

Going Abroad - A Foreigner's Outlook on Indian Hotel Investment - Michael J. Pajak

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Despite global economic woes Indian hotel development has remained a strong investment but certain dynamics must be understood and appreciated before investors branch out.

Rising oil prices, the fall of Bear Sterns, speculation about Lehman Brothers, a government bailout for home mortgagees/guarantors Freddie Mac and Fannie Mae, and unemployment exhibiting a single month increase of 50 basis points in May - all these factors and more have made U.S. growth a rather dreary landscape. With the ongoing economic quagmire in the U.S. having led the world economy to a position described as 'teetering on the brink' according to the mid-year UN economic projections report, it is important for investors and developers to solidify their core competencies domestically while outlining and implementing the best policy for entry into emerging markets (EM). At this point it is evident that developing nations hold great potential for investors and India is among the forerunners of these markets. But business styles and norms in foreign countries can be very different and India is by no means an exception. The following article seeks to provide potential investors with an outlook on the current investment climate in India as well as the various challenges and opportunities to success abroad.

ECONOMY

India's economic expansion is strongly correlated to the advent of its new political reform, which coincided well with an upward trending U.S. and global economy. The Congress-led United Progressive Alliance (UPA) completed four years in office as of May 2008 during which they have targeted economic growth and progress resulting in numerous reforms. However, differing perspectives tend to hinder the group occasionally. The November 2006 implementation of the UPA's 'Open Skies Policy', which allowed domestic carriers to commence international flights, start-up of various low-fare carriers and fleet expansion by domestic players has pushed India's doors open even wider. With burgeoning IT, ITes, and BPO industries India's expansion has taken center stage among emerging nations. GDP has exhibited tremendous potential with growth rates of 9.0% in 2005/06, 9.4% in 2006/07, and 9.0% in 2007/08 - evidence of a self-perpetuating trend where growth inspires confidence, in turn promoting continued growth. Even if the UPA, Reserve Bank of India (RBI) and Securities and Exchange Board of India (Sebi) are not always on the same page, which occasionally results in contradictory policies and legislation, the opportunities for foreign investment have grown exponentially in recent years.

GLOBAL IMPACTS AND INDIA

As with any market downturn there are varying opinions of where the economy is in the cycle. While the IMF has estimated that financial sector losses by the end of the first quarter 2008 totaled \$945 billion and the UN has warned of a severe downturn related to the projected 1.8% GDP worldwide growth in 2008, down from 3.8% in 2007, not all economists envision such an apocalyptic scenario. The Bank of England's Financial Stability report indicates a position by the bank that the worst is over and losses related to the credit crisis have been too heavily impacted by deflated market prices. Fitch Ratings also reported that future losses should be minimal and its estimate of total losses relating to sub-prime mortgages equates to 'around \$400 billion, of which 50% reside within the banking sector'.

The ability of eleven of the largest banks to generate a total of \$260 billion to shore up their balance sheets in the wake of over \$330 billion in write-downs and consistent Dow Jones growth on the heels of oil price declines or even the sentiment of a short-seller crackdown could indicate that investors' appetite for risk is not yet dormant. Furthermore, U.S. unemployment remained stable between May and June at 5.5%, while this level does exceed recent highs, it is only slightly greater than the average since 1990 of 5.4%. The U.S. populace may not be so easily convinced - continued housing foreclosure rates and record oil prices have justly led to skepticism. Furthermore the Dow Jones fell to near 'bear' market levels by the end of June as global inflation levels have exhibited no signs of retreat. While the U.S. may not be in the grips of a recession a retracted period of slow growth could be as bad as or worse than an acute dip.

