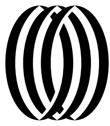

Jones Lang LaSalle Hotels

Hotel Sale-Leaseback Transactions

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Foreword

Sale-leaseback deals have been part of the property markets since the early 1970s, but not until recently have they emerged as a viable alternative financing structure within the pan European lodging industry—starting in the UK and expanding to France and Germany as a result of more favourable accounting treatment and recently gaining popularity in Spain. Investors have developed an appetite for larger portfolios of hotels to fast-track representation in the sector, and the sale-leaseback structure provides the necessary capital to acquire such portfolios. This is evidenced by the nearly €3.5 billion invested over the last two years in European hotel sale-leaseback transactions. There is also an increasing willingness by investors to accept a variable income stream to share in rental growth but having their required minimum return underwritten by the hotel operator as tenant.

Although there is considerable capital across the world that could be accessed by hotel companies, the key issue is accounting treatment of leases and the effect on corporate worth. Creative structuring can allow access to capital whilst not placing too heavy a liability on the leasing company.

In this edition of ***Hotel Topics***, Jones Lang LaSalle Hotels explores the advantages and disadvantages of hotel sale-leasebacks and the likelihood that the structure will emerge in the Americas and Asia Pacific. We also provide a breakdown and examination of the deals that have transpired in Europe over the past two years. Also, featured is an interview with Desmond Taljaard, Director & Senior Vice President of Hilton International, who constructed one of the UK's largest sale-leaseback deals—the sale of 11 hotels to the Royal Bank of Scotland—which freed up £312m (US$454 million) of investment capital for Hilton.

I trust you will find this edition of ***Hotel Topics*** insightful. We continue to appreciate your feedback. For comments on this edition, please contact me or Michelle Webb (michelle.webb@ap.joneslanglasalle.com).

Peter Barge
Chairman and CEO
Jones Lang LaSalle Hotels

Overview of Hotel Sale-Leaseback Transactions

By Anwar Elgonemy, Troy Craig and David Gibson

Sale-Leaseback transactions have come to the fore in Europe, although they have not taken off in the U.S. or Asia Pacific. This article examines the advantages and disadvantages of sale-leasebacks, benchmarking the trends in the hotel market against the wider real estate market.

Introduction

Listed hotel companies are under constant pressure from global equity markets to raise cash and cut debt as a means of improving debt / equity ratios, returns on capital and earnings multiples. Selling non-core hotel property assets and leasing them back from purchasers can help to improve such performance measures and permit greater investment in expanding core business areas.

Apart from the immediate injection of cash, the hotel company moves the slowly appreciating property asset off its balance sheet, eliminating a "burden" on earnings. Generally speaking, property usually returns an average of 10% a year, while a listed hotel company may be seeking much greater returns. The buyer benefits from acquiring a stable asset with very sound returns based on long term leases to blue chip hotel companies being in place.

For listed hotel companies, a key performance benchmark is the rate of growth in the spread and depth of market penetration on a global basis. This need requires a constant flow of capital and therefore the sale and long-term leaseback of established properties represents an alternative source of much needed capital.

Real Estate Sale-Leasebacks

Owners of real estate generally finance property acquisitions in order to reduce their cash investment. The two principal disadvantages to owning real estate that is subject to debt are: (1) The debt shows up as a liability on the owner's balance sheet, and (2) financing is generally limited to a specified percentage of the fair market value. The sale-leaseback transaction therefore offers owners another financing alternative.

Real estate sale-leaseback investments have bond-like characteristics and therefore they especially appeal to passive institutional investors. They typically provide a stable, predictable cash flow, act as a moderate inflation hedge and have lower volatility than multi-tenanted commercial property investments, due to the long-term contractual nature of their income stream. This is more so the case with hotels where owners' returns are especially vulnerable to fluctuating earnings that move in close tandem to the local hotel market cycle. Hotel investment with long term leases in place (as opposed to management contracts), protect owners from such vulnerability, thereby increasing their appeal to passive institutional investors.

