



Don't Fall in Love with Your Asset\$!

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Today in our industry, nothing is meant to last forever, and this is true of hotel ownership. If we look at industry trends in terms of corporate strategy, we clearly notice that most major hotel firms are gearing toward an asset-light approach to remain competitive.

From a global perspective, the hospitality industry has seen an exceptional level of transaction activity, changes in hotel ownership, and new management structures over the last five years. One of the main factors that stimulated these key trends is probably the split between hotel ownership and hotel operations. Indeed, publicly quoted hotel operating companies are selling owned properties and concentrating on core business as they continue to recover from real estate cycles. This strategy allows them to lighten their balance sheet, gather capital to finance international growth, and execute share buy-backs, thereby increasing their share price.

According to Steve Rushmore, President and Founder of HVS, 2006 was a “*Good Time to Own Hotels in the United States*” as hotel values continued their rapid growth and both occupancies and room rates escalated and capitalization rates declined. HVS research indicates that in 2006 there were 249 hotel transactions valued at more than \$10 million, up from 237 in 2005, with the average price per room rising to \$203,000 from \$160,000. The HVS 2006 U.S. Major Hotel Transactions Survey also shows that in 2006, the ten largest sales by price per room reflected an average of \$874,000. Moreover, of the sales tracked by HVS, 17 had a price per room greater than \$450,000, with the largest portfolio sale being Host Hotels & Resort’s acquisition of 33 hotels for \$4.1 billion.

In 2006, public companies, including hotel operators, continued to be net sellers. Large hotel companies, such as Marriott International, InterContinental Hotels Group (IHG), and Hilton Hotels Corporation, continued to sell assets in order to raise capital and meet stock market expectations. As a matter of fact, companies in favor of a separation between “bricks and brain” pointed out that the stock market is more likely to better value hotel companies with less ownership than those involved in real estate. According to Mark Abramson, former Senior Managing Director at New York-based investment bank Bear Stearns & Co., Inc., the need to divest real estate was understandable since the public equity market was not rewarding hotel companies for the value created in these assets to the same degree that private equity and hotel REIT investors were willing to provide. Nevertheless, questions remain: Should public equity markets own hotel companies? For how long will these companies be listed on a major exchange? We should now examine both buyers’ and sellers’ (*hotel operating companies*) value drivers and focus on the potential pitfalls of asset-light strategy for hotel companies over the long term.

SELLING THE FAMILY JEWELS

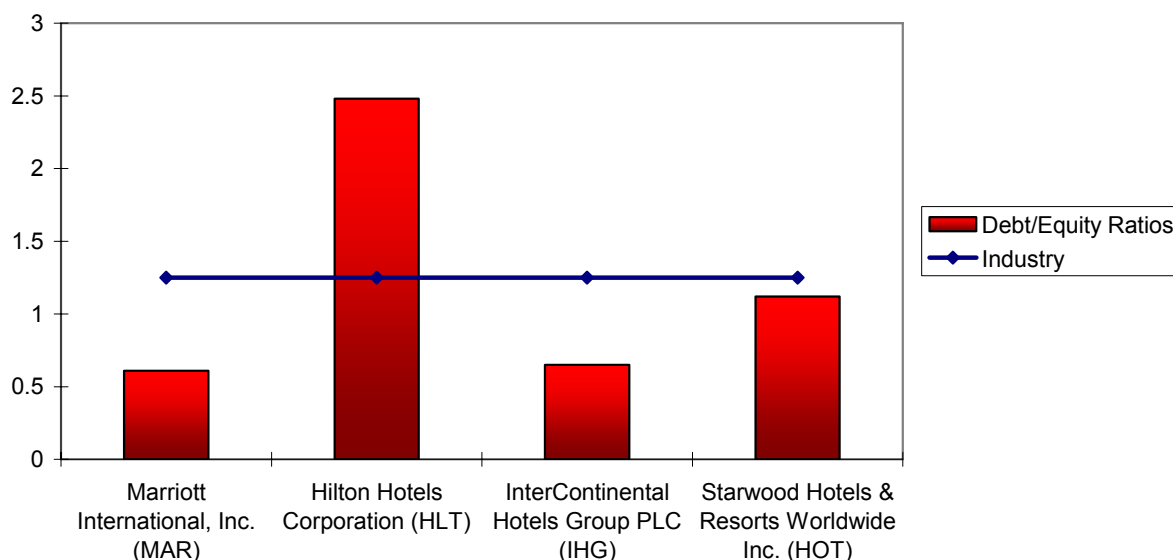
In 1993, Marriott Corporation decided to split up its hotel business by creating two different entities: Host Marriott (now Host Hotels & Resorts) as the largest REIT owner of luxury and upper upscale properties, and Marriott International. The objective was to manage and franchise hotels and operate the management services and distribution businesses¹. At that time, most hotel chains still believed that one way to grow was to add real estate to their “collection.” Nowadays, the hotel industry has changed, and major players have made concerted moves, focusing on the higher-margin operating business. However, the gains from the sale of these core assets are one-off, and it could take years or even decades to recreate a portfolio of owned properties of the type that major hotel chains have recently sold. In 2006,

¹ <http://marriott.com>

public lodging companies dominated the seller side, demonstrating the asset-light trend, enabling each stakeholder to focus on core skills. As noted by Gisle Sarheim, Vice President at HVS, New York, “while the traditional ‘own/operate’ model has proven successful for small private hotel companies, it has become a hurdle for larger public lodging companies.”

