Real Estate, Hospitality, and Construction

Ernst & Young

Quality In Everything We Do

Hospitality Industry
Top 10 Thoughts for 2006

CAPITAL MARKET ACTIVITY

Asset Class of Choice, Appetite for Hotels Remains High

Favorable lodging industry fundamentals, a low interest rate environment, and attractive pricing among the publicly traded lodging stocks combined to create another exceptional year for the capital markets. While the year 2004 was characterized by increased IPOs, secondary offerings, and a considerable amount of mergers and acquisitions, activity in 2005 brought aggressive share buy-back programs among the large publicly traded companies and several significant mergers and acquisitions, especially among privately held companies. Approximately $23 billion of M&A activity took place in 2005.

More than $100 billion was raised by private equity funds during the first three quarters of 2005, a record-breaking year for the industry. The availability of capital and the growing interest among private equity firms in the lodging sector contributed to a considerable number of public-to-private transactions. Blackstone continued its foray into lodging with its $3.2 billion acquisition of Wyndham during the first half of 2005 and its subsequent $3.4 billion acquisition of LaQuinta. Colony Capital purchased the Singapore-based Raffles Holdings Limited for approximately $1.0 billion and made a $1.3 billion investment in Accor Hotels.

In all the transaction activity, there has been a shifting of business models within some of the large brand-hotel companies. Starwood Hotels & Resorts and Host Marriott, the largest publicly traded lodging REIT, announced a $4.0 billion transaction for 38 hotels, thereby significantly reducing Starwood's exposure to the underlying real estate, since the assets will keep their brand affiliations and will continue to be managed by Starwood. Hilton Hotels recently announced an agreement to acquire the lodging assets of the UK-based Hilton Group PLC for approximately $ 5.7 billion.

Given that the outlook for the lodging industry remains positive and profits among this asset class are anticipated to remain strong, capital activity should continue for the next several years. While interest rates may increase in the near term and there may be fewer lodging targets available at attractive prices, the outlook for the equity and fixed income markets should provide support for continued M&A lodging sector activity.

INTERNATIONAL ACTIVITY

Going Global

During 2005, a number of major changes and shifts occurred in the global hospitality market as foreign markets continued to expand. The lodging markets in India, China, and UAE experienced considerable growth with continued plans for steady development in the future.

According to the Organization of Asia-Pacific New Agencies, Dubai is anticipated to increase its lodging supply by 18,200 to 20,000 rooms by 2010, an increase of approximately 100%. There are concerns of oversupply; however, given the historical growth in demand and the increased public spending on tourism in the Emirate, the market is expected to absorb the supply additions.

China has continued to maintain a strong growth in the hospitality market. *Asia Pulse* indicated that during the first eight months of 2005 Chinese lodging markets experienced an average RevPAR growth of 14.3%. Furthermore, commercial markets such as Beijing and Hong Kong reported growth in excess of 20%, and despite the rapid growth in lodging supply, Shanghai increased by 17%. Such high growth rates are estimated to continue as international visitation continues to the region and with the Summer Olympics in 2008.

With the Indian lodging market experiencing a RevPAR increase of 31.3% from 2003 to 2004, and a 26.2% increase from January 2005 to August 2005, India is not only a growing hospitality market but profitable as well. Luxury and Upscale hotels are operating at 90% occupancy levels versus 70% last year along with room rates for many hotels in

Mumbai, Delhi, Banglore, Chennai, and Hyderabad reaching all-time highs the winter season of 2005.

With significant global growth opportunities, Marriott International is targeting 13% of its 2006 to 2008 additions in Europe, Middle East and Africa and 9% in the Asia-Pacific region. Similarly, Four Seasons plans to open 24 additional properties in 10 additional countries. In addition, on a much larger scale, InterContinental Hotel Group plans to open 125 hotels in China by 2008. Hilton International continues its global reach with plans to add another 19 hotels by the end of 2006 and another 23 hotels by the end of 2007. Starwood's acquisition of the London-based Le Meridien global hotel group increased its portfolio and global reach with more that 130 luxury and upscale hotels in 56 countries worldwide.

