



# Hotel Investment Strategy Annual



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# Investment Strategies for Turbulent Times

## Where We Were.....

It was hard to be an optimist heading into 2002. A gloomy economic picture fuelled rapid declines in hotel occupancies and rates, and airlines, the lifeblood of the industry, were teetering on extinction. One of the hardest hit sectors of the economy over the last 18 months, hotels have had to deal with shrinking corporate and group demand, aggressive rate wars and waves of negative publicity about performance.

Most periodicals and researchers made dire predictions at the end of last year, but few held true. A resilient leisure market (stimulated by cheap travel) and limited new supply environment have combined to keep the sector's head (just) above water.

Few investors panicked, instead holding through the downturn, aided by favourable financing conditions. The predictions of bankruptcies and desperate selling proved (as we predicted) wrong. In most cases values remained intact, despite income declines.

## Where We Are Going.....

A synchronised improvement in economic conditions around the world would be the single largest factor to lift hotel performance. This would precipitate a recovery in corporate demand that would reverberate to room rate and ripple out to all other demand segments. Given forecasted demand and supply dynamics, coupled with the anticipated capital market environment, the risk-return profile of hotels in 2003 is compelling. Yet to understand and seize the opportunity, investors must answer two key challenging questions:

- When will fundamentals improve?
- Which hotel investment strategies are most likely to succeed in a slow global economy?

The 2003 *Hotel Investment Strategy Annual* addresses these questions with respect to Americas, Europe and Asia Pacific. Prior to the regional sections we identify on a global basis, common investment themes and profile the economic picture for 2003. We also discuss portfolio analysis and diversification. This includes how investors can maximise returns by understanding the hotel real estate cycle, an exploration of the critical issue of mid-stream investment analysis, and the value of, and methodology for, cross-border investing. The combination of a low interest rate environment and improving hotel

fundamentals represent a compelling cocktail of opportunity for investors and lenders. We explore some of the acquisition, construction and re-financing strategies on offer in 2003. 'World Winning Cities' is a prolific research venture being undertaken by Jones Lang LaSalle and we touch on its implications for hotel investors.

## Keeping Ahead of the Curve

As 2003 approaches, tenuous with the possibility of market recovery, several common themes emerge:

- Flat occupancy and weak average daily rate (ADR) will be the norm, not the exception, in 2003. Strong revenue per available room (RevPAR) growth will be a rarity across all the major markets.
- At the same time, investment yields for top quality unencumbered properties in the largest and most liquid markets will be under downward pressure.
- Our empirical models and instincts indicate that better risk-return opportunities can be found by staying several steps ahead of the rush to safety. This gravitation to a low risk-return spectrum creates three strategic responses:
  - 1) Sell properties to investors who demand the lowest-risk assets in the safest markets and are willing to pay dearly for them. This is a particularly relevant strategy in Europe and North America.
  - 2) Buy properties one step ahead of the "core crowd" ... in markets that have yet to attract low-risk capital, but are large enough that they will soon. In Asia and some parts of Latin America, assets can be bought at steep discounts to replacement cost and opportunistic returns can be earned.
  - 3) Reposition properties in need of capital improvements to sell into the core market.
- The strongest markets, in terms of sound fundamentals at a reasonable price, include: Canada, some parts of the United States, Australia, South Korea, Singapore, Amsterdam (city centre), Barcelona, Rome, Milan and regional UK markets.
- Emerging and developing markets are places to earn higher returns. Higher yields, though, come at a price—greater sovereign risk, lower liquidity and lower transparency. Markets where our research shows realistically strong potential returns over the next three

years include: China, Greece (although watch for a dip in performance in the immediate post-Olympic period), Mexico and the larger EU candidate countries.

Around the world, yields have undergone a roller coaster ride following the 9/11/01 shakeout. In our initial investment advice following 9/11 we advised that massive discounts to replacement cost would not be available during this cyclical downturn. This was clear given the moderately leveraged market, with owners under limited-to-no lender pressure to sell. Still, required yields shot up and it was not until mid 2002 that the market started to witness some realistic compression.

Yields are unlikely to compress to any further significant degree given the following:

- Price pressure from leveraged buyers will lift. Rising interest rates in the U.S. will make it more difficult for leveraged buyers to compete for assets.
- The risk premium that hotel real estate must earn over the risk-free rate provides a significant “floor” for yields. This premium remains intact because interest rates are

so low. But government rates cannot fall much further in most of the developed countries particularly in the U.S. and there is in fact evidence of a rising interest rate trend in 2003 in North America.

- Higher yields in lesser markets or in publicly traded hotel real estate will reduce pressure on the core, direct markets.
- An increase in assets being offered for sale will also reduce yield pressure, as investors will have a larger pool from which to select.
- A lift in property performance will also allow for more realistic cap rate patterns.

**Not a One Size Fits all Solution**

But investor expectations will perform true to form and vary markedly in 2003. Different investors respond inimitably to market conditions. Based on anecdotal experience of executing lodging deals over decades, the table below places into context six broad groups of hotel investor types and characterises their strategies and ultimate anticipated activity in 2003.

**Investor Profiles**

Type	Background	2003 Business Plan
The Shrewd Investor	The Shrewd Investor (‘Shrewdie’) has been around the block – was among the first to pick up hotels in the early 90’s sell-off. He is confident of his analysis, recognises the market cycle and has investors to back him.	Accumulate quality assets. Looking for quality in terms of market and product that will retain value. Portfolio acquisitions and larger assets are efficient and will be the focus.
Steady Eddie	Eddie owns hotels – always has – and will maintain exposure to the sector. He is a conservative underwriter, but is comfortable with the product type and sees a place in his portfolio for hotels.	Purchase one or two hotels in 2003 at fair prices. Look to “blue chip” markets.
Two Toes In	Two Toes is thinking about getting back into the acquisition business. Looks at every deal, but to date, can’t make them pencil. Capital is there, but only for a “steal” - not comfortable enough with his analysis to fairly price assets, so throws out lowball offers.	Throw out offers and see if anyone bites. May buy one or two assets.
Nervous Nellie	Nervous Nellie is waiting for a clear indication of where the cycle is. Other investors buying assets will give him more confidence; however, investor support is not there.	Look at everything and complain about pricing. May throw in an offer on something, but unlikely to buy anything in 2003.
Big Hat, No Cattle	Big Hat is out there talking up a storm about his intentions. Wants to grow and is looking to expand rapidly at this time in the cycle. Big Hat has some investors lined up, but his eyes are bigger than his stomach. Investor support might not be there.	Throw in offers and tie a few deals up, but they will fall apart in due diligence. Can’t get financing. May get one or two small deals done in 2003.

## Regional Economic Outlook

Economic and geopolitical risks will be present in 2003. The synchronous slowdown of 2001/02 affected all the world's major economies. Some fared better (Australia, Canada, China, Greece, Korea) than others (Germany, Japan, United States). In 2003, we expect to see a tentative recovery take hold in the G-6 (ex Japan), but volatile conditions in the Middle East make forecasting particularly difficult.

### North America

Macro-economic forecasts for the United States waver between slow growth and almost no growth in 2003. Military action in Iraq remains a wild card. The Fed's aggressive action in November will have little effect on business investment as long as companies fear over-capacity and weak demand. Although consumer confidence has been shaken by one event after another, the resilience of the American consumer should not be underestimated. Three reasons for consumer optimism: 1) record low interest rates, 2) tax cuts, and 3) job losses that were concentrated in a few sectors of the economy (financial services, telecom, travel) while jobs actually grew in other sectors (health services, education, consumer goods, residential construction).

Canada will show more resilience to the global slowdown than the U.S. It experienced less of a bubble economy and benefits from a weak currency. Mexico, despite being caught up in the economic woes of the United States, has made impressive improvements in the stability of the peso and the health of its banking sector. It is poised to do well when the United States recovers. In short, real estate investors throughout North America should not plan on getting much help from a U.S. recovery until well into 2004.

### Asia Pacific

China has now replaced Japan as the major engine of growth within the region. However, China will play a very different role than Japan. China acts as a magnet for capital; Japan was a capital exporter. China's growth will be fuelled by massive, rapid shifts: from rural to urban, from agriculture to manufacturing and services, from a centrally planned economy to capitalism. Japan's growth was fuelled by exports and technological prowess. The advent of a more open consumer society in China will bring with it growth rates of six to seven percent in the years ahead.

Japan's economy, by contrast, will be struggling to avoid slipping back into recession in 2003. Structural reforms in Japan's economy are more likely to be pushed harder under Heizo Takenaka, the new Minister for the Economy and Financial Services. But entrenched interests in Japan's Liberal Democratic Party have thwarted serious efforts at reform before. Japan is still a very wealthy country with massive capital reserves and five times the per capita income (in terms of purchasing power parity) of China. A serious overhaul of Japan's banking system is a crucial step before the Japanese can begin to finance its own recovery. In Australia, moderate growth of 3.5 percent is expected in 2003, but the export-oriented economies of Taiwan, Singapore and Hong Kong are susceptible to weakness in the United States. Despite slow export growth, Korea has been growing at six percent and may be beginning to overheat. The Bank of Korea may raise interest rates to head off inflation and cool off Korea's rapid recovery from the Asian crisis of 1998.

### Europe

A slow recovery in Europe's economy is expected in 2003, with a return to growth at the level of the long-term trend not likely until 2004 or 2005. Germany has a particularly weak economy and occupier demand for real estate is currently anaemic. The periphery of the Eurozone will continue to exhibit higher growth than the core. Ireland, Greece and Spain have benefited greatly by adopting the common currency—interest rates are lower and inflows of investment capital are higher than in the pre-Euro era. The UK and Scandinavian countries have benefited from having independent central banks. They retain the ability to fine tune monetary policies to their particular situations versus the "one size fits all" interest rate within the E-12.

The UK government is committed to announcing its intentions in respect of joining the Eurozone in 2003. Poland, Hungary and the Czech Republic are at the head of the queue of Central and Eastern Countries waiting to join. Liberalisation of the Central European market is well underway and growth rates there are expected to be significantly higher than for the EU.

# Portfolio Analysis and Diversification

## Strategic Response to the Hotel Real Estate Cycle

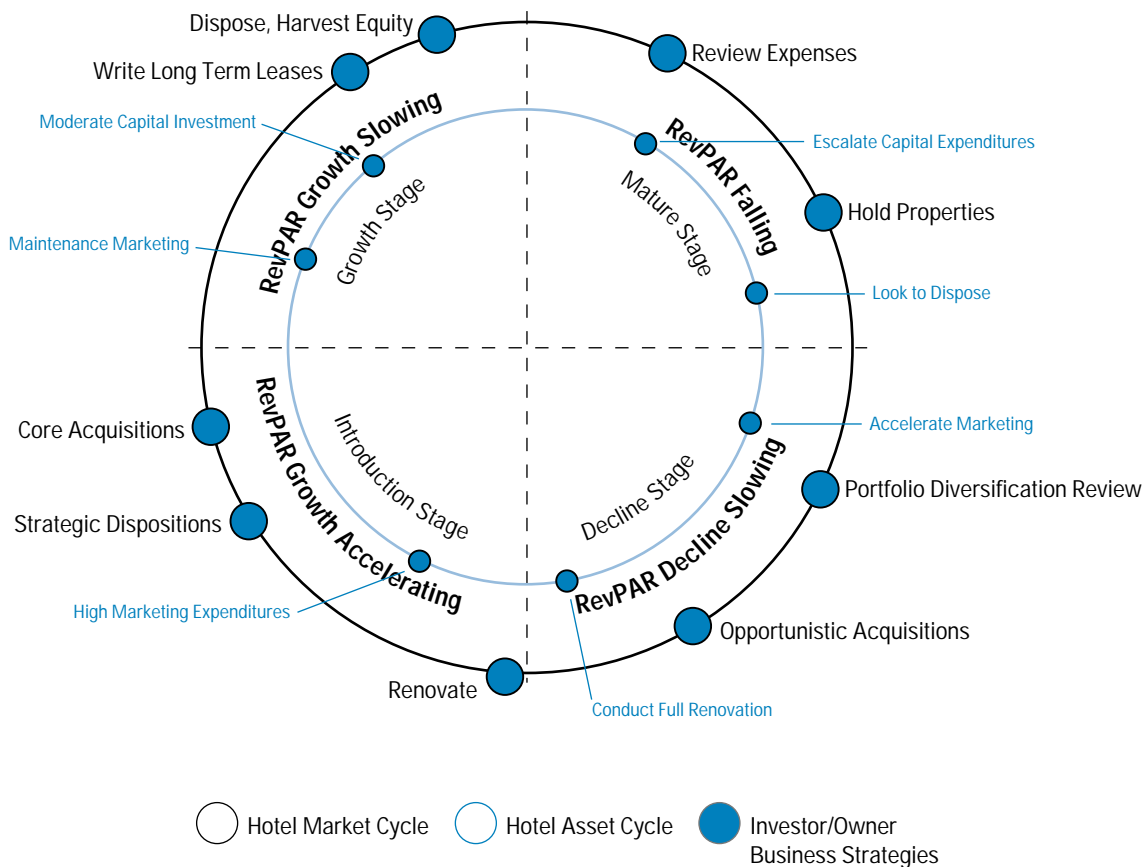
An investor's portfolio mix should anticipate changes in the hotel real estate cycle. Many of the largest hotel markets in Western Europe and North America are likely to remain in the "recessionary" stage of their respective cycles throughout 2003. Astute investors, however, should anticipate a shift to the "recovery" phase of the cycle as early as mid 2003. By contrast, many of the far eastern markets experienced the "contracting" phase much earlier and are now in the recovery phase. Asian markets like Korea and China have already entered the recovery phase of the cycle. The regional sections that follow place numerous key cities on the hotel market cycle both now and their expected positions at the opening of 2004.

structure during 2003 will achieve the best results. This includes looking at markets where capital is still in relatively short supply, such as Asia Pacific. It also means pursuing deals that do not lend themselves as readily to debt financing. Finally, it also means keeping some powder dry as the pain of the post-bubble economy begins to bite more aggressively at hotel owners' bottom line.