However, over the long term, one of the major risks for hotel groups applying asset-light strategy might be the loss of control of their assets. By taking a hotel operating firm private, investment vehicles such as private equity firms could take over control of management agreements, hotel chains’ only bargaining power, and unencumbered properties. Recent transactions include the sales of the famous Hilton Metropole and Hilton Birmingham Metropole for GBP 417 million. According to Robert M. La Forgia, Executive Vice President and Chief Financial Officer of Hilton Hotels Corporation, Hilton’s asset sale program has delivered more than \$2 billion in proceeds since early 2005. In addition, he added that consistent with Hilton’s strategy to grow the managed and franchised business and reduce hotel ownership, the company intends to place additional hotels on the market; for example, Hilton recently agreed to sell ten properties throughout Continental Europe to Morgan Stanley Real Estate Fund for approximately \$770 million. As many hotel chains aligned with the asset-light approach, Hilton Hotels Corporation used the proceeds from sales to pay down debt and lighten its balance sheet. Such transactions usually allow hotel chains to regain large amounts of money to capitalize on opportunities and soften debt as a means of improving debt/equity ratios, earnings multiples, and returns on investment. In fact, major listed hotel chains require a constant flow of capital to meet equity market expectations and maintain a solid credit rating. This is the case with Marriott International, Inc., which focuses on management and franchise contracts, investing where expected returns exceed the cost of capital, selecting real estate development or temporary ownership to enhance management agreements, and recycling capital as part of its investment philosophy².

Figure 1 – Debt/Equity Ratio for Major Hotel Chains as of January 2007



Source: Reuters as of January 2007.

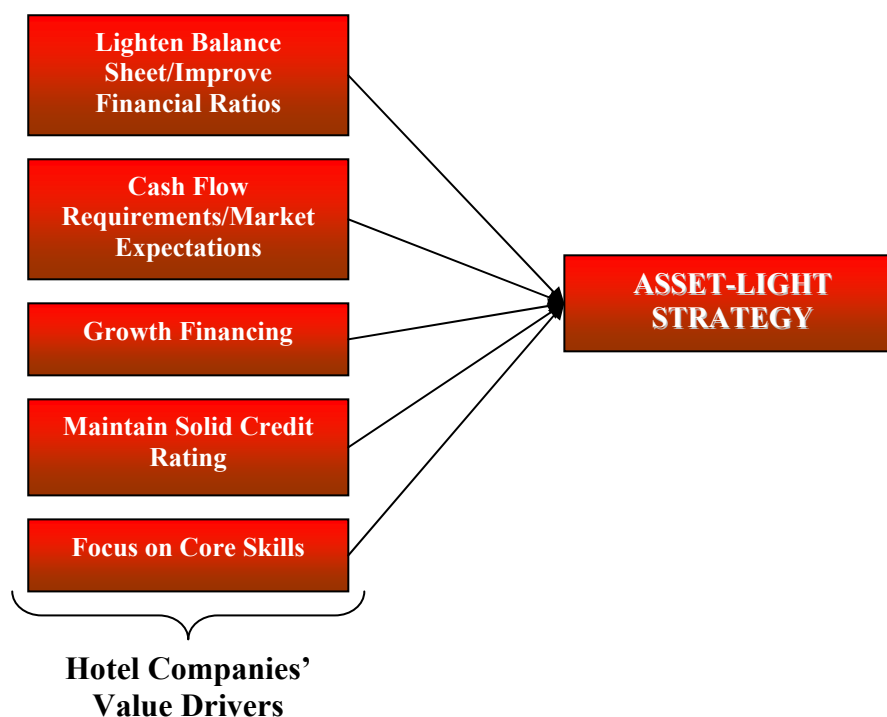
² Marriott International Financial Outlook, June 2, 2005. <http://marriott.com>

As illustrated in Figure 1, most hotel chains have debt/equity ratios below the lodging industry level, except Hilton Hotels Corporation, which completed a leveraged acquisition of Hilton Group plc, including owned assets (known collectively as “Hilton International”) for approximately GBP 3.3 billion (\$6 billion) last year (after trying to reduce debt as mentioned previously). Maintaining a low debt-equity ratio helps these companies preserve their investment-grade credit ratings and increases their debt capacity in order to finance future projects, thereby strengthening their financial flexibility. Furthermore, to finance their growth, hotel companies prefer to use internally generated funds rather than debt. In this respect, major asset-light companies do not really need the public equity markets to grow. Their capital requirements are usually low, even if they occasionally require minority equity investments to “purchase” management contracts. This means that the logic for being public with regular access to the equity markets is less compelling.

