on a strong note for the hospitality industry. Significant improvements were achieved in lodging performance indicators in most regions of the world, the global hotel transaction market showed heightened activity and significant amounts of capital were raised to invest in the sector. An observable influx of foreign investment in US real estate was welcomed, a new monetary policy was established and the US Government emphasized stimulus programs for the lending markets.

However, global economic and political events, such as the Arab Spring, natural disasters in Asia, the S&P downgrade of US sovereign debt and the European debt crisis during the second half of the year, and continuing signs of weakness in the US housing market destabilized the recovery. These economic concerns created a more uncertain environment for lodging companies and investors to grow via low risk acquisitions, divest underperforming assets and seek to refinance existing properties. These dynamics contributed to difficulties for asset valuations.

Despite the hurdles experienced in the second half of 2011, the lodging sector is expected to continue its recovery in 2012. Transaction activity is anticipated to improve with a focus on core assets in key gateway markets. At least in the initial months of 2012, debt financing is expected to remain scarce, requiring investors to be resourceful. International travel and tourism volumes, driven by the burgeoning BRIC economies, are anticipated to increase. Furthermore, mega events in Europe and South America from 2012 through 2016 will impact the global hospitality sector. As owners and operators strive to enhance value and competitiveness, industry best practices, such as sustainability and brand refreshment, will remain top of mind throughout the year.

As globalization among all industry stakeholders and participants has become the standard, it is ever more critical to be aware of the changing transactional, developmental and operational landscape, including tax and accounting, to be best positioned for success and to maximize value.

We are pleased to present our *Global Hospitality Insights: top thoughts for 2012*. The report reveals key issues and trends we believe will be the primary areas of focus in the global hospitality industry this year.

Contents

On a global scale, lodging market participants see positive signals pointing toward the sector's continued improvement in 2012. However, the obstacles affecting the recovery in late 2011 are expected to cause uncertainty in the sector in the medium term.

Where do we go from here?

After showing strong signs of recovery during the first half of 2011, the lodging industry faced considerable uncertainty during the second half of the year. The global economy appeared to slow amid the European debt crisis, doubts about fiscal matters and high unemployment in the US; the Arab Spring; and natural disasters in Asia. Not surprisingly, the bullish sentiment felt across the lodging industry in late 2010 and early 2011 has been replaced by an increasingly cautious attitude and more moderate growth expectations for 2012.

Nonetheless, lodging performance indicators around the world continued to improve throughout 2011. According to Smith Travel Research (STR), the European market led the way with 13.7% growth in revenue per available room (RevPAR) through November 2011, while Asia Pacific and the Americas followed with RevPAR increases of 10.4% and 8.3%, respectively.[1]

As a key driver of growth, corporate travel outperformed both transient and group travel worldwide. Global business-related bookings grew by 6.1% year over year through September 2011 while global leisure-related bookings increased by 5.6% during the same period.[2]

Europe's RevPAR growth in the first half of 2011 can be attributed to a partial rebound in business travel and group business, a comparative lack of new lodging supply and an increase in intra-continental tourism due to the devaluation of the euro relative to other currencies, as well as the absorption of displaced leisure travelers looking for a politically stable vacation destination during the Arab Spring as an alternative to locations in North Africa.

However, since the summer months, the Eurozone crisis has depressed both consumer and business confidence and has led to a softening in European RevPAR comparables, which were close to flat in October against the prior year. We are also seeing a gradual downgrading in forecasts for 2012 across the sector. Maintaining levels of food and beverage expenditure appears to be a particular challenge, and with limited opportunities for further cost efficiencies, given measures already taken in the 2008–09 downturn, profitability is likely to remain under pressure.

The revolutionary movement in the Arab world negatively affected lodging markets in the Middle East and North Africa (MENA) region, particularly in North Africa. Lodging markets across Egypt, Tunisia, Morocco, Saudi Arabia and Israel experienced declines of 85.0% in net hotel bookings and 37.2% in rates since the start of the unrest.[3] Three of Egypt's major tourist destinations experienced significant year-over-year declines in RevPAR through November 2011: Cairo, -56.2%; Hurghada, -34.0%; and Sharm El Sheikh, -36.8%.[4] Within the MENA region, the Middle East exhibited better performance with a RevPAR increase of 3.8% through November 2011,[5] primarily driven by demand growth in Dubai.

The US lodging market achieved RevPAR growth of 8.2% through November 2011.[6] Urban locations continued to experience the greatest RevPAR increases with Boston, Chicago, Los Angeles, Miami and San Francisco posting double-digit RevPAR growth, primarily driven by ADR increases from continued growth in business travel.[7] Accordingly, the luxury segment showed the

strongest performance improvements, as it did in 2010. Across the US, luxury hotels achieved the most significant RevPAR increases with 11.4% growth through November 2011, driven by a 6.0% increase in ADR and 5.0% increase in occupancy.[8]

The luxury and other segments in the US lodging market also continued to benefit from the absence of a noteworthy development pipeline. Overall, lodging markets across the United States face marginal supply growth of 0.7% in room inventory through 2012[9] while other regions exhibit stronger development pipelines. As of mid 2011, Asia Pacific had the largest development pipeline – 1,290 hotels totaling 310,230 rooms.[10]

The particularly notable pipeline activity across the Asia Pacific region reflects strong lodging market performance during 2011, particularly in Southeast Asia, which emerged as one of the strongest performers in the region for the year. According to STR Global, this sub-region experienced year-over-year November RevPAR growth of 21.2% driven by a 5.6% increase in occupancy and a 4.8% increase in ADR.[11] This performance can be attributed to increases in arrivals from China and India, especially in key markets such as Thailand and Singapore. However, concerns over a slowdown have begun to surface. Growth in China's gross domestic product (GDP) is anticipated to slow from 9.1% (3Q2011) to 7.0% in 2012.[12] In India, concerns have emerged surrounding inflation, which was at 9.8% in August 2011, well above the five-year historic average of 6.5%.[13]

Although lodging market participants remain optimistic and the global lodging market is expected to grow in 2012, deceleration in the broader economy and uncertainty about the path and speed of recovery caused a number of analysts to downgrade performance projections in the third quarter of 2011. In the US, there are divergent 2012 forecasts, with analysts estimating RevPAR growth from a low of 3.9% to more than 7.0%.[14] Positive signals come from the US Department of Commerce, which projects international travel to the US to continue its strong growth through 2016; visitor volume is expected to increase 4.0% in 2012 and reach 64 million visitors. Revenues generated by international visitors are expected to increase 5.7% and reach US$116 billion.

Europe is anticipated to see marginal increases in 2012 with inbound travel growth expected to slow from 5.6% in 2011 to 2.3% in 2012.[15] The European Travel Commission sees core Eurozone countries facing increased downside risk from exposure to the region's debt crisis and pressure on currency. The pipeline of new hotels appears strong, with 869 hotels in the course of development as of November 2011, a 19% increase from the prior year. However, given the current market uncertainties, we would expect this figure to start to decline, at least in the first half of 2012.

Lodging markets in the Asia-Pacific region are expected to continue performing well through 2012. Growth is anticipated to be driven by strong performance in key cities throughout the region. According to STR Global, Singapore is projected to lead the world in RevPAR growth with 9.6% expected in 2012.[16] However, overall ADR growth in 2012 across the Asia-Pacific region is projected to be more modest when compared to 2011 numbers, due to a strong supply pipeline and corresponding inventory increase.[17]

In the MENA region, conditions are anticipated to improve slowly. In 2012, growth in Dubai is expected to level off;[18] however, key Egyptian markets are expected to begin recovering after the presidential election set for early in the year.[19]

On a global scale, lodging market participants see positive signals pointing toward the sector's continued improvement in 2012. However, the obstacles affecting the recovery in late 2011 are expected to cause uncertainty in the sector in the medium term. First, the European debt crisis appears far from resolved, causing fears of financial market contagion, which could hinder economic recovery. Second, doubts about the fiscal course and nominal job growth in the US, combined with the anticipated political stagnancy in the presidential election year, raise questions about the speed of the economic recovery in the US. Finally, cracks have appeared in the developing economies, particularly with respect to GDP and inflation growth in China and India. Should these key markets experience a significant economic slowdown, lodging fundamentals could be negatively affected.