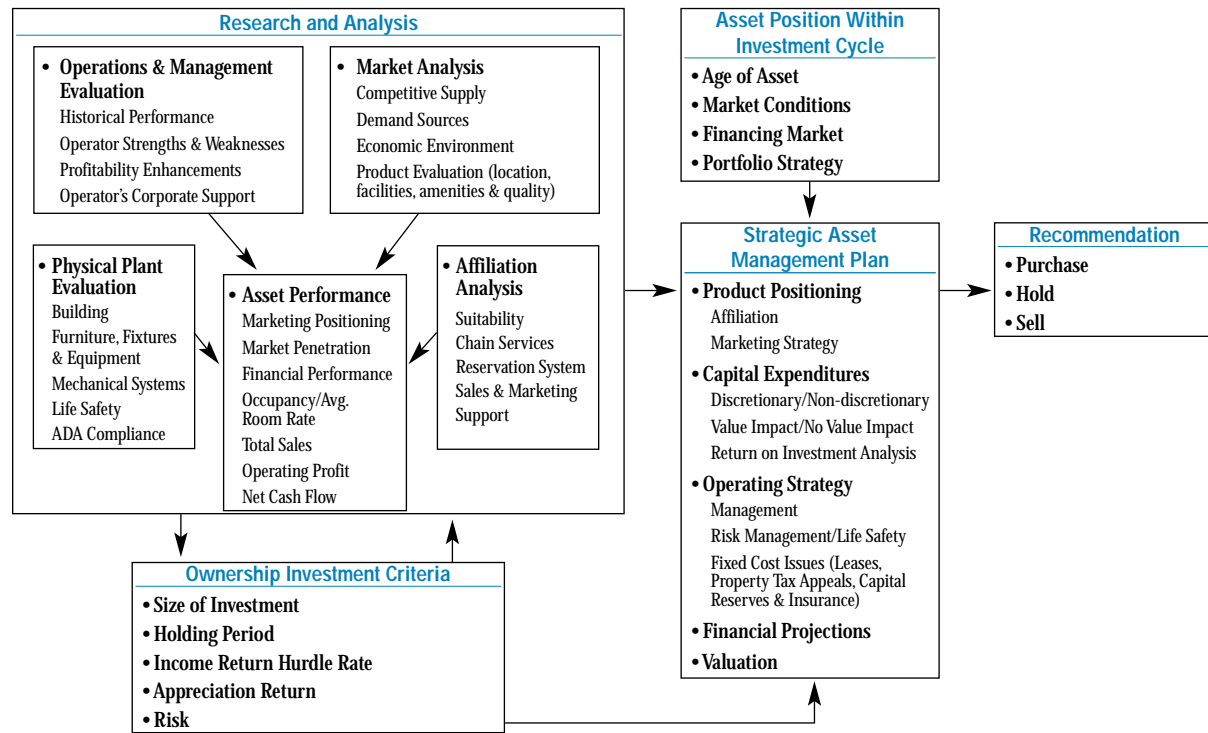
The above considerations are primarily concentrated on new investment propositions. Just as critical is the relationship between the market cycle and an investor's current portfolio mix. Too often, focus is given to macro-cycle issues, with an individual asset's life cycle given little emphasis. Certainly, the relative merits of the geographic and asset-type distribution of an investor's portfolio will be dictated in broad terms by the market cycle. But without an overlay of the asset cycle an investor should be loath to making buy versus sell versus hold strategy decisions.

Investors who help fill in the gaps in the industry's capital

The Ultimate Cycle - Market and Asset Overlay



**The Strategic Asset Management Planning Process**



Source: Joseph L. Pagliari, Jr., *The Handbook of Real Estate Portfolio Management*, (Chicago, Irwin, 1995), p.522

The broad goals of a hotel portfolio strategy focus on return, risk, diversification, liquidity and financing. The challenge is to translate these broad goals to be both definable and measurable. Once a target portfolio is identified, the hotel investor must develop a portfolio strategy. This must be consistent with the allocation ranges of the portfolio and the current and expected conditions of the underlying properties within the portfolio.

With an understanding of diversification and risk reduction at the portfolio level, investors should focus on developing a short, mid and long-term strategy for each asset in the portfolio. The more specific strategic asset management planning process for a hotel portfolio is highlighted as follows, culminating into either a buy, sell or hold recommendation by the investment advisor.

At the micro-level, hotels are retail-oriented, labour and capital-intensive businesses. At the macro-level, the lodging sector is cyclical, event sensitive, and volatile. Furthermore, at the micro-level, hotel products are similar to consumer products, experiencing four fundamental stages, or maturity levels, in their life cycle, these being introduction, growth, mature and decline.

Depending on the maturity level, specific strategies need to be implemented that are prudently timed in accordance with the relative position of the market cycle. That is, a market-

asset cycle timing strategy that changes if there is a recession, recovery, expansion, or contraction period.

During recessions, traditional investor thinking is to hold down expenses and write short-term leases, while during a recovery opportunistic acquisitions and/or the preference of holding properties prevail. During market expansions, the improvement of hotel real estate portfolio quality and core acquisitions becomes paramount. Then, in a contraction, the mood changes and the time is for portfolio diversification review, strategic dispositions and the writing of long-term leases.

Investors/owners need to also apply a three-dimensional, strategic thinking process that overlays the hotel market cycle with the hotel asset cycle, along with their underlying business strategies.

For example, if Hotel X's hotel asset cycle (maturity level) is in the introduction stage, but the hotel market cycle is in a recession, how should the investor/owner implement a pricing strategy that covers initial costs? As hotel investments are about controlling downside risk in order to maximise yields, adopting the market and asset cycle overlay will allow for accurate answers to the multifaceted questions of how the risk should be managed with adequate cash reserves, intelligent renovation plans, low property break-even levels, and an asset diversification strategy.

### Characteristics of the Hotel Asset Life Cycle Stages

	Maturity Level			
	Introduction Stage	Growth Stage	Mature Stage	Decline Stage
Rooms Revenues	Low	Fast increases	Little or no growth	Decline
Cash Flow	Low to negative	Moderate	High	Low
Competition	Little competition	Increasing in number and strength	Highly competitive	Declining in number
Demand Profile	Early adopters/risk takers	Mass market/target market	Mass market/replacement	Replacement
Marketing Expenditures	High	Continued high but decreasing as a percent of total revenues	Declining	Very low
Capital Expenditures	Low	Moderate	Moderate or high	High
Asset Appreciation Maximisation	Low	Very high	High	Low

Source: Jones Lang LaSalle Hotels

## Mid-Stream Investment Analysis

The downturn in the hotel markets that started in early 2001 has pointed to the need for a well-planned and well-executed exit strategy. Those investors who believed the boom-boom hotel real estate markets would continue forever, and that there would always be another investor willing to pay the seller-estimated price for their asset, have been sorely disappointed.

In 2003, investors must continue to recognise that hotel real estate is an illiquid investment within their overall portfolios, and that the disposition strategy should be one of prudence and patience.

Fundamentally, an exit strategy for a hotel investment/portfolio entails the following, as part of the mid-stream investment analysis that prepares an asset for sale, and maximises an investor's yield:

1. Hold-sell analysis for properties in portfolio.
2. Structuring transactions to enhance liquidity.
3. Constantly assessing the capital markets for the optimal debt/equity opportunities.

Hotels have a definite functional life, and asset values decline exponentially after the mid-life (mature stage) point of a hotel. However, major renovation and repositioning strategies can postpone a hotel's mid-life for many years, depending on the strength of its location and market, solidifying the seller's exit strategy.

The checklist for the mid-stream investment analysis include:

- a) How can you mitigate the potential lack of cash flow.
- b) How can the potential for negative-event volatility be reduced?

- c) What is the optimal capital expenditure/renovation program that renders the highest return on investment upon sale?
- d) Will the renovation program provide a sufficient return on investment, and is the payback period less than the balance of the holding period?
- e) Is the depreciation methodology applied prudent given the age of the asset and its underlying before-tax cash flow?
- f) Should an upcoming sale of a portfolio include assets individually, as a group, or a combination of group and individual sales?
- g) Is the sum of the parts greater than the whole portfolio?
- h) Does the estimated market value upon sale require an additional equity contribution, and if so, how will that gap be filled?
- i) Are there debt-restructuring possibilities that can increase equity levels upon disposition?
- j) What capital gains tax savings can be attained upon sale (i.e. 1031 Exchange)?
- k) Can the asset be sold encumbered or unencumbered, and if encumbered, how to mitigate this issue?
- l) To what extent will the event of sale impact the investor's balance sheet and credit rating?
- m) Is an asset in the portfolio a landmark property, which may need to be "carved-out" in order to reduce the overall risk of the portfolio?

Not preparing for a high-yielding exit puts the hotel investor at risk of leaving "money on the table". In essence, mid-stream investment analysis is not dissimilar to the process of personal financial planning that prepares individuals for retirement where the end goal is defined upfront and then worked backwards through specific

checkpoints over time. The event of selling the hotel asset at a predetermined point in time with the highest return is the end goal around which all mid-stream investment analyses evolve.

## Cross Border Investing - A Global Perspective From Local Knowledge

As world markets become more inextricably linked and travellers touch more destinations, hotel investment has increasingly become a global concern. Unlike pure real estate, this has grown not only from the widening search for acceptable returns, but also from a desire to build a dominant global presence. Many of the world's largest hotel owners are also the world's largest hotel operators e.g. Six Continents, Starwood Hotels & Resorts and MeriStar.

Excluding the brand building benefits, from a pure investment perspective, the benefit of going global is primarily diversification and the opportunity to earn higher returns. Capital will tend to flow from low-yield origins to higher-yield destinations. In the world of low inflation / single-digit returns, yield is king and the wider the geographic perspective the better the chance of finding it.

But investing across borders brings with it practical problems. Taxation, market transparency, current volatility and sovereign risk multiply as the perspective broadens. The sheer choice of markets is daunting: our 'World Winning Cities' research program has identified more than 100 cities in 47 countries with institutional-sized real estate investment markets. How can an optimal selection of markets be made from such a bewildering choice?

A common solution is to recognise only the North American, Western European and Asia Pacific regions, conduct a regional allocation exercise and then cascade the problem to the regional manager. This is a simple solution, however it overlooks the potential risks these regions conceal about relative returns. Analysis of returns around the world suggests that global diversification benefits have more chance of being efficiently captured if allocation is conducted at the country or city level rather than at the broad regional level.

We have found it best to frame strategy at the country level. Strategy is formulated in five steps:

1. Define the eligible countries.
2. Establish a neutral strategic weighting by reference to an appropriate measure.
3. Develop forecasts of expected returns and risk analysis to set a strategic balance.

4. Use country and market factors to set risk premia and required returns.
5. Compare the expected and required returns to finalise tactical portfolio tilts.

An international real estate program should follow the same path as a domestic strategy. The first step is understanding investor objectives, which are then converted to criteria to sift out countries that are either unlikely to contain stock capable of delivering appropriate returns over the preferred investment period or those that are currently seen as too risky. The remaining set of eligible countries comprises the portfolio universe.

The second step involves establishing the neutral position to ensure portfolios do not become over exposed to specific markets and economies, which can easily happen if portfolios are constructed on a deal by deal basis. For the hotel sector, neutral weighting can be based on GDP or size (total hotel rooms). An investor willing to accept illiquidity and transparency risks may well adopt GDP weights, as this better represents the potential of emerging and developing markets (like China and Mexico). On the other hand, those investors concerned about near-term liquidity may be better served by a neutral weighting based on size of investment grade properties where the weights are skewed towards advanced countries.

Having aligned the selected countries with the client investment objectives, we then generate alternative allocations based on trading off portfolio risk and expected returns using a suite of proprietary models. Returns are measured over a risk-free rate as detailed in the table below. The risk premium must of course be adjusted to fit the investor's risk tolerance.