With too much equity tied up in hotel real estate, a sale-leaseback can help in freeing up cash, unlock the value in the real estate assets and provide capital necessary for the hotel company to expand market presence.

Given the lengthy term of most of the leases tied to these investments and their consistency of income stream, real estate sale-leaseback investments typically offer less significant capital (appreciation) potential. However, during downturns in the property market, sale-leaseback investments commonly outperform core real estate due to their guaranteed income orientation and credit quality of the "blue chip" lessees. During periods of real estate market recovery, these investments are likely to trail the benchmark indices because there is limited opportunity to quickly re-lease a sale-leaseback property for higher rents.

Advantages and Disadvantages of a Sale-Leaseback

Sale-leasebacks are particularly desirable for hotel companies intent on reducing balance sheet assets to improve financial and earning ratios as well as return on capital. The financial statements of companies owning real estate without corresponding mortgage debt show the value of each asset on one side of the balance sheet, and the related equity investment in the property on the other.

Unlike mortgage financing, where the amount financed is typically less than the full value of the property, a sale-leaseback affords financing equal to 100% of the market value. Because in most countries sale-leasebacks can be treated as "off-balance-sheet", financial ratios are improved. Return on assets and on invested capital increase, improving the company's credit profile and widening the range of alternative vehicles available for future financing.

The Seller

Advantages	Disadvantages
Release scarce capital for higher returns and to grow hotel market penetration on a global basis	Diminished autonomy in relation to future capital expenditure
Debt reduction enhances liquidity and credit rating	Leasehold value diminishes rapidly, representing a significant loss
Lowers debt to equity ratio and enhances earnings ratios	Loss of ownership on lease expiry
Provides guaranteed tenure and market presence without locking up capital	Loss of future asset appreciation
Seller (as the ultimate tenant) is in a strong negotiating position from the outset when formulating lease terms	Lease payment likely to be greater than interest expense
Long term tenancy covenant can enhance the asset value	Credit agencies may attribute a debt service coverage factor to the lease payments
Rental payments are tax deductible	Lease can become a contingent liability (U.S. issue)
Leases more valuable than management contracts	Stigma attached to "off balance sheet" items in the post Enron environment
Plentiful purchasers due to expanding pool of passive institutional funds seeking a diversified property investment portfolio	
Ability to negotiate flexible lease terms as part of the transaction	

The Buyer

Advantages	Disadvantages
Allows passive institutional investors to diversify property investments into hotels without the problematic volatility usually associated with the asset class	Being aggressive with the seller may give the buyer an investment without a tenant
Able to recoup the assets in the future	Either the price or the rent will be to the seller's advantage; quite often both
Capital appreciation (primarily on leases with variable rental)	Totally reliant on the business success of the tenant operator
Ability to select blue chip operators as tenants	Real estate and hotel market risk
Low risk investment provided the credit worthiness of the tenant operator is properly assessed	Functional and economic obsolescence issues are especially pertinent for hotels
Depreciation allowances	
Wide choice of hotels / markets available given the acute need of operators to release capital to expand market penetration and improve financial performance measures	

There are downsides to hotel sale-leasebacks, however. Companies may find they can be more flexible with a hotel they own rather than lease, particularly when dealing with renovations, expansion, etc. In some cases, companies that have recently sold property assets can have their credit downgraded as a result. Furthermore, the accounting regulations in some countries require the contingent liability of the total rental payments to be recorded as a contingent liability on the balance sheet against the capital value of the lessee's interest. One market response to this has been the breaking down of the total lease term into shorter periods (ie 10 years) with the renewal option at the election of the lessee.

Sale-Leasebacks in the Hotel Sector

While the sale-leaseback concept has been widely applied in the non-hotel property sector for decades, it is only recently that it has been adopted in the hotel sector. Given the constant need for hotel companies to expand global market penetration levels and the expanding pool of passive institutional capital seeking a more diversified property investment portfolio, hotel sale-leasebacks are likely to become increasingly common.