1 *Global hotel industry performance for the month of November 2011*, Smith Travel Research, October 2011.

2 "Business and leisure travel growth continues," *The Pegasus View*, September 2011.

3 Ibid.

4 *Middle East Hotel Benchmark Survey*, Ernst & Young, November 2011.

5 *Global hotel industry performance for the month of November 2011*, Smith Travel Research, October 2011.

6 Ibid.

7 *STR Monthly Hotel Review*, Smith Travel Research, November 2011.

Creative capital

The capital markets presented two stories in 2011. In the first half of 2011, capital deployment increased significantly compared to the prior 18 months, buoyed by the widespread recovery and outlook in the hospitality market, as well as the improving economic climate. As lenders regained greater confidence in hospitality assets, investors and owners had more options available. While still a far cry from peak levels in 2006 and 2007, overall US commercial mortgage-backed securities (CMBS) issuance in real estate increased from US$4.5 billion as of year-to-date September 2010 to US$26.9 billion as of year-to-date September 2011.[1] At the same time, the industry saw stabilization and even slight loosening of the strict debt underwriting parameters of 2009 and 2010. However, in the second half of the year, many lenders significantly slowed their activities as confidence in the global economy, and the financial markets in particular, eroded once again after the events of summer and autumn 2011. Nevertheless, with lodging fundamentals enjoying a favorable outlook, debt capital is expected to be available in 2012. That said, lenders are anticipated to be selective in capital deployment, with a focus on strong sponsorship, cash flow, brand affiliation and location. Potential borrowers will need to put more effort into securing financing and may increasingly need to explore wider financing possibilities, such as private mezzanine funds, high-yield bonds or even financial support from brand operators, in order to maximize their options.

From an equity perspective, a considerable amount of capital allocated to real estate is waiting to be deployed, and companies continue to plan raising capital through various means, including initial public offerings (IPOs). Assets that are located in prime global gateway cities are getting the most focus and attention from investors, who are seeking such opportunities due to the perceived relative safety, which includes steady demand growth and higher barriers to entry. Even as demand increases and equity capital continues to come in, the availability of debt to fund investments is still unknown. A continuing shortage of readily available debt capital is anticipated as many lenders continue their strategy of "extend and pretend" while waiting for more advantageous opportunities and try to avoid balance sheet issues until there is more clarity in the market.[2] However, there have been signs that banks may be entering a more proactive stage of greater willingness to force sales of leveraged assets where the equity is "under water." In Europe, for example, some high-profile portfolios have been going through such sales processes, and their degree of success will be influential in determining the speed at which equivalent assets come to market.

In the US, there continues to be a strong preference for assets in core markets by both equity and debt players. Banks, still working through legacy investments, are carefully screening opportunities while life insurance companies, sitting at full capacity, are looking to infuse capital into select, "best-in-class" properties and sponsors. The market has seen an increase in opportunistic lenders, who are capitalizing on the uncertainty by helping to fill the void left by more traditional lenders. They are seeking higher returns by focusing only on more junior tranches, including mezzanine and preferred equity positions. Foreign equity investors continue to view the US as a relatively safe harbor to deploy capital and look toward key gateway cities, where they can enjoy additional return on their investments if the US dollar strengthens. Investors are looking at major flags in these cities, and with profits driven by room demand, there is a renewed focus on operators who are hotel specialists as they are the key to driving the results investors expect and lenders project.[3]

In Europe, despite the uncertainty around the unresolved sovereign debt crisis, prime real estate assets in core markets (primarily gateway cities), such as London and Paris, are still looked upon as safe investments. A polarization of the marketplace has occurred as investors with a "flight to quality" mentality focus on core cities in Western and Central Europe and the Nordic countries.[4] In the UK, the limited availability of

8 *STR Monthly Hotel Review*," Smith Travel Research, November 2011.

9 "PKF Forecasts 2012: Optimism Among Pessimism," hospitalitynet.org, November 2011.

10 "STR report global hotel pipelines for August 2011," Asiatraveltips.com, September 2011.

11 Ibid.

12 "Pimco Sees China GDP Slowdown Continuing," *Wall Street Journal*, October 2011.

13 "Hotels in India: Trends and Opportunities," *HVS Global Hospitality Services*, October 2011.

14 "PKF Forecasts 2012: Optimism Among Pessimism," hospitalitynet.org, November 2011; and "STR Projections 2012," *Hotel News Now*, November 2011.

15 "European Tourism 2011 – Trends & Prospects, Q3/2011," European Travel Commission

16 *STR Global Market Forecast*, Smith Travel Research, October 2011.

17 *Carlson Wagonlit 2012 Travel Price Forecast*, Carlson Wagonlit Travel, October 2011.

18 "Economic Impact of Travel and Tourism," World Travel and Tourism Council, November 2011.

19 *MENA Chain Hotels Market Review*, HotStats, September 2011.

As traditional lenders are being more selective, investors and real estate owners are exploring different sources for debt financing.

debt has affected the volume of transactions in the market, with major UK banks still nursing extensive legacy issues and being somewhat reluctant to lend to the hotel sector, aside from low-risk, single-asset deals. In Germany, investor interest in hotels remains high; real estate is still seen as a relatively stable asset with regular cash flows. Consequently, the scarcity of debt has had an impact on the development and transaction markets; investors with cash available are at a clear advantage.

In Asia, although the real estate market fundamentals and regional economic outlook are positive, investors have become more cautious in light of the geopolitical events that have started to affect sentiment. Return requirements of both equity[5] and debt have widened, and in many markets, investors are required to commit additional equity. China remains a bright spot as both foreign and domestic investors continue to focus on increasing their portfolios in the country. Since China is still a growing and developing market, the country is focusing on the stability and development of its real estate market. As a result, developers had more difficulties in obtaining capital from traditional means in 2011, and some are using alternative sources for financing. Still others are looking for opportunities to form partnerships with foreign investors in order to gain access to capital. Japan also continues to be a focal point as one of the region's most active countries for investment and transactions.[6] Core foreign funds continue to move forward with due diligence, and opportunistic funds are seeking deals because of the significant availability of capital ready to deploy.[7]

Around the globe, despite the recent volatility in the global financial markets, existing real estate investment trusts (REITs) and IPOs still remain top of mind for many real estate companies as an alternative strategy to fuel growth and as a means by which to access the public equity markets. Despite the costs and risks associated with operating a publicly traded company, public and going-public real estate companies are using this approach to address capital requirements, reduce debt, take advantage of distressed investment opportunities and capitalize on what is viewed as a prolonged economic and real estate recovery. A public real estate company must consider the common success factors and investment risks of being public, which typically revolve around market, asset, management and balance sheet characteristics.

Coming out of 2011, volatility in the capital markets is expected to continue through at least the initial months of 2012. While many equity investors still have significant capital waiting on the sidelines, debt capital is expected to be more difficult to come by. As traditional lenders are being more selective, investors and real estate owners are exploring different sources for debt financing. There are also signs that the global brand operators, who continue to expand their portfolios and take advantage of consolidation opportunities, may be willing to relax their "asset-light" strategy and assist developers and asset owners through loan guarantees, equity investments and even direct loans. In some cases, operators are prepared to acquire freeholds in order to obtain brand-enhancing sites, albeit with the intention that the property element will be disposed of at some future point. Overall, there is no doubt that raising debt capital will continue to demand more creativity and resourcefulness throughout much of 2012.

1 "Summary of CMBS Issuance," *Commercial Mortgage Alert,* 30 September 2011.

2 *Emerging Trends in Real Estate 2012*, Urban Land Institute, 2011.

3 Ibid.

4 Lauren Parr, "Is Real Estate Still Considered a 'Safe Haven' Investment in Europe?" Urban Land Institute, 19 October 2011.

5 *MarketView: Asia Pacific Capital Markets Q3 2011*, CBRE, 2011.