**Ingredients of Market Risk Premia Above a Risk-Free Rate**

Factor	Typical Range* (bps)
Sovereign Risk	0-200
Property Market Transparency	50-300
Market Fundamentals	20-300
Management Experience and Brand Exposure	50-300
Leverage	0-200
Liquidity	50-200
Total Range	170-1,500

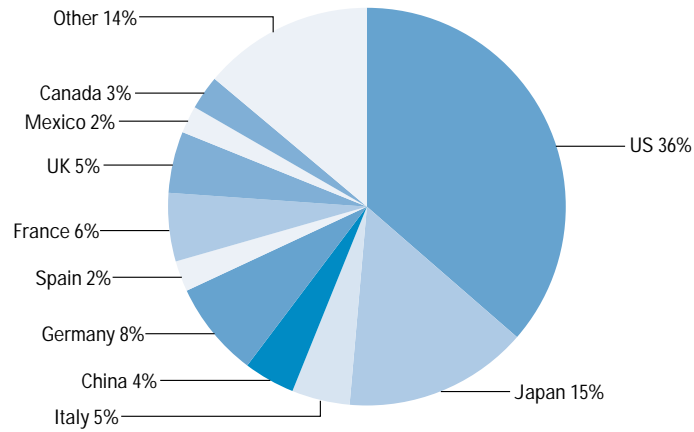
\* For stabilised properties in developed countries with less than 60 percent leverage.

Source: LaSalle Investment Management; Jones Lang LaSalle Hotels.

Converting an investor's objectives into reality is a complex process. As interest in international investing grows, potential risks multiply and it becomes important to use a structured process. In our cross-border strategies, we have chosen to retain a local focus even when looking across the globe so that we evaluate the rich diversity of world markets. Of equal importance, though, we have developed top-down processes that give investors a strategic view of how the various pieces fit together in an international portfolio.

**Hotel Investment Universe - GDP Share**

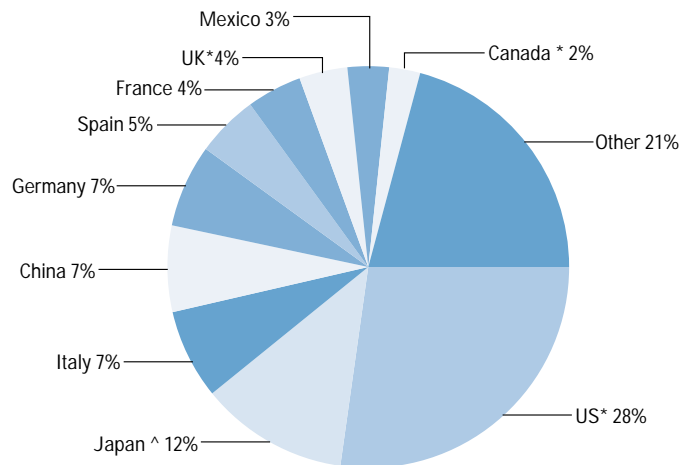
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Source: Jones Lang LaSalle Hotels, OECD, EIU

**Hotel Investment Universe - Hotel Supply Share**

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Source: Jones Lang LaSalle Hotels, World Tourism Organisation  
 2000 data (unless otherwise stated); \*1999 data; ^1998 data

## Risk Premium Factors

		Country	Rank by GDP \$ PPP* per Capita 2001	GDP U.S.\$ Billion** 2001	GDP U.S.\$ Billion PPP 2001	Growth Forecast 2002-06 %	Real Estate Transparency Tier 1-5	Country Stability Score
<b>Advanced Economies</b>	1	United States	\$35,600	\$9,810	\$9,810	3.10%	1	81.0
	2	Norway	\$30,200	\$162	\$173	2.75%	3	91.8
	3	Switzerland	\$30,100	\$231	\$340	1.70%	3	91.8
	4	Ireland	\$29,200	\$97	\$113	4.28%	2	89.3
	5	Denmark	\$29,100	\$153	\$207	2.43%	3	87.8
	8	Hong Kong	\$28,174	\$164	\$190	3.73%	2	84.5
	7	Netherlands	\$27,800	\$380	\$503	2.40%	2	86.0
	8	Singapore	\$27,146	\$84	\$111	5.13%	2	90.0
	9	Austria	\$27,000	\$189	\$270	2.08%	3	86.0
	10	Australia	\$26,300	\$366	\$462	3.58%	1	82.5
	11	Belgium	\$26,200	\$230	\$321	1.90%	2	84.5
	12	Japan	\$26,100	\$4,141	\$3,371	1.10%	3	85.0
	13	Germany	\$25,900	\$1,846	\$2,702	2.18%	2	83.5
	14	Canada	\$25,200	\$909	\$717	3.18%	1	84.8
	15	Finland	\$25,200	\$121	\$167	2.78%	3	89.3
	16	Italy	\$25,100	\$1,089	\$1,504	1.90%	4	80.5
	17	Sweden	\$24,800	\$210	\$281	2.55%	3	83.8
	18	United Kingdom	\$24,500	\$1,424	\$1,335	2.10%	1	82.8
	19	France	\$24,400	\$1,310	\$1,805	2.28%	2	81.5
	20	Israel	\$20,627	\$113	\$133	3.78%	4	65.8
	21	Spain	\$20,100	\$582	\$724	2.93%	3	80.8
	22	New Zealand	\$20,000	\$50	\$70	2.58%	1	79.8
	23	Portugal	\$18,000	\$110	\$129	2.05%	4	79.3
<b>Developing Economies</b>	24	Greece	\$16,800	\$117	\$145	3.40%	5	74.8
	25	South Korea	\$15,760	\$422	\$752	4.88%	3	79.8
	26	Chile	\$15,220	\$70	\$226	4.78%	5	76.8
	27	Hungary	\$12,400	\$52	\$57	4.10%	4	77.3
	28	Czech Republic	\$12,151	\$56	\$125	4.43%	4	76.8
	29	Saudi Arabia	\$10,980	\$186	\$236	3.48%	5	73.3
	30	Argentina	\$10,212	\$269	\$383	3.05%	5	49.3
	31	Poland	\$9,600	\$176	\$165	3.68%	4	75.8
	32	Mexico	\$9,100	\$617	\$902	3.25%	4	70.3
	33	Venezuela	\$8,750	\$126	\$215	2.10%	5	55.0
	34	South Africa	\$7,890	\$121	\$350	3.15%	3	66.8
<b>Emerging Economies</b>	35	Brazil	\$7,490	\$513	\$1,306	3.73%	4	60.8
	36	Colombia	\$6,921	\$82	\$298	3.25%	5	61.8
	37	Thailand	\$6,560	\$126	\$405	3.83%	3	76.0
	38	Turkey	\$6,400	\$148	\$430	4.23%	5	57.5
	39	Malaysia	\$6,210	\$88	\$157	5.23%	3	76.8
	40	Russia	\$5,401	\$310	\$781	4.23%	5	70.8
	41	China	\$5,120	\$1,159	\$6,505	7.78%	4	74.8
	42	Peru	\$5,053	\$54	\$133	4.50%	5	68.3
	43	Romania	\$4,827	\$40	\$108	4.60%	5	68.0
	44	Philippines	\$3,830	\$69	\$317	4.35%	4	71.3
	45	Ukraine	\$3,680	\$20	\$287.6 *	4.63%	5	68.0
	46	Egypt	\$3,570	\$93	\$233	3.43%	5	66.5
	47	Indonesia	\$3,210	\$131	\$696.8 *	4.60%	5	58.8
	48	India	\$2,536	\$403	\$2,584	5.93%	5	65.8
	49	Vietnam	\$2,250	\$33	\$177	6.90%	5	70.3
	50	Pakistan	\$1,910	\$54	\$277	4.78%	5	58.0

\* Purchasing power parity

\*\* At market exchange rates

Sources: EIU, Countrydata.com, LaSalle Investment Management.

## Financing Opportunities in 2003

Capital favour towards lodging has been hot and cold over recent years. The boom period of equity raisings between 1996 and 1998 was followed by a shutdown of public equity capital to hotels. Private equity and traditional lenders took over which resulted in an increase in spreads and tougher terms and conditions. Loan-to-value (LTV) ratios were (and continue to be) typically 65 percent or less. The table below highlights the fluctuation in average spreads for hotel loans secured by first mortgages.

However, conservative lending has been a saviour for the financial stability of the hotel sector. Default rates are at historic lows, with the average loan delinquency for U.S. hotels at less than one percent<sup>1</sup>. CMBS financing has been more aggressive, particularly at its peak in 1997 and 1998, sometimes financing properties at 70 to 75 percent of value. As a result of this more aggressive lending program, CMBS loan delinquency rates for U.S. hotels doubled as at the end of 2002 from the same period a year ago, but at 4.6 percent remains low.

### Open for Business

Even after factoring in the impact of 9/11, lenders saw fewer opportunities for new business than anticipated, particularly for larger loans (in excess of \$US 15 million). Restrictive terms and conditions imposed immediately following 9/11/01 began to ease in the latter half of 2002. While spreads were still wider and proceeds less than pre-9/11 levels, the gap narrowed considerably, and, because of the low interest rate environment, investors with well-capitalised properties could achieve very favourable financing terms. This trend is expected to continue into 2003, particularly as the anticipated recovery materialises.

Most hospitality lenders interviewed as part of the research for the 2003 *Hotel Investment Strategy Annual* maintained their commitment to hotel lending. Barring any major economic or political upheaval, they expect to see a modest recovery in operating performance over the

next two years. Re-financings are expected to be a larger source of business than new financings in 2003. This trend should continue over the next three to five years.

Worldwide, 1998 represented a record year for hotel financings. Notable proportions were financed for five-year terms and are therefore now approaching maturity. Many of these loans will be maturing at fairly high LTV ratios, and may require new equity and/or mezzanine debt to accomplish a refinancing.

### Plain Vanilla Acquisition Financing

Attractive financing terms exist for qualified investors. Preferred property types will be upscale and above in CBD locations and urban resort properties with high barriers to entry. Select lenders in all classes of credit providers (commercial banks, international banks, investment banks, life companies, credit companies) will consider acquisition financing in this category. Depending on the particular property, senior lenders will generally offer lending on a 55 to 65 percent LTV basis. Both floating rate and fixed rate financing is typically available for acquisition financing. Floating rate financing is usually priced off of LIBOR<sup>2</sup>, currently at historical lows. Some institutions that price off of LIBOR, usually investment banks, often require a LIBOR floor, which can be 2.5 percent or higher. Borrowers who opt for floating rate debt would do well to enter into an interest rate swap agreement, which essentially locks in a low interest rate for the term of the loan. Fixed rate lenders typically finance on a longer-term basis and price off of Treasuries.

### Adding Some Flavor with Mezzanine Financing

Investors who feel comfortable with a higher level of leverage may wish to consider adding a mezzanine tranche to their capital structure. Mezzanine providers, which include commercial banks, investment banks and opportunity funds, will lend additional funds to bring total proceeds to 65 to 75 percent of value. While mezzanine

**Basis Point Spread on a Hotel Loan of \$US 20 million**

	North America	Europe	Asia	Australasia
1996-1998	150-225	75-150	75-150	100-175
1999-2000	200-300	100-200	100-200*	125-225
2001 (pre-9/11)	200-300	150-250	150-250	135-235
2002	225-350	175-300	200-300	115-215

\*only in select countries like Singapore, otherwise debt markets effectively closed  
Source: Jones Lang LaSalle Hotels

<sup>1</sup>Source: American Council of Life Insurers (ACLI)

<sup>2</sup>London Inter-Bank Offering Rate

debt is more expensive and increases the risk profile of the investment, an investor can significantly improve their leveraged IRR for a property that is expected to experience steady improvement in operating performance.

The comparative equity return advantage of mezzanine finance is illustrated in the table below. On the assumption that a hotel valued at \$US 50 million was earning an EBITDA<sup>3</sup> of \$US 5.5 million a year (11 percent yield) and achieved an annual EBITDA growth of four percent, this table shows a 370 basis point (17.1 percent) gain in IRR for an owner pursuing a mezzanine portion to their debt structure (over a five year hold).

### Refinancing Existing Debt

You have weathered the storm of the last year – you have been able to keep your loan current and meet your covenant requirements. Cash flow is projected to improve steadily, if not dramatically, over the next two years. Should you refinance? There are a number of factors to consider in determining if this makes sense for your investment. Does your loan have substantial prepayment penalties or yield maintenance? Are you comfortable with the current loan amount, or are you hoping to refinance for a higher level of proceeds? Does the current LTV fit within your lender's criteria, or will they request a pay down in order to refinance? Do you plan on holding the property long term, or do you think you may sell in three to five years?

*Loan with less than two years to maturity, comfortable leverage ratio.* If you and your lender are comfortable with the present loan amount, and you are a long-term investor, refinancing your loan early may be cost effective in the long run. Locking in to a low interest rate now for a five to ten year refinancing may justify any prepayment costs. A fixed rate loan priced off of Treasuries, or a floating rate

transaction with an interest rate swap will provide long-term protection against rising interest rates.

*Loan with more than two years to maturity, comfortable or highly leveraged transaction.* Depending on the type of financing you have, the longer your maturity the less cost effective it may be to refinance. If you have fixed rate financing the yield maintenance and/or prepayment expense may make refinancing prohibitive. If you have a floating rate financing that is unhedged, this may be a good time to invest in an interest rate swap or other derivative product. In either case, if your loan matures in three to five years, you are likely to be refinancing in a more aggressive lending market, and should be able to maximise proceeds and reduce interest rate spread. This will partially offset what is likely to be a higher interest rate environment in the medium term.