The timing and breadth of the global economy's impact on India is the key question. As of April and May, the Indian economy has proven resilient to foreign influences. Surely the announcement of India's GDP of 9.0% in fiscal 2007/08 is further evidence to India's bright future amidst a dreary global outlook. According to The Economist, emerging markets have yielded record growth levels and the potential for future growth is immense. Although India witnessed foreign investment of roundly \$24.5 billion in 2007/08, which was an increase of roundly 56% over the previous fiscal year, emerging markets' potential is not being fully tapped - consider that investment banks derived 80% of their revenues from developed nations despite these countries accounting for only 71% of global GDP¹. Unfortunately many foreign institutional investors, hastened by poor recent equity market appreciation in India have withdrawn funds from these markets to patch holes cropping up in their U.S. portfolios. This trend coupled with soaring oil prices and inflation levels have surely caught up with the Indian economy in June, however, India's economic troubles are similar to those faced by other EMs and rich nations alike and are not indicative of mid- or long-term problems in the subcontinent. As highlighted previously, during time of global economic strife it is essential to shore up one's domestic operations but defensive measures alone are not sufficient to guarantee a firm's future. So as western markets slow investors need to keep their minds on foreign opportunities to balance their portfolios.

INFLATION

As inflation becomes a more common concern among the rich nations, many emerging markets have been criticized for their loose fiscal policies. Although many rich nations have recently taken notice to inflation, India and many other emerging markets have been tackling the issue for much of 2008. India's inflation rate was well maintained by the RBI at around 3-4% through much of 2007/08 with a target less than 5%. Inflation stood at 3.5% as of late December 2007, however, WPI based inflation exhibited unchecked increases between March and July with a record thirteen-year high of 11.98% for the week ending August 1. High oil, food, cement, and steel prices have been largely to blame for inflation throughout Asian emerging economies. According to The Economist, if inflation measurements are correct then it is likely that five of the ten largest emerging economies will exhibit double-digit inflationary levels this summer. It seems that while economic growth in EMs may have largely detached from U.S. economies, monetary policy is still linked.

Due to the high level of poverty, food and oil costs highly impact India's population. As such, the RBI has focused their sole attention on curbing inflation. Similar to the general political and cultural norms, the RBI is a rather conservative fiscal policy-maker. Recent action taken by the RBI, occasionally incorrectly chosen, includes imposing bans on certain commodities trading and exports and raising the cash reserve ratio and the repo rate. Unfortunately, these monetary policies are yet to take full effect and a recent increase in subsidized fuel prices has further exacerbated the situation. The task of balancing inflation and exchange rate while maintaining strong economic growth is a challenging one - unfortunately the RBI's lack of autonomy from the government makes a difficult situation worse.

LODGING DYNAMICS

As if accommodating India's current room night demand was not a challenging task enough, base demand coupled with robust levels of unaccommodated and induced demand will prove even more daunting. India measures roughly one-third the size of the U.S. but features a population 370% greater, at roundly 1.1 billion. This population is the second largest globally and accounts for 17% of the world's population. Needless to say that the country's lodging needs are being grossly underserved. The existing internationally branded rooms in India totals approximately 40,000 - less than the room supply of Manhattan, New York. According to HVS, the Pan-India occupancy level exhibited a robust 72% and average room rate of Rs7,075 (approx. \$177) for the fiscal year 2006/07. The U.S. average recorded in 2007 was 63.2% at \$103.64 according to Smith Travel Research. Considering that these U.S. figures are based on an inventory of approximately 4.59 million rooms compared to the Indian branded room inventory of roundly 90,000-100,000 excluding the unorganized sector, which represents roughly another 100,000 rooms, leads one to wonder about India's tremendous potential.

The severe supply-demand imbalance has prompted hoteliers to increase rates significantly over the past two to three years. HVS maintains that India needs approximately 160,000 new rooms in the nation's top 25 markets. As this new supply enters the market a rate rationalization is expected, each market will vary based on supply but HVS anticipates many markets to achieve stabilized rates in 2012. This rate consolidation will also serve to induce demand from the mid-level domestic leisure segment and the meeting and conference segment, both of which were previously priced out of the market. The industry will further benefit from the rising disposable income levels among Indians as the number of domestic holidays increases as well as per trip spending. Unfortunately, domestic tourism statistics are grossly skewed and all domestic travel is registered as tourism regardless of purpose of trip. Based on these recording principles, domestic tourism visitation totaled roundly 529 million in 2007. Even if a mere 10% of the estimated domestic visitation can be correlated to tourism then India benefited from approximately 53 million domestic tourists in 2007. Regardless of purpose of visit, domestic travel increased by 140% between 2000 and 2007, which can be viewed as an extremely positive trend for the lodging industry. While international tourism will provide an impetus for the lodging industry it cannot be considered a staple. International tourism totaled 5 million visitors in 2007 with factors such as the country's lagging infrastructure having checked growth.