LODGING FUNDAMENTALS

Good Times Continue to Roll

Lodging fundamentals are anticipated to exhibit strong performance for year-end 2005 and into 2006 due to anticipated increases in ADR in every major market versus 2004. Significant increases in ADR, which increased 5.2% according to Smith Travel Research year-to-date through November 2005 versus the same period in 2004, have been driven primarily by the return of the corporate traveler due to improving economic conditions. Additionally, ADR has increased due to limited supply growth, and even the reduction of lodging supply during the past year in some major markets. Lodging supply increased an estimated 1.3% in 2003 and 1% in 2004 nationwide, and new lodging supply growth is anticipated to be less than 1% in 2005 due to numerous notable hotels exiting the lodging market or undergoing conversion into residential units. However, with the recovery in lodging demand taking hold in 2004, *Lodging Econometrics* anticipates an estimated 88,711 hotel rooms to open in 2006 and lodging supply is anticipated to increase by approximately 100,000 guestrooms in 2007, representing the most significant number of new openings since 2001. However, as construction costs have increased, and are anticipated to further increase an estimated 10% – 20% in the short term due to the impact from recent major hurricanes, many of these projects may not materialize. Additionally, though lodging supply is showing signs of growth at an increasing rate, overall supply growth is below normal levels at this point in the cycle.

With RevPAR for the United States exhibiting an increase of 8.2% year-to-date through November versus the same period last year, positive hotel operating performance is anticipated to continue for the foreseeable future. According to a recent report by Torto Wheaton Research, the lodging sector is anticipated to offer investors the greatest return in the real estate sector in 2006, with unleveraged average annual returns for hotels anticipated to be approximately 12.1% over the next 10 years. Real estate investment alternatives are anticipated to exhibit single digit returns, ranging from approximately 5% – 8%, with office properties the next highest at approximately 7.8%.

As a result, both REIT and C-Corp lodging stocks have shown continued signs of strength, with lodging REIT returns demonstrating an increase of approximately 7.7% year-to-date through the beginning of December versus year-end 2004, according to the National Association of Real Estate Investment Trusts. Additionally, a majority of the publicly traded lodging companies outperformed the S&P 500 index, which experienced an approximately 3.0% increase during the year, and large-cap hotel owners experienced an average stock price performance of approximately 16.5% during the year. The financial outlook for the hotel industry is anticipated to remain favorable into 2006 with demand exceeding supply growth.

PRIVATE RESIDENCE AND DESTINATION CLUBS

The Cross-Pollination of Lodging Segments to Produce Lodging Hybrids

With approximately 1,000 baby-boomers turning 60 everyday, the demand for second and vacation homes is anticipated to remain strong for the next several years. For baby-boomers who enjoy traveling and seek to minimize the hassle of second-home maintenance, hybrid lodging developments (e.g., condominium-hotels, destination clubs, and fractionals) are increasingly meeting this need. Private Residence Clubs (PRCs or fractionals), condominium-hotels and destination clubs (DCs) are being marketed as offering all the amenities and services of traditional luxury resorts and having the appeal of real estate ownership. PRCs and DCs go beyond traditional fractional ownership as they offer vacation "credits" that can be utilized at various luxury private homes and estates, yachts, and condominiums around the world.

PRCs and DCs are being developed throughout the world in mixed-use resort developments, traditional vacation home communities, and unique real estate settings. PRCs and DCs have been used interchangeably by several developers, analysts, and travel writers so that it is difficult to define them separately. Conceptually, PRCs and DCs are no different than other fractional interest programs, including timeshares. However, PRCs and DCs offer a level of quality in facilities and services that are aligned with their six- or seven-figure membership fees. It is possible to separate PRCs and DCs based upon a club's equity component. Equity PRCs and DCs, similar to fractionals, transfer a real estate deed for a fraction of the assets with each new club member. Non-equity clubs, similar to country or golf clubs, provide no deed to assets but usage rights to assets included in the club's portfolio. Both models may offer refunds on initial membership fees in the case of a member terminating their membership.