6 Ibid.

7 *Asia Pacific ViewPoint: Investment Activity October 2011*, CBRE, 2011.

Understanding your capital agenda

Access to capital and its effective use is of critical importance in today's volatile economy. Hotel executives continue to look for ways to grow shareholder value by focusing on their capital agenda: preserving, optimizing, raising or investing capital.

Capital is a powerful word in the hotel space these days. Capital provides companies the opportunity to invest and grow, and without it, companies must deleverage and downsize. In 2008 and early 2009, companies focused on deleveraging in their balance sheets. However, between mid-2009 and 2011, capital flooded the financial markets, providing hotel companies and REITs with tremendous purchasing power but at the same time, an increase in debt to their balance sheets (albeit at a lower interest rate than previous debt loads).

Policy-makers and pundits speak of companies holding excess cash on their balance sheets, which they say inhibits the growth of the US economy. However, our research on the largest hotel C-corps and REITs shows that even if the cash on the balance sheet is at all-time highs, long-term debt is only slightly below the historical peak. Its recent decline can be attributed to refinancing opportunities to pay down existing debt, as well as to asset dispositions. The net debt (long-term debt less short-term investments) has declined in the last five years, but this level of debt is still affecting the way companies approach transactions and growth.

As of year-end 2011, the ongoing debt crisis in Europe, the effective shutdown of the CMBS market and volatility in capital markets are impacting the ability of hotel companies to raise debt funding. Further, the hotel sector is tainted by one of the highest delinquency rates — 12.66% in the real estate class as of November 2011.[1] Finally, public REITs continue to face a challenging financing environment because of depressed stock valuations. These ongoing trends are limiting the number of transactions to levels not seen since 2009 and thus, the ability of hotel companies to expand and grow inorganically (via acquisitions).

Given this landscape, C-corps and REITs are continuously looking for creative ways to maximize shareholder returns. However, challenges exist in today's economy: 1) cost cutting has been driven to maximum levels and is only a partial solution to maximizing shareholder returns in a cyclical downturn; and 2) investors are seeking a return to corporate investment to allow growth in valuations consistent with long-term levels.

Ernst & Young's global real estate and hospitality survey shows that, as of October 2011, despite the slowdown, a large percentage of executives polled said they were positioning their companies for growth. Moreover, a large percentage of the companies surveyed remain optimistic and flush with cash to grow and execute transactions. Pricing the risk and sourcing debt financing associated with these deals, however, will continue to present challenges. With no clear vision of a recovery in transaction activity in the near future, hotel companies are under increased pressure to grow shareholder value.

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So how do companies plan to accomplish this in 2012? Recognizing that it is hard to control the external factors impacting growth prospects, a number of tactics, focused on better managing internal opportunities, are being employed to drive value. Our survey results and discussions with market participants, summarized as follows, are consistent with the actions taken by some of the eminent hotel operating and management companies to maximize shareholder returns:

- Companies are trying to enhance shareholder value by refinancing and divesting under-performing assets. As of October 2011, approximately one-third of the companies surveyed wanted to refinance and another one-third wanted to divest assets. In late 2010 and 2011, a number of hotel companies and public REITS sold portfolios of under-performing and non-core hotels, which allowed them to reduce leverage and invest in higher-yielding opportunities, reduce future capital expenditure requirements and potentially unlock the value of the higher-performing portfolio.
- Approximately 28% of the companies surveyed were focused on de-levering their balance sheets by paying down debt, including one of the prominent lodging REITs, which recorded a capital gain by retiring debt through a discounted payoff.
- Some of the companies surveyed planned to distribute cash by buying back shares and paying dividends. One of the major hotel operating and management companies recently announced plans to reduce total shares outstanding by more than 15% over the next several years. This may have a significant impact on the company's price per share.

Companies must evaluate the best tactics to drive growth under the current circumstances. In order to create enterprise/shareholder value, companies must determine an "optimal" capital structure, review capital allocation and develop strategies to manage cash and debt loads by:

- Examining the efficacy of share repurchase vs. regular dividend vs. special dividend
- Examining the efficacy of de-levering
- Evaluating alternatives and the pros and cons of each distribution strategy

In the current economic environment, waiting for the transaction activity to resume or the right opportunity to strike may not be the best short-term option for companies with excess cash to enhance shareholder value. Understanding your own capital agenda, whether preserving, optimizing, raising or investing, is paramount to enhancing company value.

1 "Commercial Real Estate Price Declines," *Commercial Mortgage Alert*, 9 December 2011.

Acquisitions: core and center

The US hotel transaction market showed signs of recovery in 2011 as transaction volume increased in each of the first three quarters and is anticipated to increase by approximately 50.0% in the last quarter compared 2010 levels. Most of the activity took place in the first half of the year, when a confluence of factors resulted in greater demand for high-quality assets located in key gateway markets and created a favorable environment for sellers. However, the trend shifted mid-year due to global economic concerns, creating a more even, if uncertain, playing field for buyers. Well-capitalized sellers, however, are expected to ride out the economic volatility before bringing assets to market.

Given analysts' expectations of a slow, gradual economic recovery, risk-averse investors are anticipated to continue focusing on core assets in key gateway markets in the near term. Demand for lower-quality assets located in secondary and tertiary markets, on the other hand, is anticipated to remain challenged, particularly given the pullback in the CMBS markets, a vital source of financing for these assets. According to Ernst & Young's October 2011 *Capital Confidence Barometer* survey for the real estate and hospitality industries, approximately 78.0% of global real estate executives expect asset prices to remain unchanged or to improve over the next 12 months. However, any future increases in lodging asset values are anticipated to be driven by improvements in cash flow as capitalization rates are believed to have bottomed out.

Several factors fueled an increase in US transaction activity in early 2011, including the perceived economic recovery, US monetary policy, significant amounts of capital raised to invest in distressed real estate, foreign interest in US real estate and improvements in the lending markets. Furthermore, REITs and foreign investors were the primary acquirers of hotels in 2011. Not surprising, given these buyers' typical investment profiles, the majority of acquisitions involved high-quality assets located in key gateway markets (75.0% of US transaction volume in the third quarter of 2011 occurred in gateway markets). Though higher-quality assets captured the attention of investors, lower-quality assets in secondary and tertiary markets did not receive the same levels of interest and are not anticipated to experience significant growth until core assets undergo a sustained recovery.

Europe has seen a similar increase in transaction activity, although still well short of the record levels experienced in 2007 and 2008. Gateway cities have seen the most activity, with London and Paris properties being in particular demand. The vast majority of deals have been single assets, with portfolio sales still thin. Individual "trophy" assets in the best locations still attract significant demand, and high sales values are still being achieved.

High-profile portfolio and single-asset transactions by large international hotel companies in gateway cities such as London and Amsterdam reflect a new driver of transactions. Major operators have recognized the need to put "skin in the game" to ensure brand expansion in the face of continuing limited availability of debt for developers. We may see further capital acquisitions by the major brands in order to secure strategically important assets, with the understanding that they may be unable to dispose of the freeholds themselves until the debt market, and consequently private equity and REIT demand, recovers.

Investors' focus on high-quality assets located in key gateway markets, combined with the limited supply of willing sellers, led to significant price appreciation and capitalization rate compression. Going-in capitalization rates for core assets decreased to mid-single-digit percentage points in certain markets.[1] Many opportunistic sellers opted to capture considerable price appreciation, including management companies pursuing asset-light strategies. For example, one of the publicly traded lifestyle-focused management companies sold select high-quality assets in key gateway markets in order to capitalize on favorable pricing, reduce debt and focus on hotel management activities.

The US economy was largely believed to be on track for recovery in early 2011, thus providing momentum for transaction activity by increasing lodging fundamental growth expectations (particularly for the luxury and upper upscale segments) and REIT share prices. As a result of the rise in REIT share prices to levels at or above net asset value, REITs were active in raising equity and acquiring high-quality assets, accounting for approximately 45.0% of the US$9.2 billion of large US hotel transactions through October 2011.[2] The role of REITs is expected to remain mixed in 2012 as REITs' appetite for acquisitions will largely be a function of the equity markets.

