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## Changing Ownership Structures



## Foreword

Hotels have been bought, operated and traded for many years, traditionally by individuals (often families, especially in Europe and Asia) or hotel operating companies. Until the last few years, however, they have not been popular targets for investment by mainstream or institutional property investors, especially in environments such as the UK where management agreements are the common type of operating structure. Many mainstream investors lack specialist knowledge of the hotel industry, making more difficult the negotiation of operating contracts and the subsequent and necessary asset management of the managed hotel.

In Continental Europe, property investment returns demanded by institutions have been lower than in the UK, and this has enabled operators to enter into leases with guaranteed rents at a lower level than would be required in the UK. There has thus been more institutional investment in European hotels on leases where the investor has no participation at all in the hotel operation. Asian and American investors have also felt more comfortable with the sector, and in their property asset-allocation models have more frequently included an allowance for hotels.

A number of factors have now made hotel property more widely accepted as a worthwhile investment target by a much broader cross-section of investors. These factors include reducing returns in the commercial property market coinciding with a period of strong hotel performance; increasing availability of finance; pressure on hotel operating companies to grow distribution, resulting in their increasing willingness to take on leases; and the emergence of a number of different ownership vehicles.

In this edition of Hotel Topics, Jones Lang LaSalle Hotels explores the different ownership structures currently prevailing in the three principal regions of the world – Europe, North America and Asia Pacific. We also provide a breakdown of the top hotel owners and discuss changing trends in hotel ownership, looking forward to possible future scenarios.

We hope you will find this edition of Hotel Topics interesting. Your feedback is of value to us, and we would appreciate your comments on this edition, as on previous ones. Please contact me or Karen Astbury ([karen.astbury@eu.joneslanglasalle.com](mailto:karen.astbury@eu.joneslanglasalle.com)).



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Melinda is responsible for strategic investment research for Jones Lang LaSalle Hotels, along with the marketing and tactical execution of global research for Jones Lang LaSalle. She has over a decade of experience in the hotel industry and has published a number of reports, being widely quoted in the US and international press.



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Mike has over 10 years experience in the Hotel and Tourism industry. He currently heads up the Investment Sales division for Jones Lang LaSalle Hotels for Queensland and New Zealand. He is responsible for the marketing and sale of hotel and tourism property in some of Australia's most sought after tourist destinations.



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Saowanee recently completed her MBA with Merit at Royal Holloway, University of London. Her dissertation, the inspiration for this particular Hotel Topics, was entitled "What impact has the globalisation of hotel management companies had on European hotel ownership trends?". Prior to her MBA, she worked for five years with British Airways, having graduated with Honours from Chulalongkorn University, Thailand's leading university.



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## EUROPE

By Saowanee Teerapittayapaisan, Independent Hospitality Consultant, Karen Astbury, Associate, and Valerie Clack, Vice President

European hotel investment sales have grown at an average rate of 14% per annum since 1991 but over 29% per annum since 1994. This phenomenal growth rate has resulted from a series of coinciding factors that have driven change in ownership structures in the region.

### The Changing Ownership Landscape

Individual hotel investment in Europe has soared since the early 1990s, culminating in 2000 when a record Euros 2.3 billion were invested in the UK and Europe. This volume of transactions, which does not include M&A and portfolio activity, has been both a cause and a consequence of a significant shift in ownership patterns in Europe.

Overall, in terms of the ownership structure of its hotel stock, Europe is still dominated by owner-operators, whereby a single company (often a family or private company) owns, manages and markets its own hotels. Such structures remain applicable to about 71% of European hotels.

#### HOTELS BECOMING A MAINSTREAM ASSET CLASS

This pattern is beginning to change, especially in the UK and France, and a significant shift has taken place in the status of quality hotels, which have now become a mainstream asset class. Buyers have ranged from funds and banks to property companies, institutions, specialist hotel investment vehicles and partnerships, as well as the more traditional hotel buyers – individual investors and owner-operators. Factors behind the change include:

- A strong trading cycle for hotels, accompanied by improving profitability and investment returns, this coinciding with a new era of low inflation, low interest rates and, latterly, poor equity performance;
- Increasing hotel asset values, which began to surpass office values (traditionally the property asset class of choice for institutions), making hotel conversions more viable;
- An explosion in equity available from German and American funds, and in debt available through European and American banks, increasing demand for investment opportunities;
- Increasing M&A activity in the hotel sector;
- Pressure on the major hotel operating companies to release capital tied up in real estate to pay down debt and concentrate on brand development to drive share value;

- Greater competition for product among hotel operators, making them more flexible about operating agreements;
- Increasing availability of investor-friendly leases, with guarantees or turnover-related components allowing lessors to share in the trading upside (traditionally the advantage offered by management contracts);
- Improving transparency and knowledge of the industry among the major players and consultants – many European banks now have specialist hotel investment teams;
- Development of specialist hotel investment vehicles to take advantages of this unique set of circumstances.

#### INCREASING AVAILABILITY OF INVESTOR FRIENDLY LEASES

A spiral of demand and supply has thus been created, fed by private sellers capitalising on historically high prices to get out of the industry and hotel companies either rationalising their portfolios or seeking to release capital.

### Branding

The broadening of hotel ownership has taken place in concert with the growth of branding across Europe, itself the result of strong hotel trading since the mid-1990s, improving profitability and investment returns, and the increased availability of equity and debt financing.

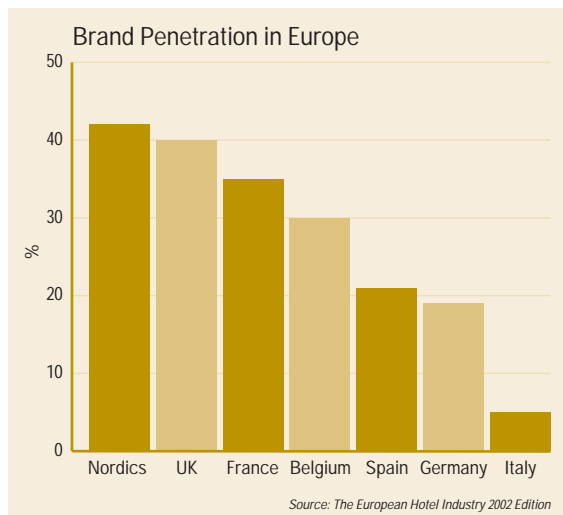
On the one hand, independent hoteliers have suffered from the lack of an internationally recognised brand, which has prevented them from driving demand, room rate and profitability in the booming trading cycle to the same extent as their branded competitors. Such owners have been more willing to sell in a period of historically high prices.