With the competitive landscape anticipated to increase to over 30 PRCs and DCs in 2006, PRCs and DCs are beginning to segment themselves. Current segments include those that are region-focused and those that are theme-focused, such as for golf, fishing, boating, or wine enthusiasts. PRCs and DCs that focus on a specific region or theme tend to provide their members with additional amenities and benefits that focus on the theme of the PRC or DC and are not offered by more traditional clubs. As the baby-boomer generation continues to spend its dollars on travel, additional niche markets may develop, thereby fueling the continued growth of PRCs and DCs.

Will the popularity PRCs, DCs, and other hybrids continue? Given the powerful baby-boomer demographics, it is certain that PRCs, as well as DCs, and other lodging hybrids will continue to receive interest from both consumers and real estate developers. Nevertheless, untested issues, including the resale value of individual PRC credits and DC units and the lack of secondary markets for hybrids (e.g., condominium-hotels and fractionals) may reduce the attractiveness of hybridized lodging segments.

CONDOMINIUM-HOTELS

Complex Nature Equals Risky Business

Condominium-hotels continue to be popular in hot real estate markets such as Miami and Hawaii and have begun undergoing rapid development in new markets, such as Las Vegas. This trend continues to address the increasing number of individuals (especially baby-boomers) interested in owning vacation real estate. Due to tight capital availability for stand-alone hotel developments in the past several years and the low interest rate environment, such developments offer an alternative financing structure and offer the potential to minimize financing risk for the developer (as developers are basically outsourcing their debt load to individual unit owners).

However, underlying this construction boom are many risk issues for those involved in condominium-hotel developments. Securities laws, particularly concerning liability if a development is deemed to have been sold as a security (and not properly registered), remain the primary legal concern. Most developers seek to avoid registration due to the time required, restrictions on advertising, broker requirements, and the use of deposits. This comes at the price, however, of being unable to mandate participation in a rental program, inability to pool income and expense, and the inability to provide buyers with income estimates, among others. After this initial hurdle comes the risk of buyer lawsuits due to unmet expectations from those who had an inflated view of the units' rental potential. How individual owners react to the realities of the hotel business (ramp-up to stabilization, seasonality, ADR versus Rack Rates, frequent renovation, etc.) remains to be seen. Additional issues include balancing operating risk, determining which party has control over the property infrastructure and shared facilities, and properly crafting all the complex agreements to work together. The critical nature of all this complexity being properly thought through may not become apparent until years after a development is analyzed and sold to buyers.

Of most importance is that the development needs to make market and economic sense as a hotel before ever being considered as a condominium-hotel. Subsequently, evaluating the economics of a condominium-hotel development beyond unit-pricing, such as the structuring of association fees, rental program fees, and fair revenue and expense allocations, remain key issues for this segment. With so many potential "land mines" surrounding the condominium-hotel segment, seeking sound legal and advisory guidance and having adequate preparation, documentation, and disclosure are absolutely necessary.

THE RISE OF THE LIFESTYLE BRAND

A Hotel for Every Lifestyle and Budget

Several new brands designed to cater to the lifestyle preferences of various traveler segments emerged in 2005. A trend that began in the late 1990s in the full-service upper-upscale and luxury segments, has found its way down to the upscale and limited-service midscale segments, providing style and comfort at a more affordable rate.

These new lodging brands have moved away from the approach taken by the traditional lodging "mega-brands" and instead aim to transcend the product-centered customer relationship to develop an emotional and long-term bond with travelers. The new lodging "lifestyle brand" takes a similar approach to that adopted by successful retail brands, focusing not only on guests' basic product needs and preferences, but also on creating a unique lodging experience that ties into guests' way of life, self-image, and interests, and delivers self-expressive benefits. These new lifestyle brands resonate with people who expect to live increasingly stylish lives and are less interested in settling for the old-fashioned cookie-cutter lodging product. These consumers are increasingly seeking a lodging product that resembles the look, feel, and comfort of their own homes.

