



Hong Kong Market Outlook

What are the Signs for Hotels in Asia's World City?

Daniel J. Voellm, Director

HVS GLOBAL HOSPITALITY SERVICES

1-2/F

24 Sai Kung Tai Street

Sai Kung

(852) 2791 5868

(852) 2791 5699 Fax

December 2008

NORTH AMERICA - Atlanta | Boston | Boulder | Chicago | Dallas | Denver | Mexico City | Miami | New York | Newport, RI | San Francisco | Toronto | Vancouver | Washington, D.C. | **EUROPE** - Athens | London | Madrid | Moscow | **ASIA** - Beijing | Hong Kong | Mumbai | New Delhi | Shanghai | Singapore | **SOUTH AMERICA** - Buenos Aires | São Paulo | **MIDDLE EAST** - Dubai



Over many years, Hong Kong has been one of the leading commercial centres in Asia. The local hotel market is among the strongest in the region and globally. In this article we highlight some of the historical trends and challenges that hotels will face in light of a global economic recession.

OVERVIEW

The Hong Kong Special Administrative Region (SAR), or commonly known as Hong Kong, is one of the two special administrative regions of the People's Republic of China, along with Macau. Located at the southeast coast of China at the mouth of the Pearl River Delta (PRD), Hong Kong also borders Shenzhen Special Economic Zone in the north and faces the South China Sea in the east, west and south. Hong Kong consists of four main areas, namely the New Territories, Kowloon Peninsula, Hong Kong Island and the Outlying Islands.

The Hong Kong SAR enjoys a favourable location within the Pearl River Delta region, excellent infrastructure, high literacy rate, respected rule of law and a well-established/regulated financial market. The economic resilience of the territory is evident in the strong growth in financial services, logistics, tourism and professional services after the severe acute respiratory syndrome (SARS) outbreak in 2003. With the launch of the Closer Economic Partnership Agreement (CEPA) II in 2005 and subsequent supplements, coupled with a highly flexible labour market and the vitality and innovation of the local business sector, Hong Kong is likely to continue to shift towards higher value-added services and knowledge-based economy, with an anticipated GDP growth of approximately 4.6% per annum between 2009 and 2011, according to the Economist Intelligence Unit. While the current downturn

in the financial and insurance sector has a strong impact on the local economy, the strategic location and access to mainland China provide positive fundamentals for a recovery as compared to most other countries. The fallout in the PRD manufacturing sector has strained the regional economy and it remains doubtful whether it can provide significant positive momentum for recovery. Although global trade might be slowing in the short-term, companies continue to look for closer ties with their source markets. For investors, Hong Kong provides a convenient location and environment to conduct business in mainland China. The pace of recovery will depend on the kind of policies implemented by the Central Government in accordance with the Sino-British Joint Declaration to maintain the well-being of Hong Kong.

Transportation

The Hong Kong International Airport (HKIA) was opened in 1998 to replace the old Kai Tak Airport. With a total area of approximately 57 hectares, the new Hong Kong International Airport is approximately nine times larger than the old terminal. After two expansion projects were completed by 2000, annual passenger handling capacity increased to 45 million. The passenger facilities can be enhanced to handle up to 61 million passengers a year and thereafter expand to the north and south to accommodate a maximum annual capacity of 87 million passengers. The airport connects conveniently with Tsim Sha Tsui (TST) and Hong Kong Island, via a 24-minute ride on the Airport Express.

Hong Kong is well-integrated in the regional transportation network with trains and ferries serving all key cities in the PRD. Hong Kong is also a popular destination for Southeast Asian cruises and is home port to several



ships. Current government plans envision the revitalisation of the old Kai Tak Airport site with a new cruise terminal. Scheduled for completion in 2013, the government of Hong Kong SAR aims at establishing the city as a

regional cruise hub, continuing the trend of roughly 10,000 cruise-in/cruise-out passengers in the late 1990s until 2004 (with the exception of 2003) to roughly 27,000 passengers in 2007.

Hong Kong Map



DEMAND

Given its strategic location and economic importance, Hong Kong has long benefitted from healthy and generally growing demand levels. Given the wide range of visitor origins and interests, the following section will discuss some of these aspects. The data analysed is published by the Hong Kong Tourism Board (HKTB).

Commercial Demand Generators

With an economy dominated by the service sector, headquarters of international multinational corporations operating in Hong Kong and the region are usually located in Hong Kong, as the city is one of the most important centres in Asia. The offices of these multinational corporations are located within different commercial centres, based on their industries. The majority of banking institutions, for example, are located in Central District of Hong Kong Island. Other



commercial centres include Admiralty and Wanchai on Hong Kong Island as well as Tsim Sha Tsui, which also house numerous multinational corporations. The highly developed Hong Kong Island provides no room for new development along Victoria Harbour; projects here focus on redevelopment. More development activity can be observed in Kowloon, from West Kowloon with the prominent structure of the International Commerce Centre (ICC) and Kowloon Bay.

MICE Demand Generators

The Hong Kong Convention and Exhibition Centre (HKCEC) is the major MICE demand generator for the city. It opened in November 1988, after which Hong Kong's exhibition industry experienced a period of rapid growth enabling Hong Kong to establish its position as Asia's trade fair capital and a premier international convention and meeting location.

The HKCEC presently totals 221,968 square metres with over 70,000 square metres of rentable function space. With the growing demand for exhibition space from HKCEC's current clients and potential new clients, the second expansion broke ground in July 2006. Upon completion in 2009, the expansion will add 19,400 square metres to the HKCEC, bringing total exhibition space to nearly 83,000 square metres and total rentable function space close to 90,000 square metres.

In December 2005, the AsiaWorld-Expo opened its doors on Lantau Island, adjacent to the airport. The facility features approximately 70,000 square metres of rentable space, including over 66,000 square

metres of ground floor hall space. Hall 1, also known as AsiaWorld-Arena, is Hong Kong's largest indoor seated venue with a maximum seating capacity of 13,500. The facility has attracted a number of large sourcing fairs, as well as conventions and concerts. With the expanded HKCEC and AsiaWorld-Expo, Hong Kong features two major state-of-the-art MICE facilities.