In Europe, such deals have been gaining increasing prominence over the past two years. Over the past two years, around €3.5 billion was invested through variations of the sale-leaseback structure. The highest profile deal was Nomura's sale-leaseback of the major part of the Meridien chain. The Royal Bank of Scotland (RBS) invested £100 million of equity in the portfolio and entered into a £1.25 billion sale-leaseback of the hotel assets, enabling Nomura to win the contested public bid to acquire this chain. Prior to this transaction was the Hilton sale-leaseback (also backed by RBS), where Hilton's rent is based on 25% of turnover of which only approximately 4% is guaranteed. The interesting characteristic of these transactions is that the linking of the lease rental obligations to turnover (with a low guaranteed rent) enables RBS to benefit from the above-average growth prospects they see in the lodging sector.

The upside for Hilton is a cash infusion that could be used for acquisitions, paying down debt and engineering a jump in EBITDA. The upside for RBS is a share in capital and real estate appreciation, the bond-like income of the 20-year lease and the potential for amortising the debt. The downside from the operator perspective is that it is committed to a 20-year lease obligation, which in the U.S. would need to be classified

as a contingent liability on its balance sheet. In addition, such a structure would result in the operator not participating in the capital growth of the asset.

In the United States, Marriott is a good example of a balanced approach. By capitalising on its relationship with the asset-owning company Host Marriott to enter (as the owner) into a management agreement with its operating company Marriott International, there are no long-term financial obligations of either party that might adversely affect the credit rating of either entity.

In Latin America, one of the larger users of the sale-leaseback is Club Med, which operates seven resorts in the Caribbean, five in Mexico and two in South America. Three of their resorts are currently under the sale-leaseback structure: Ixtapa, Cancun and Turks & Caicos. The paramount reason for Club Med committing to these three sale-leasebacks is for tax purposes, receiving tax deductions on the rental payments.

In Asia Pacific (excluding Japan) such transactions have yet to eventuate which is indicative of the cultural resistance to selling real estate in the region generally. However, since the financial crisis of 1997/98 some hotels have been offered in the market place on a sale-leaseback basis although none of these have actually progressed to confirmed transactions. Given that the same balance sheet/expansion pressures are present in this region, sale-leaseback transactions are likely to emerge in the years ahead.

In Japan, several sale-leaseback transactions have occurred over the past few years, and these have arisen due to the severe balance sheet pressures that many owners have faced in a very difficult economic environment. In addition to this, historically there have been very few pure management contracts in Japan and therefore hotel leases are more common there than in other parts of Asia. Recent transactions include the JPY16.5 billion sale of the Hotel Okura Kobe to AIG, which demonstrates the typical profile of sale-leaseback deals.

The tax laws governing leases are based on a number of complex rules, and each transaction needs to be reviewed in light of these rules since the treatment of sale-leasebacks varies from one country to another, although the basic parameters are generally similar. Before entering into a sale-leaseback, management should therefore consult with financial and tax advisors.

The Future

There are a number of factors which point to the continued growth of the sale-leaseback option for owner operators of hotels. These primary drivers include:

- The significant difficulty in obtaining long term tenure in management contracts for the operator.
- The increased pressure to generate improving returns on capital.
- The increased requirement of owner operators to utilise capital for expansion of its network.
- The reorganisations which arises as a consequence of mergers and acquisitions.
- The improving ability of the hotel management sector to generate greater returns from their operations.

All of these factors will combine to give owner operators greater confidence in absorbing increased risk levels when it comes to backing their own performance in the management of hotels.

European Sale-Leaseback Structures

By Core Martin and Mark Wynne-Smith

Sale-leasebacks are not a new phenomenon to the global real estate markets. However, the increasing use of this structure within the European hotel real estate sector in the recent past has meant that sale-leasebacks are now emerging as an established form of alternative financing within the pan European lodging industry.