One of these new mid-priced lifestyle lodging brands is InterContinental Hotels Group's Hotel Indigo, which opened its first hotel in November 2004 and is anticipated to roll out a total of four hotels by the end of 2005. This new lifestyle brand was designed to address the desires of style-conscious guests who are seeking experience and quality over pure functionality when traveling. It targets aspiring consumers who are seeking to "trade up" to a more stylish lodging product, while still seeking value.

Another prominent example of a new mid-priced lodging brand is Starwood Hotels & Resorts' new "aloft" brand. This brand was designed to provide increased style, comfort, functionality, and energy at affordable rates. The first aloft hotels are anticipated to break ground early 2006 and open in early 2007. Starwood is planning to roll out 500 aloft hotels by 2012.

This trend is anticipated to continue into 2006, with expansion activity of lifestyle brands gaining momentum. In 2006 the lodging industry is likely to witness the continued growth of multiple lifestyle brands, from Starwood's and InterContinental's chain-oriented brands, through smaller boutique brands such as Kimpton, Joie de Vivre, and Morgans to niche Haute Couture lifestyle brands, launched in cooperation with international fashion brands such as Armani, Versace, Bulgari, and most recently Missoni.

TOURISM

Creating a Buzz About Town

Among the many factors that affect tourism in the United States, primary research indicates that the most influential are the overall condition of the national economy, gasoline prices, security concerns, consolidation among the meetings and events industries, and U.S. government-imposed travel restrictions/requirements. According to the Travel Industry Association of America (TIA), travel expenditures for both domestic and international visitors exceeded $600 billion for the first time in 2004. For 2005, travel expenditures were estimated to increase 5.6% to more than $633 billion. Despite record-high gasoline prices and a devastating hurricane season, positive growth was driven by the rebounding economy and its impact on corporate, group, and leisure travel.

As the travel and tourism industries significantly contribute to the overall health of local economies, by creating jobs and generating market awareness, tourism authorities continue to take a proactive stance toward increasing their share of the lucrative tourism and meetings markets. As a result, competition among locations remains fierce. In addition to the top-of-mind city destinations competing for tourism dollars (e.g., Orlando, Chicago, Las Vegas, and New York), more and more secondary and tertiary cities across the United States have developed strategies to effectively compete in attracting visitation and capturing market share. Intermediate term plans (0 – 5 years) tend to focus more on local community developments including museums and parks, while long term plans (more than 5 years) focus more on improving visitation directly, with an embedded benefit to the local community, including the development of convention centers and headquarter hotels.

Still, the development of the necessary infrastructure is only part of the broader tourism picture as meeting and event planners increasingly place importance on the perceived value and overall experience of the local market. In order to successfully compete, local markets have found that they need to offer quality accommodations and amenities, a diverse array of attractions, and easy access to and around the destination. The combination of these is crucial to the development of a unique and well defined brand image which will allow for increased consumer awareness and create a buzz about town.

HURRICANE ACTIVITY

Mother Nature Not So Nurturing

The hurricanes that made landfall in the United States during 2005 have been by far the most costly natural catastrophes in our country's history. The wrath of Hurricanes Katrina, Rita and Wilma left no industry untouched and caused extraordinary industrial and commercial property damage, which will likely result in an unprecedented number of insurance claims and lawsuits – estimates indicate insured losses exceed $60 billion. Oil rigs and refineries were initially hit hard, as Hurricane Katrina reportedly affected production at more than 50 oil and natural-gas platforms in the Gulf of Mexico. This fueled an immediate increase in

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gasoline and airfare costs, due to higher jet fuel prices. While the sticker shock at the pump has subsided (for the most part) as gas prices have declined, the impact of the active hurricane season on tourism in the Gulf Coast, especially in New Orleans, has been far-reaching, beyond the physical damage to local hotels, amenities, and tourist attractions.