On the other hand, the larger (primarily US) hotel operating companies could not raise the capital to grow acceptably fast through pure owner-operation and for many years have been increasing their brand representation through management contracts and franchising. This is reflected in the PropCo:OpCo

split that has proliferated in recent years, notably in the separation of Marriott International as a pure operating company from Host Marriott, which owns all the real estate – the classic ‘bricks:brains’ split so favoured by the stock market.

**GROWTH IN THE BRANDED HOTEL SECTOR IN EUROPE**

These trends led to growth in the branded hotel sector in Europe, but it still accounts for only 19% of total room stock across Europe (or 27% averaged across the five largest markets) compared to about 70% in the USA. The potential for future branding and further broadening of hotel ownership in Europe is therefore considerable. Although many European owner-operated hotels are of small size and often unsuited to branding; others may be suitable for operation under a franchise agreement, which offers the benefit of branding while retaining ownership and control. This may enable family owner-operators to improve trading performance when capital expenditure is required to upgrade brand standards.



It is the quality branded hotels (operated by national or international hotel chains) that are of interest to, and have become the target of the wider investment market. Some of them are still held by owner-operators, but others have become the property of specialist investment vehicles or funds.

**European Specialist Hotel Investment Vehicles**

The rise of specialist European hotel investment vehicles has been both rapid and recent. It has reflected the development of such entities in the USA and their entry into the European market in the late 1990s, when US REITs and specialist hotel investment companies like Strategic Hotel Capital were actively investing in European hotels.

**RAPID INCREASE IN SPECIALIST EUROPEAN HOTEL INVESTMENT VEHICLES**

However, only one major European player in the sector, Deutsche Interhotel, has been focusing on hotels for more than seven years. Most of the others of the 13 principal European investment entities identified have been active for four years or less, i.e. since just before the peak of the trading cycle.

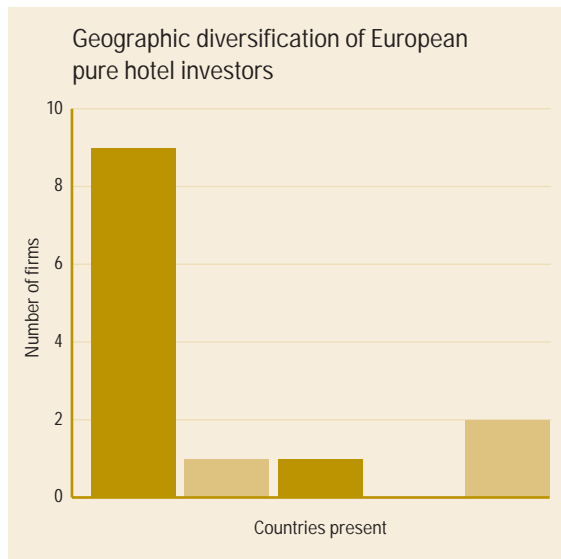
Partly due to their recent creation, the European investment groups are still small compared both to the larger hotel companies like Marriott International (operator) or Hilton International (owner and operator), and to companies in other industries. Only nine of the 13 investment entities identified had a portfolio book value of more than Euro 500 million, and only the RBS portfolio has a book value of over Euro 1 billion. Looked at another way, the top 13 of the groups that were studied only own 57,439 rooms, equal to only about 1% of Europe’s total hotel room stock. This suggests that there is still considerable scope for the growth of pure investment companies if the ‘bricks:brains’ split continues.

**European pure hotel investors, ranked by room numbers**

| Company               | Country     | Rooms   | Hotels | Brands                                |
|-----------------------|-------------|---------|--------|---------------------------------------|
| Pandox                | Sweden      | 8,277   | 44     | Hilton, Scandic, Radisson SAS, others |
| Capona                | Sweden      | 6,712   | 42     | Scandic and others                    |
| RBS                   | UK          | 6,449   | 23     | Le Méridien, Hilton                   |
| Orb Estates           | UK          | 5,500   | 37     | Thistle                               |
| Dividum               | Finland     | 5,271   | 32     | Scandic, Radisson SAS, Finnish brands |
| Deutsche Interhotel   | Germany     | 5,133   | 15     | Several                               |
| DIFA                  | Germany     | 3,420   | 15     | Several                               |
| Hospitality Europe BV | Netherlands | 3,230   | 8      | Sheraton, Hyatt                       |
| Renaissance           | Kapiteeli   | Finland | 3,200  | 21 Scandic and others                 |
| Home Invest AS        | Norway      | 3,015   | 25     | Choice brands                         |
| BAA Hotel Partnership | UK          | 2,689   | 7      | Mixed                                 |
| London & Regional     | UK          | 2,500   | 23     | Ibis, Hilton                          |
| 2018 Hotels           | UK          | 2,043   | 10     | Hilton                                |

**57,439**

In addition, this specialist owning sector is still very localised. None of these companies owns hotels outside Europe and many cannot really claim to be European in scope at all – RBS and MWB (a smaller-scale investor) operate only in the UK; Capona and Dividum only in Scandinavia; HEBV and Pandox only in Northern Europe. Only two companies own hotels in five or more countries. This is in contrast to the largest hotel operators, such as Accor, Hilton, Marriott and Six Continents, which have a presence in every continent.



