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# **Hospitality Top 10 Thoughts for 2008**

# 1

## Condominium-Hotels, Fractionals, and Destination Clubs – Evolution of the Second Home

Condominium-hotels, fractionals, and destination clubs are all hybrids of traditional hotel and timeshare products and serve as second-home alternatives. Though long-term demographics bode well for continued growth, the softening of the US real estate market is affecting buyers who purchased hybrid second-home products based on investment motivations, as opposed to lifestyle decisions.

Condominium-hotels, primarily used as a financing instrument by developers in recent years, are experiencing pull-back from developers and consumers as their complex legal and structuring issues surface. While some projects have been put on hold, others are in litigation over control, budgeting, or securities issues. Developers of recently opened projects are realizing that the typical issues faced by hotels (e.g., ramp-up of performance, seasonal fluctuations, and high operating costs), are difficult to explain to owners who may have purchased units for investment reasons. Several lodging operators have recently terminated their management agreements and/or have restricted or stopped managing condominium-hotels. The recent speculative market for condominiums and the lack of transparency for buyers about hotel operating expectations may taint this asset class in the short term. This being said, the condominium-hotel structure can be mutually beneficial for all parties when interests are aligned and carefully thought through, disclosed, and documented. Condominium-hotels work best in strong resort markets and when purchased by buyers who are looking for a second-home alternative for personal use, which also provides them with the potential to defray carrying costs by renting their properties.

Fractional residences have garnered less interest from speculators and, as a result, are weathering a declining real estate market better than condominium-hotels. Branded developments are leading the way. Developers indicate that fractionals are generating price premiums of 100% to 200% per square foot over full-ownership products, although with higher marketing costs and longer

absorption periods. The credibility of a well-known professional operator and sales team, in addition to the flexibility of an exchange program, allows owners to trade time in any destination where the operator has a property and makes these programs more appealing than those offered by independent projects. Fractionals generally fare better when developed alongside established hotels, as the hotels may encourage potential buyers, as well as critical mass for the development and associated guest services.

Destination clubs are experiencing growing pains yet have seen the greatest percentage growth in sales volume relative to other vacation ownership options<sup>1</sup>. Faced with affluent members who expect luxurious residences and world-class service in an ever-increasing number of attractive vacation destinations, operators are refining their facilities to suit the needs of this demanding clientele best. Challenges arise for clubs that rent locations, as they maintain limited control over product quality, cost increases, and guest service, resulting in disgruntled members. Because they need to be well capitalized to achieve a critical mass of members and locations, it is anticipated that the consolidation of destination clubs will continue in 2008. Other trends anticipated in the sector include refinement of the ratios of destinations to members, cancellation terms, and a general movement towards non-equity structures.

In summary, while the various second-home hybrids are expected to be tested by a softening US housing market in 2008, the underlying fundamentals of the baby boomer generation (the generation born between 1946 and 1964) — their upcoming wealth transfer and the time to enjoy it — will lead to continued growth and metamorphosis of the second-home sector.

<sup>1</sup> Ragatz Associates. *The Shared-Ownership Resort Real Estate Industry in North America: 2007*, p. 13. March 2007.

# Fair Market Value: A New Way of Looking at an Old Measure

# 2

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards 157 (FAS 157), *Fair Value Measurements*, which will be implemented in 2008. While the new Standards do not change the areas requiring fair value accounting, they do seek to reduce the diversity that has existed in the actual determination of fair value. The Standard that emphasizes fair value as an “exit measurement” will generally require companies that have historically relied on internal cash flow models to seek out actual market transactions and market data for purposes of determining values.

For financial reporting purposes, fair market value is generally defined as “the amount a seller could reasonably expect to receive in a current sale between a willing buyer and a willing seller.” While the concepts underlying such a definition are relatively straightforward, market dynamics often result in substantial complexities in the practical determination of values. It is generally thought that actual market transactions for the same or similar assets represent the best indication of asset value. FAS 157 re-emphasizes this point. However, substantial market volatility, thinly traded markets, lack of market liquidity, or perception of value on the part of the asset owner often result in the use of more highly judgmental valuation techniques: comparative adjustments to market transactions for dissimilar assets or discounted cash flow models. Nowhere has this been more apparent recently than with asset-backed securities in the financial services industry. The choice of valuation techniques has historically rested with the preparer of the financial statements. This, in turn, has resulted in the diversity in practice that the framework in FAS 157 is designed to address.

