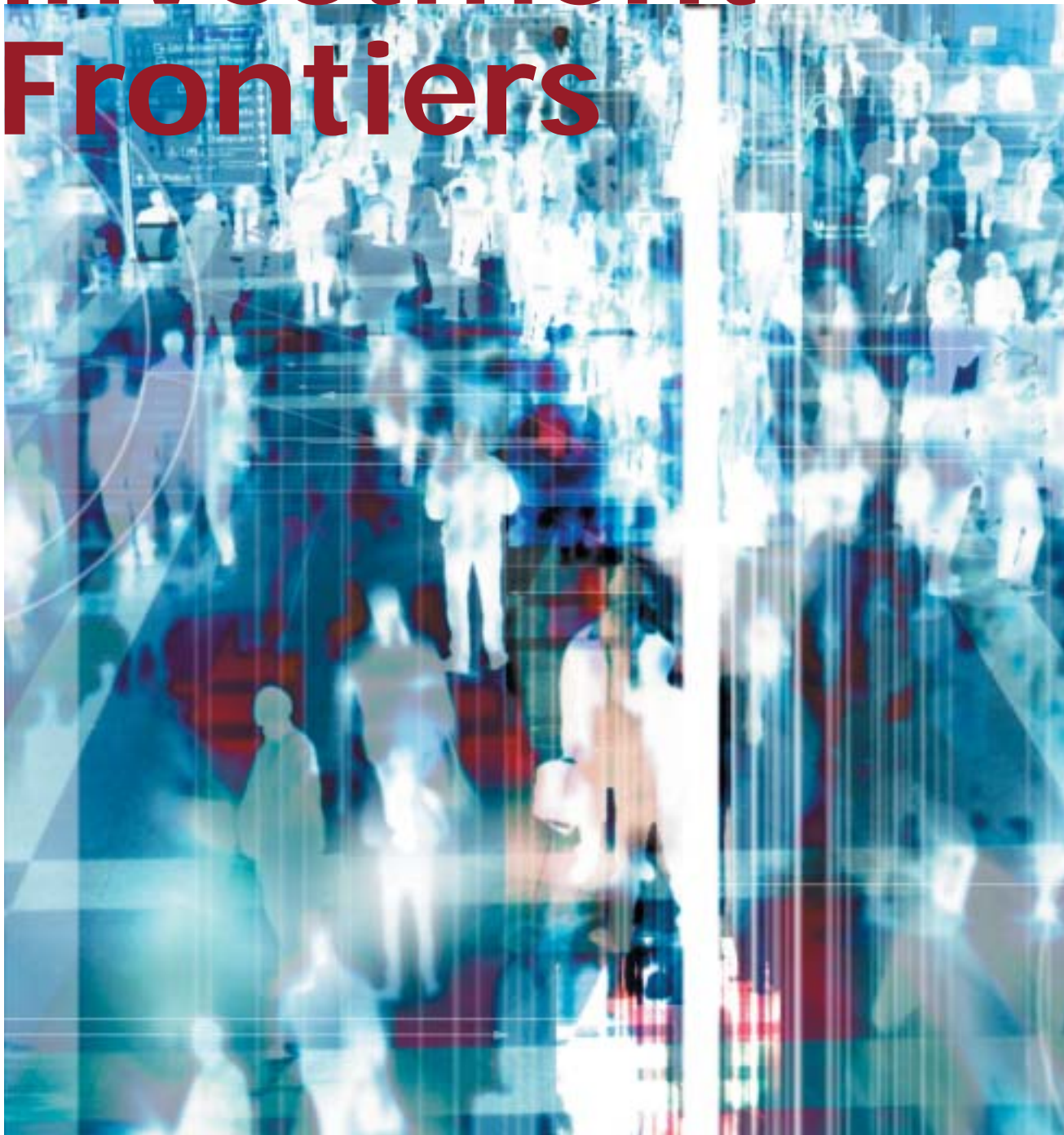


New Investment Frontiers



Commissioned by



national roundtable for industry leaders

Written by



JONES LANG
LASALLE HOTELSSM

**An Industry Action Plan
for Reshaping Hotel Investment**

March 2003

foreword

While the tourism sector is currently facing an uncertain operating environment, predictions for its longer term growth are sound.

However, for tourism to fully realise its growth potential, significant expansion in all types of tourism infrastructure will be needed. This in turn will require substantial investment, particularly from the private sector.

Despite its economic significance, the tourism sector has failed to attract its fair share of investment from the growth in capital markets. The tourism sector's share of the Australian Stock Exchange market capitalisation of 1.7 per cent is substantially below its 4.7 per cent share of Gross Domestic Product.

The Reserve Bank of Australia estimates the value of Australia's capital markets in ten years' time will be worth an extra \$365 billion. An important challenge for the tourism sector will be to attract a sufficient share of this anticipated investment to cater for its longer term capital requirements.

This is one of the key issues that the Commonwealth Government will be addressing in its medium to long term tourism strategy.

The Tourism Task Force report on this issue is therefore timely. In particular, it provides valuable insights into investors' attitudes to hotel investment in Australia.

I applaud the Tourism Task Force and the Property Council of Australia for initiating this report.

I would also like to congratulate Jones Lang LaSalle for the work in compiling the findings and all other sponsors for funding this report.



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Executive Summary

Introduction

The Property Council of Australia and Tourism Task Force have jointly commissioned Jones Lang LaSalle Hotels to undertake this research study which explores investors' attitudes to hotel investment in Australia. This study represents an update of "Perspectives on Tourism Investment – A study of institutional investors", which was completed in November 1995 by Macquarie Bank.

The primary objectives of this study are:

1. To identify impediments to non operator aligned investment in 3-5 star hotels in Australia; and
2. To recommend methods by which these impediments can be minimised or eliminated.

The ultimate objective is to increase the level of non-operator aligned investment in Australian hotels.

This report is targeted towards the education of existing and potential hotel investors, existing and potential hotel operators, analysts, financiers, fund managers, brokers and consultants.

The report represents the results of secondary research and interviews with over 30 investors, potential investors, asset consultants, fund managers, brokers, consultants, analysts and financiers.

Top Impediments

The interviews identified the following as the top impediments to increasing non-operator aligned investment.

1. Trading volatility

Hotels' cashflows are considered volatile due to the following unique characteristics:

- Tenanted daily;
- Seasonality of demand;
- Property Cycles;
- Extraneous variables such as pilots' strikes, Ansett collapse, September 11; and
- Start up period before trading and income stabilises.

This volatility is exacerbated by the use of management agreements as opposed to leases which are common in all other business relationships.

2. Poor past performance

Hotel profitability growth has been constrained by minimal real ADR growth, high labour costs and periods of oversupply. In terms of investment, there have been no major success stories and several poor performing hotel specific listed property trusts. Hotel investment vehicles have had a history of over-promising and under-delivering. Furthermore, in general, hotels' capital values have decreased since 1997.

3. Return not commensurate with risk

Investors have identified that hotel investments are considered riskier than other property assets due to their business element. Despite this inherent risk profile, hotels have traded at initial yields on par with office yields. Therefore the level of return has not taken into account the perceived risk.

4. Operator / owner alignment of objectives

Although the alignment of operators and owners has improved over recent years with the increased use of incentives in management agreements, there remains a perception that their interests are not completely aligned. For instance, the operator's future business depends on the quality and state of repair of the property while the owner is keen to maximise the investment returns and minimise outgoings. Operators generally have more power in the relationship because they control hotel operations and are experienced with hotels, whereas owners are generally distanced from the hotel operation and therefore lack control. This is further compounded by the fragmentation of owners compared to the consolidation of operators.

5. Lack of understanding / need for education

The number of institutional investors that have experience in and therefore knowledge of hotel investment is small. Given the historic poor performance and limited size of the sector, there is limited incentive to increase their knowledge. This lack of knowledge increases the level of perceived risk and is therefore a disincentive to hotel investment.

6. Hotels are overpriced / overvalued

Potential domestic and international investors believe the business risk has not been sufficiently priced into hotel purchases in the past and that investors have paid too much for hotels. This has artificially inflated the prevailing market value of many hotels.

7. Lack of information

Although the availability and reliability of market and hotel information has improved since the last study, there is still room for improvement, particularly relating to operation margins and profit and loss accounts. A common opinion is that while there is enough information, investors generally do not know how to best utilise it.

8. Liquidity / exit strategy

A flexible exit strategy is critical for investors. The relative illiquidity of the hotel market is therefore a major concern. An increase in investment interest and an expansion of the investor base would obviously improve the liquidity of the market.

9. Size

The small size of the hotel market limits the choice of quality assets and adversely affects its liquidity, investors' interest and therefore their knowledge. These increase the level of perceived risk.

10. Alignment of industry

The success of a hotel investment depends on many other sectors, such as airlines, tour operators, tourism marketing bodies, car hire business, corporate travel policy, domestic and international economic conditions, business confidence and government policy. This fragmentation is an issue as each sector has its own agenda and the interests are not aligned. In some cases, they actually conflict.

11. Capital intensive

Not only do hotels require significant initial capital outlay, they require substantial upkeep to maintain their market position and compete with newer properties. The capital intensive nature of hotels is a definite disincentive to new investment in the sector.

12. Reduce government interference

Investors believe the government should facilitate a fair market environment where all types of accommodation are developed to meet demand rather than other considerations that are not necessarily related to market fundamentals. At present, investors believe hotels are adversely affected by the incentives given to strata titled development.

13. Fund manager / investor alignment

Asset consultants, who advise institutional investors, need to see that the interests of the fund manager and investors are aligned through attractive structures and fees. The structure of the vehicle is given more consideration than the characteristics of the underlying hotel asset.

14. Low barriers to entry

Given the low barriers to entry, the hotel environment has been characterised by periods of supply-led boom and bust in the past. Oversupply adversely affects hotel profitability and investment returns and potential investors are now wary of this supply risk.

15. Expectations

In the past, investors have had negative experiences due to unrealistic expectations and overly optimistic promises. Investors need to understand the risks involved and the level of return they should reasonably expect given these risks.

Summary of Recommendations based on the results of the interviews, our ideas and previous research.

Issue	Explanation	Responsibility
Taxation		
Tourism taxes	Reduce taxes on travel (eg Ansett tax) or inject funds back into the industry.	Government
Stamp duty	Reduce or remove onerous levels of stamp duty on property transactions.	Government
GST	Eliminate GST payable on stamp duty.	Government
	Educate market about the 'going concern' rule.	Advisers
Depreciation	Base depreciation on the effective life of an asset, rather than its physical life.	Government
Land tax and rates	Increase transparency and consistency across these state based taxes.	Government
LPTs	Continue the current tax treatment of LPTs as trusts rather than companies.	Government
Regulations		
Serviced apartments	Remove Address the market distortions involving incentives for strata titled development. to ensure a level playing field.	Government
	Regulate strata development offerings and introduce an accreditation of promoters.	Government
Hotel supply	Councils should require feasibility plans before granting development consent for accommodation.	Government
	Eliminate compulsory inclusion of hotels in mixed use developments.	Government
Information / Education		
General Information	Lessen the use of jargon.	Industry wide
Market Information	Share business mix information between hotels..	Operators
	Provide demand forecasts on a regional and business mix basis.	TFC
	Publish development registers.	Government
	Improve the timing and reliability of the International Visitor Survey and the National Visitor Survey.	BTR
Investment Information	Compare hotel cycles with other property cycles to create argument for hotel investment as a method of diversification.	Advisers
	Analyse sales and yields by buyer type, rather than in aggregate.	Valuers
	Create an accurate and tailored operational benchmark system for hotel owners.	Advisers
Exit strategy	Educate investors as to the need to consider an exit strategy in the investment decision process.	Advisers

Issue	Explanation	Responsibility
Profile of Hotel Investment Market	<p>Ensure the interests of hotel owners are adequately represented in the industry, perhaps by creating a sub-committee in an existing association.</p> <p>Increase the profile of hotel experts with institutional investors.</p> <p>Push for hotels' inclusion in general and non-property investment discussions and seminars.</p> <p>Target a high profile opinion leader institutional investor to invest in hotels.</p> <p>Raise profile of hotels with asset consultants and understand their roles and requirements.</p>	<p>Owners</p> <p>Advisers</p> <p>Industry wide</p> <p>Industry wide</p> <p>Brokers / Vendors</p> <p>Advisers / Brokers</p>
Owner / Operator Alignment	<p>Alignment could be improved by owners taking equity in management company or operators taking an equity position in hotel investment.</p> <p>Include performance incentives in management agreements.</p> <p>Educate investors as to the role and availability of asset managers.</p> <p>Calculate incentive fees based on investment returns rather than Gross Operating Profit.</p>	<p>Owners</p> <p>Operators</p> <p>Owners / Operators</p> <p>Advisers</p> <p>Owners / Operators</p>
Capital Intensive Nature	<p>Undertake a triple net lease, with the operator responsible for capital requirements.</p> <p>Purchase a portfolio of well-balanced assets with different timing for capital expenditure to increase pool of available funds.</p> <p>Shorten the investment timeframe.</p> <p>Improve capital expenditure planning and operators' discipline with the use of the Furniture, Fittings & Equipment Reserve</p>	<p>Owners / Operators</p> <p>Investors</p> <p>Investors</p> <p>Operators</p>

Issue	Explanation	Responsibility
Investment Vehicles / Structures		
LPTs	Ensure that any future hotel specific Listed Property Trust (LPT) takes into account the experience of past LPTs.	Brokers / Vendors /
Separate business and property risk	Introduce income smoothing mechanisms into management agreements or replace with leases. Educate operators as to the benefits of leasehold agreements Create tranching investments which offer differing levels of risk to satisfy different investment strategies.	Owners Brokers / Vendors Brokers / Vendors
Hotels as a high risk investments	Package hotels with other property types to provide a spread of risk. Market hotels as an "alternative" rather than "core property" class.	Brokers / Vendors Brokers / Vendors
Volatility	Research and understand the timing of the cycles before buying and selling. Package hotels as part of a mixed use development, to offer a diversified income stream.	Investors Brokers / Vendors
Price in risk	Improve the accuracy of forecasting and make pricing decisions according to the required yield premium for hotels given their risk. Package hotels into geographically diverse portfolios.	Investors / Valuers
Syndicate	Create a hotel syndicate marketed at high net worth individuals, targeting growth.	Brokers /Vendors Brokers / Vendors

1.1 Background

The Property Council of Australia and Tourism Task Force jointly commissioned Jones Lang LaSalle Hotels to research investors' attitudes to hotel investment in Australia. The primary objectives of this study are:

1. To identify impediments to non operator aligned investment in 3-5 star hotels in Australia; and
2. To recommend methods by which these impediments can be minimised or eliminated.

This report aims to stimulate industry-wide discussion with regard to tax treatment of hotels, appropriate operating structures, appropriate ownership vehicles and required returns. This report is intending to assist existing and potential hotel investors, existing and potential hotel operators, analysts, brokers and consultants to better understand the rewards and risks associated with hotel investment. Access to capital will also stimulate refurbishment, upgrades and development of hotels.

The ultimate objective of this report is to increase the level of non-operator aligned investment in Australian hotels, which has wide ranging positive employment, social and economic ramifications. Increased investment would raise the profile of the hotel investment market as a viable investment product and this subsequent increase in liquidity would then serve to stimulate more investment from local and international interests.

This study represents an update of "Perspectives on Tourism Investment – A study of institutional investors", which was completed by Macquarie Bank in November 1995. However, representing the development of the industry over the subsequent seven years and acknowledging the quality of the previous research, there is a slightly different focus.

This study focuses solely on 3-5 star hotel assets, rather than general tourism assets such as casinos, theme parks, transport and attractions. The methodology is also different, relying on interviews to reveal suitable investment models rather than creating hypothetical models. Furthermore, we have extended the focus from institutional investors to include all non-operator aligned investors. By definition, non-operator aligned investment is driven by financial returns rather than the desire to establish a brand presence in certain markets. Our definition of non-operator aligned investors includes investors that do not operate hotels or do not have a subsidiary who operates hotels as well as institutional investors or fund managers.

The following report represents the results of secondary research and interviews with over 30 investors, potential investors, asset consultants, fund managers, brokers, consultants, analysts and financiers. Further detail on the methodology is presented in Appendix A.

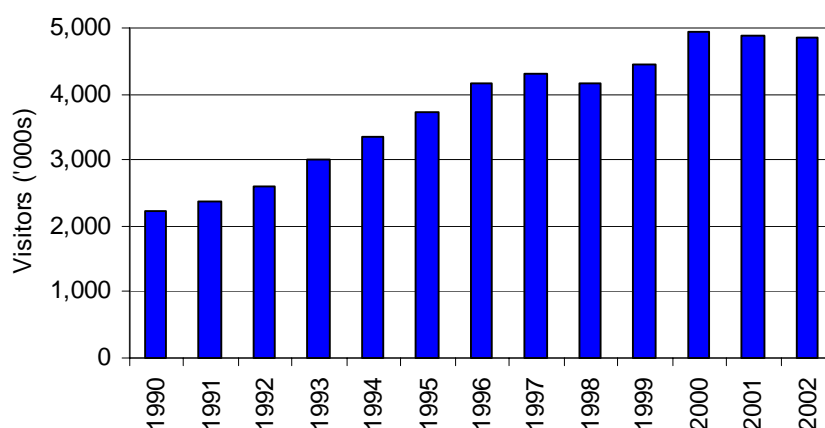
1.2 The Tourism and Tourist Accommodation Market in Australia

Australian Tourism Market

International Tourism

The Australian tourism industry has experienced tremendous growth over the last two decades. Latest data indicates international arrivals to Australia grew at almost double the rate of world tourism, at a compound rate of 8.9% pa over the 20 years to 2000. However, 2001 proved to be a post Olympic lull for Australia as arrivals declined by 1.2% under the combined effects of a global economic slowdown, September 11 and the collapse of Ansett Airlines. This represents the first year of negative growth since 1998 when the Asian economies faced a significant economic downturn. Australia's tourism industry continues to be affected by the slowdown in inbound arrivals primarily from the US and the security conscious Japanese. According to the latest data, international arrivals to Australia for the 11 months to November 2002 were down 0.9% compared to arrivals over the same period in 2001, with arrivals from the North America and Japan down by 6.8% and 4.9% respectively.

International Arrivals to Australia



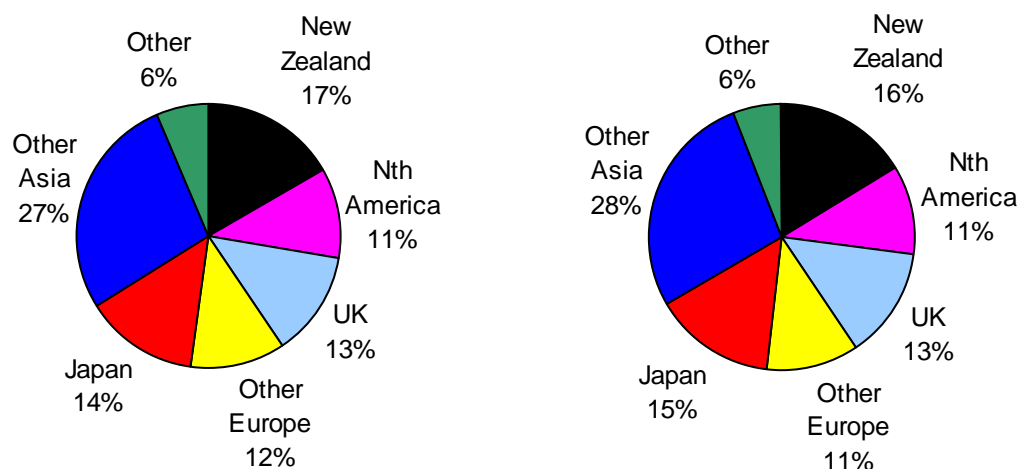
Source: ABS

On a positive note, the Asian markets, particularly China stand out as the only markets to post significant growth since September 2001. Furthermore, increased airline capacity to the key Australian inbound markets of New Zealand from July and to Japan, Asia and Europe from October should assist demand growth.

International Arrivals to Australia by Country of Origin

2001

2002



Source: ABS

Domestic Tourism

Domestic tourism dominates the Australian tourism market, accounting for 72.0% of the total nights spent in Australia during the year ended June 2000 (latest available data). However, if the international market grows at the rate forecast by the Tourism Forecasting Council, which is a higher forecast growth rate than the domestic market, this ratio looks set to change. Already in Sydney, the number of nights spent by international visitors has surpassed the number of nights spent by domestic visitors and in Melbourne and Perth the mix is fairly even.