Sale-leasebacks have frequently been used as a preferred method of financing hotel acquisitions in a number of European countries — mainly Germany and France. The investor base is growing and now includes open and close ended property funds together with pension funds, high net worth individuals and property companies. Alongside this appetite for hotel real estate is a willingness by investors to accept a part fluctuating income stream as opposed to the old style, fully fixed-index-linked rents on a 30-year term, which were akin to bond investments with no relationship to the hotel business being undertaken in the building.

The following is a review of the most recent sale-leaseback deal structures closed in Europe together with some insight as to how the market may develop over the next two years.

Europe

The first ground breaking sale-leaseback deal, which initiated the extensive use of the part fixed, part variable rent structure, was the 1999 acquisition of nine, non-core Hilton hotels by Norwich Union, a UK Pension Fund. Norwich Union subsequently leased the nine properties to Jarvis Hotels with the rent structure being mostly guaranteed, but with a profit share. A number of subsequent deals occurred in a similar vein, and these are described in the table below.

The deals listed total just under €3.5 billion that was invested over the last two years which represents a major shift in attitude by investors.

The first continental European portfolio sale-leaseback deal occurred in 2000 with the acquisition of Accor's Novotel portfolio by the German Fund, Deutsche Grundbesitz-Investmentgeselschaft mbH (DGI). Accor de-invested the capital tied up in their Novotel hotels in Spain, two in Madrid and two development projects in Barcelona and Seville, committing to 20-year leases with the option to renew.

In March 2001, the Royal Bank of Scotland acquired 11 Hilton hotels. Hilton took on a 20-year lease for nine of the properties and a 30-year lease for Hilton Hyde Park and Glasgow Hilton. Payments were linked to turnover, not profits, with 25% of total revenues being the variable rent set. Second, the guaranteed element was limited to a comparatively low 12.5% of turnover or 5% of the sale proceeds. This structure favoured both the operator, who reduces its risk for periods of slow performance, and the investor, who benefits from the upside of the market and the growth prospects of the lodging sector.

In June, the Royal Bank of Scotland acquired another 12 hotels from the Compass portfolio to support Nomura's acquisition of Meridien. The lease structure is similar to that used within the Hilton deal having a 30-year term with options to extend for a further 10 years. The portfolio was formed by six properties of the Le Méridien, the Cumberland Hotel in London, bought separately by Nomura, and five hotels from Principal, which had been acquired by Nomura in January. This deal allowed Nomura to finance its bid for Le Méridien portfolio beating Marriott, who were the most competitive trade buyer. The Royal Bank of Scotland again

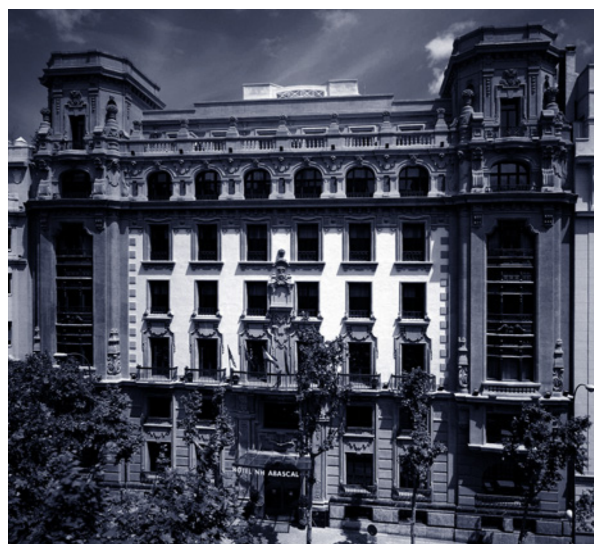
Sale-Leaseback Transactions in Europe

Portfolio	Country	Date	Rooms	Purchaser	Vendor	Price (000'€)
37 Thistle Hotels	UK	2002	5,500	Orb Estates	Thistle Hotels	950,500
4 NH Hotels	Spain	2002	643	Ponte Gadea	NH Hotels	91,500
12 Nomura Hotels	UK	2001	4,318	Royal Bank of Scotland	Nomura	1,625,500
11 Hilton Hotels	UK	2001	2,131	Royal Bank of Scotland	Hilton Intern	490,000
4 Novotel Hotels (two existing + two developments)	Spain	2000	482 + 2 development projects	DGI (German Fund)	Accor	Confidential
7 Hotels	Spain	2001	2,300	Private Investor	Airtours	110,000
5 Hotels	Southern Europe	2000	2,119	Gothaer	Club Med	112,000
8 Premier Hotels	UK	2000	600	London & Regional	Premier Hotels	72,000

showed its confidence in the sector and its in-depth knowledge of hotel operations, achieving higher rate of returns.