In Europe, the asset-light strategy has been a popular way to unlock capital by selling the asset while ensuring control with long-term leaseback and management agreements. During 2005, a number of both single-asset and portfolio transactions involved the use of management contracts. In a recently released report, Jones Lang LaSalle Hotels³ noted that InterContinental Hotels Group (IHG) has retained management contracts for approximately 88% of the 168 hotel properties divested since 2003. These figures include the sale of seven hotels in continental Europe in 2006 to Morgan Stanley Real Estate Fund (MSREF) for €634 million (\$805 million). As an integral part of the deal, IHG agreed to 30-year management contracts on the hotels with two ten-year renewals at IHG’s discretion. This provides IHG with a potential contract length of 50 years. MSREF has agreed to make capital investments in the portfolio of approximately €60 million (\$78 million), including the implementation of new brand initiatives and the addition of expanded facilities at these properties.

Utilizing management contracts can help hotel operators build a strong brand footprint. However, it can take many years to do so, a time horizon that the global equity markets are not operating on.

³ Jones Lang LaSalle Hotels (2006), *The Hotel Ownership Pendulum in Motion*.

Figure 2 – Hotel Operating Companies' Value Drivers Affecting Asset Disposition

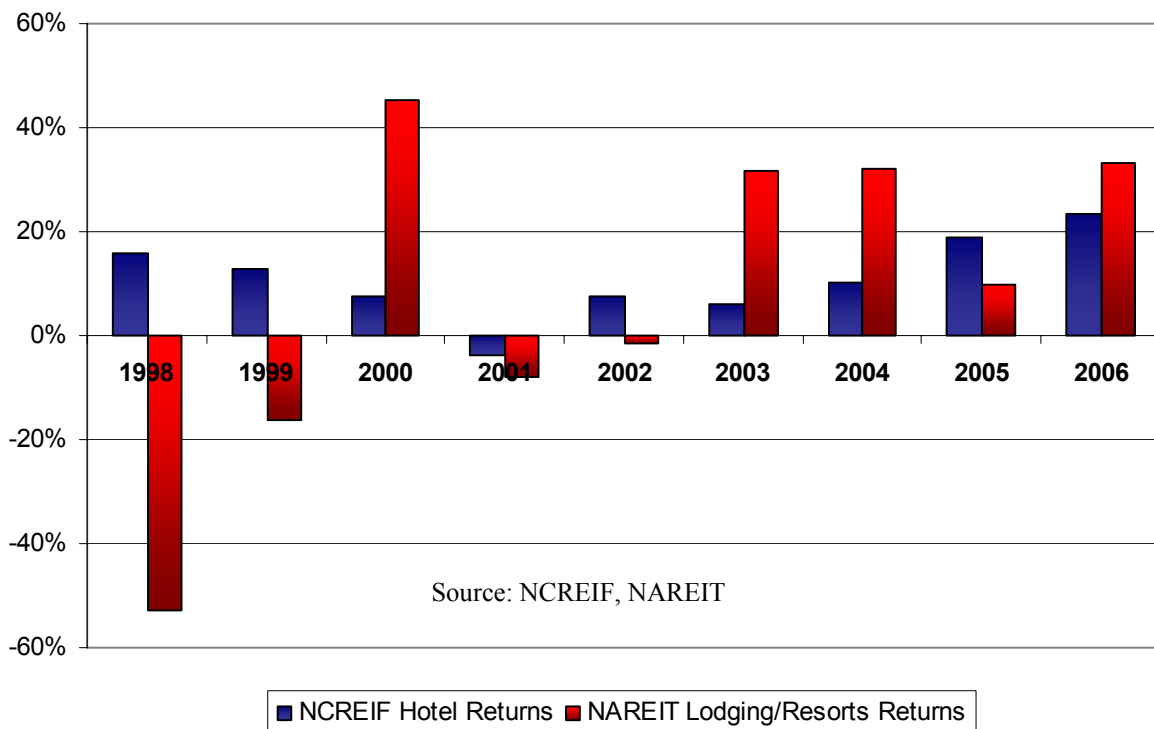
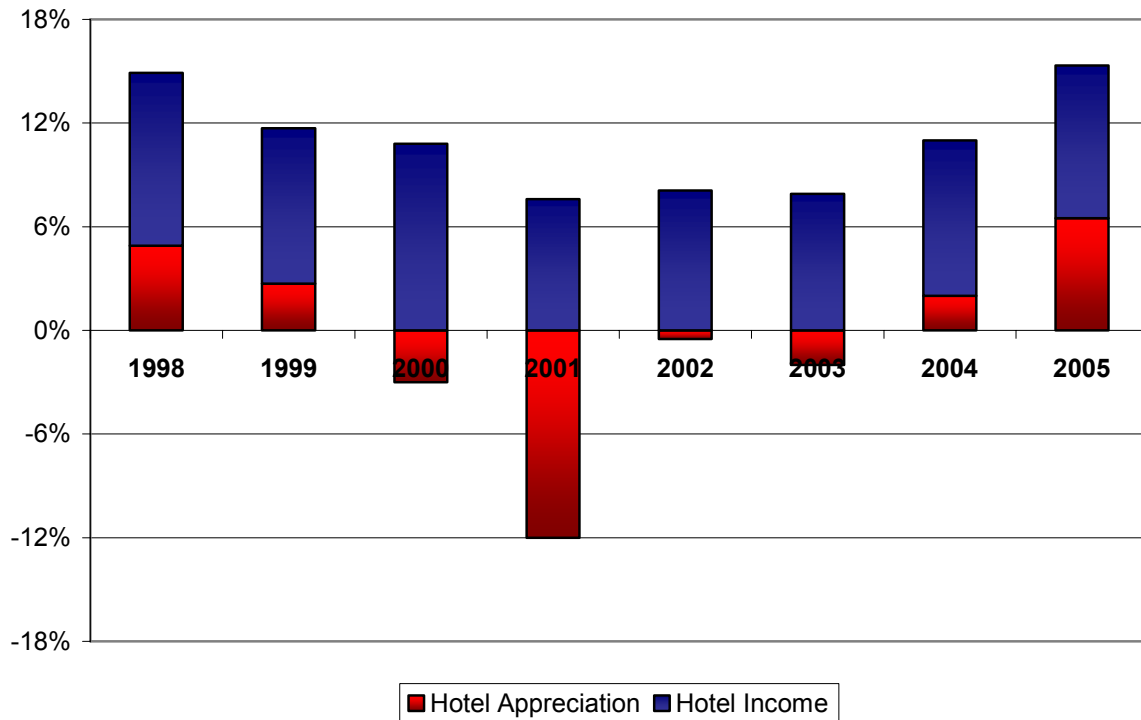
HOTELS AS AN ASSET CLASS: “HIGHEST AND BEST USE”