### Construction Financing

Construction financing, while hard to come by, is available in limited cases. Senior lenders are willing to extend financing on a very low cost basis, and in some cases will require loan guarantees for a portion of the loan. Some mezzanine lenders will also consider construction projects, but at leverage levels below that of existing properties. In this sub-sector, it is a lenders' market, so borrowers must be able to demonstrate experience and expertise, and the market data must justify the new supply. Projects must also be well capitalised and have a proven manager.

### Opportunities For Lenders in 2003

The hotel debt environment is clearly improving. While many countries are hampered by a still sluggish economy, those with a low interest rate environment and relatively stable banking conditions will provide opportunities for hotel investors to raise capital. For hotel lenders, from a risk/return basis there has never been a better time to provide new capital to this industry. The majority of major hotel markets worldwide appear to have hit the bottom of the cycle. Lenders will be able to find attractive lodging investments at lower leverage and higher yields than other real estate asset classes. From a risk-adjusted return standpoint, this means lenders will be well positioned to take advantage of improving hotel market fundamentals.

#### Introducing a Mezzanine Portion Increases Returns

	Senior Loan Only	Senior Loan with Mezz
<b>Funding</b>	<b>(000's)</b>	<b>(000's)</b>
Senior Debt	27,500	27,500
Mezzanine Debt	0	7,500
Equity	22,500	15,000
Total	50,000	50,000
<b>Pricing</b>		
Senior Loan	6.5%	6.5%
Mezzanine Loan	0.0%	13.0%
<b>Ratios</b>		
Senior Loan LTV	55.0%	55.0%
Total Loan LTV	..	70.0%
Total Loan DSC	2.4x	1.6x
<b>Equity Returns</b>		
Leveraged IRR	21.7%	25.4%

LTV - Loan to Value ratio; DSC - Debt Service Coverage ratio

Source: Jones Lang LaSalle Hotels

<sup>3</sup> Earnings Before Interest Tax and Depreciation Allowances

## World Winning Cities for Hotel Investors

Fast-forward ten years. Changes in population, consumption and the natural environment have spawned the next generation of world winning cities. Imagine if 10 years earlier you had the knowledge to indicate the cities that would be world-beaters in the lodging industry, and therefore made investment decisions that pre-empted this success.

Compelled to make this vision a reality, Jones Lang LaSalle has embarked on a multi-year quest to identify the cities most likely to succeed in the future. The objective is not merely to identify a global winner. The emphasis is also on spotting cities that will grow fast and change their nature, thus creating profitable investment opportunities. The project will identify both the 'rising urban stars' whose names may well be virtually unknown internationally, and those that are reliable performers – New York, London, Paris and Tokyo<sup>4</sup>.

The set of historical winners of the last decade (Dubai, Dublin and Las Vegas) were determined through a measure of city growth performance (measured by population and employment growth), real estate activity (measured by office net absorption and construction rate) and real estate performance (measured by prime office rental change).

Yet already this research has found that historic drivers of success are not wholly relevant to determining future winners. In contrast, new metrics are being formulated which combine analytical econometric approaches with softer studies that begin to anticipate the power of place marketing, the development of human capital and vitality, of the real estate response to supporting destination growth.

Importantly, this 'World Winning Cities' research is not designed to bequeath a generic list of cities that win on an

overall basis. Rather, the outcome will be the development of a 'mega-database' which not only houses all knowledge relevant to city growth, but also crafts efficient relationships between the various co-dependents of specific real estate industries. This allows for a customisation of what winning is and means to different audiences. For example, a hotel investor focusing on building a global portfolio of high-end resorts will have a different notion of 'winning' than an owner/operator trying to consolidate national brand presence in the mid-tier segment.

There are many ways to approach identifying future successful cities/destinations for the hotel sector. Ascertaining if hotels act as a leading indicator of a city's overall success, and what those criteria are, could mean an investor could enter a market before it becomes over-priced and/or over-built. This leading versus lagging indicator issue was debated in the latest edition of Jones Lang LaSalle's *Property Futures*, therefore we will not go into detail. Needless to say, this area is grossly under-researched and will require thoughtful consideration and case study analysis to identify common criteria for predicting city success.

Another key measure of determining the relative future success of different hotel markets is to consider elasticity of supply and demand. Elasticity is an important measure for investors because it indicates the cities where RevPAR levels are most likely to change—either up or down. Furthermore, these markets should be more predictable, thus creating better opportunities for profit. While RevPAR in itself is not a perfect measure of asset profitability<sup>5</sup>, it does provide a consistent benchmark from which to evaluate different hotel markets (geographic or asset type) around the world. Analysing elasticity patterns will be the next stage in this evolutionary project. Stay tuned for unfolding conclusions throughout 2003.

<sup>4</sup> For details on the World Winning Cities methodology, see *Property Futures*, December 2002.

<sup>5</sup> RevPAR is only a top-line measure and does not take into consideration variable and fixed costs which have a marked impact on bottom line profit.

# Americas - Opportunities in 2003

Hotel recovery will continue to build in 2003 but lackluster economic growth will reign in any astounding improvements. Teeming capital markets (both debt and equity) will grease the transaction wheels, with a mass of buyers (at more realistic prices) enticing sellers, thereby triggering an active transaction market.

## Hotel Investment Opportunities in 2003

Strong Buy	Select Buy	Watch
Montreal	Los Angeles	Caribbean
New York	Boston	Orlando
San Francisco	Chicago	Atlanta
Seattle	Cancun	Miami
Vancouver	Mexico City	Dallas
Washington D.C.	Calgary	Houston
Ottawa	Salt Lake City	

Source: Jones Lang LaSalle Hotels

## United States

The general consensus is that hotels have “bottomed out.” According to the NCREIF, the sector generated its first positive total return since 9/11/01 in Q3-02, and while not stellar results, hotels outperformed all other asset classes. This reverses a trend of “write-downs” that started last year, and has now spread to other real estate sectors.

The 2002 *Hotel Investment Strategy Annual* identified the economy as the biggest uncertainty for hotel investors. In 2003, the state of the economy is still in question, but the bigger uncertainty revolves around resumed business investment and job growth. Unless the economy shifts into a higher gear early in the year, occupancy growth will be stifled and ADR pressure will be on the downside.

Consensus forecasts predict 2.8 percent GDP growth in 2003, driven by continued consumer spending and an increase in business investment. Neither is a sure thing, particularly if there is a military action in the Middle East. Assuming reasonable economic growth, RevPAR is expected to post a four percent increase in 2003, with the giddy heights of 2000 to be enjoyed again by 2004/05.

The map graphic at the end of this section indicates our expectations for the major cities throughout the Americas in 2003. The results are somewhat beguiling as many of the major markets are forecast to achieve ‘above average’ growth rates. But this is more a reflection of how significant the downturn in these markets was in 2002

compared to the national average, as opposed to any spectacular ‘real’ growth rates. In many cases growth rates will barely lift major cities to 1998 levels.

## Get Excited

As the clock ticks over into 2003, the U.S. lodging industry has reason to welcome in the new year:

- *Shrinking supply pipeline.* Pegged at the lowest rate in six years, the one percent increase expected in 2003 is the huge reprieve the industry needs. This follows on from a 30 percent decline in room starts during 2002. Given the trading outlook, new supply will remain constrained until at least 2005.
- *Bottom line boosters.* The industry has done a tremendous job of cutting costs, including reducing non-essential services, cutting payroll and deferring maintenance. This has dropped the break-even occupancy below 50 percent. In fact, during 2002 it is expected industry profits will have increased almost three percent. While there will be some movement once demand recovers (those carpets and bedspreads have to be replaced sometime), more money will continue to flow through to the bottom line.
- *When a dollar isn't a dollar.* If the expectation among economists for a mild devaluation in the U.S. currency comes true, domestic leisure destinations (e.g. Florida markets, Hawaii) and those known for their international visitor appeal (e.g. New York) will benefit (assuming the economy in origin countries is not systemically weak).
- *Leading indicator effects.* While hotels are often the first to show signs of an economic downturn, they are also the first to rebound with economic recovery. Positive movements forecast for the economy in 2003 will translate directly to the lodging sector because of their ‘24-hour lease term’.

- *Regional markets and drive-to destinations.* These will continue to post better than average performance, given their perceived safety, accessibility and affordability for family leisure travel.
- *Full-service hotels in supply-controlled 24-hour cities.* Markets such as Washington D.C., and New York will be the first to benefit from demand recovery as they have the combined bonus of highly diversified economies, operating efficiencies and minimal new competitive pressures.

### Watch Out

While the worst is over for hotel performances, in 2003 investors should watch out for:

- *Weak corporate demand.* This will be one of the biggest risks in 2003, as the economy waits for business investment to gain traction. Leisure travellers continue to sustain the market, which is limiting ADR growth. Rate will continue to languish until corporate travel expands to near-historic levels, now forecast for mid-to-late 2003. This will most directly benefit luxury and upscale properties
- *Problems in the skies.* U.S. Airways and United Airlines (UAL) have sought protection under Chapter 11, while American has recently shaved an additional 7,000 jobs. The UAL restructuring will have the most prolific impact on the travel industry since it operates 20 percent of all U.S. flights. Fewer flights, substantial layoffs and other far-reaching cost cutting measures are expected as a result.
- *The triple terror.* A deterioration of the economy, war with Iraq and/or further terrorist attacks will clearly have a negative impact on hotel demand, particularly if the latter are targeted at tourism centres (a la Bali).
- *Major urban markets.* Markets such as Chicago, Boston, San Francisco and Miami are expected to remain weak into late 2003 as corporate demand remains frail and susceptible to economic conditions. These markets also have a high international component, which has suffered declines in 2002. Given weak economic conditions abroad, the trend in international travel will barely post a respectable turnaround in 2003, although a U.S. currency devaluation will help stimulate demand. Chicago will be supported by a strong convention year, however the financial troubles of UAL, Motorola and the loss of American Airlines provide a negative counter. Boston and San Francisco will continue to feel the tech-pain in 2003. New supply has salted wounds during 2002 although this should abate materially in 2003. Miami will remain weak as long as Latin America languishes and developers insist on

overbuilding. Investors here will have to wait until 2004 for a real recovery.

### Hungry for a Deal

Numerous and diverse sources of capital are targeting U.S. hotel real estate based on high (leveraged) cash returns, creating the unusual scenario of weak fundamentals and strong capital markets. The sheer lack of product being offered for sale and an absence of new development financing is a large factor in this unallocated capital scenario. Further, this capital views the hotel industry as being at a cyclical low, thereby providing significant upside potential.

Transaction volume dropped an estimated 50 percent in 2002 to approximately \$US 2.7 billion throughout 57 deals (over \$US 10 million), consistent with what we predicted in our *FocusOn* published in Q3-02. Average price per room dropped modestly to \$US 106,500, the result of the economic funk on upscale and luxury hotels, thereby resulting in a lack of trading activity for these asset types. Pent-up demand is being liberated following a year of uncertainty and inactivity. The prohibitive cost and availability of terrorism insurance in major cities has been an issue in 2002. Institutions and REITS have been able to keep costs down by pulling blanket policies to cross-insure assets. It is hoped that federal relief will become a reality by early 2003.

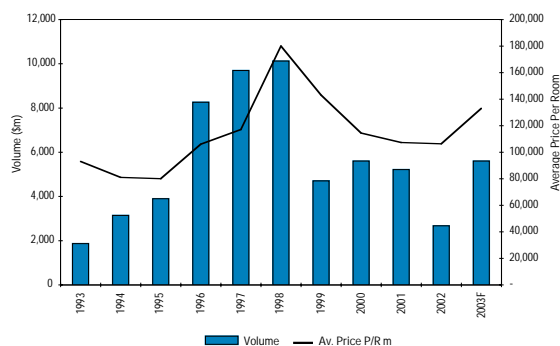
During 2003, low interest rates should prop up returns and keep investor interest high. A mass of buyers (encouraged by improving pro formas) and funding will precipitate higher prices, which will entice more sellers to market, leading to more transactions and heightened liquidity. Transaction volume is expected to hit a five-year high in 2003 at around \$US 5.7 billion. As the graph demonstrates, price per room will also enjoy an upswing, the coalescence of competitive conditions and an increase in the transaction activity of upscale hotels. Yields are expected to remain static although some modest downward pressure might occur in some markets.

*Who will be the sellers?* 2002 has been a year of introspection for many hotel players. The performance shocks have startled companies into focusing on understanding the strategic alignment of their portfolios. As a result, we are likely to see divestment of non-core assets. Brands will continue to divest assets in 2003 to pay down debt and expand their basket of long-term management contracts. Owner operators will do the same, but will also use the funds to build their mainstay product types and locations. The Wyndham portfolio sale of 14 assets (\$US 517 million) in late 2002 is a classic example of this trend. Further, institutional owners and private equity

players, who have been holding assets longer than anticipated will seek to trade out of existing assets as the market trends upwards. Also expect some modest activity from special servicers.