A brief analysis of the principal groups shows that, with the notable exception of Hospitality Europe, they can largely be divided into three main categories:

- Scandinavian hotel groups, largely founded as a result of the property workouts of the early 1990s, such as Pandox, Capona, Dividum and Kapiteeli, or as split-offs from Scandinavian management groups like Choice or First Hotels.
- UK sale-and-leaseback investors, such as RBS, the BAA Hotel Partnership and London & Regional. Orb Estates has management contracts as opposed to leases from Thistle, but since the contracts have minimum guarantees, the economic relationship is largely similar.
- Institutional investors like DIFA (and also Norwich Union, or DGI), which have focused on hotels as an important component of a property portfolio and some of which have come to specialise in the sector.

## Operating Structures

It is interesting to note that all of the above categories are focused on leases. This form of operating structure is not uncommon in Germany, particularly among domestic hotel companies. German open- and closed-ended funds, which have dominated property investment in Germany for several

years, but operate under a strong regulatory framework, have been relatively conservative, passive investors. They will accept low yields but do not favour hotel management contracts because of the risk element and regulatory constraints. When they began to look at hotel investments in the face of reducing returns in the commercial real-estate investment market in 1997-8, they demanded hotels held on a fixed long-term lease (typically 20-25 years) from a good quality covenant with an index-linked guaranteed rental income.

The hotel lease structure with an indexed rent is too passive a form of investment for most of the US-based specialist hotel investors, who like to bring an active asset-management approach to the situation and thus add value to their investments. This resulted in their preference for hotels operated under management contracts, where the operator is rewarded with fees and the owner – exposed to both the upside and downside of the trading cycle – has a much greater risk/reward profile. Similarly, specialist European hotel investment companies such as Hospitality Europe and Interhotel, which originated in the 1980s, have traditionally preferred to acquire hotels operated under management contracts as they had the knowledge and expertise to ‘manage the manager’ and maximise their returns.

Management contracts have traditionally been the most usual structure employed in the UK, reflecting the specialist nature of the sector and lack of wider or institutional investment until recently. However, they are not widely accepted in some other European countries, notably Italy. Management contracts offer the greatest capital appreciation potential and control over the maintenance of the property, and inexperienced owners can greatly improve their chance of success by employing an active and experienced asset manager.

## TREND TO GUARANTEES AND TURNOVER LEASES

Unlike leases, terms of management contracts in Europe have tended to follow a more homogenous format, varying according to the individual asset and negotiations, rather than country practices. A trend to fixed guarantees demonstrates the improving balance of reward between owner and operator: an owner must exert enough control but provide sufficient incentives to ensure that the operator optimises the performance of the hotel.

Most of the newer entrants to the hotel investment market have structured their deals as either turnover leases or management contracts with minimum guarantees, with the result that such arrangements now dominate the industry.



Why has this change taken place? The most obvious reasons include the greater degree of knowledge and involvement required of an owner in negotiating a fair management contract, undertaking asset management and taking responsibility for the maintenance and refurbishment of the real estate. These are skills not necessarily found in investment banks or funds, which are more likely to hire investment analysts than hotel specialists. At the same time, the owner is more exposed to the downside of poor trading cycles while the manager continues to receive his fees.

#### A PERFECT SOLUTION?

The development of operating structures such as the turnover lease, which effectively combines the security of a lease with the upside potential of the management contract, would appear to be a perfect solution. For new entrants to the sector, especially financial institutions or listed property companies, it requires less vigilance and a greater balance of risk.

Lease structures have been an essential part of the sale-and-leaseback deals that have emerged in Europe in recent years, whereby hotel operating companies have been able to sell down their real estate while retaining brand distribution, and investors have been able to acquire larger portfolios of hotels to fast-track their growth in the sector. Banks are increasingly prepared to buy suitable assets for relatively long leases.

There may also be another factor at work. Investment companies that specialise in hotels with management contracts, such as Hospitality Europe and Strategic Hotel Capital, have generally been established by shareholders with high return expectations, often over a relatively short time frame. In contrast, institutional investors like RBS, Pandox and DIFA will generally have shareholders with a longer-term outlook, who are interested in a lower degree of risk and lower (but consistent) returns.

This may explain the rapid growth of the lease model over the period 1998-2001 when hotel performance was strong and investors may have feared a downturn more than desiring further upside. However, when the impact of recession and 11th September has taken its toll and the European hotel market enters its trough, investors may well regret the lack of significant upside in their hotel leases and once again seek the excitement offered by management contracts.

#### LEASES SHOULD CLEARLY PROVIDE FOR ASSET MAINTENANCE

Crucial to the long-term success of any structure is clarity over the responsibility for maintaining and improving an asset. Superficially, turnover-based leases with a guaranteed component look attractive, but unless there are covenants in the lease to enforce strong physical asset maintenance, there is a built-in incentive for the operator to maximise net operating profit through minimising such costs and limiting growth in the revenue-based rent.

#### Future Trends

The broadening of hotel ownership to non-specialist investors inevitably means that lease structures will continue to play an important role in providing a more secure and attractive investment product. At the same time, it is clear that management contracts will remain popular with experienced, skilled owners, and this is particularly the case for trophy properties and high net-worth individual buyers. Such owners may have an unstructured and often unpredictable pattern of investing in hotel assets, and they are often motivated as much by the physical appeal of the real estate as by the financial considerations of the deal. It is imperative that such owners enjoy a comfortable relationship with their operators, and they frequently have an international perspective. Middle Eastern investors, for example, who invest through private property companies or directly, own some 50 large hotels throughout the world.

German open- and closed-ended funds, which currently have some Euros 10.8 billion to invest into European real estate (partly due to the poor performance of alternative investment media), will continue to invest in hotels to comply with their diversification strategies. For these institutions, leased hotels offer a long-term and secure income and, unlike office buildings, are 100% let for the full duration of the lease. Given the existing average asset allocations, German funds have a potential Euros 400 million to invest into the hotel sector. This is not only a significant source of capital for the European hotel market but also for international hotel markets, given the funds' recent shift overseas.