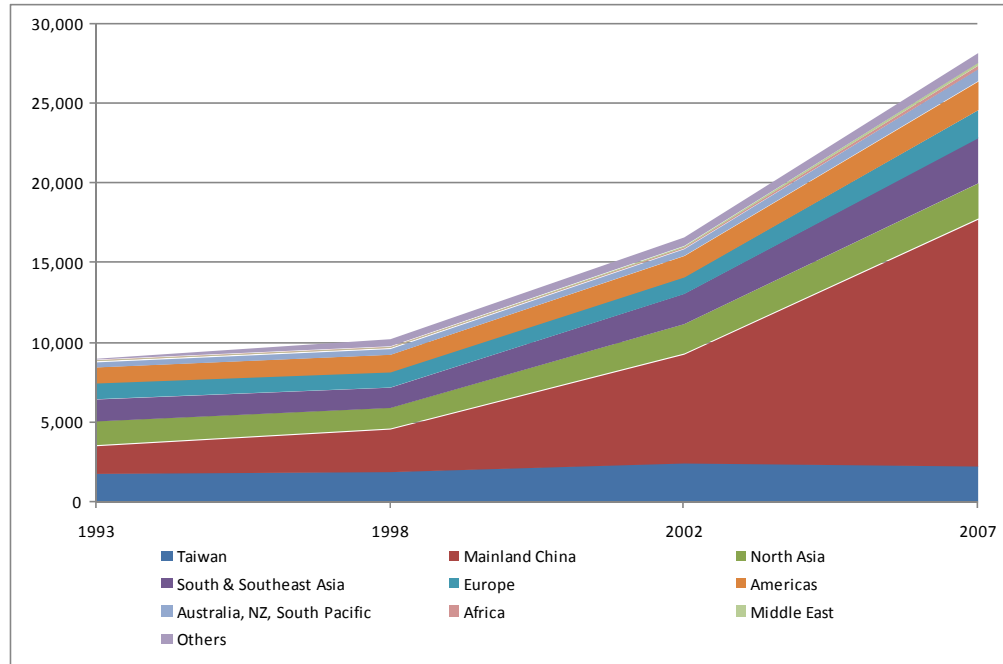
Leisure Demand Generators

Key tourist attractions in Hong Kong include The Peak, Star Ferry and the Hong Kong Island skyline with its nightly, music-coordinated laser show over Victoria Harbour. The reason for Hong Kong's popularity is due to the vibrant energy and excitement of this amazing city that exists in few other places in the world.

Other attractions include Hong Kong Disneyland, Ocean Park, the International Finance Centre building, the largest outdoor statue of a giant Buddha on Lantau Island and a 61-hectare wetland park to attract ecotourism. More often than not, visitors come to this city not for the attractions, but for the energy, shopping, food, scenic views and the overall unrivalled Hong Kong experience.

Visitor Arrivals

The number of visitor arrivals is a key indicator for the travel and hospitality industry to gauge the well-being and performance of a destination. Hong Kong's main access points are the HKIA, various ferry and port terminals, and five border crossings into mainland China. The following chart illustrates the number of visitor arrivals for 1993, 1998, 2002 and 2007 as provided by the HKTb.


Chart 1 Visitor Arrivals – By Region and Key Countries (000s)


As illustrated in Chart 1, visitor arrivals registered significant growth between 1993 and 2007 of more than 19 million individuals. Visitation statistics registered only modest growth prior to the handover of Hong Kong to Chinese rule. Since 1998, long-haul markets from Europe registered modest growth levels of around 6.0%, likely attributable to the strong performance of the global economy. More mature travel markets like the USA, Germany and Japan registered limited growth, attributable to already well-developed US and German travel markets in 1998, as well as economic challenges for Japanese travellers in the 2000s. Countries in Europe, the Americas and North Asia that had relatively few visitors in 1998 and witnessed their economies prosper posted strong growth levels, most prominently South Korea and the block of South and Central American countries. Australian and New Zealand visitors increased at a healthy rate, driven by favourable economic environment and exchange rates. In a similar fashion, Africa

and the Middle East registered some of the highest growth rates as stronger business ties were established with those regions. Southeast Asian visitor arrivals continued to increase at a healthy pace, with Indian visitors starting to show in larger numbers. The strongest increase in visitor arrivals among all nations is from mainland China. The removal of quota restrictions on the number of mainland Chinese visitors and introduction of the Individual Visitation Scheme (IVS) in 2003 resulted in an unprecedented growth in visitation. Approximately eight million more visitor arrivals were registered in 2007 over 2002. Mainland China became the largest source market by 1994 and continued to grow at an impressive rate. By 2004, more than 50% of visitors arrived from mainland China, reaching 55% of total visitor arrivals in 2007. Despite the slowdown in the shorter term, due to the global recession, emerging source markets, such as South America and India, still have great potential and Hong Kong is poised to remain as Asia's world city.

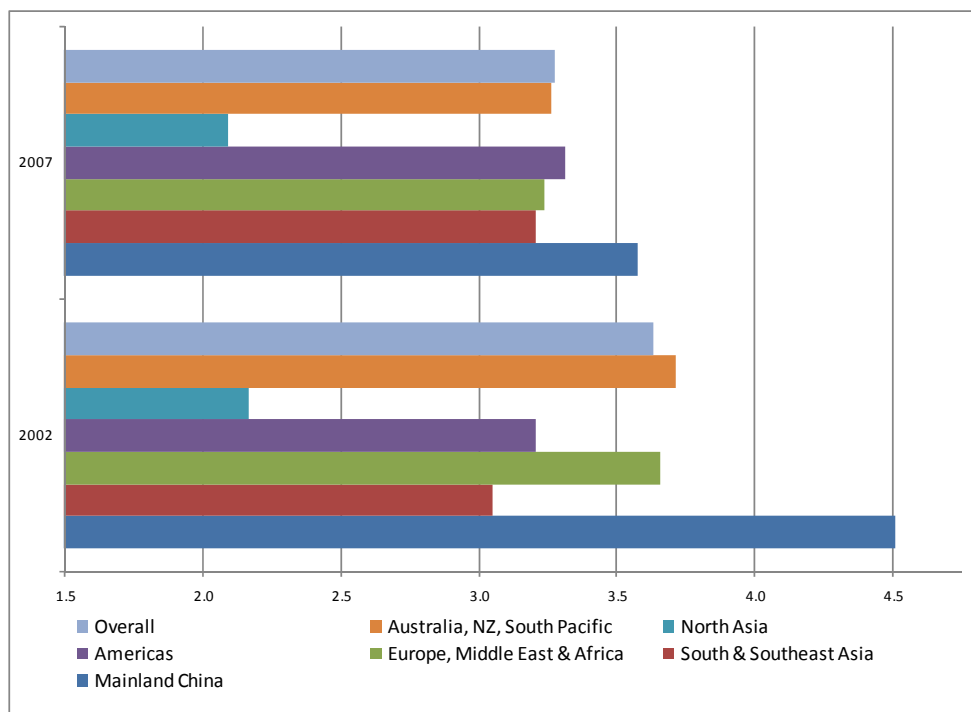


Average Length of Stay

The average length of stay indicates the ability of a destination to provide a wide range of

attractions, points of interest and activities. The following chart indicates the average length of stay for six key feeder markets.