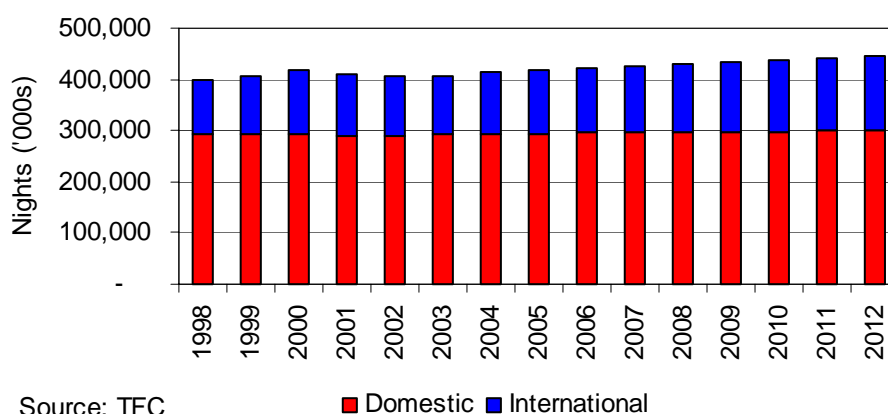
Domestic tourism has grown modestly over the past decade. However, real analysis is restricted by changes in the data collection. Between 1994/95 and 1996/97, domestic visitors increased by an average of 2.1% pa while domestic visitor nights increased by 0.9% pa, suggesting an increase in short stay tourism. These rates declined between 1998 and 2001, with domestic visitor numbers remaining stable and domestic nights decreasing by an average of 0.4% pa, confirming the trend towards shorter breaks. However, data for the year ended September 2002 shows a reverse trend, with domestic visitors increasing by 0.8% and domestic visitor nights growing by 1.2%.

Forecast Tourism Growth

In response to slower than expected tourism growth, the Tourism Forecasting Council revised their forecasts downwards during December 2002. According to the latest forecasts, international nights spent in Australia are expected to increase by an annual average rate of 2.4% pa over the next ten years to reach 146.7 million by 2012. Domestic nights spent in Australia are estimated to grow at 0.3%pa over the next ten years to reach 299.7 million by 2012.

Not all of these nights are spent in commercial accommodation. According to the latest data, 16.2% of international nights and 23.5% of domestic nights are spent in hotels and motels. Assuming these proportions remain constant throughout the period, total nights spent in commercial accommodation across Australia will increase by 0.8% pa over the next ten years to reach 94.2 million by 2012.

Forecast International and Domestic Nights in Australia



Tourism Expenditure

Tourism is economically a strategic and important sector within Australia. During 2000/01:

- Tourism directly accounted for 4.7% of expenditure of the nation's gross domestic product;
- Tourism was directly responsible for employing 6% of total employment; and
- International tourists to Australia consumed \$17.1 billion worth of goods and services. This represents 11.2% of total export earnings.

Furthermore, during the year ending 30 September 2002 Australian residents spent \$51.4 billion on domestic tourism, suggesting tourism is a \$68.5 billion per year industry.

Given the fragmentation, sheer number and geographic spread of businesses positively impacted by tourism, continued government support is necessary to ensure the industry grows to its potential. Particularly in the current environment, the marketing effort is critical, whether it be through the government funded Australian Tourist Commission or through jointly funded marketing efforts such as the "See Australia" campaign.

Australian Tourist Accommodation Market

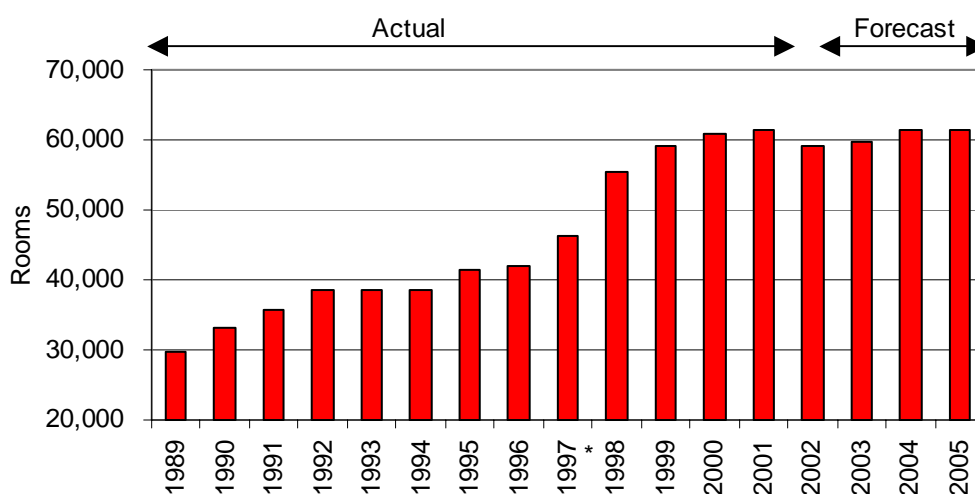
Room Supply

Historical room supply has shown constant compound growth, averaging 2.0% pa between 1990 and 1997. However, supply increases accelerated during the lead up to the Olympics in Sydney during 2000, recording average growth of 4.2% pa between 1997 and 2000. Since then, development has slowed, and in Sydney's case, supply has actually contracted due to the conversion of older hotels into residential apartments. Between September 2000 and June 2002, the number of rooms in Sydney City has declined by 6.7%.

As at the September quarter 2002 Australia had 3,847 hotels, motels and serviced apartments comprising 196,988 rooms. Currently motels and guest houses account for 42.5% of total rooms in Australia, hotels 39.4% and serviced apartments 18.1%. Of the total room supply, 166,709 (84.6%) are graded 3-5 star.

As discussed previously, development has slowed in most of the Australian markets. Looking at the five major markets of Sydney, Melbourne, Brisbane, Gold Coast and Cairns, projects under construction and mooted are expected to add 1.1% to supply in 2003 and 2.8% during 2004. This follows a 3.9% contraction during 2002 due to residential conversions in Sydney and Melbourne.

Tourist Accommodation Supply – Key Australian Markets Actual and Forecast



Source: ABS; Jones Lang LaSalle Hotels

* Series Break

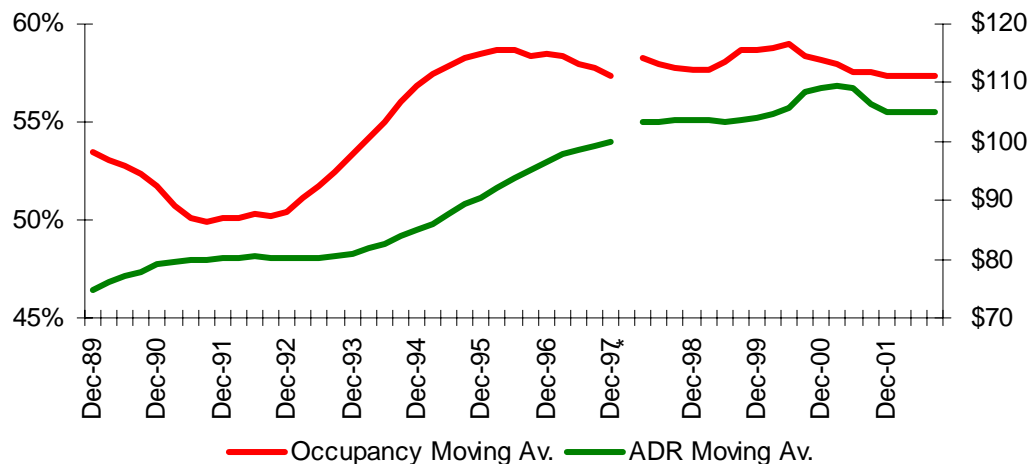
Tourist Accommodation Performance

Demand growth of 3.3% pa outpaced supply additions during the seven years from 1990 to 1997, allowing occupancies to hover consistently above 55 percent, which is generally at the lower end of the break-even point. (However, it should be noted that this varies considerably according to the operator and service levels). Annual average daily rate (ADR) increased steadily during the development of the international market early in the 1980s, recording compound average growth of 3.4% pa between 1990 and 1997.

Since 1997 however, nationwide performance has been eroded by the increase in supply additions up until 2000 and a decline in demand during 2001 and early 2002. ADR growth was modest during 1998 and 1999, before increasing by 5.1% during the Olympic year, and then falling back by 3.7% during 2001 and 1.3% in the nine months to September 2002.

The following graph shows the movements of occupancy and inflated ADR. Uninflated ADR is discussed in Section 4.2.

Moving Average Performance – Australian Tourist Accommodation



Source: ABS, Jones Lang LaSalle Hotels

* Series Break

Investment Issues

Investment Phases

The hotel and tourism property investment cycle has followed a similar pattern to the general property market, demonstrating the following stages:

- Between 1988 and 1990, Japanese investors and local entrepreneurs were active in the development and acquisition of hotels and resorts;
- From 1991 to 1994, receivers and financiers sold off a considerable amount of distressed property assets mainly to South-East Asian buyers;
- After feverish investment activity between late 1993 to end 1994, there was a break as the majority of distressed stock was cleared from the market;

- During 1996 and 1997, construction activity commenced and Australian investors re-entered the market, mainly through the listing of hotel and tourism vehicles. Sector specific property trusts were popular at this time and major listed hotel vehicles such as Grand Hotel Group and Peppers Hotel Group were launched during this period;
- Between 1998 and 2000, Asian divestment gathered pace and local investors bought the majority of hotels. Development activity peaked at all time highs and at the same time, the market saw the commencement of consolidation amongst hotel operators, eliminating some competition for branding; and
- During 2001 and 2002, development has slowed in most markets except Melbourne and Adelaide. A trend towards residential conversion of hotels in Sydney has taken hold as residential prices trend upwards. Asian buyers, particularly Singaporean investors have revisited Australian tourism property, while all but two hotel specific listed property trusts have now delisted.

Operator versus Owner Interests

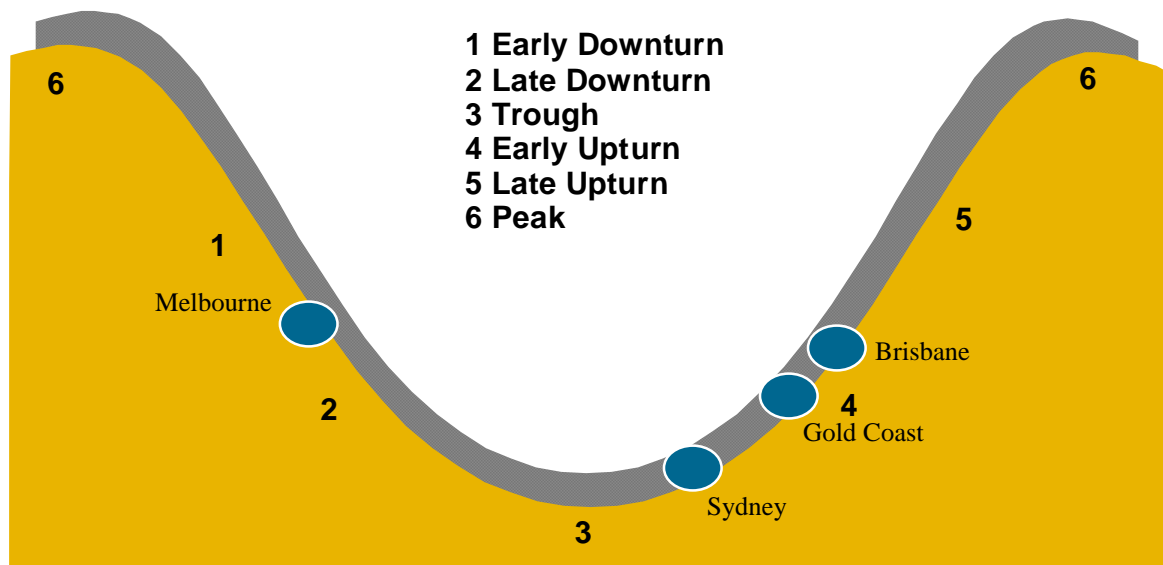
According to Jones Lang LaSalle Hotels' global survey of recently negotiated management agreements, the interests of the operator and owner have become increasingly aligned through the use of sliding incentive fees and performance clauses. The results of the survey indicate that Asia Pacific operators are subject to more competitive pressures than their counterparts in the Americas and Europe. The survey also found that Asia Pacific operators have the lowest average base fee and the highest average incentive fee. According to the survey, there is a strong trend towards financial performance criteria, with failure to achieve a specified benchmark resulting in an opportunity for termination of the management agreement. In most agreements, termination without cause or upon sale of the asset is available with compensation paid to the operator. There remains the perception that hotel operators enjoy more power in the negotiation of management agreements, partly due to their refined expertise, recent consolidation and increased market power compared to owners.

It should be noted that these observations are relatively recent, and there are still many older style management agreements in use.

Position on the Market Cycle

According to Jones Lang LaSalle Hotels' December 2002 Hotel Investor Sentiment Survey (HISS), investors in the Asia Pacific region believe recovery is imminent for the major markets of Australia, placing Sydney just past the trough and Gold Coast and Brisbane at the early upturn of the market cycle. Melbourne, which still has a number of new supply additions under construction, is considered to be between the early and late downturn.

Hotel Market Cycle



Source: Jones Lang LaSalle Hotels' HISS December 2002

Impact of Bali Bombings on Australian Tourism and Hotel Markets

From the outset we should make it clear that there are no winners from such an event as the bombings that occurred in Bali on October 12. However, we believe it important to make a few general observations and predictions as to the likely impact of this terrorist activity in the context of the Australian hotel and tourism market.

Looking at the experiences of Fiji after the 2000 political coup and Luxor, Egypt after the 1997 killing of 58 tourists, it is generally 12 months before a destination recovers from a significant terrorist event.

Some believe travellers will stay at home or closer to home, while others believe Bali will be substituted by other destinations. These include:

- Phuket, which has already seen an increase in bookings over the Christmas / New Year period;
- Queensland resorts in Australia, which have also reportedly seen an increase in domestic leisure and corporate meeting bookings;
- Other markets in Australia and New Zealand;
- The Indian Ocean islands of the Seychelles, Mauritius and the Maldives;
- The Pacific Island resorts of Fiji, Vanuatu, Cook Islands, Hawaii and French Polynesia.

Preliminary indications were that most tour operators cancelled or indefinitely postponed tours to Bali and Indonesia, but it is difficult to determine the impact on travel to other areas of South East Asia. According to the Australian Tourist Commission, some travellers from Singapore have cancelled bookings to Australia and substituted it with travel to closer destinations such as Japan or Korea. On the other hand, long haul travellers are only cancelling trips to Bali and Indonesia, and staying longer in other nearby destinations, such as Australia.

Although this is the short term scenario, history has shown that it is generally the long haul travellers that take longer to return than intra-regional tourists.

As far as investment is concerned, our contact with hotel investors in the region indicates that the Bali bombings are seen as an isolated incident. Investors remain interested in acquiring hotel assets in other prime South East Asian tourist destinations such as Sydney, Phuket and Bangkok and the sale of hotels in these countries continues to progress as usual.

However, investors may become increasingly interested in the resort markets of the region, including Australia and as a consequence, financiers may be forced to consider funding resorts, which have historically been out of favour.

One continuing issue is the rising cost of insurance for hotels given the increased risk of terrorism.

Critical Issues

Looking at the domestic and international tourism figures as well as the performance of hotels across Australia, it would appear that the Australian hotel and tourism industry has not yet recovered from the collapse of Ansett Airlines, the fallout from September 11, general global economic weakness of 2001 and soft corporate demand domestically.

Investors and operators remain confident that improvement is on the way. However, this depends on:

- the removal of impediments to increasing air capacity (eg regional airline strategy), particularly on domestic routes;
- government support for the industry;
- continued marketing efforts; and
- a rebound in consumer and business confidence which would have a flow on affect to increasing travel.

2.1 Taxation Issues

Generally speaking, property investments are known for offering tax advantages to investors through property depreciation allowances and negative gearing. Furthermore, property trusts have the ability to make pre-tax (and tax deferred) distributions of profits.

Other taxes applicable to real estate and hotel investment are described below.

General Taxes

Goods and Services Tax (GST)

A 10% GST is payable on the purchase of most goods and services. However, the sale of a going concern may be GST-free if certain requirements are met. By definition, a 'going concern' is where all of the requirements for the continuation of the enterprise are supplied to the buyer and the supplier must carry on the business until it is sold. The purchase is GST-free as long as the purchaser makes taxable supplies with it. This applies to all property types.

In terms of hotels, there are certain ways to structure most transactions to ensure the hotel remains a 'going concern' and is therefore GST-free. However, these methods are not widely known and there is a perception that leasehold hotels attract GST. Also, the 'going concern' ruling is not available for hotels held by two entities or stapled securities.

Stamp Duty

Stamp duty is imposed on transfers of property, leases and trusts. The duty varies between states from 3.75% of the acquisition cost in Queensland to as much as 6.75% in ACT (as at June 2002) of the acquisition cost. The Property Council of Australia (PCA) estimates that the abolishment of stamp duties would save the property industry \$2 billion each year.

Stamp duty is applicable to all forms of property, including hotels regardless whether the investor is a resident or foreign entity. Although there are certain structures that can remove the need to pay stamp duty in some states, foreign investors are concerned that these structures may soon be prohibited and investors may be forced to pay a significant stamp duty. For instance, the NSW Government has recently closed a loophole which allowed investors to avoid paying stamp duty by converting freehold to 200-300 year leaseholds. As an example, the stamp duty on a \$200 million hotel (or any property) in New South Wales would attract stamp duty of \$11 million, which represents a significant disincentive to invest in Australia.

Stamp duty on hotels is payable on the total acquisition cost, which includes the business and the land. Therefore, hotels are subject to more stamp duty than a stand alone business or simple real estate transaction.

Furthermore, in circumstances where the sale of a property attracts GST, stamp duty is payable on the acquisition cost plus the GST amount. Vendors and investors are obviously unhappy with this situation as they are required to pay tax on a tax.

Capital Gains Tax (CGT)

For those assets acquired after 20 September 1985, an investor must pay tax on the net capital gain as a result of the disposal of an asset. The PCA is currently lobbying the Federal Government to extend the concessions currently granted to individuals and superannuation funds

Land Tax and Council Rates

At present, land taxes are complex and vary between states in terms of rates and tax-free thresholds. In general, land tax is usually levied annually at 1-2% of the assessed land value. Tax payable on land and rates paid to the local council could be removed and replaced with one low rate consumption tax, which is shared between governments. This would improve the transparency of the property market in Australia.

Once again, this is a property-wide taxation issue which does not impact hotels specifically.

Depreciation and Amortisation

Depreciation is a tax deduction which allows investors to write off the cost of the assets used in the generation of income over its effective life. Hotels have significant depreciable components compared to commercial property. At present, depreciation is calculated on the physical life of an asset. There are criticisms that the depreciation period should reflect the true economic life of the asset, taking into account technical, commercial or regulatory obsolescence, rather than the physical life.

Amortisation is a special system of depreciation which applies to the cost of extensions, alterations and improvements to a building. At present this allowance is 4% over 25 years for hotels. The PCA believes the rate should be increased to 6.25% to take into account the average life of a hotel is 16 years rather than 25 years.

There is also a suggestion that so-called black hole expenses such as landscaping, be deemed as depreciable expenses.

However, although important, there is a general perception that there are other fundamental issues which must be addressed before this becomes a major impediment to investing in hotels.

"If you're investing and depreciation is an issue then you shouldn't be investing." (Property investment group – non hotel investor)

Payroll Tax

Although all businesses must pay payroll tax, it represents a higher portion of the profit for hotels due to their labour-intensive nature, while the impact of this tax on non-hotel property is negligible. Payroll tax varies from 3.65% in Western Australia to 6.85% in ACT.

Fringe Benefits Tax (FBT)

FBT was introduced in 1986 and is payable on any “right, privilege, service or facility provided by an employer”. FBT is payable on “meal entertainment”, where an employer provides an employee with entertainment by way of food or drink meals, which includes eating in hotels, thereby providing a disincentive for corporations to entertain out of house, reducing the potential food and beverage revenue for hotels.

Non Trading Trust Status

There is a perception that buying a business (hotel with management agreement) means that a non trading trust becomes a public trading trust, which therefore must pay tax at the normal corporate rate and distribute a franked dividend as opposed to distributing its profit pre-tax passing the tax liability (if any) to the share or unit holder.

Taxes Specific to the Tourism Industry

The tourism industry is adversely affected by the myriad of travel related taxes. A recent article in the Sydney Morning Herald indicated that surcharges add approximately 20% to the cost of a domestic air ticket. Hotel operators, as accommodation providers for travellers are also indirectly affected by these taxes. Investors would like to see these taxes reduced or at least injected back into the tourism industry. According to Tourism Task Force, some of the taxes include:

- The Ansett employee entitlements' ticket levy of \$10 on each domestic fare sold. (From October up to the end of May 2002, this levy had raised \$86.5 million. It is capped at \$500 million);
- The Passenger Movement Charge (the old departure tax) of \$38 per departure/arrival which is worth about \$325 million this year; and
- Various other state and local taxes such as the Sydney airport noise levy which has raised around \$251 million since 1994-95 to fund housing and building insulation.

In summary, the major impediments to hotel investment in terms of taxation are:

- Lack of knowledge of structures that can ensure a hotel is a 'Going Concern' during a transaction for the purposes of GST.
- Where GST is payable, it is payable on the acquisition cost plus stamp duty, thereby forcing an investors to pay a tax on a tax.
- Onerous levels of Stamp Duty.
- Land tax and rates which lack transparency and consistency across states.
- Depreciation rates based on the physical life of an asset rather than its effective life.
- Heavy taxes on domestic air travel.