The US Federal Reserve's attempts to keep both short-term and long-term interest rates at historically low levels for the foreseeable future has provided incentives for investors to search for yield on alternative investments such as real estate. As a result of the "flight to quality," investor interest in high-quality assets with "bond-like" features grew significantly in 2011, thus driving transaction activity and pricing.

Because significant levels of capital were raised to invest in distressed real estate assets during the downturn, private equity funds were motivated to identify distressed acquisition opportunities. Rather than acquiring assets on an individual or portfolio basis, however, private equity funds focused on acquiring non-performing loans as the primary method of gaining control of distressed assets. This is evidenced by the acquisition of US$700 million of debt tied to a portfolio of 143 limited-service hotels,[3] for example. However, while lenders were active, sellers of distressed loans and lodging assets were not as active as expected, a result of challenges associated with the foreclosure process and managing operationally focused assets. Further, the low-interest rate environment gave lenders the ability to delay dealing with troubled loans, meaning that distressed acquisition opportunities were not as prevalent as originally anticipated in 2011. Private equity firms are anticipated to continue acquiring distressed loans

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for the foreseeable future, particularly in view of opportunities to obtain loan portfolios from troubled European banks.

In Europe, while the level of distressed sales continued to be less than expected at the start of the downturn, there are increasing signs that banks are prepared to take a more proactive view. Recent portfolio sales, as well as imminent sales, such as an anticipated sale of a portfolio of over 40 hotels expected to conclude early in 2012, will act as a catalyst for further bank-led portfolio sales. However, the recent Eurozone crisis and the subsequent downgrading in GDP forecasts across the region will undoubtedly be followed by a general downgrading of RevPAR forecasts, which may depress both valuations and the banks' appetite for quick sales.

Foreign interest in US real estate also stimulated transaction activity in 2011, with investment levels reaching their 2007 highs in the third quarter of 2011.[4] Chinese investors, in particular, were active buyers in the US given favorable currency exchange rates, the perceived security of US investments and programs that jointly promote both investment in the US and immigration (such as the EB-5 program).[5] Chinese investors accounted for approximately US$1.5 billion in acquisitions through October 2011,[6] including the US$570 million acquisition of five luxury hotels by a Chinese investor. Foreign investors are seen likely to continue to be active in 2012 given the attractiveness of US assets and favorable currency exchange rates.

Despite the noticeable recovery in transaction activity and asset values in early 2011, global economic events and conditions destabilized the recovery and placed downward pressure on transaction activity and values. These included continued weakness in US housing and employment, the European debt crisis and S&P's downgrade of US sovereign debt. These global economic concerns caused volatility in the equity markets (including REIT share prices, which declined approximately 34% from July to October 2011[7]), decreased growth estimates for lodging fundamentals[8] and increased borrowing costs. Furthermore, some market participants were also concerned that pricing for lodging assets may have been rising faster than the potential recovery in operating fundamentals.[9] As a result, hotel asset values decreased by approximately 4% in August 2011 although the estimated impact on lower-quality assets was probably greater.[10] Additionally, although US hotel transaction volume has increased each quarter since the fourth quarter of 2010, the trend was expected to come to an end in fourth quarter 2011.[11]

The overall conclusion is that the hotel market remains highly cyclical, with both performance and transaction levels linked closely to the wider economic environment. Consequently, 2011 may in retrospect be regarded as a false dawn insofar as a sustainable recovery in revenue and profitability is concerned. It seems likely that we will have to wait a while longer to see a return to a more historically "normal" level of transactions.

1 "Some Big Funds Target Bank Private Clients," *Real Estate Alert, 12 October 2011*.

2 Ibid.

3 "Five Mile Said to Buy $700 Million in Red Roof Debt to Take Over 143 Inns," Bloomberg.com, 31 August 2011.

4 "Cross-Border Capital in the US," *Real Capital Analytics*, October 2011.

5 "Chinese Investors and U.S. Hotels: A Rising Tide of Opportunity," HVS.com, 2 September 2011.

6 "Cross-Border Capital in the US," *Real Capital Analytics*, October 2011.

7 "Some Big Funds Target Bank Private Clients," *Real Estate Alert, 12 October 2011*.

8 "Lodging Sector Update," *Green Street Advisors*, 25 August 2011.

9 *Emerging Trends Report*, Urban Land Institute, October 2012.

10 "Lodging Sector Update," *Green Street Advisors*, 25 August 2011.

11 *Real Capital Analytics*, October 2011.

International tax considerations

Lodging companies, whether mature or in their infancy, continually face the challenge of achieving enterprise growth and brand expansion. Given the global nature of the lodging industry and the increase in cross-border investments, hotel companies have increasingly been seeking new investments and strategies in emerging markets, such as Brazil, China, Africa or the Middle East, in addition to well-established regions, such as the US, Canada or Europe. When investing in different countries in a variety of locales, it is critical to consider different tax regimes, as the success of an investment can be significantly influenced by taxes. Most businesses will be aware of the tax issues involved in investing in established economies, but investment opportunities in emerging economies are fraught with new tax challenges. If not considered early enough, the financial benefits of a transaction can be significantly reduced by taxes.

Generally, it is important to distinguish between direct taxes, such as income taxes or withholding taxes, and indirect taxes, such as value-added tax (VAT), transfer taxes and stamp duties or property taxes. While the structure and nature of investments may vary significantly, there are three broad strategies to consider when seeking international hotel investments; these include establishing a local corporation to own the property, acquiring management and franchise agreements as opposed to acquiring the real estate, and utilizing a foreign company as the owner or lessor of the property.

When seeking an international hotel investment, one strategy is to establish a local entity in a target country where the new hotel will be located. In this scenario, the international hotel company will be the shareholder of the newly established entity, and the structure will include either owning the hotel property outright or leasing it from a third party (e.g., a real estate investment fund) or a related party (a foreign or local entity with the same ultimate parent). In both cases, the new company is likely to be subject to taxation in the target country. The company will need capital to run the business operation and to pay the rent. The capital will typically be provided by a shareholder loan. Subject to the jurisdiction's thin capitalization rules, the interest expenses are deductible at the level of the new company while the shareholding hotel company can generate cash flow through interest income. The payments for the rent of the hotel property are also likely to be deductible at the level of the new lessee company; the lessor will have to pay income taxes on the rent income.

The international hotel company can receive a return on the investment in the form of interest income, royalties for the use of brands and dividends. Solid cash flows can be generated out of royalties and interest. However, cash flows generated from dividends are difficult to predict. A careful review of the local taxes and exchange control rules is necessary to guarantee the benefit of those flows. For instance, local withholding taxes that often arise on payments of interest, dividends and royalties need to be considered. These taxes in particular can significantly reduce the business's return on investment if not appropriately managed. As the payments are often subject to income taxes at the level of the recipient, it is essential to analyze double taxation conventions to benefit from available tax relief. Furthermore, in certain jurisdictions these payments can also trigger the assessment of indirect taxes such as VAT.

As this strategy requires founding a local entity, the exit scenario is quite complicated and can be lengthy; the shareholder either has to liquidate or to sell the local corporation to collect the final profit from the investment.

Another approach to establishing presence in foreign countries is the acquisition of management or franchise contracts. This strategy is a vastly different approach because the international hotel company is not investing in a corporation

If not considered early enough, the financial benefits of a transaction can be significantly reduced by taxes.

or in real estate as such. The intention of such agreements is to provide management and branding services and intellectual property in return for management fees. The advantage of this strategy is the relatively low investment risk (e.g., a low capital requirement), a continuous cash flow and a rather straightforward exit scenario. From a tax perspective, transfer pricing issues have to be carefully considered as the management fees should be fully deductible in the target country and therefore should lower the taxable income of the payer. Once again, withholding taxes, if not appropriately managed upfront (through structuring and effective contract negotiation), can also reduce the return on the contract. Consideration should also be given to whether the commercial structure gives rise to a tax presence in the local jurisdiction for the recipient of the income flows. This may be the case if management activities are undertaken locally.