FOREIGN MONEY IN INDIA

Clearly the need for increased investment in the hospitality industry is needed but arriving on the scene will require a more exhaustive due diligence process and continuous endeavors than any previous deal. For a moment let us forget the occasionally xenophobic government and their various FDI obstacles and focus strictly on what it takes to pencil out a project. Presently input costs have taken the wind out of many developers' sails. Although steel and cement expenses have exhibited marked increases in recent times, land costs are leading the charge (the author qualifies that industry-imposed temporary price cuts and government persuaded price suspensions will help construction costs in the short term but these export bans and loose agreements are only temporary solutions). Land prices have grown to outrageous levels demonstrated best by a recent government land auction in the suburbs of Delhi, which resulted in a 90-acre parcel selling for \$1.25 billion. Many developers have put projects on hold as land costs are simply too high to yield the desired returns. In a scenario that features land expense at 50-65% of the overall development expense, an all too common scenario, achieving desirable IRRs in light of low LTVs (50-60%) and high interest rates (12-13%) is challenging. Ongoing inflationary pressures are not expected to allow interest rates to ease in the near future either.

With rapidly escalating construction costs due to steel, cement, and other building materials, investors in most classes of real estate are failing to witness an appreciation in prices and many builders have started to withdrawal or have taken expensive bridge loans, hoping input costs will subside over the short term. The exit or temporary hiatus of investors should result in decreased land valuations and there is evidence that land prices have caused developers already signed-on for a project to drop out. Even the largest real estate investors have been hit by increased input costs. DLF, the largest real estate developer in India and owner of vast land banks, suffered a 52-week low on the stock market as of June 9, 2008 due to concerns of real estate demand slowdown and interest rate sensitivity. Increased restlessness among landowners is likely as valuations tumble - it seems the best approach is to bring cash to the table and negotiate hard.

At the same time, a contradictory event in the real estate industry is the possibility that land costs could remain stable or even increase as money from Real Estate Mutual Funds (REMF) and Real Estate Investment Trusts (REIT) becomes more available. The good news for those waiting for affordable land is that REITs and REMFs are far from being mature, confidence-inspiring investment options nor are economists certain that India currently exhibits the amount of transparency

required for such investments to thrive. In a market that has witnessed 28 of 35 IPO's which opened in 2008 trading at a discount as of June, which resulted in a loss of Rs8,000 crore (\$2 billion), it is hard to imagine that these untested options will draw record levels of investment. The visible slowing of PE and FII money is expected to be one of several factors leading to softening land valuations in the mid-term.

THE MARKET MATURES

While certain aspects of hotel development in India are as complex as their international counterparts it is interesting to observe the building blocks of a maturing lodging industry. To overcome the financial burden and to lower potential barriers projects are often completed by the partnering of several entities. This typically includes an equity partner, a land partner, and a domestic or international brand, which typically provides both brand affiliation and management. A growing trend for equity partners is the presence of private equity money especially as IPO's have floundered on India's public markets, FII's have resultantly become net sellers in 2008, and external commercial borrowing (ECB) is not available for land acquisition, which is a cost that can reach 50-60% of the overall development cost as discussed previously. Cost feasibility purposes aside, partnership can provide local experience and vital political relationships and therefore improve a project's potential for success. Contrary to the U.S. and many other developed nations, corruption and irrational government interference is a plausible concern that can result in a prolonged battle over a project so having partners that know the ropes is advisable.

Brand growth is another part of the Indian industry's development but there are more brands to choose from than international affiliations alone. India offers a variety of homegrown chains principally comprising The Oberoi, Taj Hotels, ITC Hotels and Leela, which if put together, own and/or manage approximately 115 assets in India and totaling nearly 15,300 rooms. Choosing an international brand may be a more appealing proposition for a foreign investor in India but the domestic chains have their advantages. The biggest advantage these companies bring to the table is their tremendous reach in the most notable cities of India. Additionally, years of operating in the typical India market has let them master the art of tailoring the products and standards to suit the domestic needs. International hotel companies looking to establish themselves in India will go through a learning curve at a time when markets are expected to correct themselves and are in an unforgiving phase. Contrary to the general perception this does bring forward a certain degree of risk when one partners with an international brand. On the positive side, international brands have a proven ability to attract top talent that matters and are also supported by their formidable loyalty and marketing programs.