*Who will be the buyers?* Buyers will seek to enter the market at the bottom of the cycle and reap the rewards of the combined effect of the expected economic turn-around and the dearth of new supply. REITs will likely reappear in mid to late 2003 as their share prices stabilise, giving them scope to raise capital. Their inherent structure demands that they grow in order to retain share price power. However, private and institutional capital is expected to dominate in 2003, often teamed with operating partners. Pension funds have limited exposure to hotels and while this is unlikely to change radically anytime soon, the contrarian opportunity is likely to compel greater interest in hotels over the medium to longer term. 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 depending on its success, this could be replicated in the United States.

#### Major U.S. Hotel Transaction Trends



Source: Jones Lang LaSalle Hotels; HVS Lodging Databank

#### Disciplined Capital Markets

Twelve months ago we warned against getting excited about foreclosure opportunities and 50 cent in the dollar acquisitions. The presence of well-functioning capital markets, a result of the banking reforms and public market growth of the 1990s, placed strict underwriting criteria on hotels. This has prevented undisciplined capital from unbalancing the market during the past cycle and should continue to provide liquidity during the current downturn. While default rates are predicted to rise modestly in 2003 (primarily due to interest rate increases coupled with weak fundamentals), they will remain at historically low levels. Translation: there will be no widespread vulture opportunities in U.S. lodging investment.

#### Top Investment Strategies for 2003

Hotels offer the potential to earn attractive risk adjusted returns. But timing and planning is critical. The following are our top investment strategies for 2003:

- *Restructure or refinance your loan.* The debt markets remain open although pricing has become more conservative i.e. 225 to 325 basis points over LIBOR and LTV ratios lower (55 to 65 percent). Given the almost non-existent development market and limited transaction environment, there remain a notable number of lenders seeking hotel financing opportunities, and underweight in hotel deals.
- *Put some mezz in your stride.* Maturing loans on a highly leveraged basis should look to mezzanine financing to help bridge the gap. Mezz provides a lower cost alternative to equity if additional proceeds are required for re-financing.
- *Anticipate movements in LIBOR.* For interest rates, the only way is up. Ensure you are hedged against changes in LIBOR (expected over the medium term) otherwise you could end up unable to service loans, particularly if cash flow remains weak. The large amount of floating rate debt in the market equals the potential for isolated distressed acquisition opportunities.
- *Play the market cycle.* Buying at the trough is the best time. And guess what... we are there (see Hotel Market Cycle charts at the end of this section). Some markets, such as Washington DC and New York have already passed their lowest point, while others (Orlando and Chicago for example) may still have downside potential. Acquiring assets now and selling in three to five years when the market is toward the peak is smart strategy.
- *Selectively acquire upscale properties.* Yes upscale properties. Similar to the theme behind counter-cyclical investing, buying at the bottom of the performance cycle makes sense. It just takes chutzpah! This sector has been hit hardest but has also shown the strongest turn-around. Faster-than-average gains will ensue as the corporate demand recovery builds in late 2003.
- *Seek properties with turn-around potential.* Whether it is a hotel with capital requirements or a brand and management change, as the market improves and supply is abated, properties with these characteristics will provide the highest risk-adjusted returns.
- *FocusOn 24-hour cities with diversified demand.* The experience of Denver and San Jose for example should provide some guidance to investors about the risk of markets that rely on one industry.

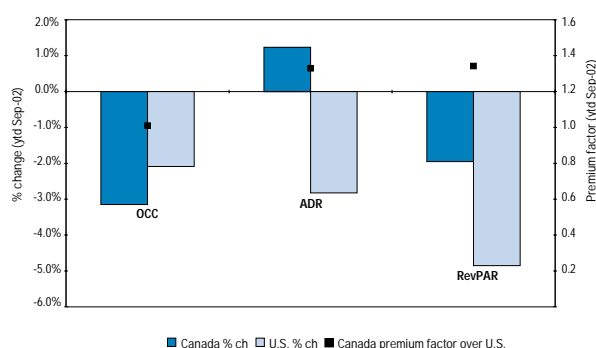
- *Don't let cap rate kill the deal.* Assessing the value of a deal purely from yield is irrelevant in today's market. Look at a stabilised year (1999 is a good pick) and obviously growth prospects, for a real assessment of value.
- *Get some Northern Exposure.* Canada's undervalued economy and hotel sector deserves attention, but investors must be selective as some markets, such as Vancouver, are weak.
- *Sell non-core assets.* The abundance of capital should underscore confidence in achieving reasonable pricing expectations. Shedding non-core assets will free up capital to pursue debt reduction or strategic asset accumulation initiatives.
- *Sell into the improving market.* If you have held a property that was scheduled for sale one-to-two years ago, consider a sale in mid-2003. Investors are seeking value, but will be willing to value the upside to the extent that a market turn-around is apparent.

## Canada

Hotel investment opportunities in Canada should be especially attractive to investors in the United States during 2003. Canada's GDP growth will exceed that of the United States in both 2002 and 2003. Compared to its trading partner to the south, the latest cycle saw less development and less volatility in earnings.

In spite of current softness, the Canadian lodging sector has outperformed its U.S. equivalent, as demonstrated in the graph below. During the first three quarters of 2002, Canadian hotels recorded a lesser RevPAR decline than the United States. To achieve this, Canada debunked the trend and recorded overall growth in ADR. In fact, just under half of Canada's 23 major markets recorded an increase in RevPAR during the period. This represents a substantial departure from the trend witnessed in major markets across the United States.

**A Comparison of Lodging Markets -  
Canada versus United States**



Source: Jones Lang LaSalle Hotels; HVS Lodging Databank

During 2003, we expect occupancy to gain some minor ground although supply increases will remain prevalent in some major markets. However, building on ADR resiliency already demonstrated in 2002, we predict growth of approximately three percent during 2003. This performance will vary across markets. Some, such as Montreal, Toronto and Edmonton will enjoy faster than average performance gains. In fact, Edmonton has been one of the fastest growing Canadian markets, recording a RevPAR compound average annual growth (CAAG) of 6.6 percent over the last four years. The city even experienced a substantial 11.9 percent RevPAR increase during 2001 and has continued to act contrary to trends by growing at 4.1 percent during ytd September 2002.

Montreal and Toronto also remain solid bets for investors during 2003 with a strong leisure appeal and diversified commercial centres. Montreal will continue to outperform on employment growth terms, while Toronto is Canada's fastest growing city with a strong GDP growth of 4.8 percent. Vancouver experienced its second slow year of economic growth in 2002 and this, combined with an influx of supply, has facilitated deteriorating performance in the hotel sector. This is likely to continue into 2003 as the market works to absorb supply and reinvigorate its economy.

Limited liquidity has characterised the Canadian hotel market during 2002. This is not dissimilar to the United States, however investors might also raise additional questions concerning the depth of certain markets. There is expected to be some uptake in investment activity, particularly as capital remains tight for new development.

## Latin America

Developing regions have the lure of vast returns but at the same time vicious risks. Hotel investment performance across Latin America is currently demonstrating that full spectrum. Mexico is a standout performer. Its fiscal austerity has helped immunise the country from the problems of Argentina and Brazil. The impact of the economic nosedive, which commenced in Argentina and spread to Brazil, is having serious consequences for their hotel markets, with many destinations also grappling with oversupply problems. There remains potential for economic contagion throughout the remainder of Latin America economies, which will negatively impact hotel markets in 2003.

## Argentina

The economic crisis that 'blossomed' during late 2001 has taken a ferocious hold over Argentina. GDP contraction is expected to measure up to 15 percent in 2002, according to the International Monetary Fund (IMF). Further declines are predicted for 2003, marking the fifth consecutive year of economic contraction. Argentina's Central Bank maintains its economy will grow 2.6 percent next year. Abandoning the U.S. dollar peg has meant inflation has run wild, shooting up to 41.3 percent in 2002 (80 percent in supermarkets) and 21.3 percent next year according to the Central Bank.

Given the volatility of the situation, economic forecasts are prone to change dramatically. The April elections are anticipated to spawn political violence and increased social tensions. Argentina is already subject to a skyrocketing crime rate, stimulated by the deepened recession and subsequent erosion of real incomes by inflation and devaluation. Argentina will also have to find funds to repay its overdue loan to the IMF in late 2003.

The plummeting peso has however had some beneficial effect (namely exports, including international tourism) and there is some flickering light at the end of the tunnel. The construction sector, one of the largest employment sectors in the country, grew in Q3-02 as well as retail sales, fuelled by foreign demand from Chile, Brazil and other non-English speaking countries attracted by the cheaper exchange rate.

The hotel sector in major cities, particularly Buenos Aires, continues to choke on supply increases introduced between 1999 and 2002. Oversupply and anemic demand has precipitated massive discounting across many of the major markets. But by all accounts this strategy is showing dividends, with regional and European visitors enticed despite safety threats. Given that further downturn is anticipated in 2003, only dramatic, solid and isolated investment opportunities should attract new investors to this troubled nation.

## Brazil

The success of Luiz Inacio Lula da Silva in the October elections caused some relief amongst economic circles. While yet to prove himself, his loud economic rumblings of fighting inflation and turning the Central Bank independent led to an firming of the Real, which was until then devaluating rapidly. Other evidence of confidence is that the outflow of currency from accounts held by non-Brazilians has markedly slowed down from a high \$US 1.7 billion before the election in October to a mere \$US 300 million in November. Foreign direct investment is holding up, while exports have surged and imports decreased, positively impacting the Brazil current account.

Despite Argentina's influence, Brazil is expected to return GDP growth of 1.2 percent in 2002 and 2.2 percent in 2003. Faster than expected GDP growth of 2.4 percent in Q3-02 provides faith that the country will achieve these growth rates. However, Brazil's broadest inflation index has to-date risen at its fastest pace in more than eight years, with a rate in excess of six percent expected in 2003. This suggests interest rates will continue to increase, a potential damp towel for broad economic growth. Yet Brazil still looks in comparative good shape in the context of many other Latin American economies.

Brazil's urban hotels are deeply affected by oversupply. In particular, São Paulo is struggling with its second year of a two-fold increase in supply. Resort destinations such as Costa do Sauipe are becoming increasingly popular with domestic demand due to the depreciation of the Real and the overall collapse of pricing. Investors are recommended to proceed with extreme caution as it is expected that over the next 12 months major markets, like São Paulo will remain in the decline phase of the hotel cycle. It is unlikely that Rio de Janeiro will experience the same oversupply problems due to the topography of this coastal city creating natural barriers to entry.

## Caribbean

Visitation to the Caribbean remains weak given the U.S. slowdown (which alone supplies 65 percent of visitors to the islands) and financial trouble in key Latin American markets. Virtually all destinations have experienced a decline in visitors during 2002, averaging in excess of 10 percent. While some growth in demand is predicted for 2003, weak forward bookings suggest a tepid, if not cold, recovery.

In particular, the struggling U.S. economy-pegged markets such as Puerto Rico, the Dominican Republic and the U.S. Virgin Islands are expected to experience continued weak demand in 2003. The former two markets are also experiencing supply increases. Puerto Rico for example, has plans to commence building more than \$US 2.2 billion worth of new hotels in 2003, with 56 projects at various stages of planning.

One of the biggest challenges the islands face is competition from the cruise line industry. Capacity has been increasing for years now at double-digit rates, and supply is now outpacing demand. Despite slowing demand for passenger cruise vessels, heavily subsidised foreign shipyards continue to build them. Cruise ships have an inherent cost advantage, particularly in terms of labour. This makes it easy to compete with land-based hotels operating in the heavily union-regulated environment of the Caribbean.

A number of hotels have closed throughout the Caribbean, including the Hyatt St. Lucia, which was less than one year old. That hotel was subsequently sold to an operator for a huge discount to its original construction costs. We expect to see significant discounts in the Caribbean and a lot of value for investors partnered with the right operators and some tolerance for risk.

**Mexico**

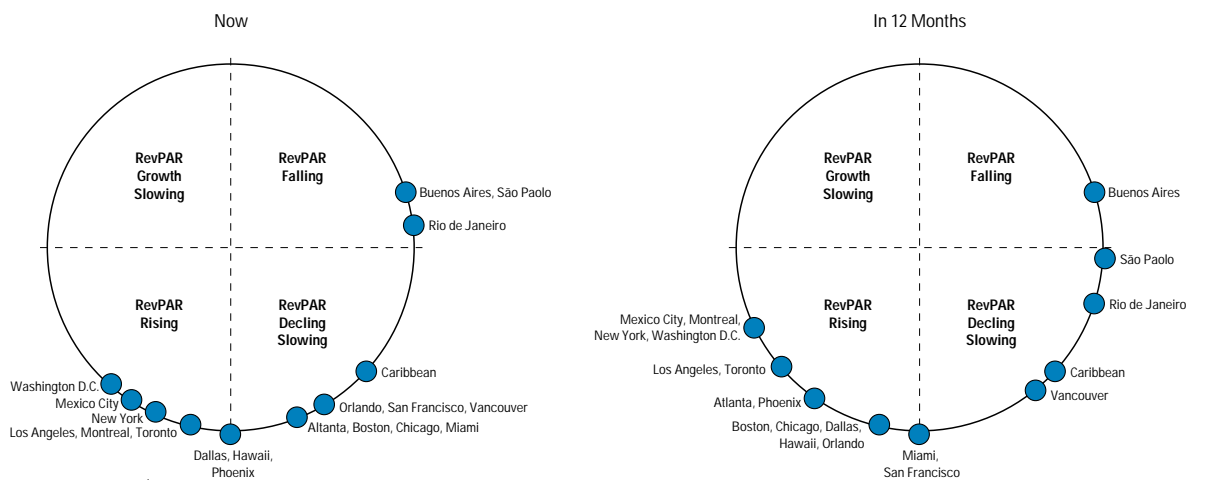
Mexico represents a logical location for well-capitalised investors looking for diversification and high returns. Mexico offers high growth rates, an expanding middle class and in some cases, well established tourism infrastructure (such as airports, attractions etc). Now the 11th largest world economy, Mexico has maintained a tight fiscal policy in recent years, which has stabilised the Peso and lowered inflation rates.