Chart 2 Average Length of Stay (Days) – Overnight Visitors by Region

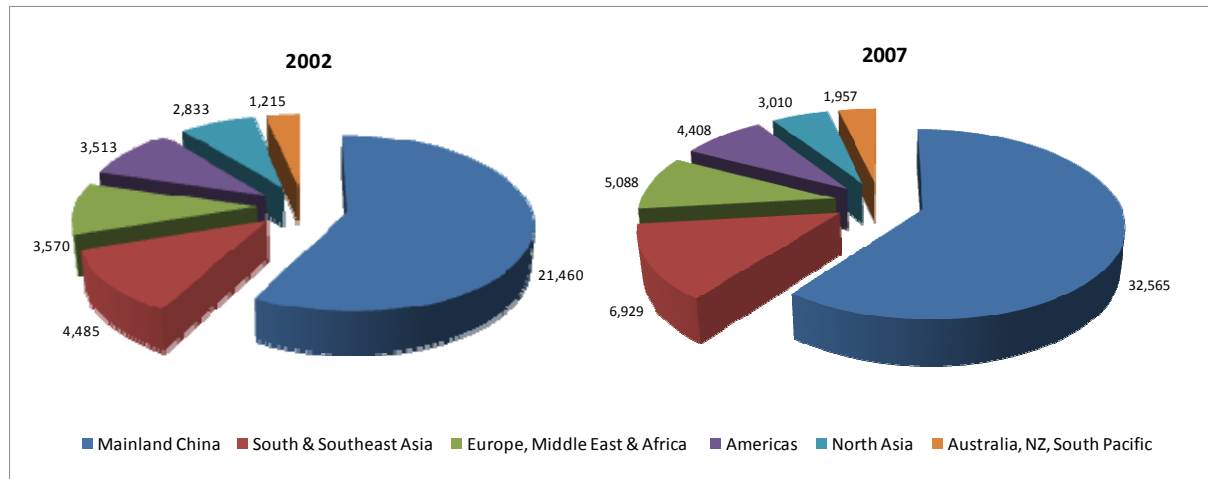
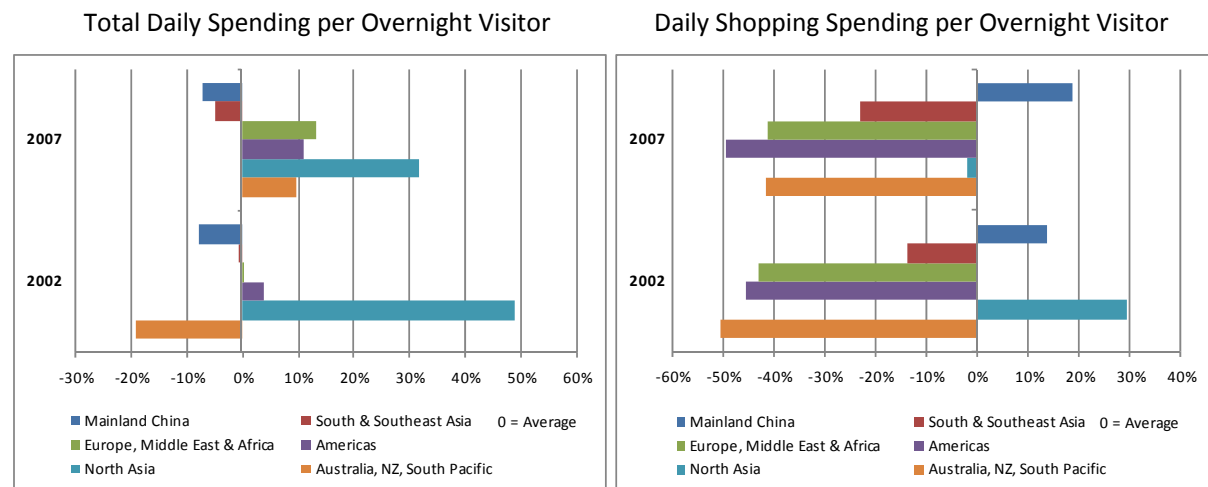


As indicated in the preceding chart, the average length of stay for overnight visitors to Hong Kong has decreased since 2002. The increased frequency of visits by Australian, New Zealand and South Pacific (Pacific) visitors resulted in shorter durations for this market. European, Middle Eastern and African (EMEA) visitors are more likely to incorporate Hong Kong in their Asia trip, visiting mainland China or other destinations as well. The dramatic increase in mainland Chinese visitors resulted in shorter stays, possibly related to more frequent and shorter return visits as well as new cities included

under the IVS scheme from less affluent regions.

Spending Pattern

Spending patterns are an indicator to assess visitor behaviour and preferences. The following charts illustrate the number of overnight visitor days (as compared to day-trips or persons in transit) and the total spending per overnight visitor as well as the shopping spending per overnight visitor for six key feeder markets as a percentage of the average for all overnight visitors.

**Chart 3 Number of Overnight Visitor Days by Region****Chart 4 Overnight Visitor Spending Patterns by Region**

According to the HKTb, Hong Kong's approximately 17.2 million overnight visitors spent nearly HK\$87.9 billion in 2007, roughly 67% more than in 2002. Although the strong increase in daily spending can partially be attributed to the shorter length of stay pattern mentioned above, EMEA and Pacific visitors registered significantly higher increases in daily spending, likely due to favourable

exchange rates at the time. While visitors from North Asia registered the highest total daily spending per overnight visitor, a challenging domestic economic environment resulted in minimal increases between 2002 and 2007. Visitors from the Americas and South and Southeast Asia both increased their daily spending as well as the length of stay, indicating a diversification in the type of



traveller. Although daily spending from mainland Chinese visitors increased, the shorter length of stay resulted in a lower total spending per trip, for reasons outlined above.

Always popular for shopping, Hong Kong overnight visitors increased their daily shopping spending at a greater rate than total daily spending. However, only visitors from the Americas actually increased their net shopping spending. In 2007, mainland Chinese overnight visitors for the first time spent more money on a daily basis for shopping than North Asian visitors – traditionally the highest spending source market. According to the HKTB, garments, leather goods, jewellery, cosmetics and skincare products, and watches are the top selling items for all overnight visitors. Mainland Chinese visitors are spending most of their money on garments, watches, jewellery, and cosmetics and skincare products.

Hotel Spending

Trends in hotel spending provide a strong indicator for the future development of the hotel market. The following chart provides the number of commercial room nights as provided by the HKTB for six key source markets. We note that we have assumed the same length of stay for visitors staying at a commercial accommodation (hotel, hostel and guesthouse) and others. The total number of overnight visitors times the share of visitors staying at commercial accommodation times the average length of stay results in the number of commercial overnights produced. Dividing the total hotel bill expenditures by the number of commercial room nights results in the average room rate per traveller. This number does not take into account double occupancy, that is, multiple persons sharing a room.