2.2 Foreign Investment

Foreign investment in Australia is regulated by the Foreign Investment Review Board (FIRB). The FIRB is a non-statutory advisory body which was established in 1967. We will discuss the activities of the FIRB before discussing other foreign investment considerations.

Proposals Requiring Approval

According to the FIRB, the following proposals which may be involved in hotel investment require approval.

- “Acquisitions of substantial interests (single foreigner with 15% or several foreigners with 40%) in existing Australian businesses with total assets over \$50 million or where the proposal values the business at over \$50 million;
- Proposals to establish new businesses involving a total investment of \$10 million or more;
- Direct investments by foreign governments or their agencies irrespective of size;
- Acquisitions of interests in urban land that involve the:
 - Acquisition of developed non-residential commercial real estate, where the property is subject to heritage listing, valued at \$5 million or more;
 - Acquisition of developed non-residential commercial real estate, where the property is not subject to heritage listing, valued at \$50 million or more (this was increased from \$5 million in 1999);
 - Acquisition of accommodation facilities irrespective of value; or
 - Acquisition of vacant urban real estate irrespective of value.”

Although all proposed acquisitions of **hotels and motels** must be approved, those operated under one title are normally approved under the Tourism Sector Policy. All other accommodation facilities (holiday flats and guest houses) require approval relating to the residential real estate sector policy.

Foreign investment in **designated strata titled hotels** will be approved if the hotel is subject to a management agreement of at least 10 years. This only applies to strata titled rooms in a designated hotel. By this, the FIRB means that:

- All the rooms are part of the accommodation pool and are managed as such;
- The hotel provides facilities commensurate with industry expectations;
- The owners’ rights do not include occupation of the rooms; and
- The hotel manager owns the rights to common property.

Foreign investors in **time share resorts** are not required to seek approval from the FIRB if the entitlement is not greater than four weeks in a year. However, if the interest is more, foreign investment is subject to approval relating to the residential real estate sector policy. Acquisitions of developed commercial property are normally approved under the urban land policy, unless contrary to national interests.

Integrated tourism resorts which were designated as such prior to September 1999 are exempt from foreign investment restrictions. Resorts designated from September 1999 onwards which are subject to a lease with a term of 10 years or more to an operator are also exempt. Integrated tourism resorts have the following attributes:

- Minimum site area of 50 hectares;
- Single developer;
- Core hotel providing 20% of total accommodation;
- Substantially non-residential in nature (commercial accommodation to comprise 70-80% of resort area);
- Non-hotel accommodation facilities;
- Almost complete or operational; and
- Extensive recreational facilities.

All other property within the resort is subject to foreign investment restrictions. Operators of integrated tourism resorts must report the ownership details to the FIRB once a year.

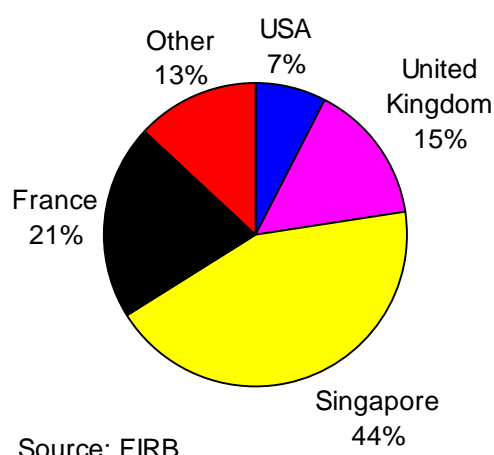
Latest Approvals

The vast majority of applications to the FIRB submitted over the last four years have been approved. For instance, during 2000-01, only 1.3% of considered applications were rejected. Most of these rejections related to acquisitions of developed residential property, where the prospective buyers did not fall into an eligible category.

During 2000-01, 42 tourism investments worth \$800 million were approved by the FIRB. Two of these represented investments in excess of \$100 million. As a proportion of total foreign investment requiring approval, tourism only accounted for 0.8% during 2000-01.

In terms of tourism investment, investment from the following countries was approved. More details are provided in Appendix B.

Total Approved Proposed Investment in Tourism by Country of Investors (2000-01)



Interviews with foreign investors have indicated that the FIRB approval process is not arduous. However, the process adds a further 30 days to the investment timeframe and may be a hurdle for smaller organisations with a low public profile that are inexperienced in foreign investment.

Other Foreign Investment Considerations

Property Tenure

Most of the land in Australia is freehold except in ACT, which is largely leasehold. However, compared to non-hotel property, a significant proportion of hotels, especially in city locations, are leaseholds.

Exchange Controls

Generally, there are no restrictions on the inflow and outflow of money in Australia. The buying and selling of foreign currency must be conducted through a Foreign Exchange Dealer registered by the Reserve Bank of Australia. Transfer of \$5,000 or more Australian dollars or foreign cash must be reported to the Cash Transaction Agency.

Withholding Tax

According to the Australian Taxation Office, there are three types of withholding tax that affect non-residents:

- Interest withholding tax is payable at 10% of interest paid to non-residents. This is not affected by tax agreements.
- Dividend withholding tax is payable at 30% on dividends paid to non-residents. If the resident's country has a tax treaty, this is generally reduced to 15% (although it can be 10, 20 or 25%).
- Royalty withholding tax is payable at 30% (or 10-25% if double tax treaty exists) of gross royalties.

Thin Capitalisation

The thin capitalisation rule limits tax deductions for overseas investors with more than 75% debt funding in their Australian assets. This rule affects only the more aggressive foreign investors rather than the capital rich funds. However, there is some confusion regarding the definition of debt to be included in this ruling.

Transparency

According to the Jones Lang LaSalle Transparency Index, Australia's real estate market is the most open and transparent in the Asia Pacific region. This index assesses five key attributes:

1. Availability of independent public and private market investment performance indices;
2. Availability of market fundamentals research;
3. Availability of reliable financial statements;
4. Governance (the alignment of interest between directors, managers and investors); and
5. Taxes, penalties, restrictions on cross-border transactions.

In summary, the foreign investment regulations are generally considered fair and encouraging, especially for larger, experienced investors. However, the withholding tax may be an issue with some investors.

“I think they are relaxed actually” (Bank, tourism investor)

2.3 Planning Systems and Government Incentives

As with other property types, the development of hotels in Australia is regulated by the local councils' Local Environmental Plans and Development Control Plans. These plans are consistent with the State/Territory based State Environmental Plans.

The Tourism Task Force has made the following recommendations with regard to the planning framework currently in place in Australia.

1. Ensure that the real economic impact of additions to tourism accommodation supply is provided to town planning professionals and local councils. These would be provided through detailed impact studies and ensure only viable developments enter the market.
2. To regulate these studies, the Planning Institute of Australia should develop an accreditation scheme for tourism consultants that provide economic impact statements for development approval by Councils and State Governments.

The Tourism Task Force considered various policy responses which could be used to create stable returns. One of these ideas was to establish a form of bed licensing for tourism accommodation providers, similar to the treatment of hotel licenses or nursing home licenses. Bed development licences could be purchased for a fee and diminish in value over a set period. The Tourism Task Force has decided that this is not appropriate for the hotel industry, but there are other hotel investors who believe it would have a positive impact. Some advantages and disadvantages are listed below.

Introduction of Bed Development Licences	
Advantages	Disadvantages
Future supply a known entity	Interferes with market forces
Assist forecasting	Inhibits development investment
Reduce risk of oversupply	Inhibits growth of operators

It is generally recognised that the local, state and federal governments of Australia do not provide systematic incentives for hotel investment in Australia. Furthermore, the market suggests this should continue to be the case. Firstly, government interference may encourage unviable investment and secondly, government support of a particular development introduces an element of political risk into the investment equation and therefore increases the overall risk.

"You need one regime that needs to be rational, governments need to be constant and they can't distort decision making." (Industry lobby group)

As discussed in Section 2.2, the regulation of foreign investment in Australia does not appear to deter foreign hotel investment. In fact, the transparency of the investment and real estate markets increases Australia's appeal as an investment destination.

However, several specific points of discussion were identified during the interviews.

Incentives for Strata Titled Development

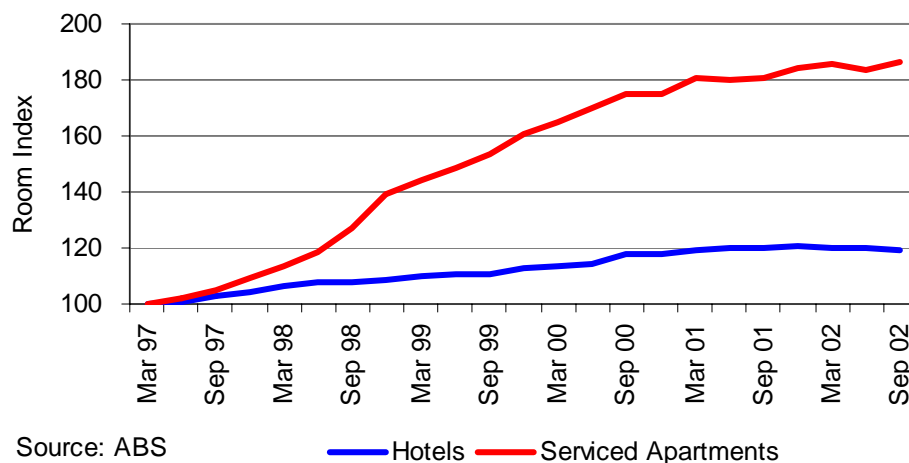
Hotels compete with other forms of tourist accommodation in terms of investment and development dollars as well as accommodation demand. In this regard, the ease with which developers can add strata-titled serviced apartment supply to the market is widely seen to be detrimental to hotel investment. The addition of new

strata development supply is driven by factors other than accommodation market fundamentals such as surging residential prices, as serviced apartments are relatively easy to convert to residential apartments, personal values and high marginal tax rates that encourage residential investment for negative gearing purposes. In addition, the fact that GST is not payable on holiday letting assists the profitability of these developments. The fact that serviced apartments are difficult to define, makes tracking and analysing the segment complicated.

Firstly, the upsurge in serviced apartment supply is said to have exacerbated the oversupply situation in many hotel markets.

The number of serviced apartment rooms in Australia has grown by 86.8% between March 1997 (when serviced apartments were first separately analysed) and September 2002. To put this into context, total room supply (including hotels, motels and serviced apartments) only increased by 18.7% and hotel rooms grew by 19.2% over this period. Serviced apartment rooms have consequently increased their share of the total market from 11.5% in March 1997 to 18.1% in September 2002. Not only have serviced apartments accounted for much of the development activity, but they have also driven a substantial proportion of room night demand growth across Australia. In fact, serviced apartments have captured 63.5% of the total room night demand growth over the past four full years.

Serviced Apartment Room Supply Growth



Furthermore, some strata developments have been criticised for over-promising returns only to disappoint investors once the guarantee period is over. Negative experiences such as this are likely to taint the market perception of tourism investment generally.

Although the backpacker segment caters for a different market to the 3-5 star hotel market, it is worthwhile noting that there is a perception that professionalism of the backpacker accommodation market is being eroded by the ease with which boarding houses can gain development consent.

Incentives for Hotel Development

Occasions arise where local or state governments encourage or even require the inclusion of a hotel as part of a mixed-use development. It is the opinion of the major players in the market that the development of a hotel should be based on the findings of a professional feasibility study, rather than a 'build it and they will come' mentality.

Other Suggestions

Other suggestions for government incentives include:

- The Government should change the Export Market Development Grant (EMDG) so that it does not preclude the larger owners and operators from participating. At present, the EMDG is only available for Australian businesses with an annual income of less than A\$50 million and annual export earnings of less than A\$25 million.
- The Government should offer tax benefits to anyone investing capital and resources in marketing Australia as a tourist destination.

In summary...

Rather than introduce incentives for hotel investment, the role of the government should be to facilitate a fair market environment, where all types of tourist accommodation are developed in response to accommodation market fundamentals rather than in response to other government policy distortions.

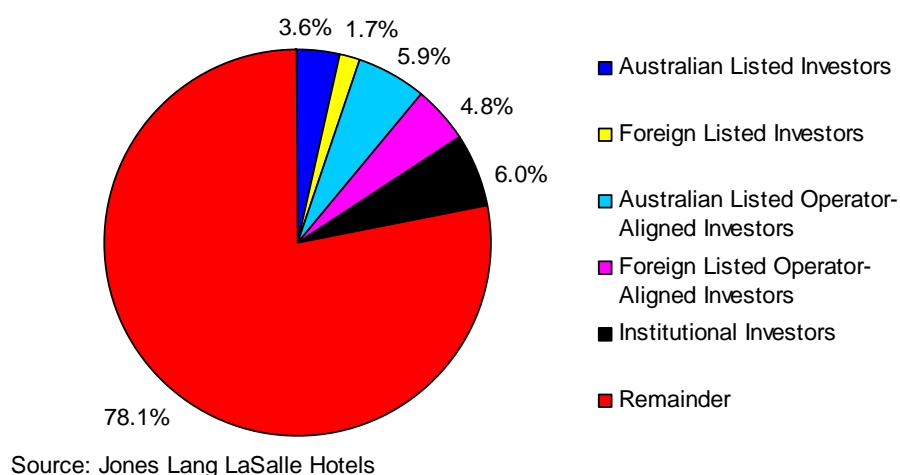
2.4 Current Investment in Australian Hotels

Ownership By Investor Type

Within Australia's 3-5 star tourist accommodation category, we have identified the number of hotel rooms owned by major domestic and foreign publicly traded companies as well as institutional investors.

As can be seen from the graph below, institutional investors currently hold 5.8% of Australia's 3-5 star hotel room stock and listed entities together account for 27.1% of current supply. Private investors comprise the great bulk of the remaining 78.9%.

Owners of Australian Tourist Accommodation by Investment Type



Overseas Experience

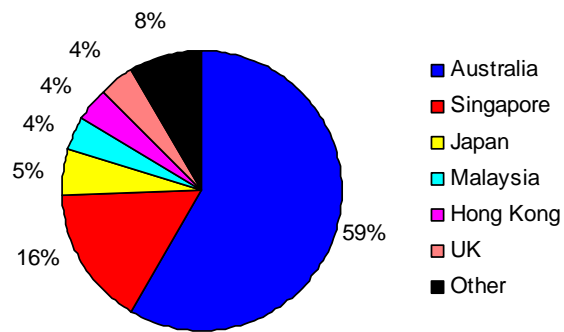
The lack of institutional investment in hotels is a global trend. It is estimated that private investors account for the following shares of the respective global hotel investment community.

- USA 81.1%
- Europe 78.5%

Ownership By Geographic Origin

The latest analysis of ownership by geographic origin comes from Jones Lang LaSalle Hotels' annual survey of Top Owners conducted in November 2002. According to this survey of 133 major hotel owners spanning 394 establishments and 66,700 rooms, domestic investors own the majority of hotel rooms in Australia. This proportion has increased from 51.0% in 1997 to 58.8% as at 2002.

Origin of Owner – Australian Tourist Accommodation – As at November 2002



Source: Jones Lang LaSalle Hotels

In summary...

The hotel investment market suffers from a lack of institutional investment. However, this is a global phenomenon.

2.5 Business or Real Estate

“It looks like property but it’s not like property.” (Domestic institutional hotel investor)

It is generally understood that hotels represent a unique hybrid of business and real estate. This is because the owner usually takes on the operation of the hotel or at least carries the volatility of income as well as the underlying property and land. Consequently the investor must consider the business risk as well as the real estate risk. All of the people interviewed were acutely aware of this attribute of hotels, although it is often not reflected in terms of pricing.

“It’s not just property risk it’s business risk – and that’s like having two assets.” (Domestic fund manager – hotel investor)

However, there is a perception that potential investors are hindered by a lack of understanding of the business risk involved in hotel investment. The investment performance of hotels is generally measured against other forms of property, which further exacerbates this problem.

“The thing I have on my mind at the moment is just trying to get people educated that it’s not just a property you are buying.” (Domestic fund manager – hotel investor)

According to the interviews undertaken, investors require the element of business risk either be eliminated or priced into the acquisition in order for hotels to assert themselves as viable property investments.

In summary...

Investors need to understand the element of business risk inherent in hotel investment.

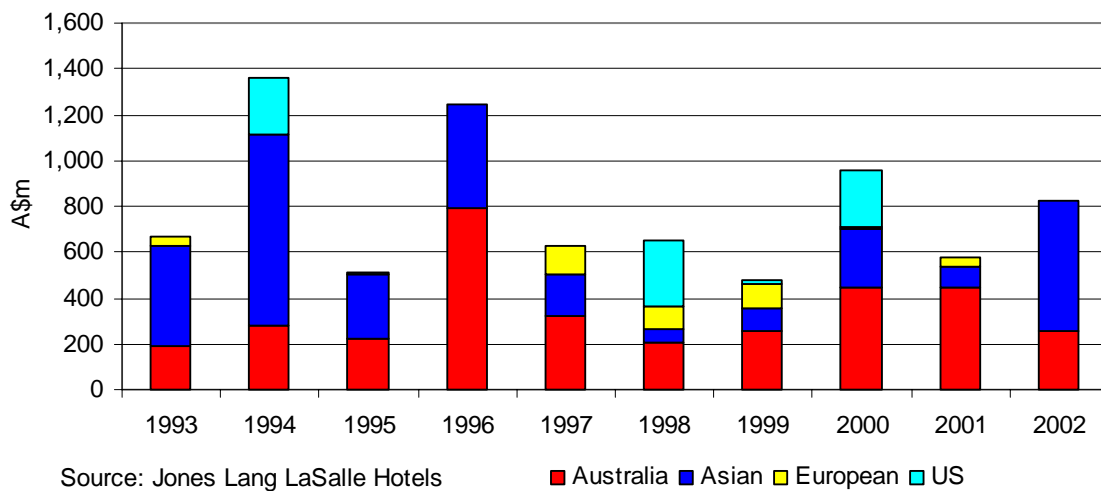
Once aware of this risk, it needs to be reduced, managed or priced into the investment.

2.6 Liquidity of the Hotel Investment Market

Direct Hotel Investment

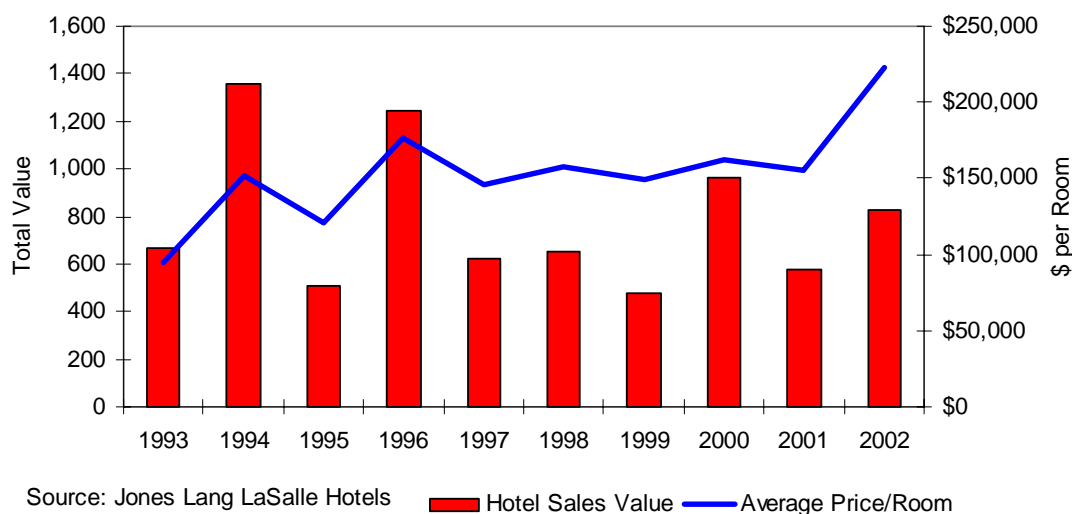
Since 1993, the level of major hotel investment has fluctuated from a low of \$479.3 million during 1999 to a high of \$1,360.9 million during 1994. The average annual sales volume over the ten full years is \$790.0 million and the average number of rooms sold each year is 5,226. This represents a mere 3.1% of the total room stock of 3-5 star hotels as at September 2002. However, as only hotels over \$5 million are included in the analysis, this measure is likely to understate the true liquidity of the direct hotel investment sector.

Major Hotel Sales in Australia by Buyer Origin 1993- 2002



Since 1996, the average price per room has been in the range of \$145,000-\$223,000. However, care should be taken when drawing conclusions, as these statistics are susceptible to significant skewing according to the type of properties sold in any given year.