## THE AMERICAS

By Melinda Mckay, Senior Vice President

Hotel Owners come in all shapes and sizes. More recently, however, we have seen the development of sumo-heavy players that have influenced the dynamics of hotel acquisitions and development. The shape and even identity of top owners today looks very different from five years ago.

### Current Ownership Structures

#### **Individual Ownership**

High net-worth individuals have been consistent players in the US hotel investment arena. They traditionally feature in the under-\$20 million asset bracket, opting for boutique-style properties. For example, assets recently transacted including Club Med Huatulco (Mexico), the Raleigh Hotel South Beach (Miami) and the Malibu Beach Hotel (California) were all acquired by high net-worth individuals. However, they are certainly not precluded from the large trophy assets: The Lodge at Pebble Beach, the Four Seasons in New York and the Inn at Laguna are all owned by high net-worth individuals.

#### INDIVIDUALS ARE CONSISTENT PLAYERS

The taxation structure pieces income (gain or loss) from hotel properties together with the owner's other items of income (gain or loss). The individual ownership structure generally has a lower return parameter than formal ownership structures (such as REITs), given the lesser administrative burden and absence of a floor on required returns.

#### **Partnerships (General and Limited)**

Partnerships have a similar feel to individual ownership, particularly in relation to tax treatment and yield flexibility. Partnerships are tax conduits, whereby taxable income (gains or losses) is passed directly through to the individual partners, who then treat this income as though they were

individual owners of the asset. In a similar vein to individual ownership, partnerships are strong competitors for assets given there are no statutory return parameters, which might otherwise limit their ability to secure transactions.

#### **S Corporations (S-Corp)**

An S Corp is an ordinary business corporation that has elected to be taxed under Subchapter C of the Internal Revenue Code. Earnings are passed through to shareholders for taxation at their individual rates, thereby avoiding double taxation. However, S-Corps are limited to 35 shareholders and can only use domestic capitalisation. Other strict rules exist for qualification under this ownership status. S-Corps are not generally adopted in the US hotel sector.

#### **C-Corporations (C-Corps)**

C-Corps are regular corporations that have not elected to be treated as Subchapter S corporations (see above). There are no restrictions imposed on the number or type of shareholder. As it is a taxable entity, a C-Corp will file its own tax return, paying tax on its net profits each year. Profits remaining after tax can be distributed to the shareholders as dividends. This highlights one of the core disadvantages of C-Corps – double taxation.

#### **Real Estate Investment Trust (REIT)**

In the United States, REITs have a number of rules of formation. These include strict statute provisions under the Internal Revenue Code; beneficial ownership by a minimum

#### Top Advantages of C-Corps

- ✓ **Limited liability** – members only have exposure to the assets they invest in the company, and are protected against personal liability.
- ✓ **Multiple levels of ownership** – greater autonomy in structuring shareholder return by using common and preferred stock with different rights, terms and conditions.
- ✓ **Accumulated income** – although there is a ceiling, this income can be passed through to shareholders, thereby representing a capital gain when these shares are sold.

#### Top Disadvantages of C-Corps

- ✗ **Unfavourable tax treatment** – double taxation, plus recognised as independent entity therefore losses retained at the corporate level (which might not be valuable if it does not have any other income to offset the loss).
- ✗ **Administrative costs** – formal requirements, such as annual reports, accounting standards and directors' meetings.
- ✗ **Shareholder restrictions** – shareholders are unable to assign earnings separate from their shares, although are able to assign shares at their discretion.

of 100 persons with beneficial interest represented by certificates of transferable shares; at least 75% of total assets must be real estate assets; at least 95% of its taxable income (less certain allocations) must be distributed to shareholders.

There are three types of REITs: Equity (directly own real estate – the majority of REITs fall into this category); Mortgage (finance versus own assets); and Hybrid (includes ownership and financing).

REITs have been in existence in the United States since the 1960s. Most of the growth in hotel REITs occurred in the mid- to late 1990s. They were the darlings of Wall Street in 1997. What ensued was a veritable capital orgy with hotel REITs buying wildly and building portfolios at a stunningly swift rate.

#### GOLDEN AGE OF REITS IN 1997-8

The concept of the 'paired-share' (including 'paper-clipped' and 'stapled') REIT proliferated in the 1980s, and a handful survived after Congress legislated to end them in 1984. These structures – whereby a hotel-operating C-corporation was paired with a hotel-owning REIT, essentially giving the former the tax advantages of the latter – were behind a spate of hotel acquisitions in the USA in the 1990s and the beginnings of a similar boom in Europe.

This special status was a significant factor in the acquisition of ITT Sheraton by Starwood Lodging, a paired-share REIT, and was also behind the acquisition by Patriot American – also a paired-share REIT – of the Arcadian hotel chain in the UK and France. The tax loophole allowing the structure was eventually closed by Congress in 1998.

By 1999, the tech stocks had gained all the attention, and with hotels experiencing less upside, hotel REIT portfolio building took an extended nap. The bursting of the tech bubble caused investors to return once again to their reliable real estate partners. However, not too long after, a slowdown took place in the economy and, correspondingly, in the hotel sector. Capital markets remained skittish about earnings volatility, making it difficult to raise capital. Then came 9/11, and with it a sharp devaluation of stock prices and total returns.

#### REITS CONTINUE TO EVOLVE

The REIT Modernization Act, enacted in January 2001, has enabled companies to participate in previously restricted income-generating activities. By abolishing some of the former inflexible income and asset rules, companies will be able to enhance earnings by participating in more vertically integrated investments, collecting income from non-real estate sources and setting up taxable subsidiaries to enter into formerly prohibited businesses.

As an example, hotel REITs are now able to collect asset-management revenue by acting as their own lessees, and rental profit is no longer their only source of revenue. Given the diversification of revenue sources, this results in a steadier cash flow and should (theoretically) elevate the rate of return.

#### Limited Liability Company (LLC)

LLCs have become wildly popular in the United States in recent years. While they have been in existence since the late 1980s, their appeal increased significantly following changes to its tax structure in January 1997. This confirmed partnership tax status without the cumbersome technical hoops, but also extended the flexibility of the LLC to choose a corporate tax treatment.