Where real estate investment is the key area of focus for the business, another international investment strategy includes a foreign entity being the owner of real estate in the target country. Under this strategy, the international hotel company is the ultimate shareholder of the foreign corporation and an operating company, likely owned by third parties, is responsible for the day-to-day operation of the property.

A foreign corporation as lessor of the property receives rent payments that are likely subject to limited taxation in the target country. Under such an arrangement, double taxation agreements will typically assign the right of taxation to the target country and the foreign corporation will likely have to file tax returns in the target country. Despite the relatively high administration burden, the advantage of this structure is the solid cash flow that can be generated through the rent income. An exit scenario for this strategy would likely revolve around selling the property or the foreign corporation.

As illustrated with the strategies described, different investment structures, such as management contracts, owned hotels or leased hotels, have diverse and complicated tax effects in different countries. It is especially important to understand these effects when entering into new markets. There is no typical model or structure that can be followed to assure a tax-efficient structure, and on the whole, the business aims will drive the outcome. Ordinarily, because each deal is different, it will be necessary to create structures for each investment on a case-by-case basis. It is also common practice for an international hotel company to mix different types of structures. However, all structures have to take into account both direct and indirect taxes to achieve a tax-efficient result that does not adversely affect the overriding commercial business case for any investment.

Refurbish, reposition or redirect?

Over the past decade, "lifestyle" brands proliferated as hotel companies attempted to adapt to the evolving desires and needs of a new demographic and a new traveler. Boutique lifestyle brands rapidly emerged in urban centers around the world. Large international hotel companies rolled out plans and established new brands in primary and secondary markets to penetrate these markets, diversify their portfolios and maintain competitiveness. As the recession overwhelmed the world in recent years, and the continued soft economy and uncertainty in the financial markets dried up capital sources, hotel companies have had to shift investment strategies while continuing to tailor them to the unique challenges and opportunities of each global market. Development activity has slowed and all but ceased in some parts of the world, with the focus turning to rebranding and refurbishing (including redevelopment, repositioning and reflagging). This has allowed hotel owners and operators to continue expanding their brands and portfolios at a lower cost relative to new development and remain competitive by responding to the interests of today's traveler.[1] However, the trend toward the establishment of brand presence through development of new hotels continues to permeate emerging markets, such as those in Latin America and Asia.

In more mature lodging markets, such as those in Europe and North America, rebranding opportunities have materialized through consolidation. In order to expand their footprint, rather than developing new brands, large international brands have been converting small, regional brands or individual hotels to their own brands, or consolidating multiple brands into one in an effort to make the brand more recognizable to potential guests and to reduce overhead.[2] Despite uncertain economic fundamentals, rebranding efforts have not been devoted only to

limited-service and upscale hotels, which typically require less capital investment in comparison to luxury hotels. Instead, hotel companies have been expanding their portfolios through creating affiliation umbrellas for luxury hotels with the aim of allowing the hotels to maintain their own unique style and appeal but provide access to distribution and marketing systems and rewards programs.[3] Being affiliated with a large international hotel company but not "branded" in the traditional sense removes the need to comply with particular brand standards. In addition, the upfront investment is smaller. Hotel companies have also been able to rapidly penetrate markets and expand their global presence by bringing hotels in different geographies under such affiliations with minimal investment.

Over the past decade, the demands of the traveler have evolved rapidly; technology and social spaces that fuse business and pleasure have emerged as key preferences. Brands developed during the latter half of the last decade are well positioned to respond to the wave of guest demand for new facility and amenity offerings. These include inviting social spaces, open lobbies, seamless technology and distinctive designs that target demand from non-hotel guests for the food and beverage departments — a phenomenon that historically has not been the priority for more traditional brands. As a result, it has been critical for hotel companies to focus on system-wide brand refreshes and repositioning of existing hotels in order to maintain relevance and competitiveness. In some cases, hotel companies must refresh hundreds of existing hotels within their portfolios. It is anticipated that rebranding and refreshing activities in 2012 will incorporate some or all of these changes in guest demand, and most will trickle through other brands and lodging segments in the coming years.[4] While much energy and capital are invested in refreshing and expanding hotels, hotel companies have also been reassessing their portfolios and determining whether to discontinue or redirect certain brands in accordance with current market dynamics and trends.

Additional opportunities to rebrand are occurring as distressed hotel properties are being sold, rebranded and repositioned in their respective markets. These properties are positioned to have the largest potential impact on their local lodging markets as their competitors have benefited from distracted owners and operators or underfunded competition for the past several years. They now face competitors that are stronger, repositioned, and, most importantly, recapitalized. The sale of these properties, particularly in Europe, which has historically had a larger number of independently managed, unbranded hotels in comparison with North America, has opened the market to a greater number of third-party operators and franchisees. Going forward, there should be an increased opportunity for institutional hotel investment and franchise opportunities in Europe as the presence of third-party operators increases.

While hotel companies focus their market penetration and brand expansion efforts on development in emerging markets, market penetration led by rebranding initiatives of acquisitions and existing portfolios are expected to remain commonplace in more established markets in 2012 and into 2013. As the economy begins to improve and global lodging brands look to expand their presence in underrepresented markets, hotel companies are anticipated to continue acquiring or consolidating local and regional brands. Such a route limits their exposure to delays in the development process and those caused by the construction finance process.

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3 "Autograph Collection Celebrates Debut of First Nine Hotels in Europe With Star-Studded Event in Rome," www.marriott.com, 11 November 2011.

4 Sachdev, Ameet, "Hyatt to rebrand its Summerfield Suite Hotels," *Chicago Tribune*, 20 September 2011; "DoubleTree By Hilton Celebrates Year-Long Global Rebranding Initiative," www.doubletreebyhilton.com, 25 May 2011; Kormanik, Beth, "How Research Should Inform Design," *Hotel Interactive*, 21 February 2011.

Emerging destinations and emerging travelers

The changing dynamics of international travel trends, driven by the increased investment in BRIC countries and the rapid expansion in travel from emerging economies, will create new opportunities for investors and operators around the globe.

Despite concerns regarding sovereign debt in Europe and the outlook for the economy in the US, 2011 marked a year of continued recovery in global travel and tourism, primarily driven by emerging economies. The recovery in worldwide tourism continued in 2011 although at a slower pace than initially forecasted.[1] According to the World Trade and Tourism Council (WTTC), travel and tourism (T&T) GDP growth was 3.2% in 2011, nearly the same rate as in 2010, when T&T increased by 3.3%. Total turnover generated by T&T was US$6.0 trillion in 2011, surpassing the previous peak of US$5.8 trillion achieved in 2008.[2] While T&T increased by 1.7% in developed economies during the year, tourism GDP in the BRIC countries (Brazil, Russia, India and China) rose by 14.9% in 2011.[3] The strongest gains in tourist arrivals were in South America, South Asia and Europe, while North Africa and the Middle East registered a drop in arrivals as tourism was negatively affected by political events in Egypt, Syria, Libya and Tunisia. According to the WTTC, international tourist arrivals recorded globally reached an all-time high in 2011 with more than 980 million travelers. This was up 4.5% from 940 million travelers in 2010, and slightly above the long-term average growth rate of 4.0%.[4]

The shift in tourism growth to emerging economies is evidenced by changing passenger volume in airports around the world. According to Airports Council International, the five countries with the largest growth in airlift in 2011 were India, Brazil, Turkey, the Philippines and Malaysia. Increasingly, airports in emerging destinations, such as Istanbul, Shanghai, Buenos Aires, Lima and Moscow, are driving global growth in tourism with double-digit increases in airlift in 2011.[5]

The expanding middle class and infrastructure improvements in emerging markets are expected to support tourism growth in coming years. Among urban households in China, for instance, income per capita has increased at an annual rate of more than 12.0% since 2007. According to the China National Tourism Institute, the country is expected to be the world's largest source of tourists by 2015.[7] Newly implemented infrastructure has also been a catalyst for private sector investment in tourism. For example, from 2002 to 2007, the Chinese Government invested approximately US$50.0 billion in Beijing's infrastructure in preparation for the 2008 Summer Olympics.[8] Similarly, Brazil is expected to make approximately US$1.0 trillion in infrastructure improvements in preparation for the 2014 FIFA World Cup and the 2016 Olympic Games. As a result of these investments, hotel operators have expanded investments in emerging economies. One large, internationally recognized hotel company reported that in 2011, it opened a new hotel in China every other week and has another 90 hotels in the pipeline.[9]

Despite these positive indicators for growth, industry analysts cite continuing impediments to increased tourism in emerging economies. These range from power outages and unavailability of water in India to uncertainty regarding Government regulation and property rights in China.[10] Brazil has been hampered by a complicated tax system and lack of equity capital that have negatively impacted international investment in the country. Inbound tourism to Russia has lagged because of onerous visa restrictions for foreign tourists and high costs for food and entertainment.