Major Hotel Sales in Australia by Rooms Sold and Price per Room 1993-2002



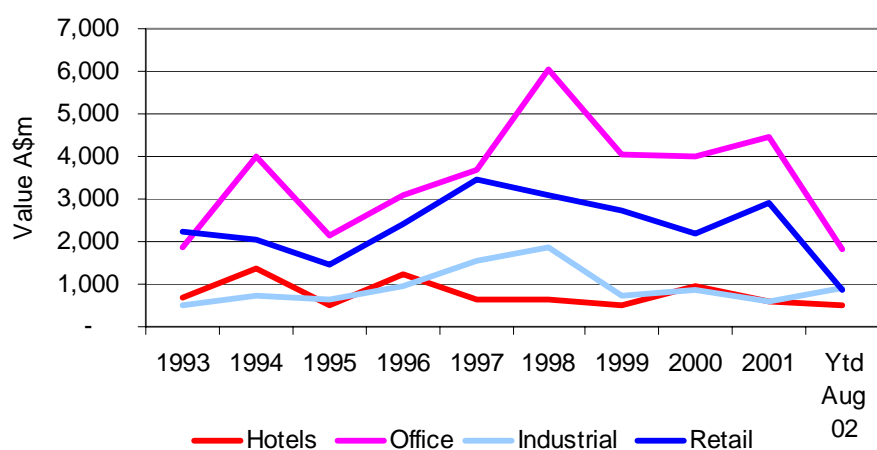
Liquidity of Other Property Types – Direct Investment

When comparing the level of hotel investment activity in Australia to other property types, it can be seen that the activity in the commercial office and retail sectors far outpaces the level of acquisitions in the hotel market. However, apart from an investment peak in 1998, the industrial sector has a similar level of transaction activity to hotels.

Over the period studied, the total value transacted can be apportioned:

- Office (46.7%);
- Retail (30.9%);
- Industrial (12.4%); and
- Hotels (10.1%).

Sales Volume by Property Type – 1993 – Ytd 2002 (Sales over A\$5m)



Source: Jones Lang LaSalle; Jones Lang LaSalle Hotels

The following table compares the liquidity of hotels to other property types over the past nine years. For the purposes of this comparison we have analysed hotels in terms of the total stock of 3-5 star hotel rooms and other property in terms of the estimated square metre area of total stock of industrial, office and retail space. On average, 3.3% of the total hotel investment grade stock is transacted each year, compared to 6.5% of industrial property space, 7.9% of office space and 11.2% of retail space.

Investment Activity by Property Class in Australia 1993-2001					
	Sales Value (A\$m)	Total Stock Traded (hotel rooms / sqm)	Average Annual Sales Value (A\$m)	Average Annual Traded Stock (hotel rooms / sqm)	As % of Total Stock as at Dec 2001
Hotel	7,074	48,554	786	5,395	3.3%
Industrial	8,418	10.5m	935	1.2m	6.5%
Office	33,328	13.3m	3,703	1.5m	7.9%
Retail	22,426	10.5m	2,492	1.2m	11.2%

Source: Jones Lang LaSalle Hotels; Jones Lang LaSalle

Liquidity of the Hotel Investment Market – Listed Property Trusts

In general, investors in indirect vehicles such as listed property trusts (LPTs) benefit from enhanced liquidity. For instance, according to UBS Warburg, the monthly turnover of LPTs during May and June 2002 was approximately 80% of total LPT market capitalisation. This measure of liquidity is an historical high resulting from investors responding to the recent strong performance of the sector. Prior to August 2001, the level of turnover generally ranged from 30-60% of market capitalisation.

However, as can be seen from the following table, hotel specific LPTs do not exhibit the same levels of liquidity as diversified LPTs, with less than 20 percent of units transferring hands during 2001.

	Hotel Specific LPTs		Diversified LPTs (with hotels)	
	Grand Hotel Group	Peppers Hotel Trust	General Property Trust	Thakral Holdings
Units on issue (m)	183.1	50.1	1,867.1	640.4
2001 sales (m)	0.2	8.1	532.4	292.1
% of total units sold during 2001	0.1%	16.1%	28.5%	45.6%

Source: Wright Investors' Service

On a general note, the liquidity of LPTs is likely to be greatly enhanced by the launch of futures contracts, which occurred on 1 August 2002. The launch of property futures in Australia will be a world first and will involve the top 27 property vehicles, which includes Grand Hotel Group, General Property Trust, Mirvac Group, Stockland Trust Group and Thakral Holdings Group.

In summary...

The hotel sector suffers from illiquidity relative to other property types.

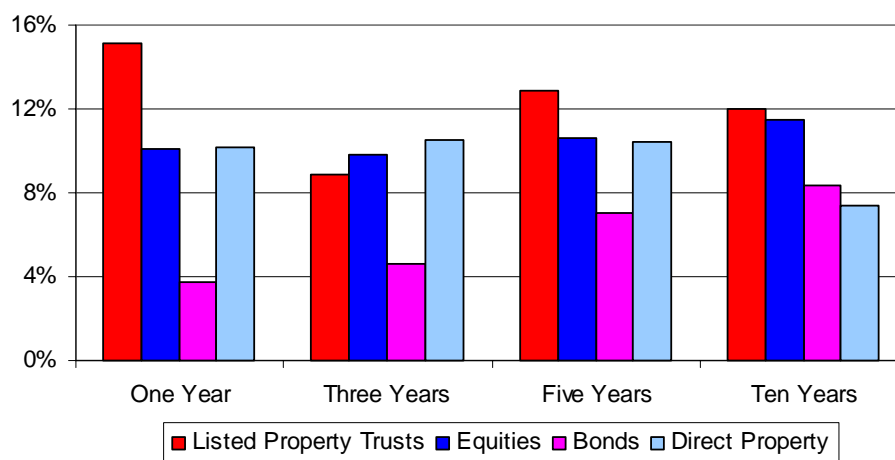
2.7 Investment Returns

Investment Returns by Asset Type

To put property investment performance into a wider context, the PCA has compared the total returns of property against equities and bonds. This measures the income and capital returns from institutional property in Australia.

As the graph below shows, listed property trusts have outperformed the rest of the market over the past 12 month, five year and 10 year periods. During 2001, the total return of LPTs was 15.1%, followed by direct property with 10.2%, equities with 10.1% and bonds with 3.8%. It is likely that direct property has performed relatively better since then, given the poor performance of the stock traded securities.

Annualised Total Returns by Asset Type – as at December 2001



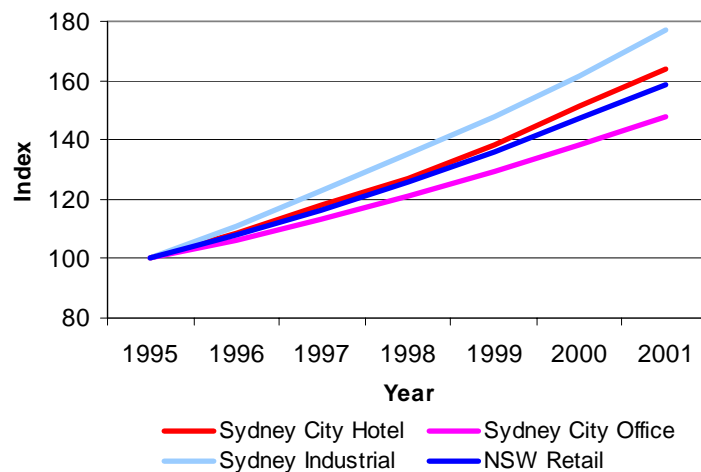
Source: Property Council Investment Performance Index, CBA, ASX

Investment Returns by Property Type – Direct Investment

The PCA has developed a hotel valuation index based on a hypothetical four star Sydney CBD hotel, which is professionally managed under a recognised national or international brand and has the ability to obtain vacant possession on sale. At present this index is only calculated for Sydney, and thus, our comparison of returns is limited to this market.

Looking at income, hotels have offered a comparatively strong return since the index commenced in 1995. Despite the decline in occupancy and ADR during 1998, 1999 and 2001, income levels have consistently improved, which indicate that hotel owners are more vigilant in managing the hotel operators and the business generally.

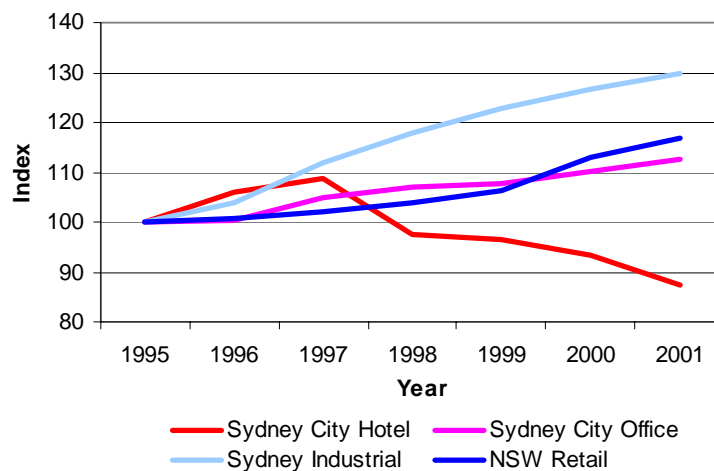
Comparative Income Returns



Source: PCA

However, the capital value of hotels has declined significantly since 1997, just after the generally recognised peak of the hotel market cycle. In contrast to other real estate asset classes, hotel values are considerably susceptible to shocks resulting from the Asian economic crisis (1998), supply additions (2000) and September 11, the global economic downturn and the collapse of Ansett (2001).

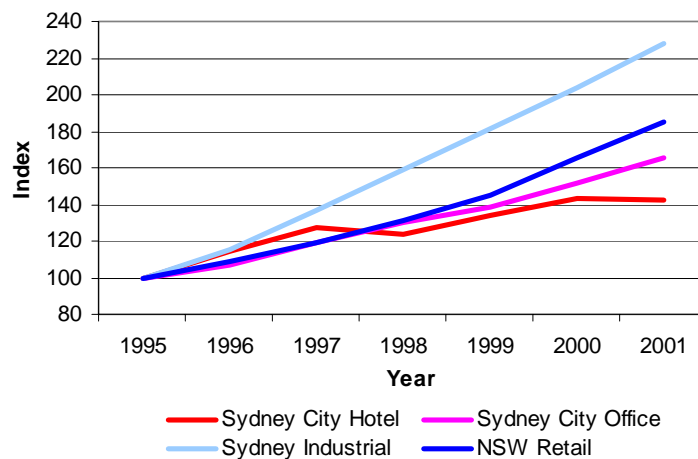
Comparative Capital Returns



Source: PCA

As the following graph shows, the depreciation in the value of Sydney hotels has meant that all other property types have outperformed hotels in terms of total returns.

Comparative Total Returns



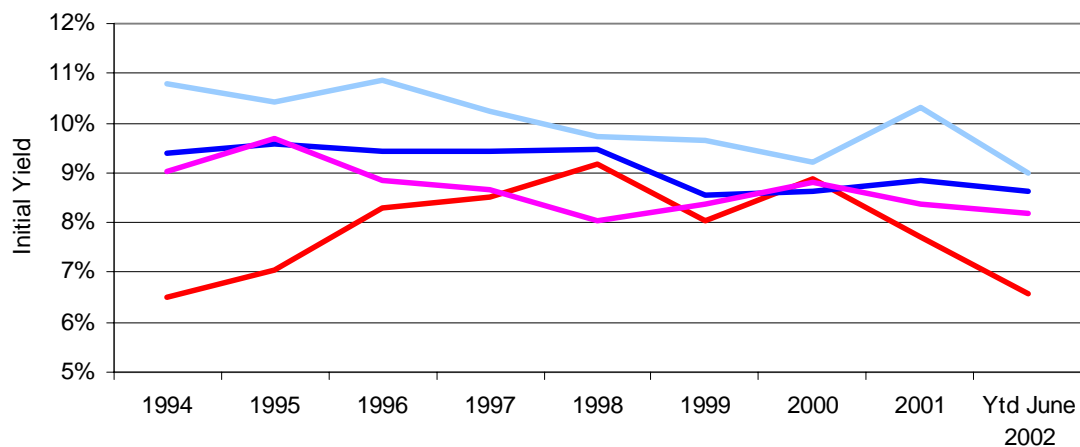
Source: PCA

Initial Yields on Hotel Sales

Where it has been possible to calculate, we have analysed the initial yields of Australian hotel sales over \$5 million from 1994 onwards. Initial yield uses the net operating profit (NOP) of the current year or first forecast year where appropriate. Care should be taken when drawing conclusions from this analysis as it is based on a relatively small base of sales (an average of 19 each year) and can be skewed by one or more sizeable transactions. However, this analysis provides a useful insight into the actual yields achieved in the Australian hotel market. The comparison is restricted to June 2002 data.

As the graph below demonstrates, 3-5 star hotel assets have generally traded at initial yields in the range of 7-9%. Other forms of property have achieved slightly higher yields led by industrial with 9-11%, retail with 9-10% and office with 8-10%. It is interesting to note that hotels are perceived as high risk assets and yet their initial yields are most similar to the level achieved by the office market which is perceived as the property type with the lowest risk profile.

Initial Yield by Property Type 1994 – Ytd June 2002

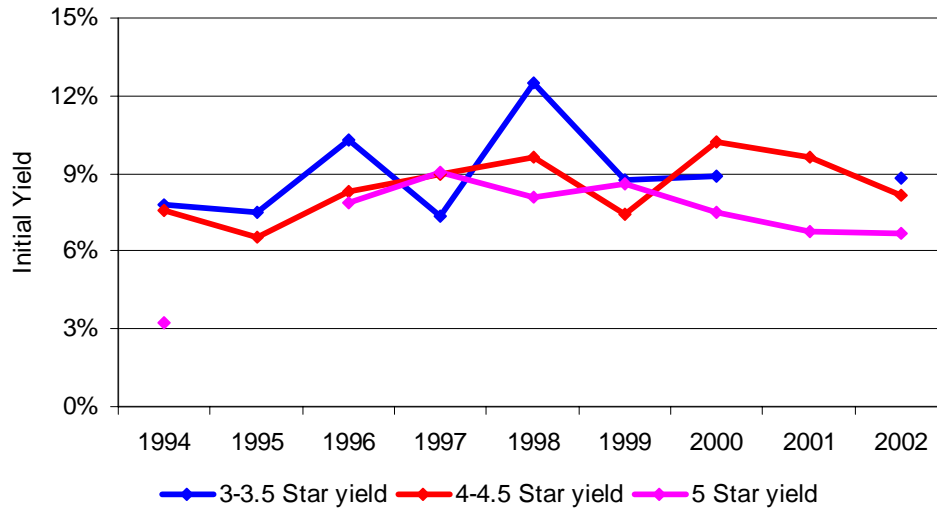


Source: Jones Lang LaSalle Hotels

— Hotel — Retail — Industrial — Office

While this trend appears quite stable, fluctuations appear when we analyse the yields by star grading. In general, the 5 star hotel market trades at lower yields than their 3 and 4 star counterparts. This indicates investors are more confident dealing with 5 star hotels and is consistent with the concept that emotional, as opposed to pure economic factors come to play where prime trophy assets are concerned. We have been able to analyse hotel sales for the year ended December 2002.

Initial Yield – Major Hotel Sales By Star Grading

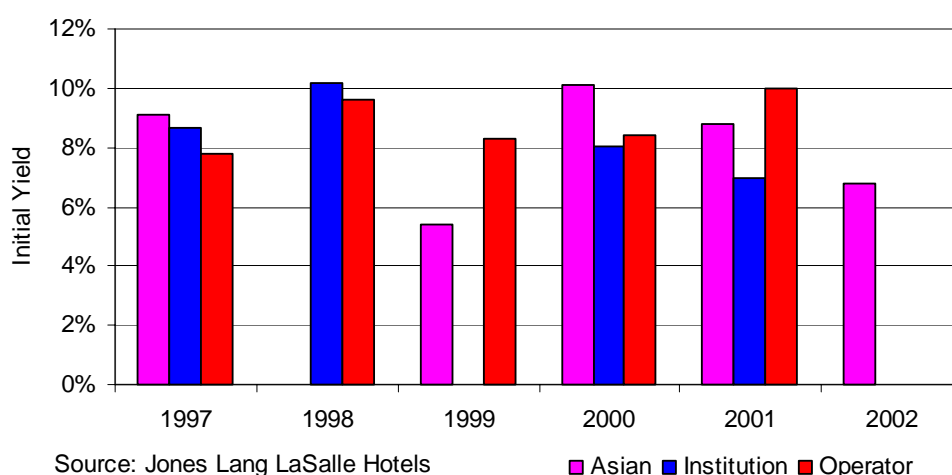


Source: Jones Lang LaSalle Hotels

When comparing the hotels purchased by institutional investors, hotel operators and Asian investors, the divergence in yield is not as notable as would be expected. On average since 1997, Asian investors have bought hotels on an initial yield of 7.2%, compared to institutions with an average yield of 8.3% and operators with 8.6%. This conflicts with the theory that operators would generally accept lower yields than institutions in order to gain market presence, but perhaps highlights the opportunistic buying of the institutions over the past five years.

All three types of investors generally accepted yields within the 7-10% range since 1997. The only exception being the Asian investors who accepted an average yield of 5.4% in 1999 in anticipation of significant growth due to the Olympic Games and an average yield of 6.8% during 2002 due to expected improvement of under-performing assets in a recovering market.

Initial Yield – Hotel Sales by Investor Type



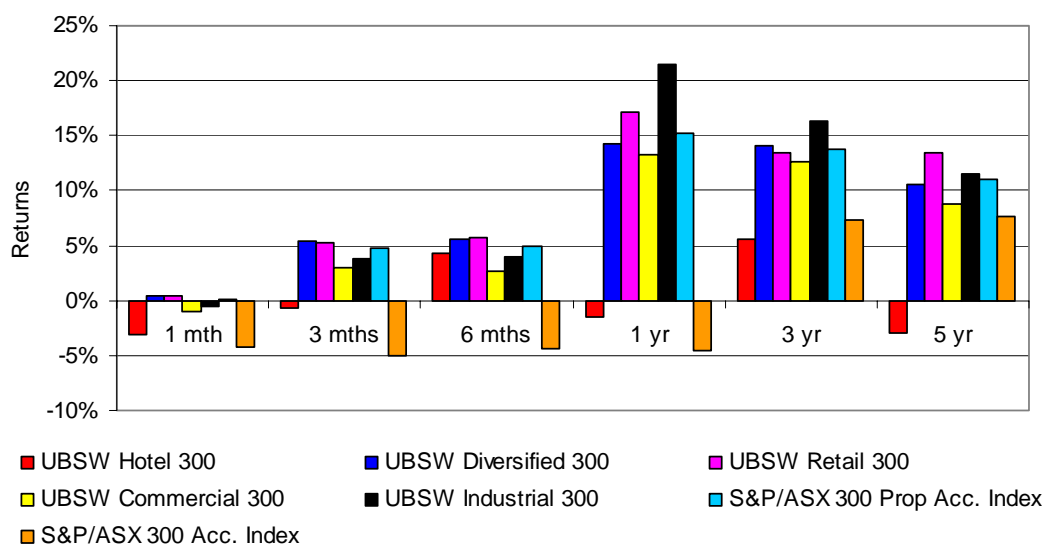
Investment Returns by Property Type – Indirect Investment

Analysis of indirect investment performance is limited to listed property trusts. The following analysis is sourced from UBS Warburg's latest Real Estate Compendium.

As can be seen from the graph and table below, the LPT (S&P/ASX 300 Property Accumulation Index) sector has consistently outperformed the All Ordinaries (S&P/ASX 300 Accumulation Index) over the past ten years. However, UBS Warburg's hotel sector, which contains Grand Hotel Group and Thakral, has generally returned less than all other sectors. The table demonstrates the contrasting performance of these two trusts.

To reduce confusion it should be noted that UBS Warburg separately analyses the hotel stocks under their "Hotel" sector. However, the official Global Industry Classification Standard (GICS), which has been used by the Australian Stock Exchange (ASX) since 1 July 2002, includes these hotel specific LPTs in their "Real Estate" sector. The GICS rating includes a "Hotel, Restaurant and Leisure" sector, which includes mainly gaming stocks rather than hotel owning vehicles.

Returns for the Period Ending June 30 2002



Returns for the Period Ending June 30 2002							
	Index Market Cap (\$m)	One Mth	Three Mths	Six Mths	One Year*	Three Years*	Five Years*
Grand Hotel Group	\$106	-14.4%	-18.8%	-22.7%	-37.3%	-16.1%	-14.0%
Thakral Holdings	\$192	4.9%	14.3%	31.2%	14.3%	11.0%	3.5%
UBSW Hotel 300	\$298	-3.1%	-0.7%	4.30%	-1.5%	5.5%	-3.0%
General Property Trust	\$5,342	1.4%	4.0%	2.9%	8.6%	12.5%	8.6%
Stockland	\$3,632	-1.1%	5.1%	5.1%	16.7%	17.8%	13.0%
Mirvac	\$2,583	1.6%	8.1%	11.6%	20.1%	18.6%	n/a
UBSW Diversified 300	\$15,649	0.5%	5.4%	5.5%	14.2%	14.1%	10.6%

Source: UBSW
* Annual Compound Returns

In summary...

In the past, hotel investment returns have been inferior to other property investments.

2.8 Overseas Experience

As outlined in Section 2.4, the lack of institutional investment in hotels is a global phenomenon. The only institutional investors to be notably active across the world are the German institutional funds. A detailed description of these funds written by Jones Lang LaSalle Hotels' European Research is provided in Appendix C, however, we present a summary here.