Chart 5 Commercial Overnights by Region (000s)

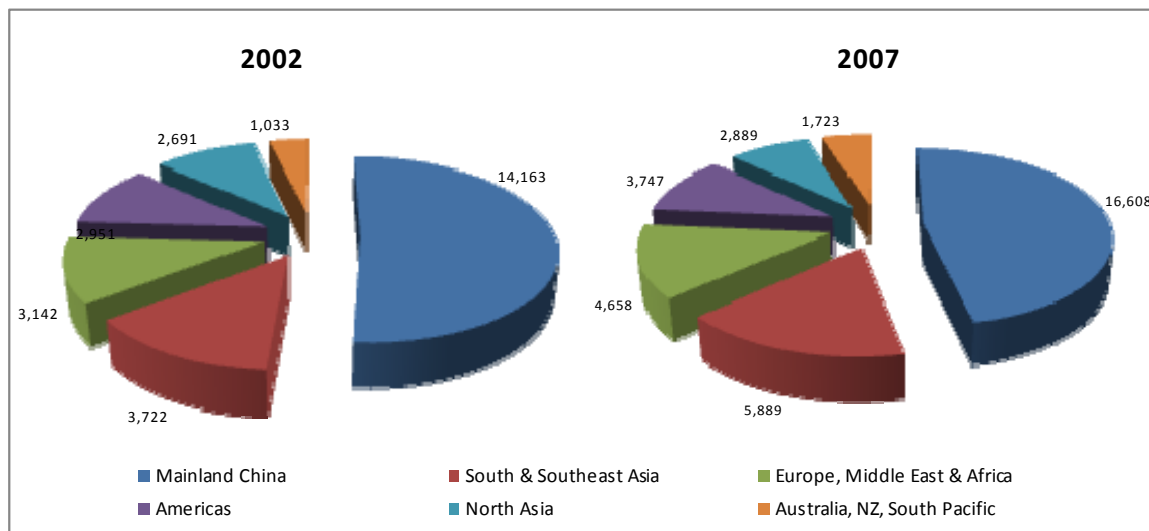
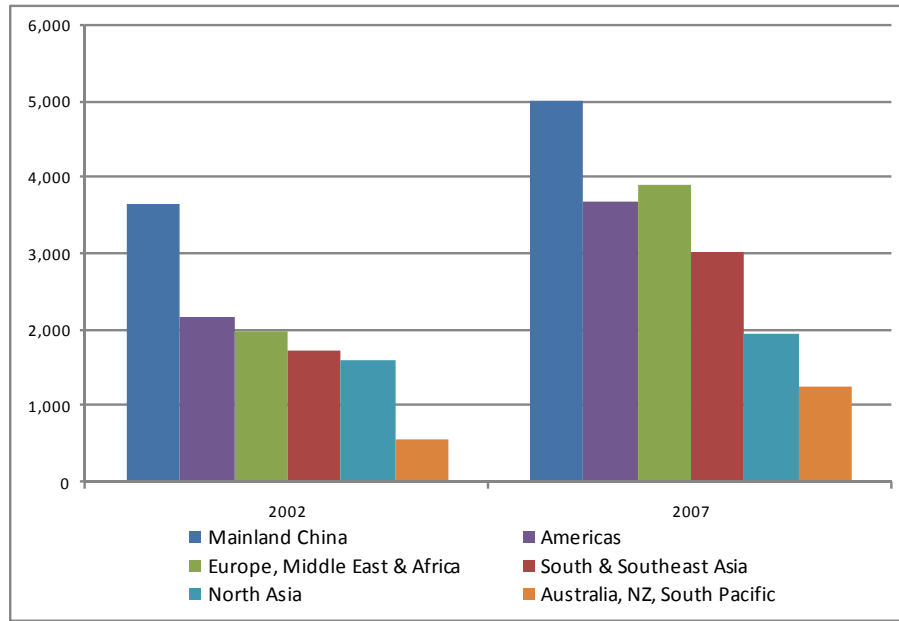
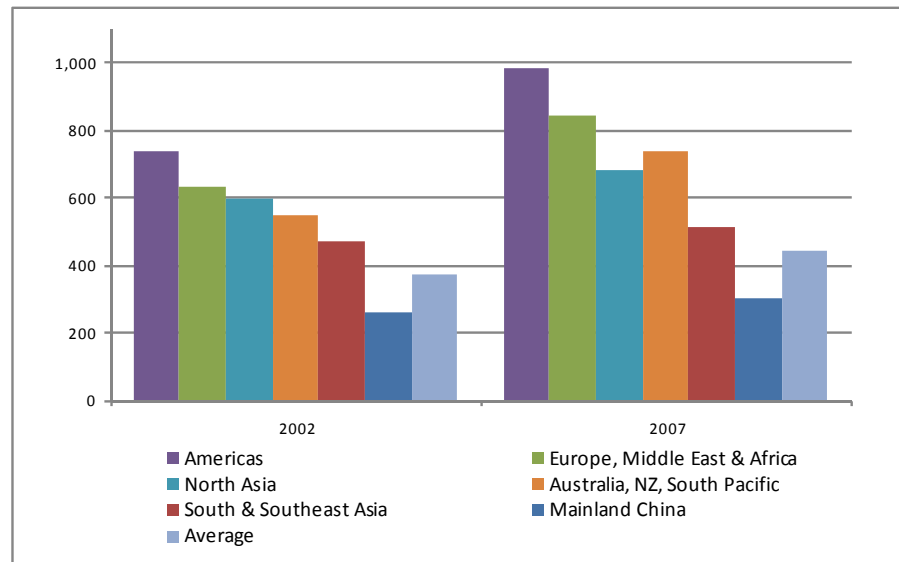



Chart 6 Commercial Overnights Total Hotel Bill Expenditures by Region (HK\$ 000s)

Chart 7 Average Room Rate Per Traveller (HK\$)


As indicated in the preceding charts, the most significant increase in commercial room nights can be attributed to mainland Chinese visitors, although the compound annual

growth rate was second lowest. South and Southeast Asian visitors followed closely behind, with an impressive compound annual growth rate of 9.6%. Driven by the favourable



exchange rate of the Australian Dollar, visitors from the Pacific registered the strongest growth rate of above 10%. Overall, the number of nights visitors were seeking commercial accommodation increased at a healthy compound annual growth rate of 6.4% between 2002 and 2007.

In terms of total hotel bill expenditures, mainland Chinese visitors contributed the largest piece of the pie of more than 25% of the total hotel bills in 2002 and 2007. With mainland China and North Asia as the exceptions, the other four key regions increased their total hotel bill expenditures at a compound annual growth rate above 10%, attributable to changes in visitor profiles and favourable exchange rates. The economic bull run during this period also played a role in this strong growth in hotel bill expenditures with a record figure of nearly HK\$20 million.