According to Allen Toman, Professor of Real Estate Finance at the Ecole hôtelière de Lausanne, hotel real estate, which was once considered an unattractive investment for being the most volatile product type, became attractive for passive investors starting in the late 1990s. The factors leading to this change in investor perception reflect the drivers that are drawing numerous investors to the hospitality industry.

- Hotel Returns

If we refer to the hotel returns compiled by the National Council of Real Estate Investment Fiduciaries (NCREIF), we clearly notice that the hotel property type had appreciation returns below its income returns from 1998 through 2005.

Figure 3 – Hotel Returns

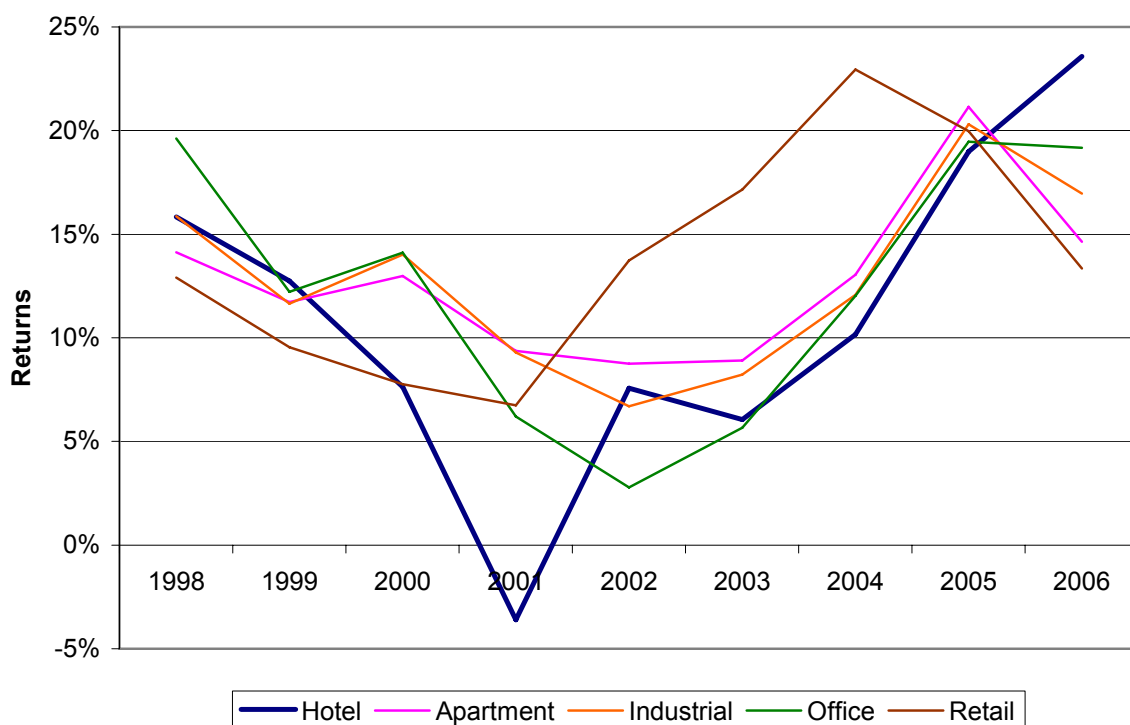


Source: NCREIF, NAREIT

In its 2006 Real Estate Capital Markets Industry Outlook, Deloitte reported that in 2005, hotels were the only property type with appreciation returns below their income returns. However, Deloitte noted that hotels are still attractive to many investors who are betting that the lodging industry will continue to improve as the economy is showing stable growth rates.

In addition, NCREIF hotel annual returns illustrate that hotel investments continue to be particularly appealing compared to other asset types. The following comparison of hotel returns and the returns for other property types shows that