- German hotels are predominantly managed under a lease structure, which means the owners receive a pre-determined level of rental income. Any revenue over and above these levels is solely for the operator;
- The funds have a long term investment horizon. They are therefore not likely to dispose of the asset and jeopardise an operator's representation. Institutions seek long term strategic partnerships and leases generally do not have a break clause in the case of the sale of the asset;
- The funds have access to reasonably cheap source of capital and therefore accept lower returns than traditional equity investors;
- German funds can be pure equity investors and do not require debt financing. This means the transactions are generally less complicated and take a shorter time to complete; and
- German funds seek high quality products, in which they invest heavily to maintain an excellent standard and hence value.

In summary...

German funds have been active in hotel acquisition since 2000. They have access to cheap capital, which allows them to accept lower yields. These funds are comfortable with long term leases and seek high quality assets.

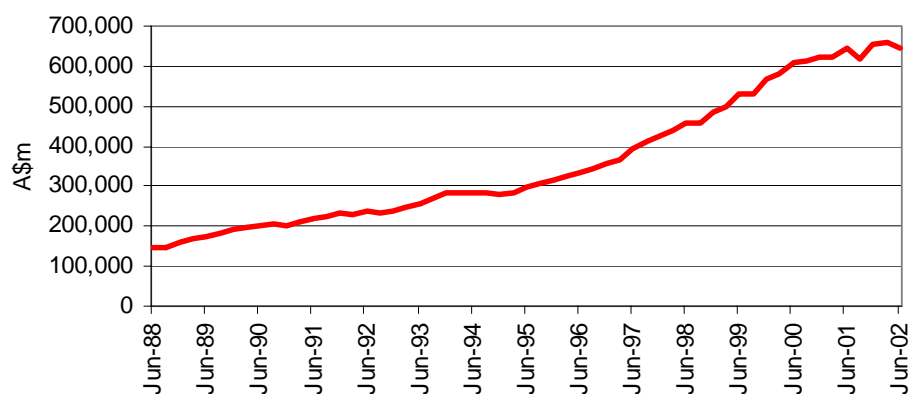
3.1 Current Institutional Investment

In this section we will discuss the growth of funds under management and the current investment patterns of institutional investors. As private non-operator aligned investors are a highly fragmented group, it is difficult to draw any meaningful conclusions as to their investment patterns.

Institutional Investment – Historic Growth

As can be seen from the graph below, funds under management have undergone significant growth (11.2% pa) over the past 14 years from \$145.5 billion in June 1988 to \$645.0 billion as at June 2002. The recent decline was a result of a decrease in asset values due to a falling share market.

Growth of Total Funds Under Management



Source: ABS

According to Property Investment Research (PIR), professional funds management groups (LPTs, unlisted property trusts, syndicates etc) own 48% of the total asset value of the Australian property market, with private investors accounting for 25% and corporations the remaining 27%.

Demand for property from the funds management segment is likely to grow as their access to capital increases, if only through the regulated increase in superannuation. According to the Tourism Task Force, the Reserve Bank of Australia (RBA) estimates that superannuation funds will have an extra \$365 billion under management in 10 years.

On the other hand, there is a trend for corporations to move property off their balance sheets and use this capital for expanding or improving their core business. Additionally, private investors do not have great levels of capital available to them.

Consequently the professional property fund managers rather than the corporations and private investors will drive the future demand for property. Although corporations are likely to offer some assets through divestment, PIR suggests only a quarter of these assets will be suitable for institutional investment. Therefore, there is likely to be a latent demand for property from professional fund managers and an undersupply of investment grade property.

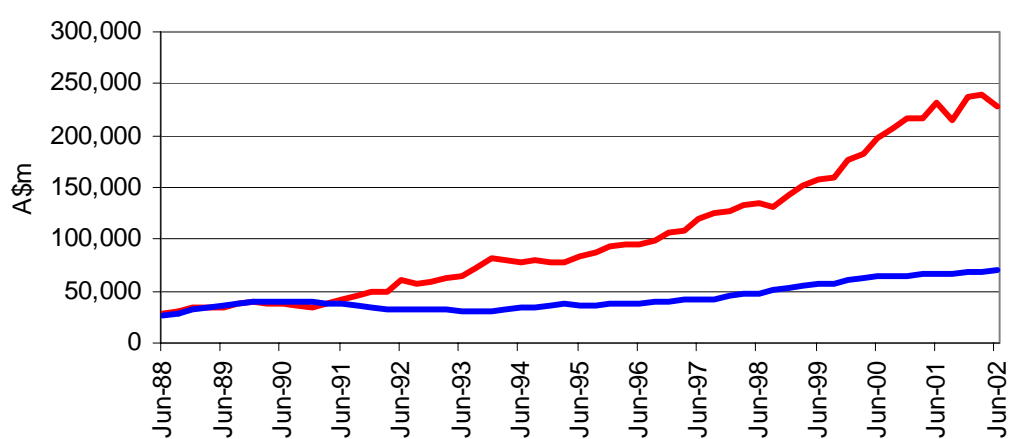
Furthermore, Australia is already characterised by a high level of investment grade property securitisation. According to the PCA, approximately 55% of all institutional

grade real estate is listed, including 80% of retail, 50% of office and 60% of industrial assets. This is much higher than the levels in North America (18%), UK (17%) and Japan (10%). As discussed in Section 3.4 hotels are not highly securitised, because this income stream is volatile.

Clearly, there are opportunities for hotels to absorb some of this unsatisfied demand for property investment.

A future consideration in addressing fund managers' desire for property is their preference for more liquid forms of investment (equities and units) compared to direct investment in land and buildings. This preference is obvious in the graph below, which shows the growth of these two asset types. Other non-property assets that comprise total funds under management are cash and deposits, loans and placements, short term and long term securities and overseas assets.

Funds Under Management by Asset Type



Source: ABS — Equities and Units in Trusts — Land and Buildings

Institutional Investment - Current Investment Patterns

Property Investment

According to discussions with investors, property generally accounts for 10% of a diversified fund under management. However, according to Intech (and UBS Warburg), growth funds have an LPT weighting of 6.4% (6.5%) and direct property of 1.9% (1.5%). This is lower than most optimisation models which endorse a property allocation of 10-20%.

Hotel Investment

It depends on the strategy of the investor as to where hotels fit into their asset allocation. In some funds, hotels can be included in property, but in others they are put into an alternative asset class, indicating they expect a higher risk and want a higher return from these assets compared to core property.

It is generally recognised that hotel investment represents a minute investment sector for institutional funds. For instance, interviews with asset consultants and property securities funds indicate hotels account for up to 1% of their funds under management

This is likely to be affected by the small level of hotel stocks currently available. UBS Warburg estimates that hotels comprise 0.7% of the LPT index, however the PCA indicates this proportion to be 3%.

In summary...

The growth of funds under management is set to continue. Consequently, there will be more demand for investment grade property.

At present, property constitutes less than 10% of funds, and hotels account for less than 1% of funds.

3.2 Major Non-Operator Aligned Hotel Investors

As outlined in Section 2.4, we have identified the number of hotel rooms owned by major domestic and foreign publicly traded companies as well as institutional investors. In the tables below, non-operator aligned investors are highlighted in red.

As can be seen from the tables below, non-operator aligned investors use a variety of investment vehicles in which to hold their Australian hotel assets. The majority of non-operator aligned investors are likely to be small private investors who are not identified in these tables due to their fragmentation.

Major Listed Owners of Australian Hotels		
Company	Rooms	GICS Classification
Fortland Hotel (FHT)	361	Real Estate
General Property Trust (GPT)	1,932	Real Estate
Grand Hotel Group (GHG)	3,255	Real Estate
International Equities Corporation (IEQ)	119	Real Estate
Mirvac Group (MGR)	348	Real Estate
Peppers Hotel Trust (PHT)	431	Real Estate
Stockland Trust Group (SGP)	569	Real Estate
Sunland Group (SDG)	608	Real Estate
Thakral Holdings Group (THG)	2,608	Real Estate
Tourism and Leisure (TLT)	162	Real Estate
Burswood Ltd (BIR)	413	Hotel, Restaurant & Leisure
Breakwater Island (BRI)	101	Hotel, Restaurant & Leisure
Club Crocodile Holdings (CCH)	564	Hotel, Restaurant & Leisure
Hamilton Island (HAM)*	756	Hotel, Restaurant & Leisure
Jupiters Limited (JUP)	787	Hotel, Restaurant & Leisure
Lasseters Corp (LAS)	255	Hotel, Restaurant & Leisure
Port Douglas Reef (PDR)*	306	Hotel, Restaurant & Leisure
Reef Casino Trust (RCT)	128	Hotel, Restaurant & Leisure
Tabcorp (TAH)	488	Hotel, Restaurant & Leisure
Amalgamated Holdings (AHD)	1,150	Media
Total	15,335	
Non Operator Aligned	5,790	(37.8%)

Major Publicly Listed Foreign Hotel Owners		
Company	Rooms	Origin
Apollo Enterprises	270	Hong Kong
Club Mediterranee	218	France
Great Eagle Hotels	386	Hong Kong
Hotel Grand Central Limited	903	Singapore
Hotel Properties Limited	199	Singapore
Low Keng Huat International P/L	881	Singapore
Marriott International	330	US
Mulpha Australia Ltd	223	Malaysia
Reliance Pacific Berhad	445	Malaysia
Six Continents Hotels & Resorts	2,591	UK
Singatronics	268	Singapore
Stamford Land Corporation Limited	2,002	Singapore
Starwood Hotels & Resorts Worldwide Inc	558	US
United Overseas Land Group	933	Singapore
Total	10,207	
Non Operator Aligned	2,279	(22.3%)

Major Institutional Investors		
Company	Rooms	Origin
AMP	363	Australia
AXA Australia	226	Australia
Babcock & Brown (TAHL)	5,104	Australia
Principal Hotel Group	1,434	USA
Commonwealth Property Hotel Fund	1,033	Australia
C+BUS	613	Australia
GIC Real Estate	980	Singapore
Total	9,753	
Source: Jones Lang LaSalle Hotels; ASX		
* Hotel assets are on the market		

In summary...

Non-operator aligned investors use a variety of investment vehicles in which to hold their Australian hotel assets.

3.3 Potential Non-Operator Aligned Hotel Investors

Australian Institutional Investors

Looking at the latest report from ASSIRT, unit trust and superannuation funds currently dominate the retail funds management sector. Over the past year, superannuation funds are the only structure to have experienced growth in net annual inflows, while the net inflow of unit trusts has decreased. Clearly, the major superannuation funds and unit trusts, represent an untapped source of capital for hotel investment.

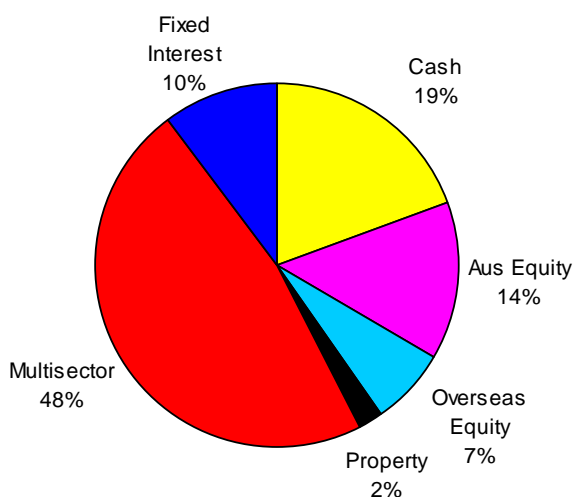
Retail Managed Funds by Tax Structure As at June 2002			
Investment Tax Structure	% Market Share	Size (A\$m)	Net Inflow 2001/02 (A\$m)
Unit trusts	44%	103,580.4	10,326.7
Superannuation	39%	90,844.0	4,597.4
Allocation Pensions & Annuities	14%	33,478.8	1,051.1
Friendly Society Bonds	1%	3,129.4	-150.5
Insurance Bonds	2%	5,025.3	-814.6
Total	100%	236,058.0	15,010.0

Source: ASSIRT Research Release

In terms of asset allocation, property accounts for a relatively small proportion of total funds under management. However, looking at the net inflows over the past 12 months, its share has increased. Although representing only 2.3% of all assets, retail funds managed \$5.5 billion worth of property as at June 2002.

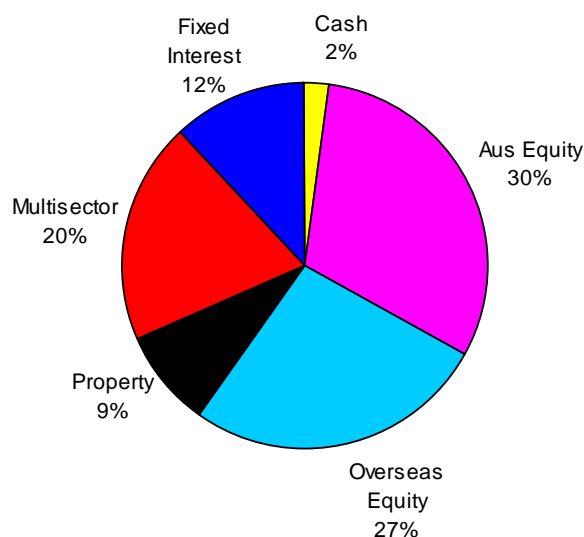
Total Retail Funds Management by Asset Allocation as at June 2002

Current Weighting



Source: ASSIRT

% of Net Annual Inflows 2001/02



Source: ASSIRT

Superannuation Funds

Over the past year, superannuation funds have favoured investment in Australian and international equities, multi sector assets and property. During 2001/02, property accounted for 7.5% of the net inflow to bring its share to 1.4%, which is lower than the total proportion for managed funds of 2.3%. The current level of property held by superannuation funds is worth \$1.3 billion.

According to ASSIRT, the top five managers in retail superannuation and therefore key potential hotel investors as at June 2002 are:

Manager	Funds Under Management (\$Am)
1. Commonwealth / Colonial First State	\$20,717.4
2. AMP	\$18,359.4
3. National / MLC	\$16,107.4
4. ING Australia	\$6,510.4
5. Westpac	\$4,994.6

Westpac may have since increased its position since acquiring BT Funds Management.

Unit Trusts

Over the past year, property has attracted 8.5% of the total inflows to unit trusts to result in a current weighting of 3.6%, which represents \$3.8 billion.

According to ASSIRT, the top five managers in retail unit trusts as at June 2002 are:

Manager	Funds Under Management (\$Am)
1. Commonwealth / Colonial First State	\$19,841.5
2. National / MLC	\$12,135.9
3. ING Australia	\$9,488.5
4. Macquarie Bank Group Managed Funds	\$9,053.7
5. BT Financial Group (Now owned by Westpac)	\$6,536.1

In terms of the level of funds under management, these five institutions have strong potential to become hotel investors.

It would appear that institutional investors with experience in hotels (Principal Hotel Group (previously known as BT Funds Management), General Property Trust) or strong relationships with hotel industry members (C+BUS, ISPT) are most likely to invest in hotels in the future, as they are more comfortable with the investment class. Hotel vendors would do well to target these institutions as well as cultivate closer relationships with those who do not have the in-house hotel expertise, nor the appetite for hotel investment.

Overseas Institutional Investors

As discussed in Section 2.8, German funds stand out as potential global hotel investors given their experience and current level of interest in the sector. However, it is more likely that institutional investors closer to Australia, particularly from Asia, will invest in Australian hotels in the future. GIC Real Estate stands out as an example of an active investor that has a mandate for overseas investment. For organisations such as this in the Asia Pacific region, Australia represents a relatively safe investment haven, benefiting from a transparent investment environment and stable political environment.

Private Investors

Although the market is too large and fragmented to be able to meaningfully nominate private investors who have the potential to become hotel investors, we can make some assumptions based on the identity and type of recent purchasers of hotels in Australia.

Non-operator aligned investors who have purchased hotels in the past two years have generally fitted into one of the following categories:

- Private investors – These investors, who are generally high net worth individuals, believe the market to be in a trough and are keen to benefit from the perceived upside – these individuals and families generally prefer to remain anonymous, but there have been several transactions over the last three years to investors in this category.
- Domestic developers or syndicates – These players have recently been active, purchasing hotels to convert into residential apartments – eg Mirvac purchased the Landmark Parkroyal in Sydney, PC Syndications purchased Novotel Opal Cove Resort in Coffs Harbour and Multiplex purchased the Oxford Koala Hotel in Sydney.
- Fire sale investors from South East Asia, particularly Singapore – eg Cockpit Hotels
- Overseas government agencies – eg GIC Real Estate
- Backpacker operators – eg Park Inn Perth, Westend Hotel, Sydney
- Unlisted funds – eg Commonwealth Property Hotel Fund (Colonial First State Property)

Further untapped investors may be reached through syndicates or private equity models. These would appeal to sophisticated investors who understand the inherent risks of hotel investment and can make an opportunistic play.

“We’re seeing more and more (of) the private equity model with exit strategies applied to property.” (Domestic super fund manager – non-hotel investor)

Listed Investment Companies

It is unlikely that we will see another hotel specific LPT while the negative experience of recent forays is still a recent memory. Therefore hotel exposure in the LPT sector will likely be through diversified trusts such as Mirvac, Stockland and GPT. There is also an opportunity for consolidation of the existing hotel trusts.

*“(Recent hotel specific LPT experiences) left a very bad taste in lots of investors’ mouths.”
(Hotel broker)*

However, sentiment should improve with time, increasing scarcity of quality non-hotel investments, better management and disclosure.

In summary...

Potential non-operator aligned hotel investors include:

- Superannuation funds;
- Unit trusts;
- High net worth private investors;
- Asian investors;
- Overseas funds;
- Unlisted hotel specific funds; and
- Diversified LPTs.

3.4 Investment Vehicles and Their Hotel Ownership

The main investment asset classes available in Australia are shares, property, cash and bonds. The available vehicles for property investment and the options for hotel investment are discussed in full in Appendix D. However, a summary of the key characteristics is given on the next page.

Although there are several high profile unlisted and listed hotel funds, the majority of hotel assets are owned through direct investment.

In Summary...

	Size	Liquidity	Term (yrs)	Performance	Minimum Investment	Entity / Property Gearing	Examples (Hotel if possible)
Direct Ownership	Not known	Low (redeemable only on sale)	10-20	Initial yield 6-10% (hotels)	A\$5m (for an international hotel)	Variable	City Freeholds, Cockpit Hotels
Property Syndicates	\$5b	Low (not normally redeemable)	5-7	Average first year yield of 8-9%	\$5,000 - \$10,000	50-65%	Teys McMahon, MCS Property, Investa Property Group
Unlisted Property Trusts	Not known	Moderate (redeemable within 12 months)	8	Not known	Varies Considerably	30%	Commonwealth Property Hotel Fund (Colonial First State), Principal Hotel Group
Private Equity Funds	Not known	Low (not redeemable)	10	14-15% total return	\$20,000 - \$1 million	Not known	Macquarie Private Equity Trust
Listed Property Trusts	\$45b	High (3 days)	Any	10% total return (7% yield, 3% capital)	\$1,000	20-30%	Grand Hotel Group, Thakral Holdings
Properties Securities Funds	\$10b (Dec 00)	High (3 days)	5	5 yr return 14.2%	\$1,000 - \$2,000	n/a	Colonial First State Property Securities Fund, Westpac Australian Property Securities Fund
Mortgage Funds	\$14.5b	High (1-60 days)	1-2	5-7% return (income no capital growth)	\$1,000 - \$5,000	50-60% LVR	Perpetual Monthly Income Fund, ANZ Mortgage Fund

3.5 Investment Criteria

Returns

Interview candidates were asked to nominate the initial yield differential required to purchase a well located, CBD, 3-5 star hotel available with vacant possession, compared to a retail, industrial or office investment.

Removing the extremes at either end of expectations, the risk premiums were as follows:

Initial Yield Premium Required to Invest in a Hotel Over Industrial, Retail and Office Property	
Industrial	+1-4%
Retail	+2-4%
Office	+2-5%
Source: Interviews	

Clearly, investors indicate that they require a superior return in order to compensate for a perceived higher risk involved in hotel investment. However, examples of hotel investment vehicles that have offered superior returns are quite difficult to find. In part, this is due to the lack of investment performance data available to investors, but it is also due to the poor performance of those more transparent markets including the direct acquisition market and the listed vehicles. (See Section 2.7)

For most local investors interviewed, there appeared to be an absence of a formalised approach for assessing the required return rate for hotel investment. It seems that investors are not comfortable with identifying these risk premiums, which could be explained by their lack of experience with this sector.

Income

Investors displayed a preference for a smooth, secure income stream, removing the volatility associated with hotels. This could be achieved through mechanisms in management agreements or through lease agreements, with the potential for the owner to share in the upside. If the income was secured, investors may be willing to accept lower yields.

Investment Horizon

The ideal investment term varies significantly depending on the type of investor. For instance, growing superannuation funds have a preference for steady income returns throughout a relatively long term (10 years or more), while some respondents suggest that the ultimate investment term for hotels should be 3-5 years so that the investor avoids making any capital expenditure. Some investors undertake an analysis to decide whether to end their investment each year, while others believe the ideal investment horizon should be 7-8 years, which is perceived to be the average length of the property cycle.