Entrepreneurs favor LLCs given their combined characteristics of a corporation (i.e. limited liability protection) and partnership (i.e. "pass through" taxation benefits). It is a reasonably new form of ownership. Within the hotel sector it has gained accelerated popularity.

Similar to REITs, the Internal Revenue Code imposes strict guidelines on the formation of these entities. LLCs are formed in a similar manner to corporations i.e. filing articles of association with the relevant state agency, with the structure now legal in all 50 US states and Washington DC.

Similar structures can be found around the world. For instance, it is similar to the *GmbH* in Germany, the *SARL* in France, and the *Limitada* in South America.

#### Top Advantages of REITs

- ✓ **Favourable tax treatment** – conduit tax treatment, meaning income is not double-taxed i.e. it may distribute to shareholders without incurring corporate tax.
- ✓ **Liquidity and diversification** – the tradability of shares enables the REIT to tap a tremendously wide investment pool. Plus REITs also offer a more diversified portfolio than the average investor/owner could obtain individually.
- ✓ **Access to capital** – allows owners to tap into the wider capital markets to finance acquisitions and developments. The real estate REIT market alone has a market capitalisation of \$163 billion.

#### Top Disadvantages of REITs

- ✗ **Restriction of retained earnings** – distribution of 95% of taxable income to retain preferential tax treatment. In addition, REITs are unable to deduct losses in excess of the amount of investor capital at risk.
- ✗ **Forced growth** – compelled in order to retain share price power. But high leverage in most hotel REITs means that capital raising is the only viable avenue, extremely difficult in this environment. In turn, this inertia constantly places further pressure on share prices.
- ✗ **Vulnerability to sentiment** – the volatility in share prices over the last 15 months is a clear demonstration. In particular, this volatility limits the ability of REITs for capital expansion plans.

**Top Advantages of LLCs**

- ✓ **Flexibility** – there can be any number of varieties of owners, and these owners can have disproportionate return allocations.
- ✓ **Favourable taxation structure** – avoids double-taxation, plus deductible employee benefits and increased tax shelter for qualified pension / retirement plans exists.
- ✓ **Limited liability** – members only have exposure for the assets they invest in the company, and are protected against personal liability. They can also be active in the management of the business.

**Top Disadvantages of LLCs**

- ✗ **Pressure to distribute profits** – an LLC is unable to accumulate income to fund future expansion.
- ✗ **Lack of familiarity** – this could stymie investment and make going public more difficult (therefore turning off venture capitalists).
- ✗ **Limited legal precedents** – the short lifespan of this investment structure means a comparatively smaller body of case law, creating uncertainty.

**Lease**

Lease ownership structures are rarely adopted in the United States. This is largely due to their often-required bondable guarantees and their long-term, reduced flexibility, coupled with the stigma associated with off-balance sheet financing in the post-Enron scandal environment. In contrast, the sale and

**LEASE STRUCTURES RARELY ADOPTED IN USA**

leaseback market in Europe is increasingly being adopted as a viable ownership structure. Sale and leasebacks can be accounted for under two main methods: the operating method, which requires no balance-sheet disclosure of future lease payments, and the capital method, which treats a lease as if it were an asset being purchased on credit.

Hotel leases in the United States appear in two forms: (1) Operating leases and (2) Lease arrangements required for REIT ownership. In either case, the lease payment is dependent on the hotel's operations and is rarely guaranteed.

**Other Forms**

Omitted from the list are two frequently used terms in real estate investing: syndicate and joint venture. The reason is that both terms merely refer to the general idea of group ownership. A syndicate may consist of any number of investors from three to several hundred. Joint ventures generally describe a two-party relationship between a hotel developer or an operator and an institution that provides the financing. Syndicates and joint ventures will ultimately take one of the investment structures/legal entities mentioned here

**Top Advantages of Lease**

- ✓ **Off balance sheet advantages** – allows companies to keep debt off its balance sheet, thereby satisfying low debt-to-equity ratios.
- ✓ **Favourable exit strategy** – for non-publicly traded entities, a pre-determined sales price can be set with the tenant, thereby increasing yields to the landlord.
- ✓ **Security** – guaranteed payments allows passive institutional investors to diversify property investments into hotels without the problematic volatility associated with this asset class.

**Top Disadvantages of Lease**

- ✗ **Contingent liability** – corporate accounting scandals mean that this type of structure will come under rigorous scrutiny.
- ✗ **Capped guarantees** – generally not favourable in a low interest rate environment where listed entities guarantee a fixed return.
- ✗ **Loss of upside** – leasehold value diminishes rapidly, representing a significant loss. In addition, loss of ownership upon lease expiry means no share in asset appreciation.

**The Changing Ownership Landscape**

The ownership landscape has undergone dramatic transformation across the United States over the last six years. Prolific merger and acquisition activity (M&A) dominated transaction headlines between 1996 and 1999 throughout the country. Over \$16 billion worth of portfolio transactions in the United States alone, plus over £15 billion in two global deals (Starwood and Bass) created the mega brands we have today.

**Tracing the Historical Heavyweights**

The mega-owners of today have grown through a combination of acquisition, development and mergers. In pure transaction terms, Host Marriott dominated the 1998 table, swallowing \$2.2 billion of hotel assets in one year alone. In 1999, Strategic Hotel Capital was the most active buyer. In 2000, a number of key players vied for top place, while 2001 clearly belonged to Blackstone who acquired almost \$1 billion in hotel assets in a

single transaction. The relative dearth of activity in 2002 has presented little opportunity for high profile headlines, although CNL Hospitality remained active, acquiring eight hotels, all but one from Marriott International.

**RE-SHUFFLE OF TOP TEN OWNERS FROM 1997 TO 2001**

A look at the top ten owners now versus five years ago underscores this transformation. Less than half of the current top ten owners were ranked in the 1996 tally. The graph on page 9 depicts the ten current largest owners (by rooms) and their respective compound average annual growth (CAAG) from 1996 to 2001. Host Marriott has consistently ranked as the largest owner in the United States, and despite the usual inertia of size, has achieved one of the fastest growth rates over the period (much of which was concentrated in 1998).