In addition, government debt earned an investment grade rating in 2001, and foreign reserves are at an all time high. The country demonstrates ever-higher degrees of integration with the United States. This creates a favourable environment for yield convergence and a higher

transparency. As a rapidly developing country with a GDP approaching six percent of the U.S. level, Mexico presents investors with intriguing investment opportunities. While the levels of sovereign and property transparency risks in Mexico remain comparatively higher than the United States, they have and will continue to decline for the foreseeable future.

Mexican resort areas, while suffering from some short term overbuilding, are considered safe, accessible and affordable. This will continue to boost performance in 2003. Performance in resort destinations on both coasts, namely Cancun and Puerto Vallarta, were hurt by hurricanes during 2002. However, in general, performance conditions have remained remarkably clear, as leisure travellers, both from the United States and Europe, continue to visit. New supply in Riviera Maya is now capped with very limited new building taking place due to the lack of funding. Cancun is projected to absorb its new supply quickly, and is positioned to recover the fastest. Mexico City hotel occupancy and ADR has shown resilience and stability and should continue to perform well in 2003 in tandem with the U.S. economic recovery.

**Americas Hotel Market Cycle**



Source: Jones Lang LaSalle Hotels

The Future for Major Cities Across Americas



\*Jones Lang LaSalle's Regional Economic Growth Indices (REGI) provides a leading indicator of the economic strength of 150 major cities across the Americas. Based on several factors such as forecasts of employment, population and income, employment momentum and business conditions, the REGI Indices provide a broad measure and comparison of the forecasted economic health of prime property markets. As of Q3-02.

\*\*Benchmarked against the U.S. average. When reviewing these rankings keep in mind that many of these markets performed very poorly in 2002, which explains why their growth rate in 2003 is so strong against the U.S. average. In many cases this growth rate will barely lift them to 1998 levels.

^Canadian REGI which ranks 10 major cities in Canada. As of Q3-02.

## Europe – Opportunities in 2003

The European market remains volatile and difficult to predict. Despite the underlying strength in hotel markets, which will ensure strong buyer sentiment, in 2003 investors are advised to be more prudent than ever.

### Hotel Investment Opportunities in 2003

Strong Buy	Select Buy	Watch
London	Regional UK	Spain
Paris	Scandinavia / Baltics	Central & Eastern Europe
Italy	Regional France	
	Czech Republic	
	Amsterdam (city centre)	

Source: Jones Lang LaSalle Hotels

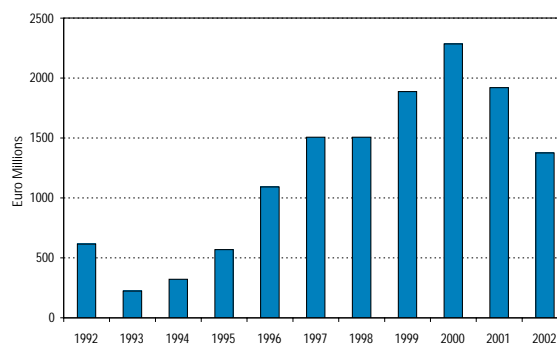
During 2002, Eurozone GDP growth forecast is down again, to only 0.8 percent. Growth in both Germany and France continues to be sluggish. The forecast for the Eurozone in 2003 is now below two percent, with growth in Germany expected to be below one percent. As a consequence, a return to long-term growth levels is not expected until 2004, possibly 2005. However, interest in quality hotel investments remains strong with debt still available, especially given the lower Euro cost of borrowing and relatively stable five and ten year swap rates. Transparency of prices since the introduction of the Euro throughout much of Europe should encourage further investment in 2003. Results from the close of 2002 demonstrate that trading is beginning to recover, but this recovery remains patchy, with the situation in Germany remaining particularly challenging. Within Europe, the economic slowdown has been more prolonged than originally anticipated.

Despite the weakening occupier demand for hotel real estate, investment funds continue to flow into the asset class. The performance of equities and low yields offered by bonds has attracted investors to property. Although other property asset classes are beginning to experience real downside, quality hotels have become a more mainstream asset class, especially in the UK and France, and continue to attract capital. A strong trading cycle for hotels, accompanied by improving profitability, and investment returns, which coincided with a new era of low inflation, low interest rates and, latterly, poor equity performance, has bought about this increased interest. Historically, hotels are the first form of real estate to experience the effects of economic downturn, but also the first to benefit from recovery.

Not surprisingly, hotel investment volumes have fallen in

2002, although to a lesser degree than might have been expected. There remains a lot of capital looking for product. The fall in volumes is more a consequence of sellers choosing not to bring assets to market in a depressed trading environment, rather than a lack of buyers. The number of sale and leaseback transactions have increased, and the phenomenon is slowly spreading to parts of continental Europe.

### Single-Asset Transactions Across Europe (Over €10 million)



Source: Jones Lang LaSalle Hotels

### Issues for 2003

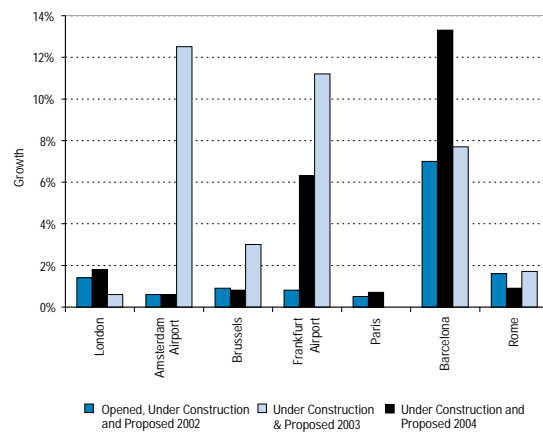
A number of issues will influence the hotel performance and investment landscape in 2003 as follows:

- *Is there capital available?* In 2002 debt has continued to be available through both European, and to a lesser extent American banks. This will continue in 2003, and criteria for lending are likely to remain stringent. In recent years there has been an explosion of equity available from German and American funds, which is likely to continue for as long as the stock markets underperform. This increase in capital availability will stimulate demand for hotel investment opportunities.
- *German funds to become bigger players.* German open-ended funds exist to invest in properties that generate secure rental incomes. In 2002, the German funds have been seen as an alternative to the poorly performing global stock markets. A lack of available mainstream rental property leased to financially secure covenants, has encouraged the German funds to look to hotels. As a result, the German funds have become major players in

the European hotel investment market, dramatically increasing the liquidity of certain gateway markets. German funds dominated the few transactions that did take place in Germany in 2002, but the strict regulatory framework, which prevents investment in hotels operated under management contracts, has frustrated this newfound appetite.

- **Sale and leaseback transaction set to grow.** In 2002 this structure became increasingly popular across Europe. These structures provide an innovative method of off-balance sheet financing that presents a win-win situation for both the investor and operator: the investor has a realisable form of security for his investment while the operator has a tranche of newly acquired development capital. Now open-ended and closed-ended funds, pension funds, high net worth individuals and property companies using highly leveraged structures, are all becoming interested in sale and leasebacks. While the pressure for brand expansion exists, operators will continue to participate in sale and leaseback contracts, as they re-cycle capital tied up in real estate to fuel growth or improve their balance sheet. In 2002, there were four sale and leaseback transactions in the UK and Spain, totalling €1.8 billion.
- **Budget Airlines saved the day.** The meteoric rise of budget airlines and cheaper travel came to the aid of hotels in many markets by stimulating demand. The accessibility of low-cost travel has encouraged Europeans to take more holidays including long weekends, to visit destinations that have not previously been served by other air-carriers, and to travel by air when they would previously have travelled by sea or rail. The constriction of travel budgets within the corporate sector has forced higher number of business travellers to use the low-cost airlines.
- **European Union expansion widens investment potential.** In 2004, Malta, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia will all join the EU, taking the total number of member countries from 15 to 25. This is broadening the potential Eurozone investment territory, and is likely to lead to a general eastward focus on opportunistic hotel investment in the medium term.
- **Supply remains a threat in some markets.** Whilst supply has been relatively stable in some of Europe's core markets, such as Paris and Rome, and could even contract in London, other markets have, and will see significant increases. As illustrated in the graph, markets such as Amsterdam, Barcelona, and Frankfurt Airport will experience double-digit growth in supply until 2004. If all the proposed projects come to fruition, this is likely to have a significant impact on trading performance

#### Annual Supply Growth for Selected European Cities



Source: Jones Lang LaSalle Hotels

Europe's economic recovery appears to be split between the stronger growth markets, such as the UK, Ireland, Italy, Spain, Greece and the Nordics that all have a relatively strong outlook, and those more closely linked to Germany, where the outlook is bleak. Across the continent, it has been those hotel markets with strong barriers to entry and good demand fundamentals, which appear to have turned the corner. Those markets suffering from an imbalance in these fundamentals continue to show RevPAR declines. In 2003 the expectation is that trading across Europe will see minimal, if any improvement. A return to healthy growth levels is not expected until 2004.

#### Recommended Investment Strategies in 2003

Investors should focus on the following investment strategies in 2003:

- Acquire hotels in gateway cities where the fall in trading has been greatest, but new supply is most constrained
- Look to exploit counter-cyclical opportunities as markets reach the bottom of the cycle, but beware of supply pressures.
- Concentrate on established markets, which have a healthy supply and demand balance.
- Watch Scandinavia and the Baltics for opportunities. Also watch selective Eastern European markets, such as Prague, which will benefit from EU enlargement and are forecast to deliver strong GDP growth
- Take a medium term view on returns unless the economy "double dips". In 2003, there is an economic risk that major markets, such as Germany will go into further economic decline, or remain at 2002 levels. For opportunistic buyers, this is a high-risk environment and therefore higher rates of return will be expected.

More cautious investors will await significant signs of recovery.

- Continue to invest capital in product improvement.

### United Kingdom

The London market appears to be fulfilling the 'first to fall, first to bounce back' philosophy, although the bounce back has been slower and later than originally expected. As a city, London is heavily reliant upon overseas visitors and any drawn out conflict in Iraq will have a disastrous effect on the fledgling recovery currently taking place. A relatively healthy domestic economy and robust domestic demand have aided this gentle recovery. However, while the U.S. economy remains in a state of flux, there is little likelihood of a full trading recovery in markets exposed to U.S. demand.

London appears to have reached the bottom of the trading cycle, moving slowly toward the upside. The capital remains one of Europe's most strategically important cities and increasing or consolidating representation is seen as vital for many operators.

Trading in the regional UK markets held up relatively well in 2002.

Manchester – has benefited from major city redevelopment in the aftermath of the IRA bombing in 1996 and from the Commonwealth Games, held in July 2002. The city experiences a good balance between weekday and weekend demand. The outlook for Manchester in 2003 is positive. Interest in the market remains strong, with major operators who are not represented, looking for opportunities. Investor interest is domestic driven with some overseas interest coming from the European mainland.

Birmingham – received a significant boost from hosting the Ryder Cup in 2002. The city has undergone major re-generation projects, including the largest retail development in Europe – The Bull Ring. This impressive retail development should help to redress the imbalance between Birmingham's weekday and weekend visitors. There has been strong investor interest in the city and in the future this interest is likely to increase as the city undergoes a dramatic transformation.

Edinburgh – has previously suffered from over-supply, but increasing demand from domestic visitors, has brought about a stabilisation in trading levels. This increase in domestic visitors has more than compensated for the drop in U.S. visitor numbers. The city has also benefited

significantly from being on a low-cost carrier route. These combined factors have resulted in a good trading year in 2002. Edinburgh continues to be seen as a strategically important city for investment, and a key financial centre. However, the city currently lacks good quality product in key locations, which has hindered investment opportunity. A change in this situation will bring about a significant increase in investor interest.

Cardiff - continues to benefit from an extensive redevelopment programme and the continued closure of England's national stadium (Wembley in London) has benefited the city's new Millennium Stadium as major sporting events have been held here as an alternative. As a consequence Cardiff enjoys a healthy balance between business and leisure travellers. However, trading levels are not likely to grow in the future at the same rate they have previously. Investor interest has been largely domestic, and this is likely to continue to be the case in the coming years.