There are a plethora of property investment vehicles available that can offer a diverse range of terms, from the daily liquidity of listed property trusts to the long term direct ownership of a hotel asset. However, their exposure to hotels is limited.

Exit Options

A flexible exit strategy is critical for a successful hotel investment. In order to take advantage of the cyclical nature of the hotel market, investors need to be able to redeem their assets at the optimum time. This is especially important given that the capital growth of hotels since 1997 has been negative (see Section 2.7). Therefore, capital gains are not assured, but rely on a flexible exit strategy.

Closed ended funds seem to be more popular with investors as they offer a defined exit strategy. In this way, investors are more comfortable that the interests of the fund manager and the investors are aligned. However, the redemption period should be flexible so as to optimise realised capital growth.

A lack of defined exit strategy has been identified as a negative impact on the performance of hotel investments. In the past, there is a perception that institutions and LPTs have been guilty of purchasing at the peak of the cycle, while other non-operator aligned investors have not considered an exit strategy and have consequently suffered.

"It's a matter of location and timing and it's about where you enter that point in the cycle. And it's about having an exit strategy." (Domestic hotel investor)

Gearing

Once again, investors' tolerance to gearing greatly depends on the nature of the investor. Institutional investors generally adopt conservative gearing levels such as 20-30%, while aggressive syndicates would be comfortable with debt levels up to 50-65%. With mezzanine funding, gearing can reach up to 100%, however, levels of 75-80% are more likely. Although mezzanine funding has yet to make inroads into the hotel investment market in Australia, it is more suitable to development or refurbishment projects that guarantee capital growth and enable extinguishment of the mezzanine debt within a maximum of 3-5 years.

Property Characteristics

In general, properties with the following attributes appear to be attractive to potential investors:

- Located in a well established tourism region, usually major city CBDs;
- Diverse business mix, including exposure to corporate, leisure, international and domestic markets;
- Operation by an international management company with a lease or performance hurdles;
- High barriers to entry such as scarce development sites;
- The ability to sell with vacant possession;
- Hotel as part of a mixed use development so the investor can benefit from diversified income streams; and
- Minimal capital expenditure required.

Lenders

There are several critical investment attributes that lenders examine, including:

- The investors' ability to service the debt;
- The investors' ability to service capital expenditure requirements; and
- Maintaining loan to value ratios (LVR);
- The existence of a portfolio of properties to reduce the likelihood of a one-off loss and reduce the risk.

In summary...

Hotel investors require:

- 2-5% yield premium over commercial property;
- Smooth, secure income streams;
- Flexible exit strategy;
- Diversified income streams;
- Geographically diverse portfolio;
- Management by an international operator; and
- Minimal capital expenditure.

Gearing and investment timeframes vary considerably.

3.6 Decision Making Process

Not surprisingly, our interviews demonstrated that there is no one decision making model that is used by all potential investors in their evaluation of a hotel investment. In fact, the decision making processes vary significantly between investors. Generally, sophisticated investors have a process whereby the potential investment is reviewed by several levels of their hierarchy, but this is where the similarities end.

The decision making process is particularly influenced by the investors' geographic coverage as well as their previous hotel experience, level of internal expertise and perceptions of future market performance.

For instance, if the investors have a global orientation, the decision making process may involve a comparison of other global opportunities, whereas this step is not necessarily fundamental to local investors.

"If you are a global player there are much more attractive markets to play in with stronger demographics." (Property investment group – non-hotel investor)

Being a global company however, may allow access to more resources. For instance, one company interviewed has a dedicated hotel expert that evaluates hotel opportunities around the world. This person:

- Compares the hotel on a global basis;
- Examines the profit and loss account line by line;
- Assesses the potential upside; and
- Examines the leases and management agreements.

It seems that institutions who have invested in hotels have either 'fallen into it' as part of a mixed use development, such as AMP, or have in-house expertise, such as Principal Hotel Group and Colonial First State.

Investors with experience in the hotel sector generally have a formalised evaluation process. These investors examine the property and the market as well as the legal and financial implications. Experienced hotel investors separate themselves from other investors in their ability to drill down into the operations of a particular asset, looking at the operational benchmarks to determine the level of potential upside.

"If you talk to other investors...they don't have the in-house skills to check operations, they can review financials, and they can review the legals (sic), but they don't have the details to assess operational risk." (Domestic banker – hotel lender)

For others, time and lack of internal resources are considerations. This is particularly important for investors who are inexperienced with hotels.

"The problem is, these people have limited time to make investment decisions. They are not going to go to the Cornell School to learn about hotels. Because at the end of the day it will only be probably 1% of their portfolio." (Domestic hotel investor – fund manager)

For this reason most funds employ the services of asset consultants who review their investments. Other funds may approach a real estate adviser to ‘hold their hands’ through the process, analysing the hotel offering and advising them on an appropriate bid.

Asset Consultants

Asset consultants take on the role of ‘gatekeeper’ for most major superannuation funds. Their main function is to assess whether a potential investment fits their clients’ investment strategy. Potential investments can be presented to the asset consultants or directly to the clients, but in the latter case, clients generally seek input from their asset consultants.

Major factors analysed by asset consultants include:

- Determine where the investment would fit in their clients’ portfolio and meets the objectives of each asset class (property, other, opportunistic etc);
- The ability of the fund manager to deliver on their promises and add value (skills, experience and capabilities);
- The attributes of the structure;
- Flexible exit strategies (the ability to get in, realise profit and get out)
- The alignment of the fund manager’s and investors’ interests;
- Fee levels; and
- Assessment of risks (portfolio versus single asset fund).

The asset consultants interviewed do not usually analyse the underlying hotel asset in detail. As hotels form a small part of the investment market, they do not have the expertise to provide a reliable analysis and therefore recommend clients’ undertake further due diligence on their own part. Some may provide preliminary feedback on the balance sheet projections, but their focus is on the fund manager and the structure of the investment offering rather than the underlying asset.

“We’re not experts in the sector...Our job is to make sure the alignment (between investor and fund manager) is fair, the fees are reasonable, the exit provisions are reasonable and the manager’s got the necessary expertise.” (Asset consultant)

Their lack of expertise may be a function of the small size of the hotel market as well as the lack of hotel investment vehicles currently marketed to institutional investors.

“We don’t have a process for looking at these things because there aren’t any around.” (Asset consultant)

In Summary...

The decision making process varies significantly amongst investors. It is particularly affected by investors' level of hotel experience as well as their global or local investment scope.

Asset consultants are the gatekeepers to many fund managers. Their main concerns are:

- Allocation of investment types within their clients' portfolios;
- Investment vehicles' structure and fees;
- Alignment of fund manager and investor;
- Proven performance of fund manager; and
- Exit options.

3.7 Information Sources

As mentioned in Section 3.6, the method of assessing a hotel opportunity varies greatly among investors. Investors differ in terms of their internal expertise and resources as well as the time they are willing to dedicate to source hotel information.

The following section outlines the common information sources used to evaluate a hotel investment opportunity.

Direct Hotel Investment

Market Information

- International and domestic tourism – Bureau of Tourism Research, Tourism Forecasting Council;
- Trading data (market wide occupancy, average daily rate (ADR) and revenue per available room (RevPAR)) – ABS, AHA, operators;
- Tourism market overviews – real estate agents and other hotel advisers;
- Operational data – Horwath Benchmark Study and other hotel advisers;
- Sales data – real estate agents, other advisers, newspapers; and
- Supply and demand studies – hotel advisers.

The general consensus is that level of and availability of market information is acceptable.

*“Typically the reports (supply and demand studies) prepared are pretty good....quite detailed.”
(Property investment group – non-hotel investor)*

Property Specific Information

Investors rely on the vendor and agent to provide them with the property specific information, such as:

- Business mix;
- Capital expenditure – required to keep the property in good condition;
- Depreciation schedule;
- Details of liquor licence;
- Development potential;
- Land Title;
- Leases / Concessions;
- Major rooms contracts;
- Management agreement;
- Manager – experience / size / brand quality / reservations;
- Occupancy and ADR statistics;
- Profit and loss accounts (an example is given in Appendix E);
- Rates and taxes;
- Schedule of Employees; and
- Technical summary.

There are far ranging opinions regarding the quality and availability of property specific information. For instance, some potential investors believe hotel information is inferior to commercial property.

“Trying to get information from a property trust manager on individual hotels is a lot harder than commercial buildings because there are competitive issues therein.” (Domestic property securities fund manager)

On the other hand, some investors believe the information is superior and benefits from hotel operators and owners sharing trading information.

“If I compare the information I can get on hotels in comparison to the information I could get on office, hotels are up here and offices are down here” (Domestic superannuation fund – hotel investor)

“As a debt provider...we actually get the real data from each property ahead of the market. We are probably better informed than the market generally” (Domestic bank – hotel lender)

These investors believe it is the interpretation of the information that is the problem, rather than its availability.

“I think the hotel market doesn’t suffer from that (a lack of information). I think it’s more people understanding the information in front of them is the problem.” (Domestic property securities fund manager)

Indirect Hotel Investment

Properties securities funds which invest in LPTs look at the total return over the next 2-5 years. Some funds have the in-house experience to forecast profit and loss accounts, and use information from:

- Real estate companies and other advisers – market information, future supply etc; and
- Hotel managers – market sentiment, competitive actions.

“Most of the information is pretty good...the macro side is OK. It’s just getting information from the (trust) manager” (Property securities fund manager)

However, other funds use UBS Warburg’s quarterly report, which provides recommendations as to buy, sell or hold hotel sector specific LPTs shares. The ASX also provides basic information on hotel specific and diversified LPTs.

Helpful Additional Information

The interviews and previous research have identified the following additional information is helpful in assessing hotel investments:

General Comments

- Lessen the use of jargon, provide explanations of terms and use consistent terms across the industry; and
- Some investors believe there are not a lot of experts in the market. This may be due to the small size of the market, or the lack of exposure given to the existing experts. They believe the industry would benefit from increasing the profile of hotel experts.
- A central repository for all relevant information would assist hotel owners and potential investors.

Market Information

- Segment analysis – nights spent in hotels by geographic origin and business segment;
- Demand forecasts on a regional and segment basis;
- Future supply information – councils should produce development registers which identify projects and number of rooms likely to be developed over the short to medium term by local government area;
- The timing and reliability of the International Visitor Survey and National Visitor Survey could be improved;
- Sales analysis that reflects a directly comparable hotel and buyer;
- Correlation of performance with business confidence; and
- Comparison of market cycles (hotels v other forms of property).

“Certain assets attract different types of investors and I don’t know whether valuations reflect that cost” (Domestic bank – tourism investor)

Property Information

- Profit and loss accounts – operational benchmarks, profit ratios, management fees; and
- Reliable forecast trading performance.

In summary...

The general consensus is that level of and availability of market information is acceptable. However, there are far ranging opinions regarding the quality and availability of property specific information.

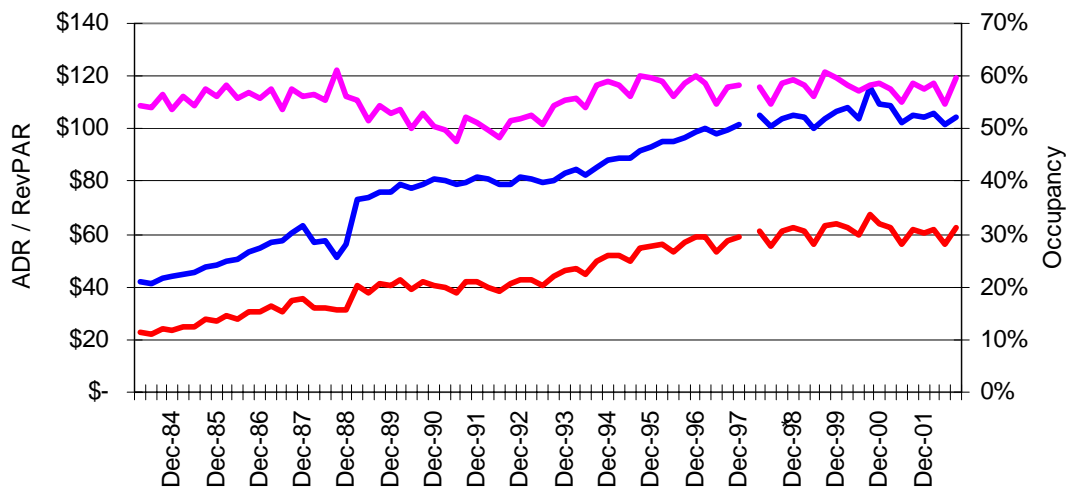
4.1 Impediments - Inherent Attributes of Hotels

There are several inherent attributes that separate hotels from other property types and these are generally considered impediments to non-operator aligned real estate investors. These attributes are discussed below, followed by recommendations of methods by which to minimize or eliminate these impediments.

Volatility in hotel trading performance

Hotels are perceived to suffer from a volatile cashflow profile. Looking at the graph below, which demonstrates the top line performance measures of occupancy, average daily rate (ADR) and revenue per available room (RevPAR), this volatility is quite obvious. The graph clearly demonstrates the seasonal and cyclical pattern of occupancy and ADR and the impact of extraneous variables such as the pilots' strike in 1988 (in terms of ADR) and the recession in the early 1990s (in terms of occupancy).

Australian Tourist Accommodation – Quarterly Performance



Source: ABS

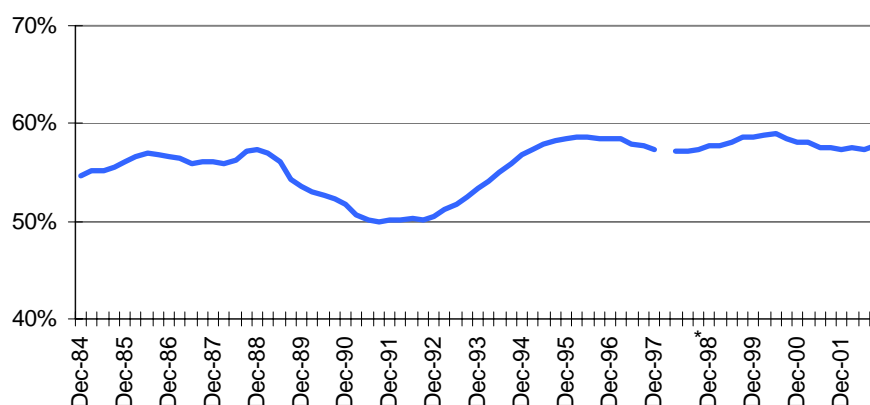
— ADR — RevPAR — Occupancy

* Series Break

Further volatility arises due to the fact that unlike office blocks, hotels are tenanted daily. Although sophisticated operators now undertake yield management and generally have contract business which fills the bulk of their hotel rooms, there is still an unknown element of daily demand and the lead time for hotel bookings is generally shorter than the leasing of an office building.

Hotels are also said to be affected by the general property cycles which are 7-10 years in duration. This can be seen in the graph overleaf where we have removed the seasonality from the historical occupancy of Australian tourist accommodation.

Moving Average Occupancy – Australian Tourist Accommodation



Source: ABS

* Series Break

Furthermore, the cashflow and profitability of an individual hotel is affected by the fact that hotels do not trade to their full potential as soon as they open. Instead, it generally takes three years before the hotel has established itself and trading is said to have stabilised.

These elements of volatility increase the perceived risk of hotel investment and are therefore considered major impediments to increasing non-operator aligned investment in hotels in Australia and across the globe.

Recommendations

Although hotels have an element of business risk, they are priced and marketed similarly to less volatile real estate investments. To increase investors' comfort with this, there are a number of options worthy of consideration.

1. Separate the business and property risks;
2. Market hotels as a high risk alternative asset;
3. Take advantage of the volatility;
4. Price in the higher risk; or
5. Reduce the business risk by controlling the business.

Separate the Business and Property Risks

The interviews revealed that many potential investors believe lease agreements represent an opportunity to remove or minimise the volatility and associated 'business risk' from hotel investments when compared to traditional hotel management agreement arrangements.

"Management agreements are fatally flawed" (Hotel investor - domestic)

By using a lease structure, the owner receives a steady income over the term of the period. Generally, investors require a tripartite leasehold arrangement with a sufficiently rated international operator. However, some investors assume all 5 star operators would offer a reasonable covenant. As a note of explanation, under a tripartite lease, the operator pays for any capital expenditure requirements. Under a normal lease, the owner pays for the capital expenditure.

Some concerns identified by investors included:

- Lack of suitable operators in Australia;
- As they represent contingent liabilities on the operators' balance sheet, operators have been reticent to undertake leases;
- The misconception that leasehold investments attract GST; and
- As there is only one tenant (the operator) there is still an element of risk. If that tenant goes, there are limited replacements.

Operators need to be educated as to the benefits of leasehold arrangements, including secured tenure and the potential for upside.

Although some potential investors expressed concerns with this concept, the majority were in favour.

“Business risk belongs with the people that are supposed to be the experts of the business” (Hotel broker)

Another method to separate the business and property risk, which was uncovered in the interviews, is to develop a tranching hotel investment aimed at the sophisticated retail market. A tranching investment would involve splitting the investment into different levels of risk and return, and may include the use of mezzanine debt.

“Slice out some of the risk components...put that risk to people that are capable of understanding that” (Domestic bank – tourism investor)

Market Hotels as a High Risk / High Yield Alternative Asset

The classification of investments is particularly important to fund managers and asset consultants. As hotels are a hybrid of property and real estate, they do not fit easily into the “core property” allocation of super funds. Instead, they are likely to be better suited to an “alternative” or “other” category. Hotels may therefore benefit from being marketed as an opportunistic investment, categorised with development capital, private equity fund, hedge funds and infrastructure investments, rather than as a low risk property class.

As demonstrated in Section 2.7, hotels have offered a comparatively strong return since the PCA valuation index commenced in 1995. This could be used to market hotels as an ‘alternative’ high yielding investment.

Another alternative is to package hotels with other property types, so there is a spread of risk and return profiles. This could be done by diversified funds themselves, such as the GPT model or intermediaries such as hotel brokers and fund-to-fund managers could create a package which provided funds with a total property investment solution.

“I think...there is a definite willingness from some of the diversified funds to consider putting assets into hotels so long as it is a very limited part of their overall portfolio” (International hotel owner and operator)

Take Advantage of the Volatility

Taking the opportunistic play further, hotel investment has the potential to offer higher returns than have been achieved historically through buying in the trough and selling at the peak of the market cycle. Although this may be the stated aim with some hotel investments, it has rarely succeeded. Investors are very reluctant to purchase in the trough when hotels are out of favour, thereby reinforcing the already high level of liquidity concern.

Price in the Risk

Many hotel and investment players believe that hotels are currently overpriced for the level of risk involved. The sales analysis in Section 2.7 certainly supports the notion that hotels do not offer superior returns to compensate for the perceived level of risk. This is further perpetuated by the fact that current market valuations reflect these comparable sales as a key measure for ascertaining the valuation, and the relatively small size of market and inherent illiquidity means there are limited comparable sales. Although it should be noted that valuers do not solely rely on comparable sales, but generally use the discounted cashflow method to ascertain the value of the hotel.

“I would actually prefer the management risk because you price it in” (Asset consultant)

The perception that investors have paid too much for hotels is a difficult issue to address, as by definition, the market value of a hotel is the price paid for it by an investor. However, looking at the reasons for their so-called inflated purchase prices, we can suggest methods to improve the situation.

Generally, investors that purchase hotels on low yields believe they will be able to improve the performance of the hotel. To realistically assess the potential upside, advisers need to improve the accuracy of their forecasting. Then, the investors should develop an internal process for evaluating a hotel investment, set appropriate hurdle rates and expect returns in accordance with this realistic forecast and the inherent risk of hotels.

Reduce the Business Risk by Controlling the Business

In contrast to the passive investors who believe the operators should bear all the risk, there are other investors who suggest sharing the risk and therefore the returns would be an attractive alternative. Investors who take some control over the operation of the hotel are likely to feel more comfortable with the business risk inherent in their investment.

There are degrees to which the owner and operator can share the control of the business. For instance, the owner may completely control the management company (eg GPT and their operator Voyages), form a joint venture, provide for performance incentives in the management agreements, calculating incentive fees based on investment return rather than GOP, or simply employ asset managers as a link between the owner and operator. As far as this function is concerned, advisers should educate owners as to the role and benefits of asset managers, as there appears to be a lack of knowledge at present.

Another suggestion is for the operator to have equity share in investment and take the first loss. As they have the most control over the profitability of the operation, it is reasonable to argue that they ought to have some equity at stake.

*"I think it's going to help the industry if the operators are prepared to take more of that risk."
(Domestic bank – tourism investor)*

Capital Intensive

Not only do hotels require significant initial capital outlay, they require significant upkeep to maintain their market position and compete with newer properties. The capital intensive nature of hotels is a definite disincentive to investors.

Recommendation

As mentioned in Section 3.4, an investment timeframe of three years would limit the requirement for capital expenditure. However, in the long term, continuation of this treatment would be detrimental to the asset and its future trading viability.