While financial statements under US Generally Accepted Accounting Standards (GAAP) are fundamentally based on the historical cost model, fair market value is increasingly finding its way into the preparation of such

statements. The hospitality industry is no exception, with the requirement that valuation of goodwill and contract intangibles, allocation of purchase price, impairment assessment, and carrying values of hotel assets be reported as fair market values. FAS 157 will require hospitality companies to seek out actual market transactions related to such assets. Absent such transactions, “observable market inputs” (e.g., cap rates, discount rates, multiples, revenue per available room [RevPAR], and growth rate assumptions) must be sought out for purposes of modeling fair value calculations.

Only after a company has demonstrated that such information is unavailable will it be acceptable to employ internal models using internal assumptions for purposes of determining fair value. In such cases, extensive footnote disclosure will be required with respect to the modeling technique and associated assumptions. In that respect, FAS 157 will not only have an impact on how companies determine fair value, it will also expand transparency in the marketplace with regard to those determinations. Going forward, FAS 157 will allow for increased consistency and comparability in fair value measurements across the marketplace.

# 3

## Hotel Development: Pipeline Remains Strong, Countering the Credit Crisis with Modern Brand Development

The US lodging industry was hit with record-high construction cost increases in 2006. In 2007, by comparison, it has experienced only moderate price increases, despite a 29.7% increase in the cost of diesel fuel in 2007.<sup>2</sup> The increase in fuel price was somewhat defrayed by a decrease in the cost of key construction materials, such as gypsum and steel products, which declined in 2007 by 22% and 3.7%, respectively. Higher construction costs and land prices have led to only a marginal reduction in the number of proposed hotel projects that have broken ground, an indication that the credit crunch has not yet had a significant impact on development.<sup>3</sup>

As reported by Lodging Econometrics,<sup>4</sup> the US industry set another record, with more than 5,000 hotels in the pipeline in the third quarter of 2007. The current credit crisis has not had a significant impact on those projects; however, increases in cancellations and postponements are expected in the fourth quarter of 2007 and the first half of 2008. While construction financing may be more expensive and more difficult to secure in the short run, it is expected that interest rates will stabilize at higher, yet still relatively moderate levels. Commercial and public construction continues to offset shortfalls in the housing market with the lodging industry leading the pack in new commercial construction. Reduction, although slight, in the supply pipeline, due to less favorable financing terms for deals under negotiation, is anticipated to benefit the performance levels of existing hotels, as other sectors of the economy are exposed to a potential softening and the reduction of new supply becomes less of a threat.

In terms of investment strategy within the US, a clear shift has begun toward development projects and away from acquisitions. Ernst & Young's *2007 Hospitality Investment Survey* indicated that this trend is seen likely to continue

through 2010. It has become increasingly apparent during the last two years that in certain markets, despite rising costs, building a new hotel may be more feasible than buying an existing hotel as demand outpaces supply.<sup>5</sup>

Development activity persists as lodging industry executives remain bullish on the short- and long-term outlook. Whereas the 2006 surge was led by projects in Las Vegas and Atlantic City, this year's top metropolitan areas for new hotel construction were Chicago and Orlando.<sup>6</sup> Looking forward, industry leaders expect 2008 to reflect the impact of the development pipeline buildup. Supply additions are expected to hit the market at an annual rate in excess of 100,000 new rooms from 2008 to 2011. The majority of 2008 development activity, however, is expected to occur in the Upscale and Midscale without Food and Beverage hotel industry segments.<sup>7</sup> The Upscale segment is expected to reflect the rollout of its new brands by larger hotel companies seeking to reach critical mass on brands such as Hotel Indigo, Hyatt Place, and Cambria Suites. In the Midscale segment, considerable development activity is expected to come to fruition due to generally shorter development time frames relative to the announcement of projects, compared with those of full-service hotels.

<sup>2</sup> "US No. 2 Diesel Sales by All Sellers." US Energy Information Administration. 14 January 2008.

<sup>3</sup> Robert Murray. "September Construction Slides 9 Percent." *McGraw Hill Construction*. 23 October 2007.