The calculated average rate per traveller registered only moderate growth between 2002 and 2007, slightly above inflation. The Pacific, EMEA and the Americas exhibited the strongest increases in spending, again likely related to corporate spending. Travellers from the Americas remain the highest spending visitors on a per capita and *per diem* basis for hotels. Visitors from the Pacific moved up one spot to claim third position, ahead of North Asia.

The HKTb publishes the related statistics report on an annual basis and trends for the year-to-date 2008 period cannot be presented.

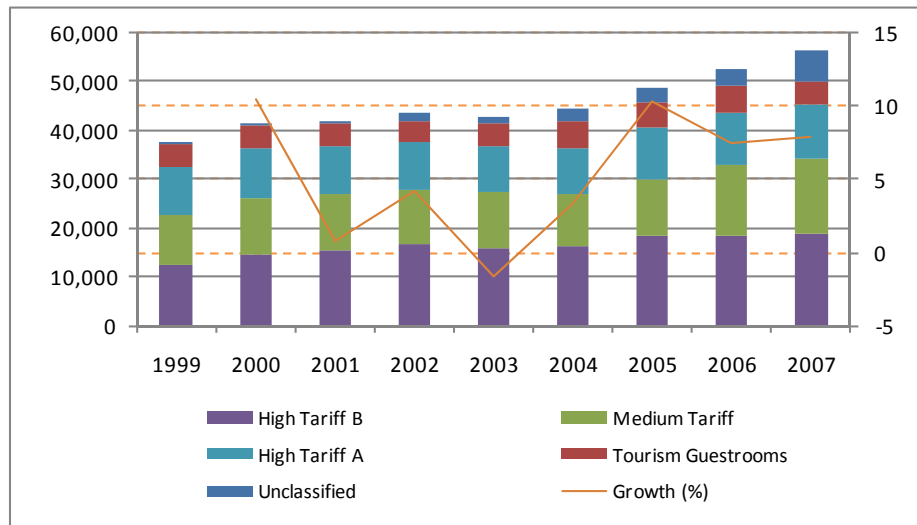
However, the economic slowdown and cascading effect is likely to have a negative impact, not only on the number of commercial room nights, but also on the spending power. The recently registered strong increases in visitors from the Pacific and high average room rate per traveller of almost HK\$1,000 for visitors from the Americas are unlikely to be sustained. It remains unclear whether the stimulus package announced by the mainland Chinese government can prevent any decline in visitation from mainland China. As the visa regulation that allowed mainland visitors in Hong Kong to transit to Macau has been modified earlier in 2008 to require separate visa applications, Hong Kong might also register a moderation in visitation levels. In the longer term, accommodation catering to mid-market travellers will face stronger growth potential as compared to the higher end of the market.

SUPPLY

According to the HKTb, Hong Kong offered roundly 56,600 accommodations to travellers in 2007. The following will discuss the history of increases in supply and provide an overview of new supply entering the market.

Existing Supply

The following chart provides an overview of the room count in five different categories, as classified by the HKTb, between 1999 and 2007.

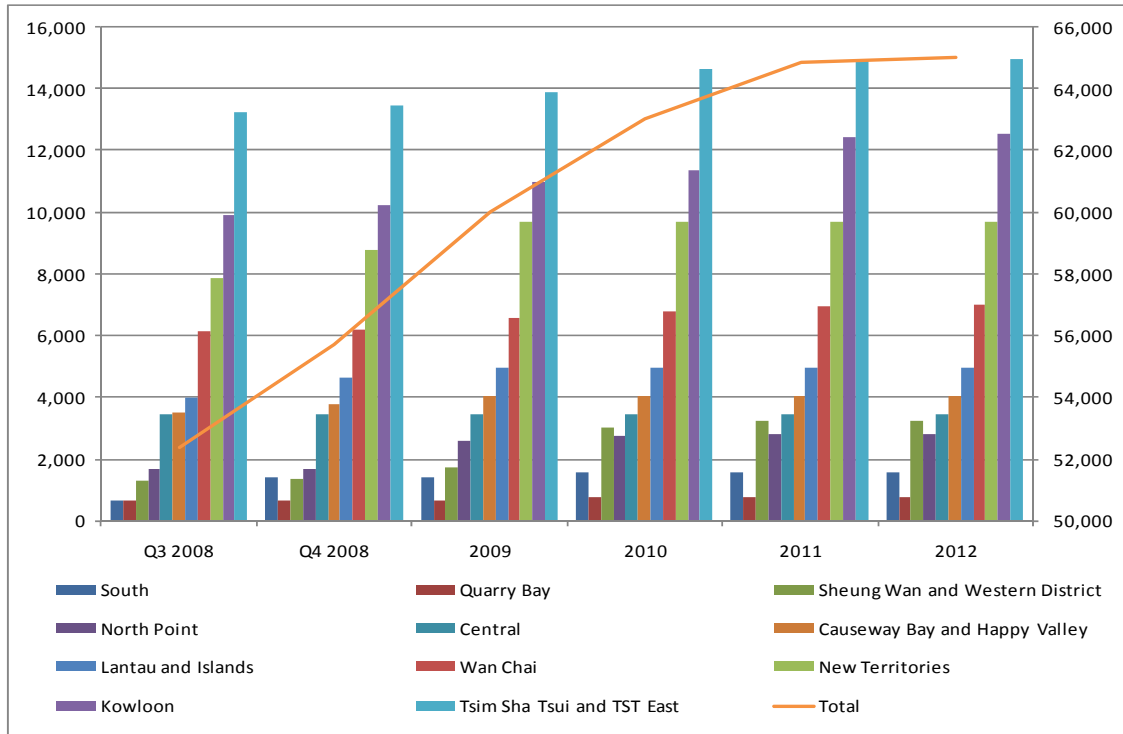

Chart 8 Historical Hotel Supply by Category


As indicated in Chart 8, accommodations supply increased at an impressive compound annual growth rate of 5.3% over the eight-year period reviewed. Years of strong increases in supply were 2000, 2005 (above 10%) and to a lesser extent 2006 and 2007. The most significant increases between 1999 and 2007 occurred in the High Tariff B and Medium Tariff categories of roundly 6,300 rooms and 5,300 rooms, respectively. The availability of properties and sites in secondary locations that are more suitable for the development of lower-tiered accommodations and more creative adaptive reuse of small footprints, as well as the opening up of new areas, such as the New Territories, resulted in a stronger growth in Medium Tariff and High Tariff B hotels. A considerable share of this new supply came in the form of serviced apartments, mostly adaptive reuses of second-tier office and residential buildings. The HKTb does not provide a separate classification for serviced apartments. At the same time, the number of unclassified establishments – establishments

that do not report to the HKTb survey – increased significantly. The High Tariff A category registered only minimal growth, reflecting the scarcity of suitable sites and the inferior financial returns for high-end hotels as compared to office developments. The conversion of the Hilton Hong Kong to office use and more so the demolition of the Ritz-Carlton Hong Kong for redevelopment as an office building exemplify this trend.