One way to increase the funds available for capital expenditure would be to invest in a well-balanced portfolio of assets and use the pool of funds wherever and whenever most necessary. This would rely on purchasing assets that have capital requirements at different times.

Operators should develop a detailed plan of capital requirements and be disciplined with respect to their use of the FF&E Reserve. By thorough planning, the operators should be able to prepare for a major refurbishment without calling on the owner for additional capital.

Where a triplenet leasehold is in place, capital expenditure is the responsibility of the operator. This alleviates the misalignment of the interests of the operator, whose future business depends on the quality of the property and the owner, who is keen to maximise their investment returns and minimise outgoings.

In terms of individual hotels, there are certain assets that are more capital intensive than others. Efficient design, architecture, furnishings and preventative maintenance can reduce the capital requirements and should be sought in hotel investments.

Management Intensive

Unlike other property types, hotel managers greatly influence the profitability of the operation and therefore the investor's return. This is related to the business risk involved in hotel investment.

"Its more management intensive than any other segment. It's a business." (Domestic superannuation fund – non-hotel investor)

Although the management intensive nature is one inherent aspect of hotels that can be considered an impediment, it is the perceived lack of alignment between the interests of the manager and owner that is where the true impediment lies.

*“There’s certainly a perception out there that the operators make money and the owners don’t”
(Asset consultant)*

Although the balance of power has improved in recent times due to the use of incentivised management agreements, there is still the perception that operators have more power in the relationship as they control the hotel operation and are comfortable with hotel investments. In contrast, the owners are generally distanced from the operation and therefore lack control and intimate knowledge of the operation. This inequality is further compounded by the fragmentation of owners and the consolidation of operators.

“The operator market is much more consolidated than the ownership market, so...they’ve got more bargaining power.” (Domestic property analyst)

Recommendations

The ways to ensure an alignment of interests would be the same as reducing the business risk by controlling the business, as discussed earlier.

In addition, the interests of hotel owners could be better represented by an existing industry body. This would also address the fragmentation of this sector and provide a valuable lobbying platform.

In summary...

There are inherent attributes of hotels that are impediments to non-operator aligned investment. Hotels are:

- Volatile;
- Capital intensive; and
- Management intensive.

Methods to remove or lessen these impediments:

- Use triple net leases rather than management agreements;
- Educate operators as to the benefits of leaseholds;
- Offer hotels in a tranching investment;
- Package hotels with other property types to provide a complete investment solution;
- Market hotels as an “alternative property” asset class rather than “core property”;
- Operator to take equity in ownership of hotel;
- Owner to take equity in operation of hotel;
- Educate owners as to the role and benefits of asset managers;
- Calculate incentive fees based on investment return rather than GOP;
- Reduce investment horizon to reduce capital expenditure;
- Improve capital expenditure planning;
- Research and understand the cycles of the market before buying and selling;
- Improve the industry representation of hotel owners to provide a lobbying platform and address the fragmentation of the sector;
- Improve the accuracy of forecasting and make pricing decisions according to the risk premium required for hotels; and
- Invest in a well balanced portfolio with complementary timing of capital requirements.

4.2 Impediment - Historic Investment Performance

Institutional and other non-operator aligned investors need to see a track record of performance in order to be confident to invest in hotels. As discussed in Section 2.7, the market has yet to see consistent levels of attractive hotel investment performance.

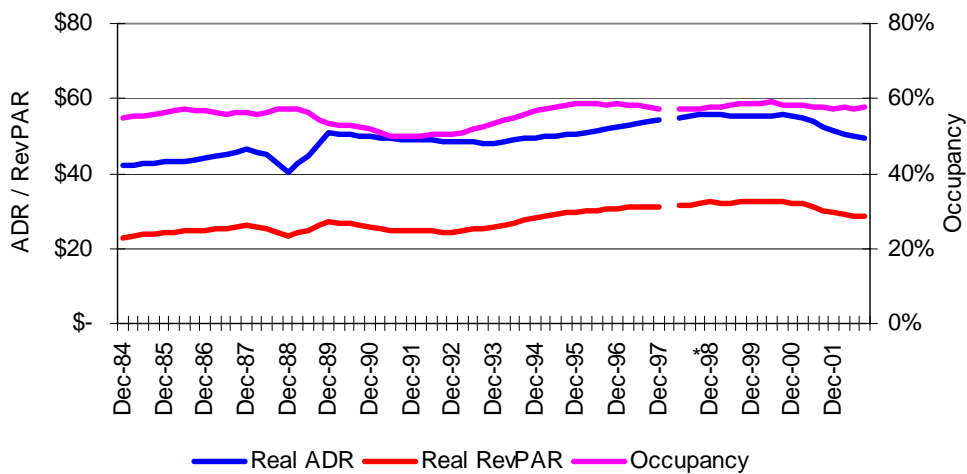
“No one in this country that I’m aware of to date has been able to make good money (from) the investors’ perspective.” (International hotel owner and operator)

Hotel Performance

The poor investment performance can be partly explained by the modest growth in the performance of the underlying assets. Looking at the graph below, the lack of top line trading growth in the hotel market is obvious. Since 1985, occupancy has grown at an average of 0.1% pa, while real average daily rates (ADRs) have increased by 1.2% pa.

“Having gone through the various cycles there are very few good news stories” (International hotel owner and operator)

Moving Average Quarterly Performance – Australian Tourist Accommodation



Source: ABS

* Series Break

One of the impediments to increasing the profitability of hotels is that Australian room rates remain extremely low compared to global standards.

5 Star ADR (USD) 2001	
New York	\$296
London	\$287
Phuket	\$208
Tokyo	\$201
Seoul	\$176
Hong Kong	\$170
Shanghai	\$125
Bali	\$122
Jakarta	\$120
Bangkok	\$112
Singapore	\$110
Sydney	\$108
Beijing	\$102
Source: Jones Lang LaSalle Hotels, Australian Bureau of Statistics, PricewaterhouseCoopers, Deloitte & Touche	

The labour intensive nature of hotels impacts heavily on their profitability in Australia, given the relatively high direct and indirect labour costs. According to Horwath's "2001 Worldwide Hotel Study", total payroll and related expenses represent 35.6% of total sales for hotels in Australia and New Zealand. As can be seen below, only North America has higher labour cost ratios:

- Africa and the Middle East – 26.1%
- Asia – 27.3%
- South America – 27.4%
- Europe – 31.4%
- Australia and New Zealand – 35.6%
- North America – 36.2%

Furthermore, the profitability of Australian serviced apartments benefit from a reduction in overall labour costs (as a percentage of total revenue) due to the lower level of food and beverage outlets in such establishments. According to PricewaterhouseCoopers "Hotel Industry Report 2002", the average GOP before fixed charges and management fees for hotels across Australia was 28% of total revenue during 2001, while for serviced apartments this is 40%.

Another element that has hindered the performance of hotels in the past has been inappropriate development and periods of oversupply. Although the impact of each development cycle lessens as the markets grow, there are still hotels and especially serviced apartments that are built to make a development profit rather than to meet unmet demand for accommodation and the low barriers to entry exacerbate this.

Investment Performance

As discussed in Section 2.7, the yields achieved by hotels are generally less than property types with a lower risk profile. Although investors have accepted these low yields in the past, this is considered a disincentive to further investment.

"The returns that you get for the risk aren't commensurate with other asset classes" (Global property investor – non hotel investor)

The poor performance of the hotel sector specific LPTs (as discussed in Section 3.3) and serviced apartment developments (as mentioned in Section 2.3) have further tainted the market perception of the investment potential of tourist accommodation.

“We keep on seeing too many questionable offerings” (Domestic hotel institutional investor)

Investors need to understand the cyclical nature of the hotel investment market, so they can identify when to invest and when to exit. They need to understand that capital gain is only possible if the timing is right, otherwise hotels should be sold on their yield potential.

The tourism industry suffers from being highly fragmented. This fragmentation was recently shown by newspaper reports detailing conflicting opinions as to the outlook of the industry. In order to be treated like a sophisticated investment class, industry members need to self regulate with regard to over-promising investment returns, understating investment risks and publishing misleading and sensational press releases.

Recommendations

It is impossible to change the past performance of hotels, but there are certain ways in which the future performance can be improved.

To simplify the problem, there are three ways in which to increase the profitability of hotels:

1. Increase revenue;
2. Decrease expenses; or
3. Improve investment offerings.

The consolidation of operators we have witnessed over the past ten years should result in an increased level of professionalism. Further improvement in the business acumen of general managers and the increased use of professional asset managers should improve the operational profitability and ADR levels achieved by hotels.

As mentioned earlier, oversupply is another aspect of the hotel trading environment that affects hotel profitability and investment returns. If the supply risk could be reduced, operators would be able to increase their room rates at a greater rate than has occurred over the past decade. In order to achieve this, the development of future supply needs to be controlled. To do this, local councils could require developers to conduct feasibility studies prior to granting development approval.

To prevent unsophisticated investors from being burnt by questionable offerings, a system of accreditation of promoters should also be introduced. Furthermore, offering documents need to be regulated to highlight the risks associated with investment in tourist accommodation. Investors need to know what the risks are and what kind of returns they should be taking for those kind of risks when income guarantees expire.

Industry members need to improve the creativity of their investment offerings. The need for new structures was one of the top critical factors nominated by the investors interviewed for this study.

“I don’t think there has been a lot of high quality stuff around” (Asset consultant)

Some ideas include:

- Package hotels in an “other / alternative / opportunistic” section of a diversified fund and create a total property solution for fund managers. This fund could account for 5% of the fund, providing exposure to all core property types plus another section with hotels and development/international property;
- Offer a tranching hotel investment aimed at the sophisticated retail market;
- Offer a hotel specific LPT once the market has overcome the stigma associated with the previous offerings. This LPT needs:
 - Responsible trust management;
 - An owner that has management expertise (Stockland, Peppers, Mirvac);
 - Low gearing;
 - Conservative accounting and management; and
 - The 3% FF&E reserve needs to be retained and not paid out.
- Create a hotel syndicate aimed at high net worth individuals (private equity players);
- Educate investors as the advantages of leasehold agreements compared to management agreements;
- Create an unlisted closed ended trust of 3-4 hotel assets diversified geographically linked to the establishment of a third major Australian brand.

In summary...

The poor past performance of hotel investments is an impediment to further investment. Specifically, hotels have suffered from;

- Low ADRs;
- High labour costs;
- Oversupply;
- Low initial yields on direct investment;
- Low returns on hotel LPTs;
- Over-promised returns;
- Questionable serviced apartment developments;
- Lack of knowledge of market cycles; and
- Fragmentation of the industry.

Methods by which to improve the future performance of hotels:

- Increased professionalism of operators (through consolidation);
- Constraints on future supply development;
- Accreditation of serviced apartment promoters; and
- Create new hotel structures.

4.3 Impediment - Size of Hotel Market

The small size of the hotel market in Australia has several ramifications.

Most importantly, the number of investors familiar with hotels is small. A lack of knowledge and experience in the sector increases the level of perceived risk and is therefore an impediment to attracting potential investors. Furthermore, limited knowledge can result in poor investment decisions. For instance, many investors buy hotels on low yields, appearing to believe they can improve the performance of the hotel and receive a good return on their investment. However, only experienced players who are intimately acquainted with operational benchmarks can do this successfully.

The wider investment market currently lacks knowledge of the sector because it forms a small portion of the investment pool. As mentioned in Section 3.1, hotels represent, at the most, only 1% of total funds under management. This looks set to continue as their poor investment performance gives investors few reasons to expend resources on this sector in the future. Furthermore, the small size of the market limits the availability of quality investment grade hotel assets.

“You don’t want your Board looking at these investments and spending a lot of time because they are not going to be a big part of the fund.” (Asset consultant)

We have mentioned that hotels suffer from being a small sector in the wider Australian investment market, but it is worth also noting that all investments suffer from the fact that Australia is a small market on a global scale. This impacts liquidity, information and awareness of hotels.

“The US and UK markets are a lot different to our market...They are a lot bigger and there’s liquidity.” (Domestic property securities fund manager)

However, on a positive note, the small size of the market seems to have facilitated the sharing of information between players, improving the availability of hotel trading information.

Recommendations

Although the knowledge of investors could be improved by attending seminars and courses, this would only be effective if investors are actively interested in and receptive to the sector, and this will only occur when the investment returns meet expectations. As mentioned earlier, the size and erratic performance of the market means there is generally a lack of strong interest in hotels, particularly by institutional investors, so hotel specific seminars and courses for institutional investors are not likely to be well attended or effective.

Therefore, as well as holding hotel specific investment conferences, the hotel industry should ensure hotels are included in other investment forums, held for instance by the Securities Institute and PCA. As well as raising the profile of hotels across the board, it is particularly important that investors associate hotels with non-property investments, so as to enhance the perception that hotels are not the same as general property classes.

To further raise the profile of the hotel industry, hotel experts need to expose themselves to the broader investment market, (particularly institutional investors and

asset consultants) to become public “go-to” people. This can be done through speaking engagements, personal contact, issuing responsible and educational press releases and writing educational papers.

It has often been cited that the fund management industry is susceptible to sentiment and fashion trends. It would only take one opinion leader to successfully invest in hotels and others would follow. Therefore, rather than a blanket approach, the hotel industry should form a strong relationship with one or two highly regarded institutional investors and sell the hotel story to them.

As outlined in Section 4.1, to further raise the profile of the hotel investment market, hotel owners should be better represented in existing associations.

In Sections 4.1 and 4.2 we discussed packaging hotels as part of a group of “other” property investments. This approach would force institutional investors to examine the hotel component and increase their knowledge of the sector.

In summary...

The small size of the hotel market is an impediment to investment.

- **Investors have limited knowledge and limited experience; and**
- **The market suffers from reduced liquidity.**

Suggested methods to reduce the impact of the market’s size include;

- **Raise the profile of the hotel investment industry and hotel experts;**
- **Improve the industry representation of hotel owners to provide a lobbying platform and address the fragmentation of the sector;**
- **Package hotels with other property types;**
- **Forge relationships with institutional investors; and**
- **Particularly target an institutional opinion leader.**

4.4 Impediment – Illiquidity of Hotel Investment Market

Although linked to the small size of the hotel market, the illiquidity of the market is seen as a major impediment to hotel investment and is therefore worth a separate mention. Investors believe hotels are “lumpy” assets and fear that there is limited quality stock. The liquidity of the hotel market in Australia was discussed thoroughly in Section 2.6.

Recommendations

The only way in which the liquidity of the direct hotel market can be improved is to make the assets more attractive to investors. In short, this means addressing all of the impediments mentioned in this study.

Alternatively, investors can invest in the hotel market via diversified vehicles on the stock exchange.

In summary...

Hotels suffer from illiquidity.

Liquidity can be improved by:

- Addressing all the impediments mentioned previously;
- Targeting new investor types;
- Increasing the number of investment structures available to investors; and
- Increasing the hotel exposure of diversified vehicles.

4.5 Top Impediments

Each of the people interviewed were asked to nominate the three most critical factors that need to be addressed in order to increase the level of non-operator aligned investors in Australia. The results are as follows:

Top Ten Critical Factors Non Operator Aligned Investment in Hotels		
Ranking	Factor	% of Responses
1.	Trading volatility	19.3%
2.	Poor past performance (investment and trading) (3)	14.5%
3.	Return not commensurate with risk (1)	13.9%
4.	Operator / owner alignment (5)	10.8%
5.	Leasehold arrangement	7.8%
6.	Lack of understanding / need for education	6.0%
7.	New structures (4)	5.4%
8.	Hotels are overpriced / overvalued	4.8%
9.	Lack of information (6)	3.0%
10.	Diversified package	2.4%
	Liquidity / exit strategy (2)	2.4%

(x) Position of importance in 1995

The first four of these factors are by far the most important nominated, accounting for almost 60% of the respondents. The first three of these all relate to the performance of the hotel investment, indicating that this is the critical issue.

Interestingly, eight of these ten factors relate to impediments, while the respondents used this forum to nominate three methods to improve the investment offering through leaseholds, diversified packages and other new structures.

Looking at the results of the previous study written, not much has changed, with all external factors nominated in 1995 appearing on the list in 2002. The new additions to the list were generally not options in the questionnaire used in 1995.

Appendix A - Methodology

The methodology is separated into secondary and primary research.

Secondary Research

Information Factor	Sources Consulted
Non operator aligned investment level and identity	Jones Lang LaSalle Hotels' top owners survey
Investment vehicles available	Literature search / interviews
Investment returns	Property Council of Australia index, Jones Lang LaSalle Hotels' sales analysis
Foreign investment barriers	Foreign Investment Review Board, Australian Tax Office
State and federal taxes, concessions and imposts	Australian Tax Office

Primary Research

The methodology for investor interviews was as follows:

Data Collection Method

As the research is largely exploratory, guided face to face interviews were deemed the most appropriate method of collecting data. Given the timing restrictions, small groups were considered more efficient than individual interviews. The content and format of the questions was decided with input from the steering committee and two individual pilot interviews were conducted to identify any potential problems.

Sample

Interviews were conducted with 31 fund managers, investment bankers and senior hotel owning company executives. The participating companies are listed below:

Companies	
AMP Henderson Global Investors	ISPT
Babcock & Brown	JANA Investment Advisers
C+BUS	Knight Frank Expotel
CB Richard Ellis	Lend Lease Real Estate Investments
Colliers International	Macquarie Bank
Colonial First State Property	Principal
Colonial First State Funds Management	REST Superannuation
Deutsche Asset Management	Six Continents Hotels & Resorts
Frontier Investment Consulting	Telstra Super
GE Capital Finance	Tourism Task Force
General Property Trust	UBS Warburg
GIC Real Estate	Victoria Funds Management Corp
Grand Hotel Group	Westpac Institutional Bank
Investa Property Group	William M Mercer

The interviews discussed the following:

- Current investment vehicles and their performance;
- Decision making process;
- Investment criteria;
- Level to which existing vehicles are perceived to satisfy criteria;
- Suggested improvements to investment vehicles;
- Reasons for shying away from hotel investment;
- Key barriers to entry for foreign investors;
- Implications of government concessions and imposts; and
- Suggested government incentives.

Analysis

As most of the data was qualitative data, it was analysed by our team for any recurring themes and formed the basis of Section 4 of this report.

Appendix B – FIRB Approvals

Applications Considered 1997-98 to 2000-01								
Action	1997-98		1998-99		1999-2000		2000-01	
	No.	\$b	No.	\$b	No.	\$b	No.	\$b
Approved unconditionally	1,694	54.3	1,724	56.4	1,170	56.3	1,003	80.0
Approved with conditions	2,567	25.2	2,918	10.7	2,737	21.7	2,298	26.3
Total approved	4,261	79.5	4,642	67.0	3,907	78.0	3,301	106.3
Rejected	114	0.1	112	0.2	96	0.1	46	9.7
Total decided	4,375	79.7	4,754	67.2	4,003	78.1	3,347	116.0
Withdrawn	390	-	337	-	408	-	318	-
Total considered	4,765		5,091		4,411		3,665	

Source: FIRB

Approvals By Industry Sector 2000-01				
	\$ Billion			
	No. Approvals	Acquisition Cost	Proposed Development Investment	Total Proposed Investment
Agriculture, Forestry & Fishing	10	0.4	..	0.4
Finance & Insurance	39	14.4	0.4	14.8
Manufacturing	84	21.4	0.4	21.9
Mineral Exploration & Development	75	23.3	0.4	23.7
Resource Processing	7	0.9	..	0.9
Service (excl Tourism)	167	28.0	3.1	31.1
Tourism	42	0.8	..	0.8
Real Estate	2,810	8.3	4.4	12.7
Total	3,234	97.6	8.7	106.3

Source: FIRB

Appendix C – German Institutional Funds

What are they?

Among German institutional investors, open-ended real estate funds clearly dominate the German real estate markets. Open-ended funds are property funds which invest directly in real estate, offering shares to private investors. These shares are not limited in number and are freely available to individual investors via the retail banking networks. Investors can trade these shares without any limitation, which is perceived as an advantage over closed-ended funds for whose shares there is no “open” market. A significant attraction for investors in open-ended funds is that about 40-50% of the annual payout is tax-free.

Closed-ended property funds are another important source of institutional capital. The closed-ended property fund market is highly fragmented and complex and has developed a more private structure than the open-ended funds. For instance, unlike their open-ended counterparts, closed-ended funds are not required to publish a statement of accounts. A recent survey by the German magazine CASH identifies 267 active closed-end funds in Germany, with a capital value of US\$14.8 billion, reflecting an increase of US\$397.2 million since the end of 2000.

These funds must invest 50% of their capital in real estate and the income must be derived from renting or leasing rather than operational income. The underlying leases, which are the basis for investment, are typically 20-40 years. In the past, the tax advantage offered allowed investors to offset the real estate losses they made against revenues generated in other asset classes. This meant the funds could afford to accept lower yields in the first few years following an acquisition. This tax incentive is no longer valid due to a change in Germany’s tax laws in 1999, reducing the attraction of real estate funds to many tax-driven investors. Consequently institutions have had to review their strategy in order to compensate. To compete with other forms of investment, the funds have bought higher yielding properties as evidenced by the increase in overall returns shown in 2001.