<sup>4</sup> Patrick Ford. "U.S. Construction Pipeline Sets Another Record." *Lodging Econometrics*. 31 October 2007.

<sup>5</sup> *Ernst & Young Hospitality Investment Survey*, December 2007.

<sup>6</sup> Associated General Contractors of America. "Construction Economics" *The Data DIGest*, 22-29 May 2007.

<sup>7</sup> Mark Woodworth. "New Forecast Report from PKF Hospitality Research No Sunset on the Horizon." *Hotel Online*. 12 September 2007.

## Inbound Investments: US Goes Global

# 4

Lured by a booming market and a weakened US dollar, foreign companies are deploying capital into the US at a record pace. In September 2007, foreign organizations spent approximately US\$276 billion in acquiring various US businesses, near the 2000 record of US\$325 billion.<sup>8</sup>

In light of the recent credit crunch, the debt markets in the United States have significantly slowed, which has brought domestic hotel transaction activity by domestic investors to a minimum. However, heavily capitalized foreign investors and entities have benefited due to decreased competition for acquisition targets, as these transactions are less reliant on debt financing.

In addition, the steady decline of the US dollar has further increased the attractiveness of US assets for foreign investors. Throughout 2007, the US dollar steadily declined against most of the world's major currencies. Predictions that the dollar will fall even further are an indication that conditions for subprime borrowers and the overall credit landscape in the US have the potential to worsen. While the decrease in the dollar's value has prompted domestic lenders and investors to proceed with caution, if at all, investors originating abroad, especially those who are highly capitalized, have enjoyed an increase in their purchasing power.

Transactions such as Istithmar Hotels' acquisition of the Mandarin Oriental in New York and Taj Hotels Resorts and Palaces' acquisition of the Ritz-Carlton Boston and the Campton Place Hotel in San Francisco were indications of heightened interest in US real estate from abroad in the first half of 2007. Given the change in the US financial markets in the third quarter of 2007, foreign investors have become increasingly focused on the US real estate market, paying particular attention to lodging properties.

Marked by large-scale investments such as those in Las Vegas, investors from the Middle East have become prominent players in US real estate markets. However, investments such as the acquisition of a 90% interest in the St. Regis Hotel in Washington, D.C. by Claret Capital, a private investment firm based in Dublin, Ireland, in September 2007 demonstrate that investors continue to make inroads in US real estate.

The weak US dollar and strong lodging fundamentals are expected to continue to attract non-US investors. As credit conditions raise caution among domestic investors in the short to medium term, it is anticipated that foreign investors will continue to drive a significant portion of investment activity through 2008.

## Lodging Life Cycle: Are the Good Times Coming to an End?

# 5

The hospitality industry has had steady growth since the events of 11 September 2001 with significant demand increases. With a compound annual growth rate of 7.9% for RevPAR from 2003 to 2006, RevPAR growth in 2007 is expected to be approximately 6%,<sup>9</sup> and 2007 overall RevPAR is anticipated to be close to its previous peak recorded in 2000 (adjusted for inflation). As hospitality cycles historically last between six to nine years, current

indicators suggest that the hotel industry will continue to achieve gains in 2008, although smaller than gains in previous years.

While the lodging industry is experiencing RevPAR growth, occupancy levels and average daily rate growth rates are decelerating.<sup>10</sup> According to a recent poll<sup>11</sup> of the Hospitality Asset Managers Association (HAMA),

<sup>8</sup> Weil, Dan. "Weak Dollar Allows Foreigners to Snap up US Firms." [www.newsmax.com](http://www.newsmax.com). 16 October 2007.

<sup>9</sup> Smith Travel Research. Lodging Review. December 2003-2006.

2008 RevPAR growth for full-service properties is expected to increase by 5%, and 2008 net operating income (NOI) growth for these properties is anticipated to increase by 5% to 6%, slightly below 2007 estimates. Furthermore, those polled responded that the lodging sector is in the end stages of expansion. Similarly, most of the publicly traded domestic companies provided lower estimates than in the prior year.