Additions to Supply

Although real estate development projects are facing strong headwind in the current financial crises, at this point mainly due to the lack of financing, the supply pipeline for the Hong Kong hotel market remains strong. The following chart shows the current number of rooms available in 11 areas across Hong Kong, excluding tourism guestrooms. The total room count in 2007 varies from Chart 8, due to the sources consulted. Discrepancies in the room count between Hong Kong Home Affairs Department numbers and HKTb were verified at the individual property level.


Chart 9 Hotel Supply Growth Forecast by Area


In 2007, Tsim Sha Tsui and TST East recorded the largest room inventory of more than 13,000 rooms. Kowloon with nearly 10,000 rooms and the New Territories with nearly 7,900 rooms came second and third, respectively. On Hong Kong Island, Wan Chai had the largest inventory of rooms at around 6,200; Causeway Bay and Happy Valley as well as Central both registered comparable inventory sizes of roughly 3,500 rooms. Although much of the new supply for 2008 has already entered the market, a few more hotels are set to open by year end, bringing the total room count to more than 56,000. The most significant increase occurred in the New Territories, mainly attributable to the opening of L'hotel Nina et Convention Centre in Tsuen Wan with a total of 1,599 rooms. Two hotels opening in Aberdeen will more than double the supply in this area

where the main demand generator is Ocean Park. The opening of the Sky City Marriott Hotel will result in a strong increase in capacity of airport hotels on Lantau Island. In 2009, the most active area is North Point with the anticipated opening of the 828-room Harbour Grand Hong Kong. Other notable developments include two Hyatt Regency hotels in Sha Tin and TST East as well as the addition of a fourth hotel by the Swire Group in Pacific Place. Although not presented in Chart 9, the redevelopment of the New World Centre in TST East will eventually result in the closing of the Renaissance Kowloon Hotel either in 2009 or 2010. Six projects in Sheung Wan are scheduled to open in 2010, bringing the total supply to nearly 3,000 rooms here. According to the HKTB, the largest additions to supply in 2011 are planned for Kowloon. The main reason for the development activity



in Kowloon and TST was the government's change in building height restriction after the closing of Kai Tak Airport. The ICC in West Kowloon and many other developments would not have been possible in earlier decades due to air safety. This increase in density allows city planners to create new business districts on the Kowloon side, namely Kowloon West and Kowloon Bay. However, the Planning Department will exert greater control over the maximum height of new developments on Hong Kong Island in an effort to preserve the ridge line as a backdrop. The most recent example is the 'Mega Tower' in Wanchai, where developer Hopewell Holdings reduced the floor count from the initial 93 storeys to 55 storeys.

The current state of the global economy and the aforementioned challenge to secure appropriate financing for any new development are likely to have a negative impact on the timing of the majority of projects. While a number of established and cash rich developers are involved in these hotel projects, smaller entities and individuals might temporarily shelve their plans, look for joint venture partners or be forced to abandon

a project entirely. Despite several initiatives by various governments and national banks, the hiatus in lending continues, due to the larger challenges in divesting complex financial paper. Already, projects in neighbouring Macau have been put on hold while developers struggle to raise equity. If the new supply materialises as presented above, the Hong Kong room count should reach approximately 65,000 by 2012. This increase in a time of slowing economic activity and demand can exacerbate the negative impact on hotel performance.

Performance

Over the last decades, the Hong Kong hotel market was counted among the strongest in the world. The characteristics of the city mentioned earlier ensured occupancy levels largely above 80% for High Tariff A and High Tariff B hotels over the period from 1990 to 2007. The following charts present the historical supply and demand trends of these two categories from 1990 until the year-to-date through October 2008 period, as provided by the HKTB. We note that average rate data was only compiled as of mid-1998.