### Spain

As predicted, the Spanish economy has performed reasonably well in 2002. City centre hotels have continued to benefit from strong levels of domestic demand. However, Spanish resort hotels, previously thought of as a 'safe haven' for tourists, have suffered from a lack of demand. Markets such as the Balearics, reliant on German tourists, have seen a significant drop in the number of visitors, many of whom have chosen to stay at home due to economic uncertainty in their domestic markets.

The introduction of the Euro has exacerbated the situation further by creating the perception that Spanish resorts are more expensive than their Turkish or North African counterparts. In reality this situation is likely to worsen in 2003, creating the possibility of a limited number of distressed sales, and opportunities for possible consolidation by operators.

In the short term, Madrid and Barcelona face significant supply growth. While most of this growth is within the two to three star sector and involving domestic operators, it may bring about a supply and demand imbalance.

In 2003/4 Barcelona will benefit from significant infrastructure investment. The new convention centre, airport and port expansion, and high-speed train connections are all due to be completed in 2004. Barcelona has also benefited from the low-cost carriers stimulating demand. The number of travellers visiting the city rose from 600,000 passengers in 1996 to 1.5 million in 2001 – the majority of these passengers flew on low cost airlines<sup>6</sup>.

<sup>6</sup>The McKinsey Quarterly: Hyped hopes for Europe's low-cost airlines

Barcelona has a large proportion of unsatisfied or displaced demand due to high levels of occupancy. For that reason occupancy levels have not yet suffered as they have in other cities.

The Spanish investment market is relatively opaque, and is dominated by domestic banks and investors. However, in 2002 there has been substantial interest from both foreign investors and banks, and operators looking to expand their Southern European representation. This interest is likely to increase in 2003.

### France

Like London, hotel trading in Paris was hit hard in the early part of 2002. The influx of Middle Eastern business in the summer months, aided a recovery at the beginning of Q3-02. Paris is expected to be one of Europe's strongest performing cities in 2003. Our *European Regional Economic Growth Index (E-REGI)* has positioned Paris at the top of its ranking. Its high *E-REGI* score is a reflection of its large and diversified economy combined with strong employment prospects. In terms of investment, 2002 was a quiet year, with only secondary market transactions closing. While there will be few opportunities for buyers in 2003 in the French capital, those opportunities that come to the fore will represent a good purchase for long term investors.

The city of Lyons is experiencing significant capital investment in improving its leisure and conference facilities in an attempt to bolster demand. Occupancy in 2002 has remained stable due to a steady flow of business travellers, and this is likely to remain the case in 2003.

After a slowdown in demand in the Cote d'Azur in late 2001 and the early part of 2002, leisure demand has increased steadily throughout the spring of 2002. The summer months saw a marked increase in demand from both French and international travellers. Looking ahead to 2003, all the tourism indicators are encouraging, although levels of growth will remain below that of 2000.

### Italy

In Rome and Milan, hotel trading held up reasonably well during most of 2002, due to a strong and established tourism demand. Economic stability and the business environment improved towards the end of 2002, and as Italy aligns itself to European economic systems barriers to entry will continue to erode, allowing for increasing levels of investment. The historic city centres benefit from restrictions to new supply, which has helped to stabilise trading. All the signs indicate that Italy has moved more

rapidly around the cycle than many of its European counterparts.

Italian markets benefit from strong international and leisure demand, which supplements the corporate business and strong domestic markets. As international activity in office and retail markets brings about a greater understanding of Italian property markets, and as debt financing from international banks becomes more readily available, investment activity in Italy's hotel markets should increase significantly. The investment markets are currently relatively illiquid, but the factors outlined above should make Italy one of the key investment targets in 2003.

### Germany

In 2002, German markets have been punished for their reliance on domestic demand. Others have suffered due to their reliance on business from the trade fair cycle – in times of economic hardship conventions and trade fairs are the first to suffer. The four and five star hotels located in major cities have been the most severely affected.

GDP growth for 2003 is expected to be at 0.6 percent, compared with Spain, for example at 2.7 percent<sup>7</sup>. According to *E-REGI* rankings, Munich has retained its position as the top ranking German city.

As well as continuing to invest in German property, the open-ended funds have begun to target foreign markets, a move likely to be made easier by a further relaxation in the statutory framework surrounding open-ended funds.

Germany is currently in a precarious position – the economy is depressed and international business continues to stay away. In 2003, these factors coupled with oversupply will result in a difficult year for most German cities.

### Benelux

Amsterdam benefits from a strong leisure market, which in 2002 has compensated for a significant drop in corporate demand. As a consequence, trading has remained relatively stable. In 2003, the improved calendar of events at the city's Exhibition Centre – The RAI, will ensure that tourism numbers remain high, counteracting the drop in demand from neighbouring German markets.

Investor interest in resilient Amsterdam remains strong, despite low liquidity. Amsterdam is likely to be one of Europe's top performing cities in the medium-term (2004-2006), and will therefore warrant attention from investors.

<sup>7</sup> Thomson Financial Datastream

However, in Amsterdam, there is a marked contrast between the old city centre, which constricts the supply growth, and the airport and Amsterdam South-East, which is currently experiencing supply growth.

Despite Brussels' favourable position as capital of the EU, the city has seen no respite in the downward slide in trading, not helped by the collapse of Sabena, the national airline. Brussels attracts relatively low levels of leisure demand and as such has not been able to compensate for the depressed corporate and convention market. In the short-term, investors are advised to be extremely cautious, as short-term performance is likely to be suppressed by further increases in supply. However, a recovery, aided by an additional ten EU members in 2003, is predicted in the medium to longer term. Brussels, a market reliant on European business travellers and those from her neighbours – Germany, continues to suffer, showing little sign of improvement in 2003.

**Central Europe**

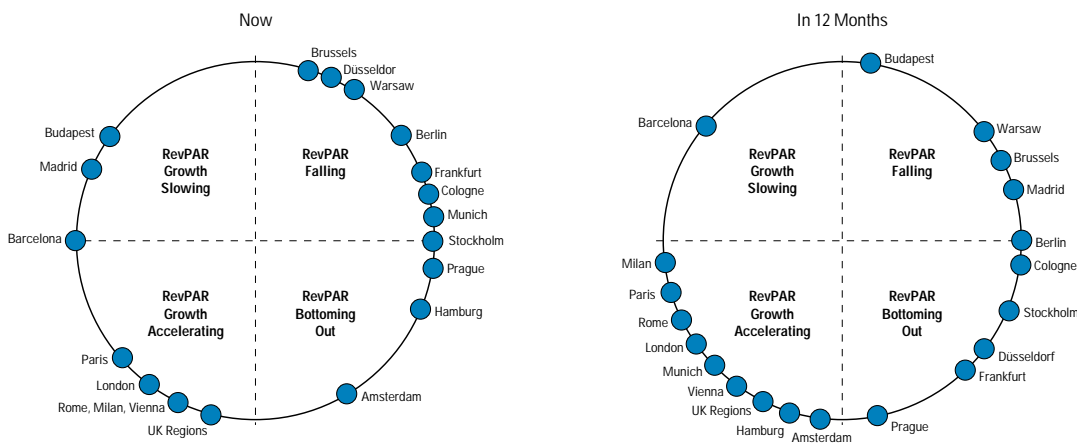
Prague had a difficult year in 2002 due to the strengthening of the Czech Crown and disastrous floods in August, but improved towards the latter part of the year with the NATO

conference in November. These extremes resulted in Prague finishing the year trading fairly flat. Q1-03 is likely to be slow as the continuing effects of the summer floods are felt. However, post-Easter, business is expected to return to normal. The forecast stability of the Czech Crown in 2003 will undoubtedly have a beneficial effect on trading. GDP growth in the Czech Republic is expected to rise to approx. 4.5 percent<sup>8</sup> in 2003, and the Czech Republic's ascension to the European Union early in 2004 will have a positive impact on investor sentiment.

Budapest and Warsaw both suffered from the combined factors of a lack of high-spending U.S. business and over supply of hotel rooms. There was little sign of an improvement in trading in 2002 and there are unlikely to be many in 2003. Towards the end of 2004 we should see some investment opportunities starting to emerge against a back drop of improving trading performance. Hungary, and consequently Budapest, should benefit financially from membership to the EU in 2004.

Other Central European cities (excluding Warsaw, Budapest and Prague) remain at the bottom of the *E-REGI* ranking, reflecting poor business operating conditions and a weak trading outlook for their main source market, Germany.

**Europe Hotel Market Cycle**



Source: Jones Lang LaSalle Hotels

<sup>8</sup>Thomson Financial Datastream

The Future for Major Cities Across Europe



**REGI Ranking\***

Amsterdam	8
Barcelona	14
Berlin	66
Birmingham	39
Brussels	27
Budapest	51
Dusseldorf	46
Edinburgh	59
Frankfurt	13
Hamburg	34
London	3
Madrid	9
Milan	19
Munich	5
Paris	1
Prague	68
Rome	49
Warsaw	45

**RevPAR Growth in 2003**

Benchmark against the regional average.

- Above Average
- Average
- Below Average

\*Jones Lang LaSalle's Regional Economic Growth Indices (REGI) provides a leading indicator of the economic strength of 85 major cities across Europe. Based on several factors such as forecasts of employment, population and income, employment momentum and business conditions, the REGI Indices provide a broad measure and comparison of the forecasted economic health of prime property markets. As of Q3-02.

## Asia Pacific – Opportunities in 2003

The general consensus is that most hotel markets in Asia Pacific have reached the trough of the market cycle and should see some improvement in trading during 2003. However, as always, the individual hotel markets are diverse in their outlook.

### Hotel Investment Opportunities in 2003

Strong Buy	Select Buy	Watch
Bangkok	Brisbane	Bali
Beijing	Hong Kong	Kuala Lumpur
Shanghai	Phuket	
Sydney	Seoul	
	Singapore	
	Tokyo	

Source: Jones Lang LaSalle Hotels

Full economic recovery in Asia Pacific is likely to lag the economic recovery in the United States with two noticeable exceptions – Australia and China. The immediate prospect is for economic growth to be relatively better in those countries with stronger domestic sectors, such as China, Australia, India, Korea, Thailand and Malaysia. Growth is expected to be relatively weaker in countries that depend on exports, including Hong Kong, Singapore, Taiwan and Japan. Although Hong Kong and Singapore will follow the lead of the United States, it is probable that Japan will remain trapped in a deflationary spiral with slow or no growth over the next several years, regardless of the expected recovery in North America. The recent bombings in Bali have negatively impacted the economic outlook for Indonesia, and have adversely affected other regional destinations that have been the subject of travel warnings.

As the single most important economic influence in the region, China has become of increasing interest to a widening range of international real estate developers and investors. Other hotel real estate markets in Asia (such as Thailand, Japan and Korea) have become more open and transparent over recent years and this trend looks set to continue. Investors have the added option of investment through REITs, which are now available in Japan and Singapore, although investors have yet to use this vehicle to acquire hotels. Hong Kong is also considering legislation to introduce REITs. However, non-performing loan work-outs across Asia could undermine hotel real estate values.

In uncertain times, hotel investors traditionally act defensively. The following strategies are recommended in 2003 to maximise risk-adjusted returns:

- Look to the safe havens of the more liquid and more transparent real estate markets of Australia, Hong Kong and Singapore. At present, Australia is likely to be the most attractive to risk-averse investors.
  - Diversify geographically. There are low or negative correlations in economic performance and hotel returns between Australia, Hong Kong, Singapore and Japan, but high correlation between hotel returns within any one country. Therefore, geographic diversification reduces risk more than sector diversification.
  - Appoint an operator with proven performance.
  - Maximise performance through proactive asset management.
  - Use leverage to boost returns, while being mindful of the added risks and lenders' loan-to-value covenants.
  - Employ multiple exit strategies.
  - Consider hotels that appeal to a diverse business mix base.
- However, the best form of defense is sometimes attack, and:
- Opportunistic investors may find opportunities in Korea and Japan where local capital is sidelined and there is a rising incidence of non-performing loans and distressed sellers.
  - Examine undervalued hotel stocks where the net tangible asset value is higher than the market capitalisation.

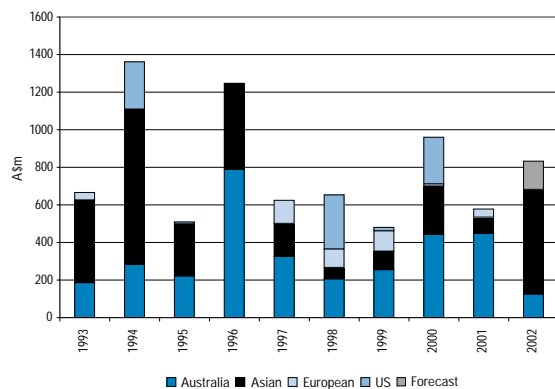
### Australia

Australia's economy has recorded a surprisingly resilient performance during 2002. However, amid growing expectations that the previously robust housing market may have peaked and in light of the global economic uncertainty, which is impacting exports, the outlook for 2003 remains cautious, with forecast GDP growth of 3.3 percent. That said, the expectations for Australia are more bullish than many of its Asia Pacific counterparts.