The expected decline in GDP growth further indicates that the lodging cycle is shifting and that demand growth is waning. Historically, room demand growth has been strongly correlated to changes in GDP. Real GDP growth is projected to slow to a rate of 2.2% for 2007 and 2.6% for 2008, compared to expansions between 2.9% and 3.6% from 2004 to 2006. The threat of a more accelerated deterioration of economic conditions, or even a recession, due to the debt and housing markets may cause the current positive lodging cycle to end sooner than expected. Because new lodging supply is anticipated to accelerate in 2008, the effect of negative, or even minimal, economic growth would have a greater impact on industry fundamentals. A prolonged decline of the

US dollar could have a beneficial effect on US lodging demand, as domestic leisure trips are expected to grow in 2008 by 2% and international travel to the US is projected to rise 3.7% in 2008.<sup>12</sup> However, although inbound international travel is anticipated to increase, it has yet to surpass the level reached in 2000.

The end of previous cycles in the US lodging industry was often accompanied by significant increases in supply. While the current hotel construction pipeline is showing strong quarterly growth compared with that of the last three years, lodging supply growth is anticipated to remain below its historical average through 2008.<sup>13</sup> The slowdown of the capital markets that began in mid-2007 is expected to decelerate the pace of the supply pipeline further. As lenders are reevaluating risk and pricing, developers are finding it increasingly difficult to obtain financing commitments for their projects. Annual supply growth between 2008 and 2010 is estimated to decrease by at least 3,000 rooms, which could extend the current cycle. While certain factors could potentially shorten or lengthen it, most indicators suggest two years remain in this cycle.

# 6

## Green Hotels: Environmentally and Economically Friendly

With the increased focus on the environment and climate change during the last few years, real estate and hotel developers and guests alike are focusing on environmentally friendly (or “green”) hotels. While a few years ago, it was estimated that developing a green hotel would cost upwards of 20% more than building a hotel by conventional standards, the cost premium has decreased significantly. Furthermore, according to the US Green

Building Council (USGBC), the most significant green performance features add only 2% to 7% to the initial design and construction costs of projects, with these additional costs constantly decreasing.<sup>14</sup> The additional costs are often recovered within one to two years through decreases in expenses, making the development of green hotels appealing from both an environmental and an economic standpoint.<sup>15</sup>

10 Smith Travel Research. Lodging Review. January and November 2007, and PKF Hospitality Research, Hotel Horizons. 3rd Quarter 2007.

11 Green Street Advisors. 2007 Hospitality Asset Managers Association Meeting Survey. 3 October 2007.

12 “Modest Growth Predicted in US Travel Projected in 2008.” *Travel Industry Association of America*. 30 October 2007.

13 “LE’s U.S. Construction Pipeline Sets Another Record at 5,011 Hotels with 654,503 Rooms. Hotel Companies Ready to Reap Benefits of Repositioning Strategies.” *Lodging Econometrics*. 31 October, 2007.

14 “Leadership and Sustainability: Gettys Blazes a Trail In Green Hospitality Design.” [http://www.hotel-online.com/News/PR2007\\_3rd/Sept07\\_GettysGreen.html](http://www.hotel-online.com/News/PR2007_3rd/Sept07_GettysGreen.html). 27 September 2007.

15 “JMBM Hotel Lawyers Announce First Green Hotel Development Conference.” [http://hotellaw.jmbm.com/2007/07/jmbm\\_hotel\\_lawyers\\_announce\\_fi.html](http://hotellaw.jmbm.com/2007/07/jmbm_hotel_lawyers_announce_fi.html). 27 July 2007.

Green hotels are economically designed and environmentally friendly properties typically identified as green by meeting standards set forth in Leadership in Energy and Environmental Design (LEED) certification. These standards include programs for sustainable site development, water savings, energy efficiency, materials selection, and indoor environmental quality. Strong economics have resulted in a number of major hotel companies either developing green hotels or retrofitting existing properties, to become part of the green movement. Additionally, numerous developers of existing luxury-branded hotels and residences, as well as new brands, are now focusing on environmentally friendly hotel design and operation. Former Starwood Hotels CEO Barry Sternlicht is launching a group of environmentally friendly hotels and condominium properties under the “1” Hotel and Residences brand. The buildings will derive 50% of their energy from renewable sources and will use energy-efficient systems and recycled materials, thus qualifying for LEED certification.<sup>16</sup>