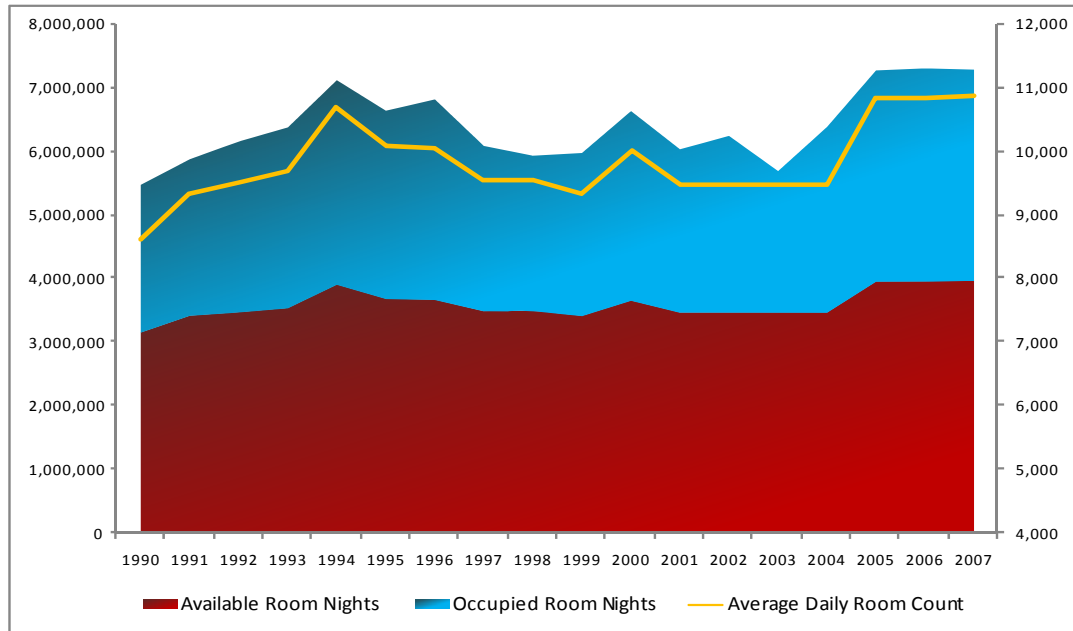
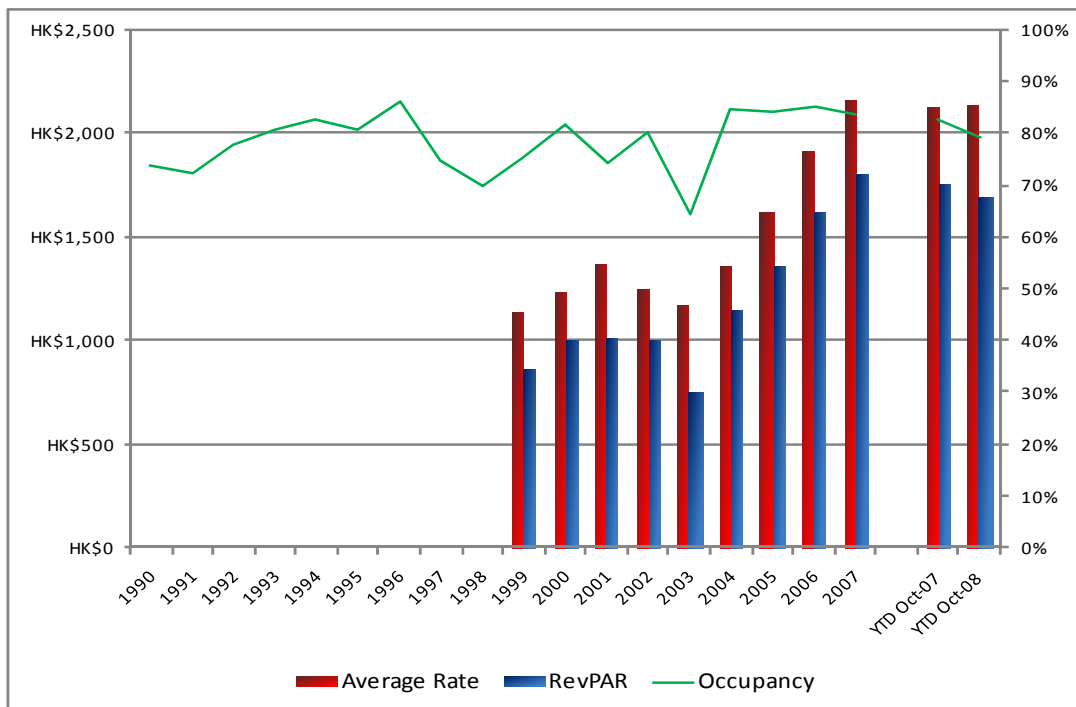
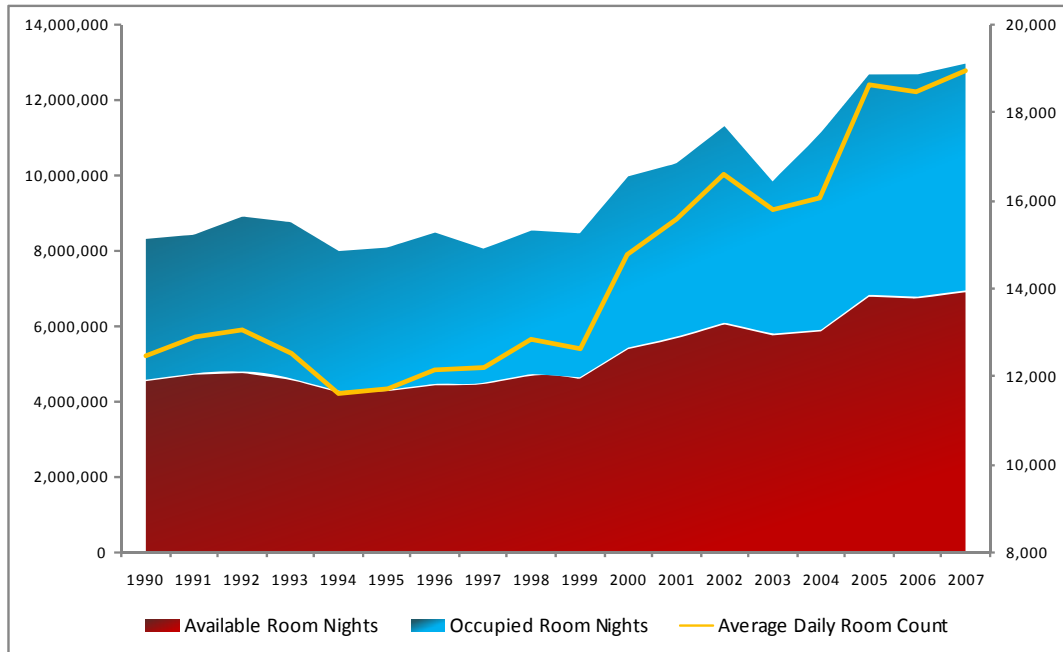
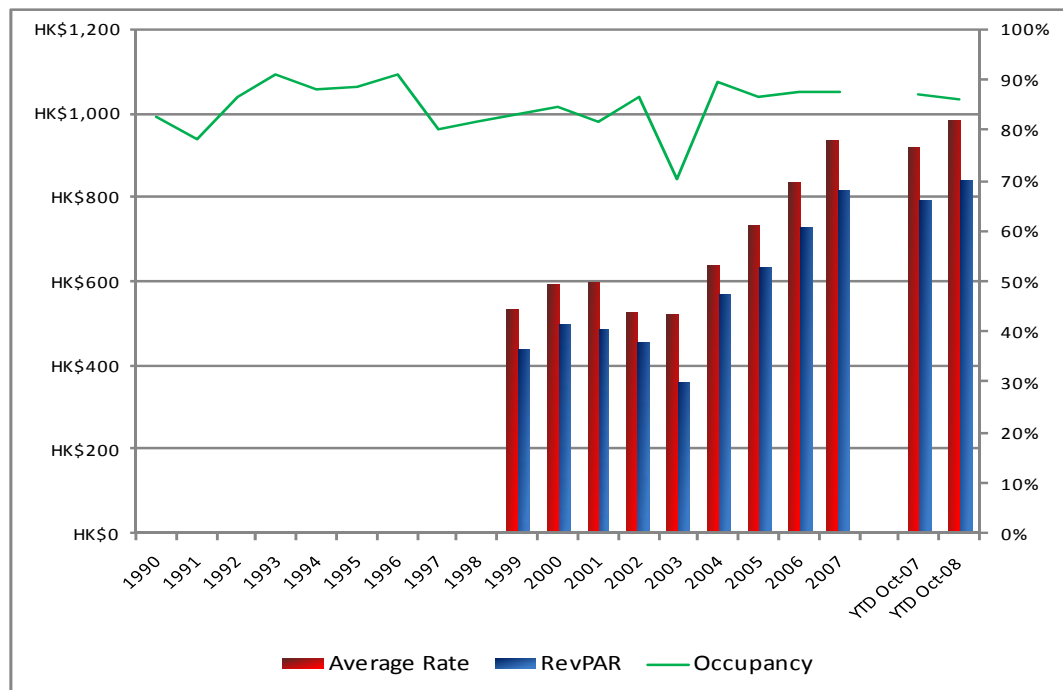

Chart 10 Historical Supply and Demand Trends – High Tariff A Hotels (HKTb)

Chart 11 Historical Market Performance – High Tariff A Hotels (HKTb)



Chart 12 Historical Supply and Demand Trends – High Tariff B Hotels (HKTB)

Chart 13 Historical Market Performance – High Tariff B Hotels (HKTB)