**Benchmark of the Primary Hotel Investment Vehicles in the United States\***

|  | <b>Real Estate Investment Trust (REIT)</b>  | <b>Partnerships (General and Limited)</b>  | <b>Publicly Traded C Corporation (C-Corp)</b>   | <b>Limited Liability Company (LLC)</b>                     |
|--|---|--|---|--|
| <b>Liquidity</b>   | High  | Limited  | High  | Limited  |
| <b>Minimum Investment Amount</b>   | None  | Generally high but not always  | None  | Generally high but not always                              |
| <b>Reinvestment Plans</b>  | Common  | Not common   | Common  | Not common   |
| <b>Double Taxation Liability</b>   | No  | No   | Yes   | No   |
| <b>Ability to Leverage Property Investments without Incurring UBIT for Tax-Exempt Accounts</b> | Yes, makes REITs suitable for individual IRAs, 401(k), and other pension plans"                                   | No   | Yes, at the price of a corporate level tax (state and federal)  | No   |
| <b>Investor Control</b>  | Yes, investors elect trustees   | No, often (but not always) by limited partner/s                                      | Yes, investors elect directors  | No, often (but not always) by limited partner/s            |
| <b>Independent Directors</b>   | Yes (no for private REITs)  | No   | Yes (no for private C-Corps)  | No   |
| <b>Beneficial Ownership</b>  | At least 100 shareholders required; most have thousands   | Shared between any number of limited and general partners                            | Normally thousands  | Usually more than one; unlimited number and variety        |
| <b>Growth Mechanism</b>  | Additional public offerings of stock or debt  | Increased contribution by partners, introduction of new partners, increased leverage | Additional public offerings of stock or debt  | Increased sale of stock in the company, increased leverage |
| <b>Ability to Pass Losses on to Investors</b>  | No  | Yes  | No  | Yes  |
| <b>Subjects investors to state taxes</b>   | Only in state where investor resides  | Yes, for all states in which it owns properties                                      | Only in state where investor resides  | Yes, for all states in which it owns properties            |
| <b>Return Parameters</b>   | No statutory limitations. Goal is to attain returns higher than a REIT's dividend yield (currently between 8%-9%) | No statutory limitations   | No statutory limitations. The goal is to attain returns that are higher than the cost of capital (which vary significantly) | No statutory limitations                                   |
| <b>U.S. Examples</b>   | Host Marriott Corporation, Hospitality Properties Trust, Felcor Lodging Trust                                     | Strategic Hotel Capital, Tharaldson Enterprises, Oxford Capital Partners             | Westmont Hospitality, Lodgian, Sunburst Hospitality Corp  | Sunstone Hotel Investors, Hardin Capital, FFC Hospitality  |

\*excludes individual ownership

Source: Jones Lang LaSalle Hotels; NAREIT; Hagan and Associates

The Felcor/MeriStar merger of 2001 would have toppled Host Marriott's position and created an 80,000 room gorilla, but it was terminated in September 2001 due to adverse changes in financial markets. It is very unlikely this merger will be consummated in the foreseeable future due to debt issues faced by MeriStar. If a buyout were to occur, it would be from a private player, such as an opportunity fund. All other things being equal, such a merger represents the only real way to challenge the dominance of Host Marriott in the foreseeable future.

### **The Future of Hotel Ownership**

The hotel industry has witnessed such prolific change in the composition of its ownership structure that the question of what the pattern may look like in the future is compelling. Over the last five years, changes in tax laws have encouraged new forms of hotel investment techniques. In the five years to come, the most important changes and new forms of hotel ownership are most likely to be related to liquidity and returns.

#### ***The demise of traditional REITs?***

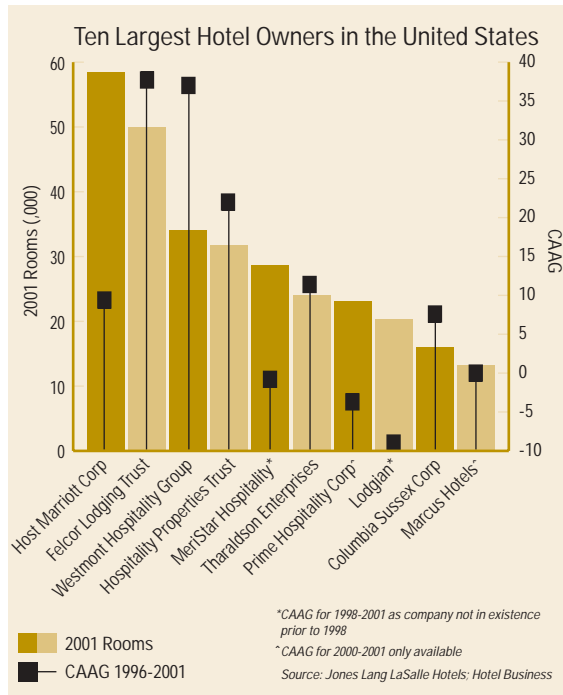
Although REITs in total own a relatively small percentage of investment grade hotels in the United States, their impact on the ownership landscape over the last five years has been

dramatic. However, volatile stock prices and reduced earnings have limited this group from conducting any critical mass of acquisition or development activity. Compounding this is their somewhat restrictive structure that limits the amount of retained earnings for ongoing capital costs and growth. As a result, it is unlikely that this ownership structure will grow markedly in the future. REITs will, however, remain popular to institutional investors who seek liquidity and diversification, but who do not have the stomach (or experience) for direct acquisitions. REITs will also remain popular for individual investors and retirees, particularly when government bonds and money market rates are at comparative lows (which is the current environment). In particular, as the stock market recovers, REITs will regain expansion capacity.