hotels generated a very attractive yield in 2006. The total return in 2006 was above the 20% level, at roundly 24%, increasing almost 25% from the previous year. Conversely, other major real estate rates of return decreased in 2006, with apartments presenting an even greater decline, of 31%.

Figure 4 – NCREIF Returns by Property Type

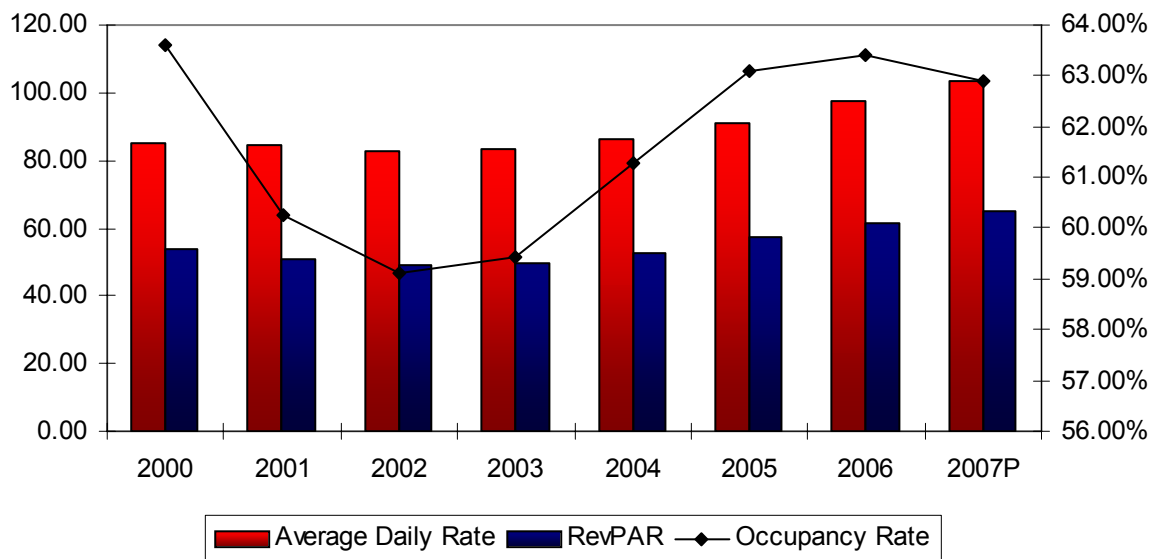


Source: National Council of Real Estate Investment Fiduciaries (NCREIF)

- Lodging Market Performance: Bullish Outlook

Over the last few years, the hotel market has gained in transparency as a result of more reliable and abundant data on hotel markets' performance as provided by firms such as Smith Travel Research, The Bench, The Daily Lodging Report, and HVS. The added transparency has reduced the hotel industry's perceived risk levels, resulting in an active hotel transaction and investment environment.

Since the September 11 terrorists attacks, the hotel industry has experienced a strong recovery as the global economy improved. With business travel increasing, demand outperformed supply as a result of the closing of several hotels for condominium conversion in major urban markets like New York. In fact, the supply of new hotel rooms is an extremely important driver for long-term health in our industry, and overbuilding can seriously hurt the lodging market's performance.