Due to the growth in travel from BRIC and other countries, developed economies are expected to continue efforts to take advantage of this new source of tourism through travel promotion activities and adaptation of hotel properties to the tastes and preferences of new travelers. In the United States, the total number of Chinese visitors is estimated to have risen from 802,000 in 2010 to 1,098,000 in 2011, a 36.9% increase.[11] Regional tourism boards have stepped up marketing efforts to attract Chinese visitors to destinations other than such mainstays as New York and Las Vegas.[12] Operators have also expanded initiatives to accommodate the unique tastes and preferences of travelers from China. For example, a European hotel services group recently signed a partnership with a prominent Chinese hotel operator to facilitate the implementation of new amenities targeted toward Chinese travelers. These include co-branding, Chinese language signage and marketing collateral, Chinese television programming and restaurant menu items.[13] In spite of these efforts, visa restrictions continue to challenge the abilities of developed economies to fully capitalize on the growth in travel from emerging economies. For example, it costs the typical family from Brazil more than US$2,500 in visa fees to visit the US. And with only four US consulates in the entire country, visa wait times can be greater than 120 days.[14]

As the global tourism recovery continues, the changing dynamics of international travel trends, driven by the increased investment in BRIC countries and the rapid expansion in travel from emerging economies, will create new opportunities for investors and operators around the globe.

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3 Data from World Trade and Tourism Council, November 2011.

4 *UNWTO World Tourism Barometer*, World Tourism Organization, August 2011.

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13 "Louvre Hotels Group Enters Partnership with Jin Jiang Inn Co," hospitalitynet.org, 29 November 2011.

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Green: the new normal

As consumer awareness of environmental issues continues to rise, integrating green strategies into design, construction and daily building operations is becoming more relevant and can be an important part of a company's overall commitment to sustainability. Meeting sustainability standards has become more important as properties that do not meet them are expected to experience lower occupancies and resale values. Building owners anticipate that valuations of newly built, green buildings have increased approximately 10.9% in 2011, with return on investments of approximately 9.9%.[1] Occupancy in these properties increased 6.4% while rental rates rose an average of 6.1% post-certification. A number of green certifications exist globally, including Leadership in Energy and Environmental Design (LEED), Green Globe, Green Key, Energy Star, Green Seal and the Sustainable Tourism Eco-certification Program (STEP). Each serves as a guide for various components of building and operational sustainability. The widely accepted LEED certification has been adopted by more than 30 countries and continues to evolve to adapt to the higher demand for certification guidance.

Irrespective of certifications, hotel owners and operators are increasingly identifying significant opportunities to reduce negative environmental impacts associated with guest rooms, event space and general facility use through such measures as energy and water efficiency, waste reduction and management, sustainable and local purchasing, and the use of alternative transportation. Hotels are also proactively contributing to user health by providing comfortable and productive environments with improved indoor air quality, access to daylight and views and occupant control of lighting and thermal environments.

In the United States alone, hotels represent more than 5 billion square feet of building space, nearly 5 million guest rooms and close to US$4 billion in annual energy use. Green buildings use, on average, 26.0% less energy, emit 33.0% less carbon dioxide, use 30.0% less indoor water, and send 50.0% to 75.0% less solid waste to landfills and incinerators.[2] So why is green development still a point of contention for some? The common sentiment has been that green lodging development is expensive, and that a payback for the additional green investment is beyond the ideal timeline of most developers. However, lodging operators have acknowledged that the initial cost of investing in materials and methods to meet green standards is not as steep as it was a few years ago. The cost savings in just the first few years more than make up the additional costs that may be incurred (e.g., alternative material use and related fees). Further, additional benefits, such as improved guest satisfaction and a more engaged employee base, yield results beyond the bottom line. While the room rate premium for green hotels will continue to be debated (estimates range up to 5.0%), the effect of sustainability practices on a hotel's triple bottom line (people, planet, profit) has proven to be an invaluable measure of success.

As of May 2011, 96 lodging properties globally had achieved LEED certification, with an additional 1,100 lodging projects registered and working toward certification.[3] Regional lodging operators, particularly in Latin America, Asia and the Middle East, are taking notice and are incorporating sustainable strategies into development and renovations, despite the inherent challenges of adapting to US-based LEED standards at a local level. LEED-certified hotels can be found in locations as varied as the United States, India, Peru, South Korea, Chile, Spain, Mexico, United Arab Emirates, Indonesia, Sri Lanka and Finland.

Acknowledging that sustainable hotel practices are no longer optional, international lodging operators continue to implement sustainability measures from the corporate office to the property level. Recently, a leading international lodging company launched a green prototype that has been pre-certified as part of the LEED Volume Program, meaning that any developer that chooses to follow the plans may obtain LEED certification. The company plans to have nearly 300 LEED-certified hotels by 2015 and estimates that owners that build through the LEED Volume Program could save approximately US$100,000 in soft costs and six months in design time. The operating savings through energy and water were estimated at approximately 25%, setting the break-even point, including construction costs, at five to six years.

In addition to LEED certification, a number of hotel companies have developed their own programs to manage sustainability efforts reaching far beyond design and construction. In 2011, another leading global hospitality company announced the results of its sustainability measurement program, LightStay, citing savings of more than US$74 million in utility costs since the program's inception in 2009, through a 6.6% reduction in energy use, 7.8% reduction in carbon output, 19.0% reduction in waste output and 3.8% reduction in water use.[4] Furthermore, an India-based luxury hotel group launched EARTH (Environmental Awareness and Renewal) in 2008, which focused on three key areas — energy efficiency, water management and waste management — while benchmarking its sustainability practices through Green Globe certification. Yet another US high-end hotel and resort company has announced a plan to reduce energy consumption in its entire portfolio by 30.0% by 2020, and to reduce water consumption by 20.0%. Additionally, one of its brands only uses LEED guidelines in construction after determining that certification can be achieved with a modest cost premium typically recovered within a few years. The international lodging landscape has created an environment where sustainability is no longer seen as a public relations campaign but rather as a strategic means of managing operating costs to generate greater returns and satisfy both guests and employees alike.

Hotel company-level programs such as these demonstrate the increasing trend toward voluntary disclosures by hotel companies and the new dynamic of reporting sustainability performance to customers, shareholders and government regulators alike. Combined with tax incentives that may be available for green developments, as well as rebates from local utility companies, the increased investment in green can be mitigated. The sentiment in the lodging community is that all levels of government will eventually mandate sustainable development and operations, creating a greater need for sustainability reporting, greenhouse gas emissions regulation and climate policy compliance.

While the case for sustainable development continues to gain momentum, obstacles for lodging operators are still in place. Lodging market representatives note that vendors and other components of the supply chain continue to lag behind, citing lack of demand for more sustainable product offerings. Others point to the "mystical language" of LEED as a deterrent that makes it difficult for some properties to adapt accordingly without incurring additional consulting costs. Any hotel can be "green," but guests seek validation and certification through third-party verification of design, construction and operations. As part of hotel corporate strategy, companies are demonstrating an increasing need to allocate the adequate resources dedicated to green measures, all the while effectively communicating the impact on the bottom line to stakeholders, guests and employees.

1 *Green Outlook 2011: Green Trends Driving Growth*, McGraw-Hill Construction, 2010.