While there may be a marginal increase in up-front construction costs associated with green hotels, the benefits and future savings may outweigh the extra expenses for many developers. Numerous incentives are frequently offered by cities to developers of LEED-certified hotels,

including quicker approvals for entitlements, incentive payments, and tax credits.<sup>17</sup> Additionally, according to the USGBC, LEED-certified buildings can save from 30% to 50% in energy use, 35% in carbon emissions, 40% in water consumption, and 70% in solid waste. This will significantly mitigate the increased construction expenses with savings that translate into the equivalent of increases in average daily room rate (ADR) from US\$2 at limited-service hotels to upwards of US\$7 at full-service hotels.<sup>18</sup> Furthermore, according to a recent ecotourism survey conducted by the website TripAdvisor, travelers may be willing to pay more to stay in an environmentally friendly hotel: approximately 36% of respondents indicate the willingness to pay upwards of 20% more to stay in a green hotel.<sup>19</sup> The savings and increases in revenues may translate into higher sales values for environmentally-friendly hotels.

The focus on the environment is likely to continue. The trend is being further solidified by California State Law AB 32, which establishes a goal of reducing California’s greenhouse gas emissions by 30% to 35% of 1990 levels by 2020 and to less than 80% of 1990 levels by 2050. At least 40 other states are also taking action to combat global warming.<sup>20</sup> The development of green hotels will continue to translate into value for hotels and for the environment.

## Tourism: **7** Strategy and Branding from a Local Perspective

The US tourism market sustained high levels of growth in 2007 as state and local governments continued to recognize the benefits of using tourism to supplement their economic base. The ability of states to improve their economies by increasing visitation and tourism plays a central role in their vitality. On a microeconomic level, local city governments are beginning to realize the

importance of developing a local brand. If developed and implemented properly, a brand can be the foundation for a positive economic turnaround and can lead to growth in revenues to be used for education, development, and general growth. Cities such as Austin, Texas; Baltimore, Maryland; Cleveland, Ohio; and Kansas City, Missouri, have been recognized for their best practices in regional

<sup>16</sup> “Green: The Color of Money.” <http://www.cnbc.com>. November 2007.

<sup>17</sup> “Green Hotel Development Gaining In Popularity.” [http://www.hotel-online.com/News/PR2007\\_4th/Oct07\\_JBMLEED.html](http://www.hotel-online.com/News/PR2007_4th/Oct07_JBMLEED.html). October 2007.

<sup>18</sup> “Hotel Lawyer on the ‘Real Economics’ Behind the Paradigm Shift to GREEN Hotels.” [http://hotellaw.jmbm.com/2007/10/hotel\\_lawyer\\_on\\_the\\_real\\_econo.html](http://hotellaw.jmbm.com/2007/10/hotel_lawyer_on_the_real_econo.html). 23 October 2007.

<sup>19</sup> “Leadership and Sustainability: Gettys Blazes a Trail In Green Hospitality Design.” [http://www.hotel-online.com/News/PR2007\\_3rd/Sept07\\_GettysGreen.html](http://www.hotel-online.com/News/PR2007_3rd/Sept07_GettysGreen.html). 27 September 2007.

<sup>20</sup> Jeffer, Mangels, Butler, & Marmaro LLP. “How Global Warming Laws Will Affect Hotels: Will California’s New Legislation Set the ‘Standard’ for the Country?” *Global Hospitality Advisor*. November 2007.

marketing. For example, the “Cleveland+” brand was recently developed to position and promote Cleveland and the neighboring cities of Akron, Canton, and Youngstown as one unified region. By leveraging the strengths of entire regions, a tourism strategy can focus on the assets of those regions. Las Vegas has also successfully developed as a brand by integrating local efforts with the media and internet communities.

Local tourism can have an impact on more than just the demand for hotel rooms. It increases attraction visits, package tours, retail sales, restaurant receipts, local transportation, and other events and activities that affect the local economy in a positive way. For example, a boost in demand for and usage of convention center facilities by out-of-town groups draws attendees to stay overnight. Moreover, an effective tourism strategy

can bring national and international media exposure to attractions, unique features, lifestyle, history, and the natural environment — all of which can bring increased business to more than just hotels.