Figure 5 – U.S. Lodging Market Performance

Source: Smith Travel Research

While the hotel industry is highly correlated with macroeconomic indicators (e.g., GDP growth), the global economic outlook should support 2007 forecasts. Nevertheless, any increases in energy costs could affect airline companies, resulting in higher plane fares and curbing the appetite for travel in both the business and leisure segments. However, the weak U.S. dollar has increased foreign buying power, thus making travel to the U.S. seem affordable, despite ever-increasing airfares.

According to Mark Lomanno, President of Smith Travel Research, “The U.S. lodging industry turned in another strong performance in 2006.” He further states that “Industry RevPAR growth was somewhat lower than the all-time high of 2005. However, since 2004, RevPAR has grown nearly 24 percent – the strongest 3-year growth since STR began tracking hotel performance in 1987. We expect another good year in 2007. Room supply growth will likely increase but should remain below the long-term trend. Based on current economic expectations, demand growth should continue, with stronger numbers more likely in the second half. We believe full year 2007 industry RevPAR growth should be in the 5.5 – 6.0 percent range.”

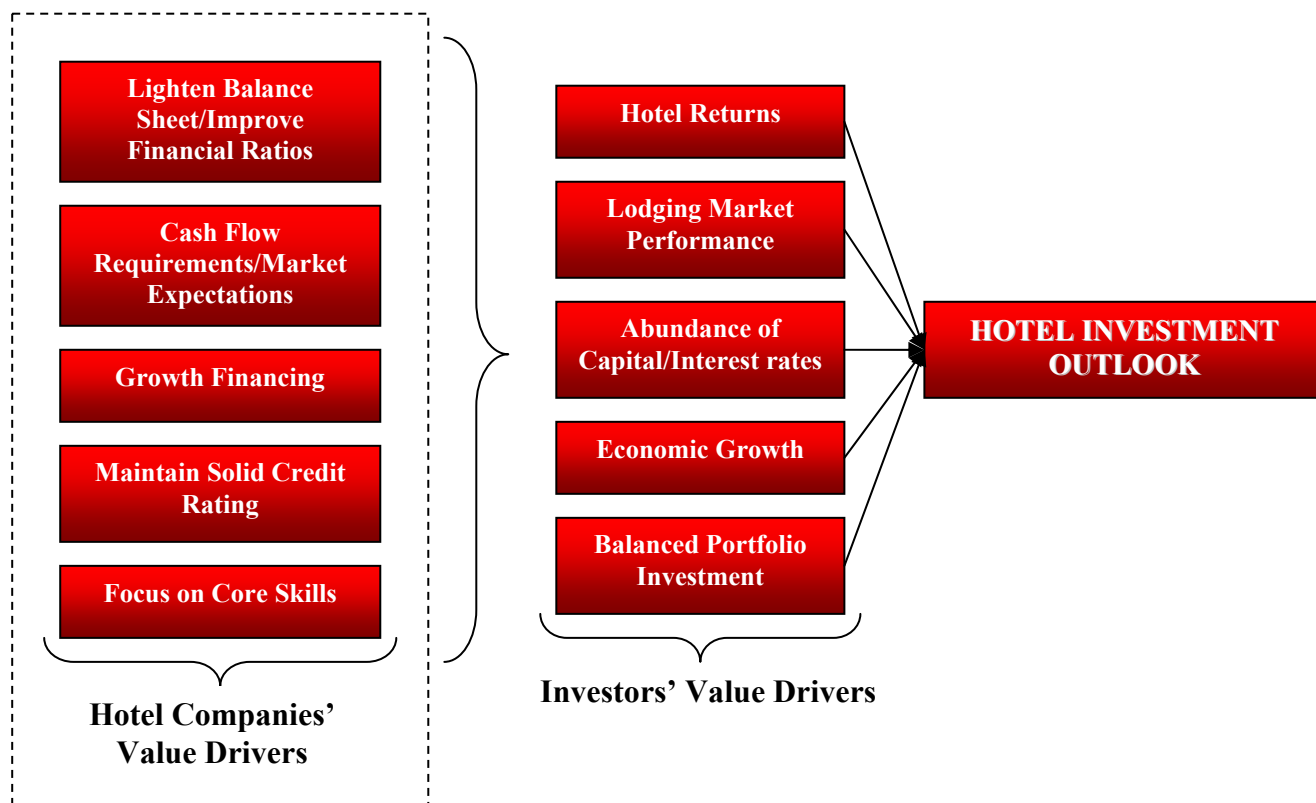
Moreover, as illustrated in Figure 5, future RevPAR growth will be rate-driven rather than the result of occupancy gains. Therefore, the sustained positive outlook for improved RevPAR is likely to positively affect hotel returns both in terms of income returns and appreciation gains into 2007 and beyond.