#### ***Private players take the edge***

The majority of recent acquisition activity has been sourced from private equity players, such as partnerships and LLCs. Their ability to raise capital has not been stymied by share-price devaluations. In addition, this investment structure appeals to institutional investors familiar with hotel investing given often superior rates of return. In general, the industry is likely to

witness more private and institutional capital flowing to hotels. The carrot is the superior risk-adjusted return in comparison to other forms of real estate. According to the NCREIF index over the long term (ten years), hotels well out-performed all other forms of real estate, achieving an annual compound total return of 12.3%, compared with 8.8% for all properties.



**Brands getting back to what they know best**

Brands have started and are likely to continue to divest assets to pay down debt and expand their basket of long-term management contracts. It must be remembered that brands are not rewarded for owning real estate. Their growth strategy relies on deploying capital to build brand presence and equity. However, acquiring or co-investing in assets to gain representation in strategic markets will remain a key tactic.

**Welcome to the world**

Hotels are the most international of all property types. The shakeout following 9/11 and the economic downturn proved that diversification is not only prudent by product type and national location, but that exposure to a broader geographical distribution does yield return benefits. Cross-border hotel owners are concentrated in the private equity market and this is likely to continue. This is because local tax laws are likely to restrict the ability of REITs and other public entities such as C-Corps to perform. However, if lease structures were more readily adopted in the United States, this would encourage much greater investment from Germany.

**A flood of pension fund money?**

Hotels represent a classic contrarian play for pension funds. Currently however, the sector is not well understood by this traditionally conservative investment source. But interest is growing. The question therefore is, how would their capital best be deployed? REITs represent a viable alternative for these investors, at least initially, to access the high return potential of the sector without being exposed to too much volatility (and risk). Current investment by pension funds in hotel REITs is, however, limited.

**BROADER GEOGRAPHICAL OWNERSHIP YIELDS BENEFITS**

Alternatively, a pension fund seeking greater returns could invest in private equity funds, which provide an opportunity to achieve this. Knowledge of the vagaries associated with hotel investment (or at least an advisor with such experience) remains indispensable. Privatisation of pension funds could provide the trigger to a major influx of retirement dollars to the lodging industry. Canada is in just such a process and this scenario – depending on its success there – could be replicated not only in the United States but also throughout the world.

## ASIA PACIFIC

By Mike Batchelor, Executive Vice President

What does the future hold for the Asia Pacific hotel investment markets?

As the hotel cycle turns and profitability improves, investment activity will increase – but who will be investing where?

### Current ownership trends

In Asia, hotel and resort property is still dominated by private ownership. For instance, even when a hotel, or especially a portfolio of hotels, is owned by a quoted company, a majority shareholding is generally held by a private or family entity. Many of these individual or family owners will also operate the hotel, especially those in the lower graded categories, while

upscale and luxury hotels tend to be operated by national or international hotel operating companies.

In Australia, the top five hotel owners in terms of room numbers are hotel funds and listed operating companies. Private Australian and Asian-based owners also control a significant number of individual hotels and small portfolios across the country.

#### Australia: Top 5 Hotel Owners as at 2002

| Name                            | Rooms | Investor Type                 | Origin    |
|---------------------------------|-------|-------------------------------|-----------|
| Tourism Asset Holdings          | 5,104 | Unlisted hotel fund           | Australia |
| Grand Hotel Group               | 3,255 | Listed hotel fund             | Australia |
| Thakral Holdings                | 2,608 | Diversified listed fund       | Australia |
| Six Continents Hotels & Resorts | 2,591 | Listed hotel owner / operator | UK        |
| Stamford Land Corporation Ltd   | 2,002 | Listed hotel owner / operator | Singapore |

In New Zealand, three of the five top hotel owners are controlled by Singaporean interests, either through direct property ownership or public vehicles. In the Pacific, apart from French Polynesia, where ownership is dominated by

French investors, most resorts and hotels in the Pacific island nations of Fiji, Vanuatu, Cook Islands and Western Samoa are predominantly owned and operated by either Australian, New Zealand or local-island-based investors.

#### New Zealand: Top 5 Hotel Owners as at 2002 (latest available)

| Name                | Rooms | Investor Type                 | Origin      |
|---------------------|-------|-------------------------------|-------------|
| CDL Hotels NZ Ltd   | 2,687 | Listed hotel owner / operator | Singapore   |
| Dynasty Hotel Group | 1,203 | Developer – owner / operator  | Singapore   |
| Plaza Investments   | 650   | Owner operator                | New Zealand |
| Scenic Circle       | 592   | Private owner / operator      | New Zealand |
| Hotel Grand Central | 504   | Listed hotel owner / operator | Singapore   |

### How have ownership trends changed in Asia Pacific?

As shown above, ownership trends vary significantly between key markets in both Australia and Asia. As a result of its broader ownership structure, the Australian market is considerably more liquid than the others, with numerous transactions taking place each year. In contrast, fewer than five transactions are completed on average in any one year in the Asian market.

There are several reasons hotels in Asia are so tightly held, including:

- Asian banks have limited power to foreclose on non-performing loans;
- Available debt is lacking in certain countries, e.g. Indonesia;
- There is usually a gap between the price expectations of vendors and purchasers;
- Lack of transactions in the past means there are few historic precedents on which to base deals;
- Many investors expect an imminent recovery and are reluctant to sell during the trough of the market cycle.

Few changes in ownership patterns in Asia have thus taken place in recent years. By contrast, some distinct changes in hotel ownership in Australia have resulted from the following phases in the hotel and resort industry there:

- Japanese developers built and/or acquired more than 50 hotel and resort properties across the country in the 1980s;
- SE Asian buyers acquired distressed property assets in the early 1990s;
- Hotel-specific listed funds entered the Australian market in 1996-97, although only two remain today after delisting and mergers;
- A number of group consolidations took place in the late 1990s (e.g SPHC, Australian Tourism Group).