2 www.usgbe.org/hospitality

3 *LEED Hospitality Projects List*, U.S. Green Building Council, May 2011.

4 www.hiltonworldwide.com/corporate-responsibility/sustainability/action

Mega events: building a lasting legacy

The hosting of a global event represents a rare and unique opportunity to share a country's hospitality with the world, capitalize on attention and visitation resulting from the event and attract long-term private and public investment to the area. Although candidate cities compete furiously for every opportunity to showcase their corner of the world, the historical short- and long-term impacts of hosting such events has varied significantly. As this decade once again will bring a number of mega events (e.g., the World Cup and Olympic Games) to both established (e.g., London) and emerging (e.g., Brazil and Russia) tourist destinations, investors need to consider the complexities involved with investments related to mega events. More particularly, they should review the lessons learned from previous events with regard to the appropriate mitigation of the upfront challenges while at the same time capitalizing on the long-term opportunities and direct and indirect economic benefits that these events bring.

For the lodging industry, creating an "oversupply" of lodging space is an ever-present risk when preparing for mega events — especially in emerging destinations. Assessing supply and demand dynamics related to the particular event, in addition to other regional and macro lodging indicators, is especially critical. South Africa's World Cup 2010 was a recent example of the impact of aggressive supply growth with a 5.7% compound annual growth rate (CAGR) of room supply over the two years preceding the 2010 event. Consequently, hoteliers in the country experienced 20.0% to 40.0% decreases in year-over-year RevPAR across their primary markets for the first six months of 2011.[1] Looking ahead, Brazil is expected to increase its room supply by 30,500 rooms over the next three years,[2] representing only a 2.2% CAGR based on current room supply. Specifically, less than 10.0% of this new supply is expected in Rio de Janeiro, where the 2014 World Cup and 2016 Olympics will be held, with 17 new hotels totaling 3,000 rooms in the pipeline between now and 2014.[3] Rio and the country as a whole have shown proactive efforts to curb oversupply with the planned use of idling cruise ships to supplement permanent hotel supply while high barriers to entry, notably growing land costs, have slowed the ability to add new hotel supply to the area. Notably, Brazil has already seen property prices in some of its key markets increase by 50.0%–60.0% over the past 24 months.[4]

Although mega events induce a mostly positive impact on a local hospitality environment, at least in the short term during the events, the impact can also be negative in some respects. The overall effect of the 2012 Olympics on London's lodging market performance is in question as there are concerns that the usually strong performance of the market might be diluted by more price-sensitive demand associated with the event and, as a result, higher-paying guests and those coming to London because of the exclusivity of the hotels and private events might seek alternative locations during this period. In all instances it remains critical that investors understand the true long-term demand profile for local markets as the lack of transparency can easily distort the true underlying requirements for new supply.

Outside of the supply-side risks, investors and hotel companies need to consider the intricacies of the local market when evaluating potential investment. Two of the most pertinent risks are regulation and transparency, always most prevalent in emerging markets often suffering from highly bureaucratic and less-than-efficient regulatory environments. Some countries, notably Brazil, have taken proactive steps to become more transparent, with the formation of the 2014 World Cup Management and Monitoring Support System (SGMC) and associated "Transparency Portal" providing data and progress updates across multiple categories for the viewing public. Such proactive steps are encouraging for investors but are not a replacement for strong relationships and an understanding of the local business environment.

Investors also need to consider the labor requirements and associated costs when evaluating new investment projects. Massive infrastructure projects drive construction prices up, which can significantly affect project-level returns. In addition, insufficient human capital — both skilled and unskilled — can become a major hurdle for both construction projects and operating hotels. London has avoided this issue due to its proximity to the continental European labor pool, which is estimated to be supplying

up to 50.0% of the construction labor for the current London 2012 projects. In contrast, Brazil's high employment and language barrier with surrounding countries will likely hinder its ability to depend on labor migration to mitigate labor costs; thus, it will require more creative solutions.

As host cities are able to mitigate these risks, the likelihood of capitalizing on their investment in the long term increases greatly. In emerging markets specifically, infrastructure investments, such as highways, airports and cruise terminals, can greatly enhance tourism for their cities, both internationally and domestically. China, host of the 2008 Summer Olympics, saw domestic tourism increase by 36.4% from 2006 to 2009, adding more than 500 million annual tourist visits and US$60 billion dollars to the local economy.[5] Brazil and Russia, with populations of 203 million and 139 million,[6] respectively, have an opportunity to expand their domestic tourism industries through careful planning and execution of their infrastructure investments, especially as their middle classes grow.

Phase II of Brazil's Growth Acceleration Plan (known as PAC II) has R$109 billion (US$59.7 billion) earmarked for transportation investment across the country. Additionally, Brazil's National Bank of Economic and Social Development announced a line of credit of R$1 billion (US$53.2 billion) specifically targeted for the renovation, expansion and construction of hotels in support of their hotel system requirements for both the World Cup and 2016 Olympic Games.

For the city of Sochi, Russia, the 2014 Winter Olympics are bringing a much needed infrastructure upgrade, as well as the opportunity for the region to become a year-round resort area rather than the strictly summer destination it currently is. Limited transportation and engineering infrastructure have historically made the area unattractive for new hotel developments, and over the last 20 years, only one international hotel company has developed a property there. The decision to hold the 2014 Winter Olympic Games in Sochi resulted in strong financial support from the federal and regional governments, aimed at building new roads, bridges, tunnels, centralized power, heating, water and sewage systems. The total government investment in Olympic-related projects will comprise RUB 327 billion (approximately US$10.9 billion). Financing from non-government sources (including private investor funds) is distributed as follows: tourist infrastructure — US$2.6 billion; Olympic venues — US$500 million; transportation infrastructure — US$270 million; and power supply infrastructure — US$100 million. Approximately 40 hotels (three-, four- and five-star) are either being developed or refurbished, representing approximately 16,000 rooms. Large investments in the construction of Krasnaya Polyana ski resort, located in the mountains above Sochi, as well as a large new stadium and sports arenas on the seashore, are expected to be a lure for visitors throughout the year and help to make Sochi an all-season Russian resort and sports center.

For investors, mega events represent significant opportunities to enter geographic regions or industries as they are typically accompanied by large pools of both public and private capital targeted for projects. These types of support, in the form of subsidized interest programs, directly impact the improvement of the local infrastructure while representing a major opportunity for investors looking to increase their returns through leverage.

In the end, only time will tell how well these upcoming host cities learn from past lessons and successfully navigate the various elements in search of the envisioned lasting economic impact. Despite all the nuances and risk associated with pre-development planning and initiatives, the true legacy of such events for tourist destinations comes from how countries plan and manage their entry into and exit from the momentary limelight. The most successful host cities, such as Barcelona, have not been content with simply preparing for their mega events but have also developed marketing and tourism programs to support their investment well after the events have ended. Investors evaluating opportunities in host cities should be cognizant of each city's post-event plans as the bridge to a sustainable mega-event legacy.

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2 "Lodging industry in numbers: Brazil 2011," Jones Lang LaSalle Hotels, 2011.

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US GAAP versus IFRS: "condorse" to align

Key metrics and externally reported financial results for hospitality groups continue to lack direct comparability despite attempts to converge accounting standards; however, significant financial reporting changes are expected in the future that will address this issue. These changes will require preparation by the industry. Starting early is the best way to avoid unwanted surprises and costly missteps.

The majority of public hospitality groups currently use one of two frameworks of generally accepted accounting principles (GAAP) across the globe: US generally accepted accounting principles (US GAAP), which are regulated by the Financial Accounting Standards Board (FASB), or International Financial Reporting Standards (IFRS), monitored by the International Accounting Standards Board (IASB). Various major global economies are in the process of completing or considering their conversion to IFRS — Brazil and Japan, for example — while more than 100 jurisdictions already mandate or permit IFRS. Although a comprehensive conversion to IFRS has been under consideration by the US Securities and Exchange Commission (SEC) for a number of years, the agency has yet to adopt a formal timeline for the change.