- Capital Availability

According to Anne R. Lloyd-Jones, Senior Vice-President at HVS New York, although the Federal Reserve implemented further rate increases in 2006, competition among lenders and optimistic expectations for the lodging sector led to narrower spreads, with the result that interest rates for hotel mortgages remained extremely low. Combined with higher loan-to-value ratios and other aggressive lending parameters, debt for hotel projects was more widely available, and at a lower cost, than at any time previously observed. At the same time, the number of equity investors pursuing high-quality transactions led to very competitive market

conditions, which put downward pressure on equity return requirements. These combined influences resulted in lower capitalization and discount rates, which in turn, supported higher values. As a result, 2006 was another strong year in terms of both transactions and values.

Figure 6 – Key Relationship Between Major Players' Value Drivers Affecting the Hotel Investment Outlook



In contrast to former periods, there are many reasons that justify why hotel real estate is widely regarded as an asset class. There are also more investors willing to allocate a greater portion of their investment portfolio to hotel real estate than in previous years as we see a growing confidence in the lodging industry as a source of sustainable income. The expansion of REITs as a tax-efficient investment vehicle also contributed to the actual outlook of the hotel industry. In the 1990s, many private equity firms could not compete with REITs, which were well accepted by Wall Street as a solid investment vehicle following the Modernization Act⁴.

At present, private equity firms are dominating the market, overwhelmed with low-priced debt. Jones Lang LaSalle Hotels noted that private equity firms' appetite for considerable levels of leverage can reach up to 95%. Conversely, U.S. REITs are restricted to 60% leverage due to their lower risk level and long-term investment philosophy. Furthermore, REITs have a competitive disadvantage when contrasted with private equity firms. Since 90% of REIT taxable income must be distributed annually as dividends, REITs aren't as financially flexible as private equity firms when it comes to investing in property improvements and capital expenditure requirements specific to hotels (i.e., increasing the value of properties, gaining

⁴ The U.S. Congress created REITs aiming to attract small investors to large-scale investments by creating publicly traded stock.

appreciation returns). Jones Lang LaSalle Hotels expects 2007 to bring additional investors to the hotel industry, including some non-traditional off-shore and high-net-worth investors as well as institutional, pension fund, private equity, and REIT off-shore buyers.

During the 2006 Americas Lodging Investment Summit (ALIS) in Los Angeles, Bear Stearns noted that every hotel firm is now a potential target, and that privatization will continue to hold up public market multiples. During ALIS, Bill Marriott, Chairman of Marriott International Inc., said that right now the hotel industry is facing a big question regarding private equity firms' motivations. "*I think something's going to happen,*" he said. Well, something big did happen a few days later when Morgan Stanley Real Estate acquired the second-largest hotel REIT in the United States, CNL Hotels & Resorts, at a price of \$20.50 per share for approximately \$6.6 billion for all the company's outstanding stock. Bjorn Hanson at PricewaterhouseCoopers LLP stated that the size of the CNL transaction shows that almost any lodging company, regardless of size, could be taken out.

To better understand the potential of private equity firms and their ability to raise capital, let's refer to the bidding war to acquire Equity Office Properties Trust (EOP) in which a group led by Vornado Realty Trust (including Barry Sternlicht's Starwood Capital) submitted a binding offer⁵ to buy Equity Office Properties for \$56.00 per share in cash and stock plus dividends (accrued from December 29, 2006, to closing) compared to a \$39 billion (including debt) offer from The Blackstone Group – the world's biggest leveraged buyout. On February 7, 2007, Vornado capitulated, leaving Blackstone the winner. As stated by Jim Butler, an attorney specializing in the hotel industry, it is clear that the largest private equity firms have a lot of capital to invest, and recent transactions suggest that some large companies may soon lose their ticker symbols. John Putrino, Managing Director at Credit Suisse Securities, said that such deals could involve major hotel operators.

So far, at least six publicly traded hotel companies in the U.S. have been taken private this year, resulting in transactions totaling over \$35 billion, including debt. The biggest hotel company acquisition in history was announced on July 3, 2007, when Hilton Hotels Corporation (HLT) entered into a definitive merger agreement with The Blackstone Group's (NYSE:BX) real estate and corporate private equity funds in an all-cash transaction valued at approximately \$26 billion. Under the terms of the agreement, Blackstone will acquire all the outstanding common stock of Hilton for \$47.50 per share, representing a premium of 40% over the previous day's closing stock price. It is anticipated that the transaction will close during the fourth quarter of 2007. This transaction will bring together Hilton's international hotel operations with Blackstone's significant portfolio of hotels and resorts to create the premier global hospitality business.