The departure of Japanese owners and the increase in activity by domestic buyers becomes clear when comparing the current ownership pattern of hotels to that of 1997:

| Australian Tourist Accommodation – Origin of Owner |      |      |
|--|------|------|
|  | 1997 | 2002 |
| Australia  | 51%  | 59%  |
| Japan  | 18%  | 5%   |
| Singapore  | 16%  | 16%  |
| Hong Kong  | 6%   | 4%   |
| Malaysia   | 4%   | 4%   |
| US   | 1%   | 3%   |
| Other  | 4%   | 9%   |

### Who were the buyers in Asia Pacific between 1992-2002?

Few hotel transactions took place in Asia in the 1990s. Those who have invested include Six Continents Hotels & Resorts and the CDL Group.

In Australia, as mentioned above, there was a new wave of investors in the first half of the decade, primarily from the tiger economies of Singapore and other South-East Asian countries. They were attracted by the opportunity to acquire Japanese-owned and developed hotel assets being offered by distressed sellers and their banks at significant discount to replacement costs.

#### NEW WAVES OF INVESTORS IN AUSTRALIA

As a financial crisis engulfed the South-East Asian economies in turn in the late 1990s, these assets came to the market again, to be acquired by domestic institutions and public companies such as GPT (Lend Lease), Thakral Holdings and Grand Hotel Group. Such companies became the dominant players in the Australian hotel investment market, but their appetite for hotel investment slowed dramatically following a combination of difficult hotel market conditions and poor performances.

#### PUBLIC COMPANIES BECOME DOMINANT PLAYERS

In the late 1990s a wave of cash-rich publicly listed international hotel operating companies entered the Australian hotel investment market. Most acquisitions were defensive plays, with operators such as Marriott International and Six Continents Hotels & Resorts securing their positions as hotels operated by them were being offered for sale with vacant possession.

In 2000-01 hotel investment in Australia was dominated by South-East Asian and domestic buyers, with some limited institutional acquisitions. Domestic developers also entered the Sydney and Melbourne hotel markets. Driven by the national real-estate boom, they acquired some 17 hotels for conversion to residential apartments and condominiums. These hotels were mostly poorer quality, older assets in fringe Sydney areas, but their removal from the market has had a positive impact on all Sydney hotels through reducing competition and improving the overall quality of accommodation. However, as the housing market begins to cool off, conversions of hotels to residential use in this number are not likely to occur for some time.

#### CONVERSION OF OLDER ASSETS BOOSTS SYDNEY MARKET

In 2002, the dominant players have again been South-East Asian investors, as demonstrated by the acquisition of the trophy assets Sanctuary Cove (A\$208m), Queensland, and Westin and ANA Hotels, Sydney (approx. A\$370m) by

Malaysian and Singaporean interests respectively. It is likely that these investors will hold their assets to benefit from the anticipated recovery phase in the medium term before contemplating divestment. In contrast to the South East Asian hotel investors of the early 1990s, we have seen the entrance of more sophisticated real estate investors, such as GIC Real Estate.

### Who will be the buyers over the next 5 years?

In Australia, a combination of the weak Australian dollar, the safe-haven status still enjoyed by the country, and counter-cyclical buying opportunities will ensure that capital continues to flow from South-East Asian investors who, since 1997, have generally bought hotels on lower yields than institutions or hotel operating companies.

#### CAPITAL FLOW FROM SOUTH EAST ASIAN INVESTORS

However, they are likely to compete with a number of Australian high net-worth individuals, selected institutions and public companies with solid cash reserves gained from the buoyant residential market of the last few years.

Investment activity should increase as the hotel cycle turns and hotel profitability improves, restoring hotel capital values to over-supplied markets. Investors are more likely to sell once a market has passed the trough of its property cycle. Markets entering the recovery phase thus remain the most sought-after. We have already seen a number of transactions in Sydney and the key Queensland markets, and the first Singapore hotel to be bought as a going concern since 1994.

### Broadening hotel ownership

Although the vast majority of hotels across the region are operated under management contracts, lease agreements are beginning to emerge in Australia, driven largely by institutional investors seeking lower levels of risk and more stable returns from their hotel investments.

#### BROADENING OF MANAGEMENT AND LEASE ARRANGEMENTS

Across the Asia-Pacific region, an increase in the use of performance-based management agreements and lease arrangements should broaden the investment appeal of hotels to non-traditional hotel owners, and overseas investors such as the capital rich German funds.

In certain markets, such as China, developers are reportedly seeking up to 50% equity participation from operators. However, evidence of such levels of participation is rare.

The sale and leaseback structure has grown in popularity in the UK and Europe but has yet to play a significant role in Asia Pacific (excluding Japan). This reflects the relative lack of liquidity in the region compared to the UK and Europe.

### Other Issues

The Asian hotel market is notoriously tightly held and there are several aspects that need to be addressed in order to stimulate investment. For instance, banking reforms would enable Asian banks to foreclose on non-performing loans, as is the practice in other countries around the world. There are also issues relevant to individual countries, such as in China, where there is much investor interest but problems of land tenure, transparency, repatriation and possible political and social uncertainty make it difficult for transactions to eventuate. In Indonesia there is a need to address the availability of debt and in Japan there is widespread pricing disparity.

Despite soft trading conditions, investors are keen to gain a foothold in the more transparent markets of Tokyo, Singapore and Hong Kong, and Thailand continues to be a favourite for investors in the light of the strong economic and tourism outlook.

#### OWNER-OPERATORS EMBRACE FRANCHISE AGREEMENTS

Mid-tier owner-operators are finding it increasingly difficult to compete with the larger international operating companies as they continue to grow. Owner-operators who are reluctant to lose a "hands-on" role are beginning to take on franchises from global groups such as Flag Choice, which offer the benefits of centralised reservations, referrals, a marketing network and purchasing parity. An increased involvement from franchised groups is expected to continue in Australia.

Owner operators are also continuing to prosper in the smaller boutique properties in the Asia-Pacific region, where personalised and friendly service is sought.

### Conclusion

As the hotel markets recover and profitability improves, investment activity should increase across the Asia Pacific region. In Australia, we expect to see a continuation of purchases from South East Asian buyers and domestic investors. However, there are several issues that need to be addressed in order to stimulate the Asian transaction market.



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