During 2011, the FASB and IASB (the boards) have made progress with the issuance of revised or new accounting standards. They continue to work together on specific joint projects designed to align reporting practices for transactions that are essentially the same. As part of its work plan to consider whether, and if so, when and how IFRS should be incorporated into the US financial reporting system, the SEC staff recently released three papers outlining a possible method of doing so, along with other analyses of IFRS globally.

The method suggested was for the US to move toward IFRS using a transitional process — known informally as "condorsement" — whereby the US FASB would incorporate newly issued IFRS into US GAAP following its own endorsement protocol. However, it appears unlikely that every major difference between US GAAP and IFRS would be eliminated under this approach. It is important for participants in the US capital markets, as well as global capital markets, to understand this likely outcome before committing to the process.

Currently, several key accounting differences still exist between US GAAP and IFRS that could have major impacts on the hospitality sector. These include accounting for leases, property, plant and equipment, customer loyalty programs, revenue and impairment. Critical joint projects to align accounting for leases and revenue recognition are expected to be completed in 2012. But with implementation of these reporting changes expected to be mandated starting in 2015, it will still be several years at least until directly comparable financial information is available for the analyst, investor and financing communities. It is also unclear whether the boards will actually achieve convergence on such joint projects as financial instruments before the SEC makes a decision about convergence with IFRS.

2011 saw the issuance by the IASB of revised accounting standards for consolidated financial statements, joint arrangements and related disclosures, resulting from the 2006 Memorandum of Understanding (MOU) between the FASB and IASB and in response to the financial crisis. The FASB completed its project to address issues for consolidation of variable interest entities (VIEs) and related disclosures although some work continues on certain aspects of consolidation under US GAAP. The IASB and FASB have indicated that they believe the requirements for consolidating structured entities and VIEs, as well as for joint arrangements, to be substantially converged. Again, however, differences will still remain even after completion of these projects due, for example, to the application of the control principle. In the near term, hospitality groups reporting under IFRS will need to revisit their accounting for joint arrangements, including the accounting for investments in entities subject to joint control that may own one or more properties. The new standard includes a revised decision-making process to assess the appropriate accounting for joint arrangements, which requires all groups to consider implications for periods from 1 January 2013 (with 2012 comparatives to be restated).

The FASB and IASB are closer to agreement on aligning accounting for leases and revenue recognition with re-exposure of both being undertaken because of the significant change required following an unprecedented response. Many respondents commented that the proposed approach for leases was overly complex, costly and in some cases, inconsistent with the economics of the underlying transactions. The new model will still result in a gross-up of the balance sheet and a deterioration of the debt-to-equity ratio and return on assets compared with current accounting. The timing of expense recognition will accelerate and be recharacterized as interest and amortization expense rather than rental expense, as it is today. This would improve financial metrics such as EBITDA but could require new disclosure to explain underlying "operating results" as these current profit measures will no longer include lease charges. A particular area of focus for the sector is also the potential change in accounting for sale and lease-back transactions with the initial assessment of whether a sale has occurred and timing of recognition of any gains on disposal completed on the basis of the revised revenue recognition proposals.

The magnitude of change that will arise for hospitality groups from the expected FASB condorsement process and new IFRS standards should not be underestimated. This change will require the establishment of cross-functional project teams that incorporate key stakeholders to ensure a smooth and efficient transition. Finance teams need to engage now with other business functions, including legal, IT, procurement, treasury, tax, property and investor relations to provide for successful application and communication of financial results.

Valuation in a shifting market

With improved lodging fundamentals, interest in the lodging sector was undoubtedly renewed over the course of 2011. From a valuation standpoint, however, current market dynamics paint an unclear picture, most reminiscent of 2008 and 2009. The hotel transaction market was active in 2011, with global transaction volume increasing 18.0% over 2010 levels to approximately US$30 billion.[1] This provided a number of valuation data points. However, unforeseen political, economic and external events once again complicated valuation practices. Investors are increasingly challenged to adapt conventional techniques for estimating hotel values to account for the unique and unexpected dynamics of today's transaction and market environment.

Globally, investors have traditionally relied on a 5- or 10-year discounted cash flow (DCF) or a sales comparison approach for investment analysis. A DCF gives an indication of a hotel's value, provided that valuation assumptions reflect the present operating and capital market environment. However, current investment parameters are unique to recent history and may result in misleading hotel valuations. The inability to access debt financing throughout much of the world has skewed indications of value derived under the traditional DCF approach. Furthermore, with only few transactions taking place, it is difficult to determine whether comparable sales prices are applicable and market capitalization rates are appropriate. Therefore, the choice of the most appropriate valuation methodologies and key assumptions should continue to be made on an individual asset basis.

Values are now more susceptible to shifting market dynamics and external forces. While the transaction market was active in the first half of 2011, the details of the trades have provided investors with mixed messages. Though few assets changed hands in the second half of the year, overall sentiment indicated continuing low cap rates for the full-service segment in the third quarter of 2011.[2] The inconsistent recovery observed across lodging segments in the US reflects a larger global trend. Throughout the Americas, Europe and parts of Asia, investors' continued inability to access financing and navigate economic uncertainty remain a primary valuation concern. The lack of smaller-scale hotel transactions, caused by the "flight to quality" of trophy assets in key gateway cities, has prompted many investors to shift their focus from cap rates to cash flow. While transactions still hold weight in a hotel valuation, alternative metrics, such as dollar-per-key capitalization benchmarks, and input from management have become increasingly important methodologies and factors to consider.[3]

In Europe, the Middle East and Africa, recent hotel valuations have rested on a foundation of economic and political turbulence. The sovereign debt crisis experienced in Western Europe, coupled with governmental unrest in the Middle East and Africa, has clouded valuation estimates across the region. However, despite perceived investor sobriety, signs of value stabilization and upward movement are present. In Germany, increased business travel in the manufacturing and export sectors has heightened domestic lodging demand.[4] In addition, while valuation expectations in the UK remain flat in areas outside of London, the 2012 London Olympic Games offer a positive short-term outlook for the London lodging market. In the Middle East and Africa, downward pressure on growth rates has resulted in higher cap and discount rates. However, previous fears of lodging oversupply have calmed as declines in the development pipeline will likely limit the absorption of new supply in the near term.

The unexpected occurrence of natural disasters in the past year has lowered hotel valuation prospects in many Asian markets. Record-breaking floods in Bangkok have decreased performance expectations for Thailand's growing lodging industry.[5] In Japan, the devastation following the March 2011 earthquake has added volatility to the lodging sector. While cap and discount rates remain stable, depressed operating metrics, coupled

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with risk-averse equity investors, have decreased values in Japanese hotel assets. Going forward, lodging recovery in disaster-affected areas will be tied to an increase in tourism and a restoration of confidence over the next 12 to 18 months.

Management of extraordinary growth remains the focal point of hotel valuations in the world's emerging economies. As supply surges in top destination cities like Beijing and Shanghai, many Chinese cities remain underdeveloped from a hospitality perspective. A flurry of development activity in a not-yet-stabilized market will likely affect hotel valuations in China for the foreseeable future. In South America, a strengthening Brazilian economy, coupled with the upcoming 2014 FIFA World Cup and 2016 Summer Olympic Games, has further fueled international investment. Yet valuation in the presence of unprecedented growth does not come without challenges. In India, tight lending restrictions as a result of rising inflation have quieted the trading market in recent months.[6] Additionally, despite strong short-term growth prospects, long development times and excessive bureaucracy remain key challenges to investors in Russian hotel assets.[7]

Through the volatility, investors remain optimistic about a global market recovery. A November 2011 survey conducted by the Hotel Investment Barometer found that more than 90.0% of respondents anticipate a lodging market peak to occur after 2013.[8] However, short-term economic and political challenges will likely slow the speed of global lodging growth. As the lodging industry prepares for the next market peak, hotel owners, operators, investors, lenders and appraisers must continue to account for both present and future market conditions in the valuation of hotel assets.

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5 "STR Global reports on Bangkok flooding," www.hotelnewsnow.com, 31 October 2011.

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