High Tariff A Hotels

In the early 1990s, Hong Kong faced a slowing GDP growth rate and strong inflation inherited from the external financial pressures due to the fixed exchange rate. During this period, the addition of new supply with the three properties at Pacific Place resulted in a decline in occupancy levels to the low 70% range. As the economy slowly recovered and the new supply was absorbed by the market, High Tariff A hotels registered prosperous times during the mid-1990s, with occupancy in excess of 80%. The closing of a number of hotels during the same period (including the Hilton Hong Kong) compensated for any slowing demand. However, the plunge in arrivals during the handover year, exacerbated by the financial crisis in 1997, resulted in a significant drop in occupied room nights. As a result, 1998 registered the lowest occupancy over the period reviewed, at just under 70%. Occupancy levels recovered in subsequent years supported by further decreases in supply with the closing of the Furama Hotel. Average rate posted strong increases leading up to the burst of the dot-com bubble and September 11. The continued integration of Hong Kong in the global economy and devastating impact of SARS left the hotel market in a free fall in 2003 with a drop of nearly 25% in RevPAR. A change in Chief Executive in 2003 and the surge in global economic activity resulted in an impressive demand growth in excess of 30%, pushing occupancy levels to an eight-year high. For the period from 2004 through 2007, the reduced room supply following the decreases in High Tariff A hotels over the previous decade resulted in a very strong average rate growth. This trend was amplified by the renovation and expansion of a number

of hotels, including The Peninsula (2004) and Mandarin Oriental Hong Kong (2006). The quick absorption of new supply that entered the market in 2005 – 1,335 rooms at the Four Seasons and Disneyland decreasing occupancy by 0.2 percentage points – underlines the strength of demand. In general, the four-year period from 2004 through 2007 bears the mark of the latest economic bull run. A comparable market performance was last registered a decade earlier, in the mid-1990s prior to the handover. Average rate growth slowed slightly in 2007, but passed the HK\$2,000 mark for the first time. In the year-to-date through October 2008 period, the net additions to supply, including the opening of the W in Kowloon West and closing of the Ritz-Carlton Hong Kong, were not as readily absorbed by the market as in 2005, resulting in a decrease in occupancy by 3.4 percentage points. Although this bodes well for the health of the market, major demand generators from the financial sector are in distress. Through the summer months, leisure visitation offset some of the slowing Commercial demand, but hotels are revising their year-end budgets to factor in the onset of the downturn.

High Tariff B Hotels

The High Tariff B hotel market distinguishes itself from the High Tariff A hotels in a continued increase in supply of more than 6,500 rooms at a compound annual growth rate of 5.2% between 1999 and 2007. Furthermore, the lower-rated hotels attained higher occupancy levels throughout the period reviewed. The room count of High Tariff B hotels remained largely flat between 1990 and 1999. As several projects that were launched after the handover were completed,



Hong Kong registered a strong increase in supply in 2000 of more than 2,100 rooms. The next wave of supply unleashed in 2005, with nearly 2,600 rooms entering the market. The key year for High Tariff B hotels in terms of demand was 2001. During the period of a slowing economy exacerbated by the events of September 11 in the USA, international travel from the USA and Europe came to a halt. While this impacted the higher-rated High Tariff A hotels, High Tariff B hotels benefitted from the strong increase in visitation from mainland China. In the years after 2003, as visitation continued to climb to record levels, strong occupancy levels in the high 80-percentile range resulted in an 80% increase in average rate over the four-year period. Demand growth slowed in 2006 and 2007 and contracted in the year-to-date through October 2008 period. The decline in supply, the change in mainland China visa regulation that separates Hong Kong and Macau applications and the economic slowdown, as well as the price sensitivity of demand are likely reasons.

MARKET OUTLOOK

Being at the end of the food chain, the hotel industry is a sensitive indicator to economic activity. Although leisure travel can offset a temporary slowdown in commercial activity, the global recession is slowly getting reflected in hotel performance. Booking paces have shortened and some events have been cancelled. Hoteliers will aim at sustaining average rate for as long as possible. In the last trough of the market in 2002/2003, average rate declined by double-digit figures over the two-year period. However, the period from 1997 to 2001 did not see a nearly as strong growth in average rate. This leaves room for speculation about a correction in the marketwide average rate. The key factor will

be how long hoteliers can hold their breath. In many dire lessons, the industry has learnt that rebuilding average rate is a long process. While a share of hotels might be more prone to face a downturn, it takes only one hotel's initiative to start competing in price and the average rates can quickly spiral downwards. In the end, the duration of the downturn and impact on visitation and demand will determine pricing strategies. At the time of this article, a marketwide downward correction in RevPAR of 15–20% is not unlikely, assuming a bottoming of the downturn in two years' time. At the individual property level, downward corrections can be exaggerated by a secondary location or dated facilities that deter travellers as choice increases. It remains unclear to what extent mainland China visitation could decrease in the face of a slowing economy. The recent correction in the Shanghai Stock Exchange, decline in real estate prices and factory overcapacities are prone to limiting spending power, voluntarily and involuntarily, of individuals. A decline in industrial activity in neighbouring Guangdong Province has the potential of limiting demand at hotels in Kowloon and Tsim Sha Tsui that typically cater to the large number of sales and sourcing agents from the manufacturing industries, including garments, toys, jewellery and textiles. The careful management of the IVS could soften a negative impact here. However, Hong Kong is not alone in facing these difficult times. Hotel markets across the region also feel demand softening. The aforementioned negative impact of the financial crisis on development projects could help to limit an oversupply situation and further depression of the market. On the positive side, Hong Kong's location and recognition as a financial and commercial centre are characteristics that



support medium-term and long-term prosperity.

VALUATION

Standing on top of a cliff, the fall is always the longest. Hotel values are impacted in a similar manner. As the worst is yet to come, cashflows and profitability in 2009 and 2010 are likely to contract. The shortage or near non-existence of debt financing translates into lower loan to value (LTV) ratios and higher interest rate spreads. As a result, capitalisation rates register an upward adjustment of 100 to 200 basis points. Equity returns and the perceived risk of hotel real estate cannot be measured at this point due to a lack of transactions. While the majority of hotel owners in Hong Kong are cash rich, yet there remains a chance of owners defaulting. The main threat arises from the relatively high leverage ratios of existing debt. As the basis for such favourable loan parameters has evaporated in the financial meltdown, loans due for refinancing in 2009 or 2010 can pose a major challenge. A loan to value (LTV) ratio of 70% is off the table at this point and new mezzanine financing to bridge the gap is at best available at unattractive interest rates. Through the compounding of effects, hotel values can face a downward correction of as much as 20% to 30%. Interestingly, the buyer-seller gap in terms of price expectation has reflected a comparable spread. The good news is that a lot of equity is currently on the sidelines waiting for the debt markets to revitalise, as even acquisitions at this point are not straightforward to finance. However, the competitive nature of the Hong Kong financial marketplace is playing against this trend.