A comprehensive strategy is essential to creating a long-lasting local brand. Extensive research is necessary before building the key messaging and creative elements that lead to a successful “imaging” campaign. In the end, a collaborative/cooperative effort must exist between convention and visitors bureaus, economic development organizations, chambers of commerce, civic groups, political leaders, and private-sector industry stakeholders such as hotel and restaurant associations. A brand name and a powerful marketing strategy that focus on long-term results can be the determining factors for a successful tourism strategy.

## 8

# Credit Crunch and Sovereign Wealth Funds Filling the Gap

Global credit markets were strong at the beginning of 2007, as an abundance of inexpensive capital flowed into real estate markets, financial markets were stable, and investors’ appetite for risk was strong. However, aggressive lending practices and weakness in the residential housing market eventually contributed to increased delinquency rates among subprime borrowers in the second quarter of 2007.

Decreasing home values and increased delinquency rates caused significant losses among investors and raised concerns about mortgage-backed commercial real estate securities. Credit ratings agencies have already downgraded more than US\$50 billion worth of mortgage-backed securities and further downgrades are anticipated. The volatility in the residential mortgage market leaked into the commercial real estate sector, despite its historically low delinquency rates and strong fundamental performance, as many investors were sidelined by illiquidity in the commercial paper market or concerned about underwriting practices, the accurate pricing of risk, and increasing capitalization rates.

While many lenders currently remain on the sidelines due, in part, to a backlog of unsecuritized loans, high-quality assets can still receive financing, albeit at less favorable terms than seen prior to the liquidity crisis (fewer interest-only loans, higher interest rates, lower loan-to-value ratios, and increased debt-service coverage ratios). As a result of increased borrowing costs and less favorable loan terms, traditionally high-leverage private equity groups are searching for alternative methods of debt financing to boost deal activity and returns. Alternative sources for debt financing include seller financing, hedge funds, mutual funds, and sovereign wealth funds. It is estimated that the global private equity industry may have as much as US\$500 billion awaiting investment. However, decreased leverage, which has a greater impact on returns than higher interest rates, is anticipated to place upward pressure on capitalization rates and downward pressure on real estate prices.

The US real estate market has recently experienced a surge in equity investment from Asian and Middle Eastern sovereign wealth funds. Some noteworthy

transactions in 2007 include Dubai World's purchase of a 50.0% interest in MGM Mirage's Project CityCenter for US\$2.96 billion and the Chinese government's US\$3 billion investment for a 10.0% stake in the Blackstone Group. The impact of sovereign wealth funds is expected to increase significantly over the next decade. While the top 20 sovereign wealth funds are currently valued at US\$2.2 trillion, their value could increase to US\$13.4 trillion in the next decade if current growth rates continue.

The first half of 2007 was characterized by a number of large-scale lodging transactions, including the

Lightstone Group's US\$8 billion acquisition of Extended Stay America<sup>21</sup> and Blackstone Group's US\$26 billion acquisition of Hilton Hotels Corporation.<sup>22</sup> In addition, Four Seasons Hotels Inc. was taken private by affiliates of Cascade Investment LLC, an entity owned by William H. Gates III, and Kingdom Hotels International, a company owned by a trust created by Prince Alwaleed Bin Talal Bin Abdulaziz Alsaud, at a value of US \$3.8 billion (including debt), or US \$82 cash per share.<sup>23</sup> Similar large-scale transactions are not anticipated in the near term due to limited availability of debt financing in the current environment.

## Brand Proliferation: The Benefits of Branding

# 9

The lodging sector has experienced an upswing in branding in recent years. While there are certainly inherent benefits in relation to non-branded properties, in today's market, the addition of a brand can make a significant impact on the cash flows of both operators and owners alike. This impact on the bottom line is evident in an expanded market share, additional revenue channels, and, in some instances, favorable financing terms.

A new travel segment has emerged recently — the lifestyle segment. These travelers are seeking amenities that blend work and play with style, resulting in creative and artistic design elements that are becoming ever more important in attracting consumers.<sup>24</sup> Many players in the lodging sector are creating new lifestyle brands to diversify their existing product offerings, as can be seen in the emergence of brands such as Hyatt Andaz and Starwood aLoft. Even traditional anti-brand hoteliers such as Kimpton, Schragger Rosewood, and Kor have jumped on the "brand wagon." These new brands enable the lodging conglomerates to capture market share that had previously been captured almost exclusively by independent boutique hotels.