BUY VS. BUILD

The length and style of hotel ownership is one factor that will impact every developer's entry into the market. Buy-outs involving a single asset or an entire portfolio are not a common occurrence - the entrepreneurial attitude and strong family culture common among many Indian owners results in long holding periods and a family-oriented succession plan. Limited supply for acquisition has led to high valuations, which has further impeded the buy-out route. With the acquisition entrance into the Indian hospitality industry limited, investors have entered the market by purchasing equity stakes in a brand or portfolio. This method has proven to be a legitimate means to entering the market and achieving very attractive returns. Presently transactions are limited, however, sales of existing hotels, mergers and consolidation of hotels and hotel companies is expected to increase, especially as more international players enter the market and the industry matures.

The development process, which is typically long and arduous in India, may also serve as a deterrent to the ground-up approach. One such circumstance relates to the government's archaic licensing process, which requires a hotel to obtain approximately 150 permits and licenses to operate - the absence of a single one will result in delayed operations. For example, as of May 2008 the Four Seasons Mumbai was fully staffed and ready to open for over eight months but a single liquor license kept the hotel's doors shut. Once approved, the gestation period for a hotel is approximately four to five years and is rarely reduced to three years. Additionally, escalating development costs may surpass budgeted contingency expense, forcing developers to seek expensive short term loans or suffer delays.

Because of these barriers HVS considers the possibility of inorganic growth to be very attractive. Although purchasing an operational hotel will require a premium, there are many properties in the unorganized lodging sector that HVS estimates could be purchased, renovated, and re-branded in one year's time. HVS also considers many of these properties to be mismanaged, allowing a proper management team to significantly improve expense ratios. As previously discussed, the pace of acquisitions will undoubtedly increase, however, an investor's best opportunity to acquire an operational hotel is currently in the unorganized sector. With that being said, it is vital to qualify that there is no proven example of such an acquisition and rebranding effort and thus it remains only an investment theory. Ownership of an 'unorganized' property is typically tied up among numerous family-related parties, and it is likely that each stakeholder possess differing business perspectives about the property at large. As a result, negotiating the acquisition of an unorganized property could very likely run aground, disrupting the investors' time horizon and creating headaches in the process.

The Greenfield development approach is a viable method and yields desirable returns. This process also allows the owner sole decision-making authority - most importantly the ability to develop an exit strategy to suit one party's interest rather than numerous stakeholders. As previously highlighted, high land prices can prove an obstacle to Greenfield projects. In an effort to work around exorbitant land prices, developers in India have started to rely on mixed-use components to improve the return of a project. Incorporating commercial, retail, and/or residential space into a proposed hotel development serves twofold. The first being that diversification alleviates the pressure for a single real estate sector to perform, which may also ease lenders' concerns. The second being that incorporating a hotel into a mixed-use development increases a hotel's demand generators - commercial space incorporated into a mixed-use development will generate room night demand, meeting and conference space demand, and food and beverage revenue from office traffic. Food and beverage revenue is also generated by retail traffic, and to a lesser degree, the residential population if such units are also included. These complementary uses result in a greater valuation.

Pre-selling residential units can also be a means of generating income prior to opening, enabling the developer to better handle escalating input costs and also easing the ability to extinguish debt and increase liquidity, thereby comforting lenders. It must be noted that mixed-use developments require a thorough understanding of numerous market dynamics and appropriate product positioning and complementation is key to maximizing profit. Although FDI investment in hotels is very relaxed the regulations regarding FDI in other real estate asset classes differs and so thorough due diligence is required before proceeding with such a project.