How were they developed?

German institutional funds were established in the 1960s and 1970s by some of the small mortgage lending banks. However, it wasn’t until the 1980s when the funds marketed their beneficial tax and diversification to small investors that they became a driving force in the real estate investment market. Historically these funds have been primarily focused on domestic investment activity. However 2001 saw them branch out and conclude an increasing number of acquisitions outside of their home domicile. German real estate funds have been active in the hotel investment market since 2000.

What are their returns?

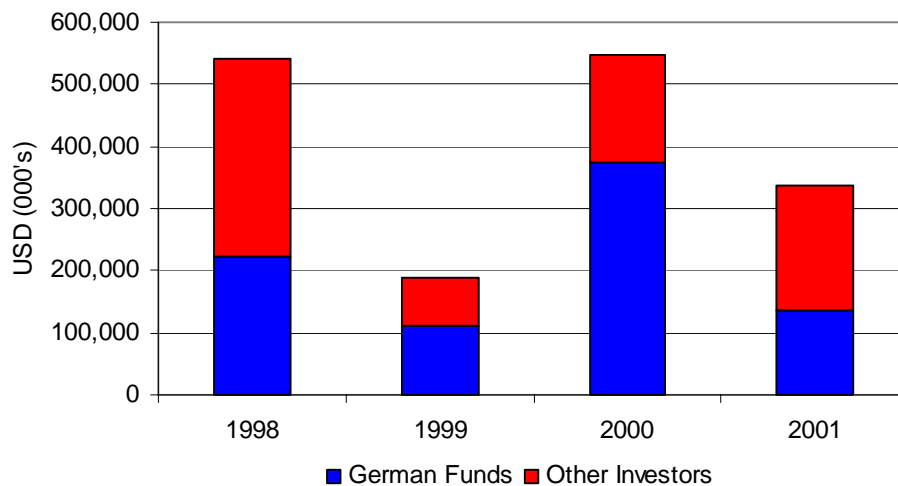
The tax advantages enjoyed by the investors in German funds allow the funds to buy on lower initial yields than other investors. Reflective of the lower cost of capital, German funds can invest with 100% equity and no gearing. Since their investors’ major objective is security, these funds are willing to pay a higher price for a long-term lease. German funds generally seek returns of 7-8% when investing outside Germany, but high quality domestic assets/tenants may have leases as low as 6.25-6.5%. High risk investments such as resorts may have rents as high as 8.5-9.0%.

Hotel Investment Activity

The dominance of institutional funds in Germany is driven by their acceptance of the prevalent operating lease structures that exist in Germany, lower cost of capital and tax efficient structures. .

German institutional funds have become active in the hotel investment market over the past decade, and from 1999 to 2001 accounted for US\$844.9 million of hotel transaction value in Germany. As shown in the chart below, 2000 represented the peak in investment activity for the German funds, their activity accounting for 60% of total investment volume. The first three quarters of 2001 saw a lessening in importance of the German funds as buyers due to the lower quality and location of assets on offer, which did not match the investment criteria of the funds.

Hotel Investment Activity in Germany



Source: Jones Lang LaSalle Hotels

Examining ownership patterns of four and five star hotels in Germany's key cities shows about 30% of quality hotel stock is owned by institutional funds, which is considerably higher than other key European destinations. Cologne, with almost 50%, currently has the highest level of institutional ownership in Germany.

Conclusion

In these times of volatile stock markets and economic uncertainty, investors tend to seek safe investment vehicles such as closed or open-ended real estate funds. In addition, on-going changes in the German law for retirement pensions will also assist property funds increase their cash inflows. As real estate funds are increasingly active, they are likely to view hotels as a source of diversification. However, the level of institutional investment may be hindered by the lack of hotel product available in the market.

Consequently, German real estate funds are likely to invest in hotel assets outside Germany, especially given hotel operators around Europe are increasingly willing to enter into lease contracts to access this capital source. According to research undertaken by Jones Lang LaSalle, German open and closed ended funds currently have approximately €10.8 billion to invest into European real estate. Given the existing average asset allocations, this means a potential of €400 million to be invested into the hotel sector – a significant source of capital for the hotel market.

Chances are that the German funds will seek assets closer to home than Australia, but they nevertheless provide an example of institutional investors that do invest in hotels. In order to learn from the German experience, there are a number of critical elements, particular to their investment activities that should be mentioned.

- German hotels are predominantly managed under a lease structure, which means the owners receive a pre-determined level of rental income. Any revenue over and above these levels is solely for the operator;
- The funds have a long term investment horizon. They are therefore not likely to dispose of the asset and jeopardise an operator's representation. Institutions seek long term strategic partnerships and leases generally do not have a break clause in the case of the sale of the asset;
- The funds have access to reasonably cheap source of capital and therefore accept lower returns than traditional equity investors;
- German funds can be pure equity investors and do not require debt financing. This means the transactions are generally less complicated and take a shorter time to complete; and
- German funds seek high quality products, in which they invest heavily to maintain to an excellent standard and hence value.

Appendix D – Investment Vehicles

Australians have a preoccupation with property. According to Hopkins (2001) eight out of 10 Australians expect to live in a home they own when they retire.

Until the 1980s property was popular as investors could benefit from stable rental returns and tax-free capital appreciation upon sale. However, access to the global share market, which was booming between 1983 and 1987 and the introduction of capital gains tax in 1985 dampened its popularity. Following the stock market crash in October 1987, property investment surged back into prominence once again until the market suffered a significant downturn due to higher interest rates and oversupply in some areas. Many investors lacked confidence in property managers and were disillusioned with the lack of regulation. The enactment of the Managed Investments Act (MIA) in 1998 has since restored investors' confidence.

More recently, investors have returned to traditional assets such as property in light of the unpredictable and volatile global share markets. In particular, the conflicts between Palestine and Israel, Pakistan and India, US and Al Qaeda as well as high profile financial collapses such as Enron have scared investors. Consequently in Australia, the property index reached an all time high during June 2002.

As mentioned in Section 3.1, 48% of the asset value of Australian property market is owned by professional funds management groups (LPTs, unlisted property trusts, syndicates etc), 25% by private investors and 27% by corporations.

Direct Property Investment

As suggested by the name, this form of investment occurs when investors purchase the property directly and their name appears on the title of the property. The owner can be an individual, a nominee company, partnership or joint venture. Direct property investment generally requires access to significant capital and a level of expertise in the asset class. Although investors benefit from total control and the potential for sizeable capital gains, downfalls include illiquidity, high transaction costs and the level of management required. According to Property Investment Research (PIR), direct property investment amounts to \$360 billion.

Direct investment dominates the hotel market in Australia, and includes the following methods of ownership:

1. Owner-Occupier – Single owner controls both the real estate and business interests.
2. Passive Private Investor – Single owner controls the real estate but divests management to a second party. This may be in the form of a lease or management agreement.
3. Strata Title – Multiple owners each control a portion of the title and collectively they appoint an operator to manage the business.
4. Time Share – Promoter retains ownership of real estate, while investor owns limited use under license or preference agreement with sunset provisions.

Indirect Property Investment

Indirect property investment involves the pooling of funds. This type of investment can be categorised in terms of redemption. Redeemable investments include listed property trusts which are priced daily and unlisted trusts which are priced according

to the valuation of the underlying asset. Unredeemable investments can only be realised when the property is sold at the end of the agreed term. Property syndicates and private equity funds are examples of this form of investment.

Unlisted Property Trusts

An unlisted property trust is an investment of pooled funds that holds direct property. The value of these trusts is determined by regular valuations and investments are redeemable. Gearing is generally less than 30%.

Unlisted property trusts were popular in the late 1980s when investors were able to redeem their investments within the 60 day maximum imposed by Corporations Law. However during the early 1990s, requests for redemptions outpaced cash inflows and managers were forced to place moratoriums on redemptions. Clearly, the liquidity of the vehicle far exceeded the liquidity of the underlying asset. In 1991, the Federal Government increased the maximum redemption period to 12 months, but the appeal of these vehicles had been tainted. Many of these trusts either became listed property trusts or were wound up. Since the advent of the MIA, confidence in these vehicles has improved.

Unlisted property trusts can be open ended or closed ended. Most unlisted trusts today are **open ended**, which means they do not have a specified term. Open ended unlisted property trusts represent total assets currently valued at approximately \$918 million. Many are termed hybrid funds as they offer a mix of direct property, property securities and cash, so as to avoid the liquidity pitfalls of the early 1990s.

An example of an unlisted open ended hotel fund is the Principal Hotel Group portfolio (previously known as BT Funds Management).

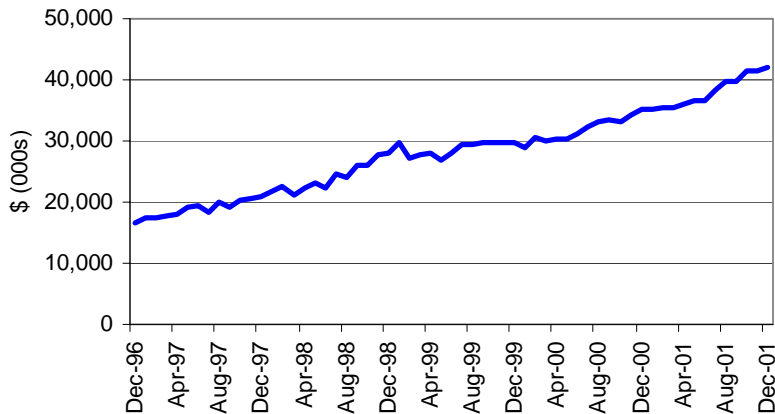
In **closed ended** unlisted property funds, the capital is realised at end of term and returned to investors when the properties are sold. Closed ended funds benefit when they have the ability to alter the termination date if it does not fall at the optimal position in the property cycle. Total industry funds under management reached \$5 billion in January 2002.

In terms of hotels, the Commonwealth Property Hotel Fund (now Colonial First State Property) is an example of a closed-ended unlisted property fund.

Listed Property Trusts (LPTs)

LPTs are unit trusts which invest primarily in property and are traded on the Australian Stock Exchange (ASX). Properties are owned by unitholders and held in trust by the Responsible Entity. According to PIR, the market capitalisation of the property sector has grown significantly from \$2 billion in 1985 to \$45 billion at present.

Listed Property Trusts - Market Capitalisation



Source: PCA

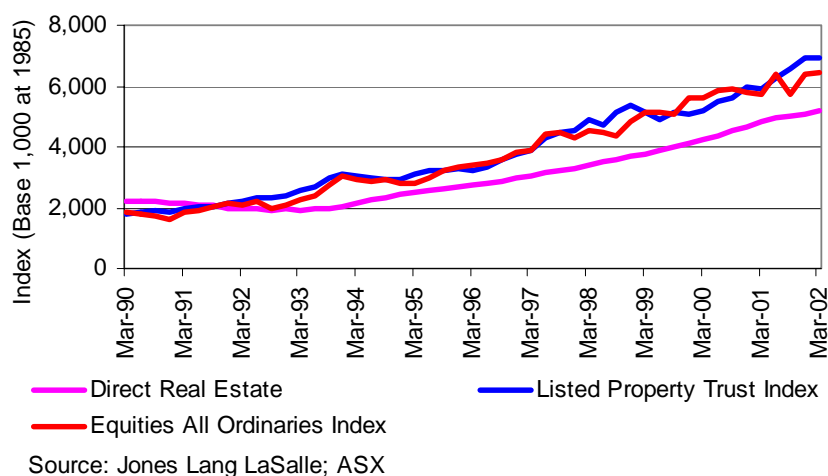
Compared to direct investment, LPTs offer increased liquidity, reduced transaction costs (mainly through the avoidance of the onerous stamp duty on direct real estate investment), require a lower initial investment and provide lower risk through diversification. LPTs are priced daily to the market and move in tandem with the equities markets rather than the direct property market.

LPTs trade in a similar fashion to US Real Estate Investment Trusts (REIT) shares in that the owners receive dividends, tax advantages and capital gains. However, Australian LPTs are required to distribute 100% of taxable income to unitholders, whereas the figure is 90% in the US. The unitholder does not pay tax on the part of the cash dividend that would be covered by non-cash expenses such as amortisation and depreciation. This part of the gain is recaptured upon the sale of the unit. LPTs focus on maximising distributions to their investors and therefore seek investments with attractive income returns rather than capital growth.

As discussed previously, during 1998 to 2000, institutional investors became nervous that the Australian stock market would suffer at the hands of the Asian economic downturn, and looked to temporarily store their funds in the safe haven of property. As these investors were interested in safety, it was the larger trusts that were more popular. This led to a period of consolidation. According to the PCA in December 2001, 15 of the 32 LPTs in the ASX 300 had a market capitalisation of over \$1 billion. In contrast, as at December 1989, the average market capitalisation was \$175.4 million.

As discussed in Section 2.7, the LPT index has outperformed the All Ordinaries for the past 10 years. However, particularly strong performance over the past two years, compared to the declining equity market has caught the attention of the investment industry and during June 2002, the LPT index reached an all time high of 1,494.

Comparison of LPTs, All Ordinaries and Direct Property Investment (Investment Grade)



In the US, the use of REITs as a means of hotel ownership has been a popular vehicle since the early 1990s. Hotel REITs have a current market capitalisation of US\$23 billion. However, hotel specific trusts now represent a small percentage of LPTs in Australia. Since the heyday of hotel LPTs, BT Hotel Group (now Principal Hotel Group) and Tourism Asset Holdings have both delisted and the Australian Tourism Group was removed when it merged with Grand Hotel Group. This has left two major hotel trusts (Grand Hotel Group and Thakral Holdings) with a capitalisation of \$290 million (as at June 2002) trading on the stock exchange. In addition, diversified trusts such as General Property Trust own hotels as part of its real estate portfolio. All the listed vehicles that own hotel accommodation are outlined in Section 3.2.

Generally, the market has been disappointed with the performance of the Australian hotel specific LPTs as discussed in Section 2.7. One of the problems with hotel LPTs is that they are under pressure to distribute all income and this leaves little capital for the necessary capital expenditure requirements. This could be rectified if the LPTs accepted a one-off significant fall in value, which would reflect more the value of the vehicle than the market valuation of the hotels. In this case, the LPTs would always trade at a discount to NTA, indicating the value may be enhanced by the break up of the trust and sale of individual assets.

Property Securities Funds

Investors can invest in funds who, in turn invest in a mix of LPTs, direct property, property syndicates and property related securities. Most property security funds invest in 10-30 property trusts. According to PIR, total assets in listed property securities funds currently amounts to approximately \$13 billion. The funds are available for the retail or wholesale investment markets or in some instances, both. Retail funds are generally open to investors with a minimum of \$1,000, whereas wholesale funds target superannuation funds and larger institutions.

The portfolio weighting of three sample listed property securities funds is shown in the table below. Interviews have indicated that hotels generally comprise approximately 1% of property securities funds.

Property Securities Funds Portfolio Weighting			
	MLC	AMP	Deutsche
Cash	2%	8%	2%
Property stocks	98%	75%	98%
Direct property	0%	17%	0%
Source: PIR			

Property Syndicates

Property syndicates involve a number of investors pooling their funds to purchase one or more property(ies). The investors receive rent throughout the specified term, which is usually seven years, and on completion of the term, the property is sold and the syndicate members receive the capital gain. Although limited redemption is becoming available, the investment is generally not redeemed until the end of the term.

Property syndicates differ from closed ended unlisted property trusts in that the investors' hold the same assets throughout the period and gearing is generally higher at around 50%.

Although some believe property syndicates have not yet reached 'critical mass', there is definite interest in the sector. According to PIR, property syndicates have grown in popularity over the past five years to reach a market capitalisation of approximately \$5 billion as at May 2002. Perinotto (2002) believes property syndicates will increase in popularity over the near future as more and more investors are attracted by returns of around 8% and tax advantages. Tax can be deferred until the syndicate is wound up and the asset is sold, so investors pay tax on profit at half their marginal tax rate rather than tax on income throughout the term of the syndicate.

Syndicates are now tightly regulated by the MIA and investors are generally not under the false impression that the investment is liquid as they were in the pre-MIA era of unlisted property trusts.

Between June 1998 and December 2001, 82 property syndicates with a total asset base of \$2.6 billion were released in Australia. The diversification by asset class is given below. There are presently no hotel specific syndicates available, nor any that offer hotels as part of a diversified portfolio.

Australian Property Syndicates June 1998 - December 2001 Diversification by Asset Class	
Asset Class	% of Syndicates
Retail	47.1%
Industrial	7.5%
Office	40.1%
Retirement	0.1%
Residential	1.3%
Other	3.9%
Source: PIR	

Private Equity Funds

Private equity funds use the unit trust structure to fund new ventures. Unlike syndicates, the initial investment (which is generally \$20,000) is called upon in four instalments, usually annually. This allows the stages of development as follows:

1. Idea;
2. Start Up;
3. Expansion – more capital is needed to fund expansion; and
4. Maturity – stable cash flow.

Like syndicates, the investment is illiquid and is locked in for the term which is generally 10 years. There is obviously a higher risk inherent in these projects as the investment is not already established, but returns of 14-15% are expected.

Walton Street Capital is an example of a private equity fund that has invested in Australian hotels, with its joint purchase of Four Seasons Hotel in Sydney during 1998 with Four Seasons Hotels & Resorts.

Mortgage Funds

According to PIR, investment in mortgage funds currently amounts to \$14.5 billion. The average term of these funds is generally one year, and there are several types described below:

- Pooled mortgage funds – usually unit trusts offering a pool of mortgage securities;
- Select Mortgage Investment Schemes – investors choose which mortgage they wish to invest in;
- Mortgage Debentures – The trustee takes a charge over the assets and the investment is fixed term.

Small scale Industry Body Supervised Schemes – Smaller funds of less than \$7.5 million which are operated by an approved industry supervisory body are not required to be licensed as Managed Investment Schemes.

- Investors' confidence in mortgage funds was eroded by the failures of the 1980s. However since then, the Australian Securities and Investments Commission (ASIC) has tightened the regulations governing this area of the property investment industry and investors are beginning to recognise that mortgage funds provide regular income with low risk.

In terms of asset allocation, mortgage funds vary considerably. In general, office, retail and industrial loans comprise the majority of the funds' value. However, some funds have exposure to rural loans and loans on other specialised properties such as pubs, motels, restaurants and nursing homes. We are not aware of any that are currently involved in hotel accommodation.

Appendix E – Example of a Profit and Loss Account

GENERIC 250-ROOM HOTEL, SYDNEY CITY CBD, INTERNATIONAL BRAND Pro Forma - Revenues and Expenses for Calculating Cash Flow from Operations

Indicative Stabilised Year Performance				
Number of Rooms:	250			
Number of Days	366			
Annual Rooms Available:	91,500			
Occupied Rooms:	67,710			
Occupancy:	74.0%			
Average Rate:	\$148.00			
RevPAR:	\$109.52			
REVENUES	Amount	Ratio	POR (\$)	PAR (\$)
Rooms	10,021,080	62.0%	148.00	40,084
Food & Beverage	5,078,250	31.4%	75.00	20,313
Telephone	355,478	2.2%	5.25	1,422
Minor Operated Departments	592,463	3.7%	8.75	2,370
Other Income (Net)	122,000	0.8%	1.80	488
Total Revenues	16,169,270	100.0%	238.80	64,677
DEPARTMENTAL COSTS				
Rooms	3,076,472	30.7%	45.44	12,306
Food & Beverage	4,265,730	84.0%	63.00	17,063
Telephone	213,287	60.0%	3.15	853
Minor Operated Departments	355,478	60.0%	5.25	1,422
Total Departmental Costs	7,910,966	48.9%	116.84	31,644
DEPARTMENTAL INCOME	8,258,304	51.1%	121.97	33,033
UNDISTRIBUTED OPERATING EXPENSES (UDOE)				
Administrative & General	1,300,000	8.0%	19.20	5,200
Base Management Fee	323,385	2.0%	4.78	1,294
Marketing	650,000	4.0%	9.60	2,600
Property Operations & Maintenance	562,500	3.5%	8.31	2,250
Utilities (Electricity, Gas, Water)	312,500	1.9%	4.62	1,250
Total Undistributed Operating Expenses	3,148,385	19.5%	46.50	12,594
GROSS OPERATING PROFIT	5,109,919	31.6%	75.47	20,440
FIXED CHARGES				
Incentive Management Fee	408,794	8.00%	\$6.04	1,635
Statutory Charges/Taxes (Land, Services, Council)	275,000	1.7%	4.06	1,100
Insurance on Buildings & Contents	55,000	0.3%	0.81	220
Total Fixed Charges	738,794	4.6%	10.91	2,955
PROFIT BEFORE RESERVE	4,371,126	27.0%	64.56	17,485
Reserve for Replacement of FFE	485,078	3.0%	7.16	1,940
NFT OWNERS RETURN (FBITDA)	3,886,047	24.0%	57.39	15,544

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GENERAL PROPERTY TRUST



MACQUARIE



We would like to thank the NSW Tourism Committee of the Property Council of Australia for its contribution to developing this report.



SERVICED APARTMENTS