The future of the Australian hotel markets of Sydney and Brisbane looks bright, given the supply reduction (in Sydney) and expected recovery in demand during 2003. Sydney in particular should also benefit from Australia's staging of the Rugby World Cup during 2003. The resort market of Cairns is likely to benefit from the introduction of Australian Airlines in October 2002 and the substitution of Bali as a resort destination. However, Melbourne's trading performance during 2003 is likely to be tempered by increases to supply, particularly in the form of serviced apartments.

Australia has long been regarded as a safe haven from an investment perspective, providing the benefits of a transparent market and a stable political and economic environment. This, coupled with the relatively strong economic performance should enhance its attractiveness as a hotel investment destination over the short to medium term. We have already seen evidence of this during 2002, with hotel investment activity increasing over the previous year. Investment has been led by South East Asian purchasers, some of which have accepted relatively low initial yields of under seven percent in anticipation of future growth. We expect a continuation of transaction activity in 2003 as international buyers, especially from Asia seek hotels at the bottom of the cycle, particularly in Sydney and Brisbane.

Transaction Activity in Australia by Buyer Origin



Source: Jones Lang LaSalle Hotels

## North Asia

### China

China continues to defy the global economic trend and is expected to record annual GDP growth in excess of seven percent during 2002 and 2003. Strong exports, government investment, foreign direct investment, domestic demand and an increase in urban income have all assisted the country in achieving its growth targets.

Beijing and Shanghai remain the standout hotel markets of the Asia Pacific region. They continue to benefit from the increasingly affluent domestic population as well as the influx of foreign corporate travellers. Operators and investors alike are confident the growth in demand will more than absorb the increases in supply over the next few years. Furthermore, given their large populations, these markets presently have a comparatively small supply of four and five star hotels.

Given the current and expected future growth, hotel investors, developers and operators are currently scrambling for a market presence in China. The main areas of interest are Beijing, as the political centre and host of the Olympics in 2008, and Shanghai, given its position as the nation's financial centre. However, there are several issues at the back of investors' minds, including political uncertainty, increasing income disparity, significant levels of bad debt, difficulties in repatriation and limited land tenure.

### Hong Kong, SAR, China

Unlike its mainland counterpart, Hong Kong has suffered from a slump in the property market since 1997. This has led to a decline in consumer spending and ongoing deflationary pressures. Although exports have recently shown signs of improvement, largely due to demand for electronic goods from China, Hong Kong is susceptible to any further weakness in the U.S. The latest forecast GDP growth for 2003 is a modest 2.7 percent.

Given the subdued economic environment, minimal or no growth is expected for the upper tier hotel segments of Hong Kong. However, the two and three star market is benefiting from growth in mainland Chinese tourists.

Despite the soft trading market and economic conditions, Hong Kong remains one of the most transparent and therefore sought after investment destinations. The sale of the Regent in 2001 to Six Continents for \$US 346.2 million is testament to the appeal of the destination, which extends to international, regional and domestic purchasers. However, pricing remains an issue.

We expect to see a number of hotels offered to the market during 2003 by owners rationalising their portfolios or in receivership.

### Japan

Japan's economy will be struggling to avoid slipping back into recession during 2003 due to a slowdown in industrial production, weak business sentiment and muted consumer

spending owing to poor employment levels and deflationary pressures. However, proposed banking reforms represent a real attempt to address the bad loans situation and there may be opportunities for hotel investors to purchase distressed assets. Given the soft economic conditions, growth in the trading performance of Tokyo hotels during 2003 is expected to be minimal. Despite this, investors are still keen to purchase assets in the city and current yield requirements are around seven percent. Pricing disparity remains the key impediment to hotel investment.

### South Korea

Apart from stalling during 2001, South Korea's economy has recovered rapidly since the Asian crisis of 1998 off the back of a strong housing market, exports and an improvement in the transparency of the financial sector. In fact, the Bank of Korea recently considered raising interest rates to head off inflation. However, given the apparent stability in the housing market and uncertain global conditions, the bank decided to keep rates on hold.

Recent performance shows the upper tier hotels of Seoul have managed to build rate despite a slight decline in occupancy.

Given the strength of the economy, there is solid interest in Seoul and other key Korean markets from both international and regional investors. During 2003, we expect opportunities to acquire prime and secondary hotel assets to eventuate, as purchasers of non-performing loans secure tenure over the properties and seek a realisation of profits.

## South and South East Asia

### Thailand

The outlook for Thailand's economy continues to be strong, aided by export growth, a robust manufacturing sector and rising consumer confidence. However, more recently, the sentiment of the business sector has been tainted by the Bali bombings and the possibility of a flow-on effect for the nation's significant tourist industry. Anecdotal evidence indicates that Phuket initially attracted some of the displaced demand from Bali since the bombings in October 2002. However, since then, Thailand has itself been the subject of travel warnings. Bangkok and Phuket were expected to benefit from strong tourism and economic growth during 2003, however this depends on the removal (or disregard) of travel warnings.

Despite the cautious outlook for tourism, indications are that regional and international investors are still keen to

gain a foothold in Bangkok as well as the lesser-known destinations such as Hua Hin and Pattaya.

### Indonesia

The terrorist attack in Bali during October has undermined the economic outlook for Indonesia. GDP growth forecasts for 2003 have been reduced from 4.0 to 3.6 percent and business confidence is expected to decline significantly. President Megawati has moved quickly to arrest the suspects, but it is yet to be seen when the international community will regain confidence in the country. Over time, however, the economy should improve.

Security and economic concerns persist in Jakarta, and it is likely to take 12 months or more for tourism to Bali to recover from the recent bombings. A month after the event, occupancies in Bali were reportedly in the vicinity of 10 percent. Given the current travel warnings, tough trading conditions are expected to continue into 2003 for this market, as demonstrated in the grid at the end of this section.

However, as Bali has recovered strongly and swiftly from previous downturns, investors are still keen to look for investment opportunities in this destination. Their primary concerns, rather than the trading outlook of the market, are the lack of debt financing and the availability of genuine offers. In contrast, investors are not yet convinced of a promising hotel investment future in Jakarta, considering the long and painful recovery of hotel trading since 1998. That said, occupancies in hotels in the city have improved in 2002 compared to 2001. As an indication of the perceived risk involved in hotel investment in Jakarta, according to Jones Lang LaSalle Hotels' *Hotel Investor Sentiment Survey (HISS)*, initial yield requirements are the highest of the region's major markets at 16.9 percent.

### Singapore

Singapore's economy is likely to be constrained by subdued consumer spending as a result of increased unemployment (albeit only 4.8 percent) and deflationary pressures. Furthermore, there is a fear that the travel warnings given by some Western countries against ASEAN countries after the Bali bombing, may impact Singapore's tourism industry. However, recent estimates indicate that Singapore's economy should recover in late 2003.

The three star market has benefited from the growth in Chinese tourists, however, the four and five star hotel market is not expected to recover over the next two quarters. Supply reductions over the long term are possible given the removal of 19 hotels from the list of

“safeguarded” hotels, which up until now could not be converted into alternative uses.

As a major business hub and gateway city of Asia, Singapore is one of the most sought after Asian cities by international hotel investors. Singapore is politically stable and is home to a transparent legal and accounting framework. In addition, there are limited sites available for hotel development in Singapore, which reduces the supply risk. The sale of the Robinson Hotel in 2002 (SUS 20.1 million), which was the first international standard hotel to be sold as a going concern since 1994, is testament to Singapore's current investment appeal. Transactions are likely in 2003 as groups rationalise their portfolios and banks gain control over non-performing assets.

### Malaysia

Malaysia's economy appears to be holding up well with GDP forecast to grow by 5.1 percent during 2003. Foreign exchange controls implemented since 1998 have resulted in a relatively stable currency environment and an inflation rate that has remained below two percent since 2000. We understand that there is no immediate plan to remove the currency peg.

As a result of Tourism Malaysia's proactive marketing efforts, international arrivals are expected to increase by 4.7 percent during 2002. Given the strong demand, five star hotels have improved occupancy and room rate during 2002. However, during 2003, inbound tourism is likely to be tempered by the travel warnings to South East Asian countries.

International investor demand for hotel investment in Malaysia is focused primarily on major four and five star properties in the capital city of Kuala Lumpur and the resort destinations of Penang and Langkawi. However, there is a general lack of hotel properties available for sale at current market price expectation. The former Holiday Inn hotel at Kuala Lumpur City Centre (SUS 14.5 million) was the only reported transacted to a local company during 2002.

### India

Official growth forecasts for India have recently been revised downwards for the 2002 fiscal year due to slowing exports, the impact of the country's drought and signs of weakening industrial activity. However, at 5.0 to 5.5 percent, the GDP growth forecasts are robust in comparison to other Asian nations. India remains a challenging market for international investors, who are likely to be further deterred by the country's proximity to the Middle East and ongoing political tensions with

Pakistan. However, the nation's huge population represents an attractive demand pool for hotel operators and owners.

In terms of trading, both Mumbai and Delhi suffered from the impact of travel advisories issued between May and July 2002. While Mumbai's hotel market is expected to remain weak due to supply issues, Delhi hotels have witnessed improved performance since August 2002 and this should continue into 2003.

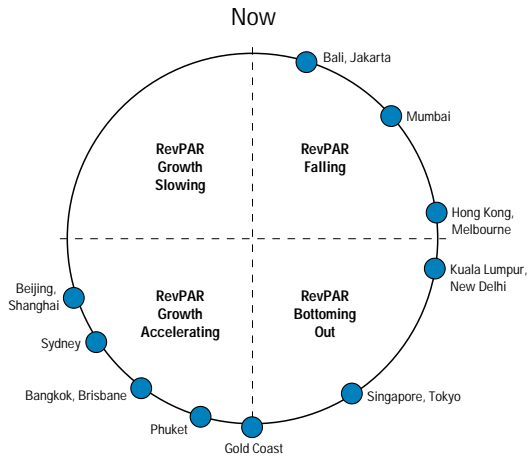
Currently, foreign investment in India is limited, and whilst it is possible for outside investors to acquire 100 percent of hotels, it is unlikely that many international grade properties will be formally offered to the market. There is however, an active domestic market as evidenced by numerous local transactions during 2002.

### Impact of Bali Bombings – October 12, 2002

The following points summarise the likely impact of the bombings on the regional hotel investment market.

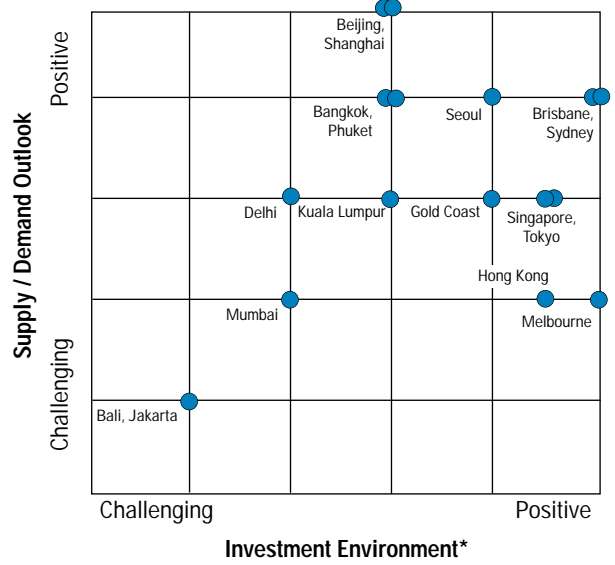
- The experiences of Luxor (Egypt), where militants killed 58 tourists in 1997 and the political coup in Fiji during 2000 indicate tourism to Indonesia should recover after 12 months.
- Full recovery depends on:
  - taking steps to ensure similar incidents do not occur again;
  - the removal of the existing travel warnings; and
  - aggressive marketing of the destination.
- Travellers' general affinity with the people of Bali may quicken the recovery process.
- Some analysts believe Bali will be substituted by other resort destinations in the region such as Phuket, Cairns, the Seychelles, Mauritius, the Maldives, Fiji, Vanuatu, Cook Islands, Hawaii and French Polynesia.
- Travel warnings are likely to be increasingly important as a determinant of demand growth.
- The Bali bombings are seen as an isolated incident and investors remain interested in acquiring hotel assets in other prime South East Asian tourist destinations.

Asia Pacific Hotel Market Cycle



Source: Jones Lang LaSalle Hotels

Investment Environment vs Trading Outlook Grid



Source: Jones Lang LaSalle Hotels

\*Investment Environment\* includes transparency, political and social stability, availability of debt, availability of assets and pricing.

### The Future for Major Cities Across Asia Pacific

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## Glossary Of Terms

ADR	Average daily rate. Total room takings divided by room nights occupied.
Occupancy	Room nights demanded divided by room nights available.
RevPar	Revenue per available room. The product of ADR and average occupancy.
EBITDA	Earnings Before Income, Tax, Depreciation and Amortisation.
IRR	The 'internal rate of return' that would make the present value of future cash flows plus the final market value of the investment equal the current market price of the hotel.
Initial yield	Net operating income in the first year of trading divided by the sales price.
Cap rate	The rate applied to the future income stream of the property to produce its current market valuation.



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