Aside from expanded market share, a brand can generate additional revenue through the recent trend of residential branding. In such developments, residential unit owners usually receive the services also offered to hotel guests, such as housekeeping and room service, in addition to the convenience, status, and reputation that come with the lodging brand. In some circumstances, they are also offered the potential to place their unit in a rental program, though this is not an option for fractional or strict branded residential developments. Hotel operators generate income by charging branding or licensing fees to developers, as well as from increased revenues obtained from offering à la carte services to unit owners. This branding fee trend evolved when lodging companies observed the premiums in pricing obtained by developers of branded developments, in some instances reported at upwards of 20% to 50% on the sale of the branded residential units relative to comparable unbranded products.

While branding a hotel is not a necessity, in today's lending market, it is certainly an added benefit. As lenders

<sup>21</sup> Kalinoski, Gail. "Lightstone Closes on \$8B Acquisition of Extended Stay." *Commercial Property News*. 12 June 2007.

<sup>22</sup> "Blackstone Completes Hilton Hotels Acquisition." *Commercial Property News*. 6 November 2007.

<sup>23</sup> "Four Seasons Agrees to US \$3.8 Billion Buyout Offer from Microsoft's Bill Gates and Saudi Prince Alwaleed bin Talal." [www.hotel-online.com](http://www.hotel-online.com). 12 February 2007.

<sup>24</sup> Associated General Contractors of America. "Construction Economics" *The Data Digest*. 22-29 May 2007.

become more stringent in their underwriting, owners and developers whose projects are associated with established brand names generally have an easier time obtaining construction financing, as well as more favorable financing terms. This is particularly evident in unproven secondary or tertiary markets when branded properties are viewed as a safer investment.

As the lodging cycle begins to shift, some industry participants believe further consolidation is inevitable. Certainly, there are pros and cons to branded and non-branded hotels. In today's market, however, the addition of the right brand can generate incremental value for all parties — owners and operators alike.

## 10 Outbound Investment: Capital Goes Around

Finding it progressively more difficult to source investment opportunities to fit their return profiles, US investors are increasingly looking outside the domestic market for cross-border investment opportunities. Approximately half, or US\$35 billion, of hotel investment in 2006 was placed in investments outside of the US,<sup>25</sup> a trend that continued in 2007. This phenomenon may be witnessed in significant portfolio transactions that occurred in the first half of 2007 and by the findings of Ernst & Young's *2007 Hospitality Investment Survey*. The survey, which targeted key decision-makers in the US hospitality industry, indicated that while currently only approximately one-third (37%) of the respondents invest in hospitality internationally, this percentage is anticipated to increase in the near to medium term as almost 46% of respondents plan to focus more on international opportunities.

While investors have increasingly turned their focus outside of the US to global markets, a few regions have demonstrated their propensity for growth more quickly than others. Europe and Asia continue to have a stronghold on investor interests due to strong ADR and RevPAR growth rates and high barriers to entry. 22% of those surveyed are currently investing in Europe, and 15% believe Europe to have the greatest potential for hospitality investment. According to the survey responses, 41% believe that Asia has the greatest potential for hospitality investment, while 19% are currently invested there. With China and

India having opened their markets to international investors, a record level of transaction volume was recorded in 2006.

Additionally, despite obstacles such as local legislation and development laws, both Latin America and the Caribbean remain attractive locations for investment. Stabilizing economies and politics in countries such as Mexico, Brazil, and Argentina further support foreign investment initiatives. Investment in the Middle East continues to grow as well, most notably developments in the Luxury segment and those with mixed-use components, especially in areas such as Dubai and Abu Dhabi, as tourist arrivals and RevPAR growth reach record levels and returns remain high.

Ernst & Young's survey further indicated that investors' interest is skewed towards the luxury segment, with a preference of 37% internationally versus 23% domestically. Investors appear to be more comfortable investing in high-end properties, which tend to attract more international travelers and to rely less on the local markets.

Finally, while international expansion does come with some additional risks, such as political and economic instability, currency risk/inflation, and prohibitive and unclear local legislation, in certain instances they also present opportunities for higher returns on investment and risk diversification.

25 Jones Lang LaSalle. *Global Hotel Investment Survey 2006*.

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