CONFIDENCE ABOUND

Regardless of the investment route all classes of investors are exhibiting confidence in Indian hotel real estate. Numerous domestic and international brands are eager to carve out their niche in the Indian hotel landscape and have begun by creating joint venture partnerships, co-branding and/or re-branding existing properties, and developing Greenfield projects. The following points illustrate various domestic and international investor transactions and commitments in India:

Accor and Interglobe Enterprises announced a joint venture to develop 25 'Ibis' brand hotels in India over the following 10-12 years. The deal is estimated at \$200 million and the stake is split 60:40, Interglobe:Accor. This deal was announced in March 2005.

Bessemer Venture Partners and New Vernon invested approximately \$8.5 million in Sarovar Hotels for the development of the Homotel brand in India. This deal was completed in late 2005.

Warburg Pincus invested approximately \$55-60 million (Rs280 crore) to acquire a 27% stake in Lemon Tree Hotels as of August 2006.

Emaar MGF and Whitbread announced a 50:50 joint venture to develop 80 hotels in India totaling 12,000 rooms and branded under Whitbread's Premier Travel Inn. This venture was announced in mid 2007 and will reportedly total \$600 million over the following ten years.

Temasek Holdings acquired a 21.74% stake in GL hotels for approximately \$30 million, the deal was announced in May 2007.

Credit Suisse invested \$50 million in Park Hotels and acquired approximately 15% stake. This transaction was completed in third quarter 2007.

Kotak Realty Group announced their acquisition of an 11.11% stake in Pride Hotel Group in October 2007.

Hilton and DLF have tied up to develop 75 hotels throughout India over the next five to seven years. Currently, 16 properties are undergoing varying levels of development. Hilton will reportedly hold a 26% stake in the tie-up and has committed \$143 million.

A joint investment in Lemon Tree Hotels by Kotak Realty Fund and Shinsei Bank was announced in April 2008. The investment reportedly totals \$30 million, which equated to a 5.9% stake. This acquisition was completed through a secondary sale by existing shareholders and values Lemon Tree Hotels at over \$500 million.

In June 2008, Goldman Sachs announced it would invest approximately \$80 million in a luxury deluxe hotel in Bangalore.

It is essential to heed a few common points if looking to enter the Indian subcontinent's hospitality real estate industry. Every investor from the small private equity player to the international REIT should consider several points:

Do not sacrifice intelligent business decisions and strategies for a quick entry into the market - many hotels are currently overvalued, a countrywide rate correction is anticipated, land costs are excessive, and the supply pipeline is significant.

Several characteristics are important globally and developers would be ill advised to neglect location, brand dynamics, and the trends of local and national demand generators.

Bring capital to the bargaining table and negotiate hard - discounts on land prices are available.

A mixed-use layout can provide for a captive source of room nights as well as generating additional revenue sources - this also prevents sole reliance on a single real estate asset class. A scenario involving pre-selling residential or condo/hotel units can increase liquidity and debt availability.

Although acquisitions are limited, purchasing an equity stake in an existing chain or portfolio will prove to be the quickest and most painless route while still providing attractive returns.

Acquiring an operational hotel will require a premium but in principle, this route allows for a quicker market entry than a ground-up project and dodges the government's archaic licensing process. HVS also considers many operational properties in the unorganized sector to be mismanaged. As previously highlighted, there is no real world example of this model - the numerous ownership interests involved on even a single deal may very well negate the 'quicker' aspect of this option.

While investors may be lining up at the door for a chance to invest in Indian hospitality, many of the smaller players are realizing that their names are not on the guest list. A plethora of factors have resulted in fewer investors successfully breaching the market including exorbitant land costs, high input costs, limited debt availability, and over-valued assets. Clearly the U.S. sub-prime mortgage crisis has slowed the global economy, but it is the authors' opinion that oil prices, inflation, and competition with other EMs for foreign investment will prove the greatest challenges to the developing Indian hospitality sector. Those investors not shaken by such challenges and able to keep an even keel with their domestic portfolios

may find themselves benefiting from declining valuations in the short to mid-term. Optimistic demand outlooks reinforced by strong GDP growth, a supply-demand imbalance, increasing levels of domestic disposable income, and relatively limited economic sensitivity to western markets proves that India's lodging industry will be a very good investment for years to come.

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