While Blackstone was reluctant to release information on its strategy, the following aspects should help in understanding the scope of the acquisition:

- *Strong International Growth:* With more than 800 hotels in the pipeline, Hilton will keep pursuing very aggressive growth worldwide, especially in Europe. Following the merger with Blackstone, Hilton will capitalize on U.S. brand portfolios such as Hilton Garden Inn and Hampton Inn, redesigned especially for the European market.
- *Synergies between Existing Blackstone and Hilton Brands:* Blackstone currently owns more than 100,000 hotel rooms in the U.S. and Europe, ranging from limited-service properties such as La Quinta Inns and Suites to LXR Luxury Resorts and Hotels. The

⁵ <http://www.vno.com>, Press release on February 01, 2007.

LXR collection includes such upscale properties as the Boulders Resort and Spa (Arizona), the El Conquistador Resort (Puerto Rico), the Boca Raton Resort and Club (Florida), the Golden Door Spa (San Diego), and the London NYC (New York). With regard to its growth strategy, Hilton will probably continue its asset disposition program and focus on growing fee business. The deal will help Hilton, adding strength in two of its key focus sectors (budget and luxury) and increase its presence in the U.S. and key international markets.

- *Synergies between Real Estate and Brand Growth*: Using its new hotel management company arm will enable Blackstone to be more active in hotel real estate acquisition and thus capitalize on the synergies between ownership and management.
- *Company Reorganization*: As a private company, Hilton/Blackstone can now refocus several of the resources associated with the stock market on internal growth. In addition, private ownership might facilitate the continued integration of Hilton Group plc (“Hilton International”).

For some mutual funds that purchased Hilton stock after the September 11, 2001, attacks, recent buyouts provided a significant premium, as the gain was nearly 500 percent a few days after the transaction. According to data from Lipper, Bank of America Corp’s Columbia Real Estate Equity Fund and Morgan Stanley Institutional U.S. Real Estate Fund are such funds. In late 2001, Hilton traded between \$8 and \$11, and Marriott International at around \$16 to \$20; a few days after the acquisition of Hilton, these stocks were trading at \$45 and \$47, respectively.

In addition to the acquisition of Hilton, other important recent deals included the US\$23 per share price for Equity Inns (to be acquired by Whitehall Street Global Real Estate for a total of \$2.2 billion) as well as Highland Hospitality Corporation (to be acquired by JER Partners for roundly \$2.1 billion). Further important transactions may occur in Europe within the coming months or in the next few years as private equity firms could still find value in buying large hotel businesses that exhibit strong growth capacity. This is the case for Kempinski, one of the oldest hotel chains, which already has several projects in the pipeline in key emerging hotel markets, such as Eastern Europe and China. By making the brand more appealing, Kempinski will prove the potential of its brand and gain global recognition. Kempinski’s asset-light structure through management and leasing contracts could be an attractive portfolio for hotel real estate investment firms like Kingdom Hotel Investments or Colony Capital, which focus on upscale properties in key destinations.

As the markets are getting more and more comfortable with the hotel industry, we can wonder how long hotel operating companies will be listed on major exchanges and if privatization is likely to continue since “size” doesn’t seem to matter anymore. The question is whether hotel companies, given the asset-light strategy, are good businesses to be owned by the public markets. According to Mark Abramson, if companies take the asset-light approach to its furthest logic, they would find (in most cases) that the remaining hotel management businesses do not have sufficient scale to be fully valued as public companies. A hotel operating company that is completely asset-light needs to have such a large number of hotels under management in order to have the cash flow and valuation sufficient to be listed in a major exchange (e.g., NYSE) that this is unachievable in all but a small number of cases. So a pure asset-light company will never be valued to its fullest as a public company.

During the past couple of years, hotel investment and transaction activity has been substantially supported by sophisticated CMBS/debt markets. The CMBS market in particular has proved to be a successful way of generating funds available for lending, while at the same time reducing lenders' exposure, and permitting institutional investors to further diversify their investments into asset-backed securities. This seemingly perfect model has, however, taken a major fall in the past couple of weeks, resulting in day-after-day stock market declines. The unavoidable sub-prime disaster, followed by a meltdown in the CMBS market, has sent ripples throughout the debt-hungry private equity market. As stated by Gisle Sarheim, spreads on CMBS deals have increased significantly, resulting in sharp declines in origination, and according to several sources, have resulted in some banks stopping quoting on new loans altogether. Banks will not be able to continue to quote until they sell the illiquid positions on their books. Sarheim further adds that for the private equity players, this is bad news. Banks are facing a challenge in placing billions of dollars in leveraged debt from corporate buy-outs such as Kohlberg Kravis Roberts' acquisition of Alliance Boots. "For private equity firms, this means increased interest rates and less-favorable repayment terms, which strikes at the heart of the deal in leveraged buyouts. If nothing else, private equity firms will have to reach deeper into their pockets or face a slowdown in deal velocity." Thus, the near future of the debt markets will be a major determinant in whether private equity firms will continue to seek out new investment opportunities in the hospitality industry as the major hotel companies continue their asset-light poker play.

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