Indeed, the displaced convention and group market in New Orleans has subsequently sent waves of disruption throughout the country. With the New Orleans Convention Center closed for renovations from September 1, 2005 through March 31, 2006, thirty-three convention meetings and tradeshows have been displaced, representing approximately $1.3 billion in lost business for the area. Despite the risk of future hurricanes and the violent images shown by the media in the wake of the storm, convention and association groups have indicated that they wish to return to New Orleans; however, the city does not want to book convention business until the city is fully ready to receive it. In an effort to redirect the convention groups previously scheduled in New Orleans, the Convention and Visitors Bureau is working with other major convention markets in the country to swap near-term meetings and conventions with dates in the intermediate future. Indeed, the Dallas Convention and Visitors Bureau is reportedly working with as many as a dozen groups that have meetings on the books in both cities, effectively moving forward the Dallas business and rebooking New Orleans to a later date.

Similar to the willingness to return to New Orleans for meetings, South Florida tourism did not see a drop off in demand in 2005 as some expected as a result of an active hurricane season in 2004. Interestingly, the region experienced one of the strongest years ever. Despite the more active hurricane cycle we are in, key tourism destinations like New Orleans and South Florida continue to be high on the list for vacation, meetings, and quick getaway trips. Additional contingency planning will be required, however, during the summer months.

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SARBANES-OXLEY AND 404

The Next Chapter

Chief Financial Officers continue to experience the challenges of a tightening regulatory environment. As 2004 was the first year of Sarbanes-Oxley (SOX) and Section 404 implementation, public, SEC-registrants committed significant resources and dollars to understanding processes and ensuring compliance. As a result, finance functions and the role of internal audit have evolved and continue to evolve, as efforts continue to focus on understanding and evaluating controls for the purpose of improving the reliability of financial reporting and corporate disclosures. The first year implementation of SOX and 404 in particular has served to improve investor confidence. The current debate surrounds the question, “At what cost ?” There is general consensus that both internal and external costs of implementation were far greater than anticipated. The challenge for companies in 2005, 2006, and beyond, is to build a 404 assessment and compliance process that is sustainable and cost efficient. Although SOX governs only those companies registered with the Securities and Exchange Commission, many believe the review and enhancements that have surfaced will promote financial reporting best practices for all companies. Many companies continue to struggle with the issue of finding sufficient resources to meet the current and ongoing challenges posed by SOX and 404.

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HOTEL CAPITALIZATION RATES

The Low-Down on Compression

As stocks struggle and the bond market begins to lose appeal in the face of rising interest rates, major equity and debt participants, in addition to newer entrants such as high-net-worth syndicates, private REIT investors, 1031 exchange buyers, and international investors, have begun to increase the supply of capital for real estate.

Often viewed as the riskiest real estate class, hotels have begun to close the cap-rate gap between themselves and other classes such as office and industrial. Some attribute the recent cap-rate spread reduction to a combination of factors, including the current softening of other real estate classes’ fundamentals, the tempered supply growth and improving demand outlook for hotels, and the increased transparency of hotel industry performance data and analysis.

As a result of the cap-rate compression, hotel cap rates have reached historic, single-digit lows as buyers are attracted to the positive forward-looking fundamentals and the inability to find alternative placements for capital with such yields. Rates for top-tier, upscale, and major market properties are currently in the 7% – 8% range (in some instances even lower) while mid-tier hotels are just under 10%.

Where are cap rates headed? Many investors believe that the ramp-up of the Fed rate will have a lesser impact on hotel values than other forms of real estate due to the protections lodging assets afford by altering rents daily. With improving lodging fundamentals, coupled with the influx of new lenders (CMBS hotel issuance doubled during the first nine months of 2005 to approximately $13.7 billion) and capital investors chasing the limited amount of deals available, the trend of hotel cap-rate compression is anticipated to continue, albeit at a slower pace. ●