In 2002, February saw the first Spanish portfolio sale-leaseback hotel deal. Joint ventures had been the favoured route with investors assuming part of the operational risk.

Ponte Gadea, Amancio Ortega's (high net worth individual in Spain) investment vehicle, purchased four NH Hoteles in Spain (located in Madrid, Lérida, Pamplona and Bilbao), which were leased back for 20 years for a fixed payment indexed annually with inflation. Amancio Ortega was attracted to the tourism hotel sector, Spain's largest economic driver, obtaining a conservative but profitable yield of slightly above the reported 7%.



At this time, NH Hoteles, as part of their plans for international expansion, were negotiating the acquisition of Astron's German portfolio. The need for cash was swiftly met by the sale-leaseback deal, which facilitated NH's international growth without compromising their distribution across Spain.

More recently, Thistle Hotels have sold some 5,500 rooms of their regional UK and London portfolio to Orb Estates for over €945 million. This is a uniquely structured deal. Although widely reported as a sale-leaseback, for the size of the transaction, it is arguably more innovative than the Hilton deal as it uses a management contract as the basis for flowing income to investors as opposed to a lease. Thistle will guarantee a minimum EBITDA of €70.65 million for the first 10 years. The operator will meet any shortfall with a cap of some €140 million for the 10-year period.

The sale will allow Thistle to pay back floating liabilities and use the remaining cash for development and strategic acquisitions. The purchaser obtains a 7.5% coupon, which will be used to finance the deal via 10-year money. This structure allowed Thistle to sell their regional portfolio at only a 2% discount to book values, which would have been hard to achieve without this structure. They used the EBITDA versus investment yield gap to good effect. Unlike the Hilton deal, Thistle should have a lower balance sheet commitment through the capped guarantee.

The trend that started in the UK and seems to be spreading throughout Europe stems from the appetite among investors to acquire larger portfolios of hotels as opposed to single assets.

A number of lessons can be learnt from these deals:

- Operators have used this structure as an innovative way of financing when other sources, mainly the stock markets and debt financing, turned their backs.
- The need for growth will motivate new sale-leaseback operations in the near future if equity and debt markets remain in their current conditions.
- Transactions involved several properties and have a number of key portfolio drivers to support them. The smallest deal was over €91M and the largest one reached €1.6 billion.
- Investors are mainly large financial institutions.
- Leases are negotiated for long terms, with a minimum of 20 years and a maximum of 30 years, often including renewal options.
- Payments linked to turnover with low guarantees are a win-win structure. The operator is not under pressure when the operation is at the bottom of the cycle, and the investor benefits from the upside of the market while maintaining a fixed minimum return.
- There has been a major change in attitude among the German funds that are eager to enter other European markets. Spain, in particular, is a desirable location due to the significant growth potential of its hotel real estate markets. There is now a willingness to accept a part guaranteed/part variable rent structure. This provides a bondable return opportunity at yields higher than those generated by other real estate assets on the base rent, but still with the opportunity to share in the real growth that hotel real estate has achieved on average over the last 20 years. Further rule changes in the constitution of the funds may see greater flexibility on this point in the future.

Future of Sale-Leaseback Deals

Hilton has recently announced that they would prefer to structure their portfolio to be equally balanced between owned, leased and under management agreements. Six Continents have also stated their preference for an equal balance between franchise, owned, leased and managed structure. This seems to prove the growing trend towards the separation of the real estate ownership from operation although operators still see themselves holding certain key assets or perhaps using their own capital to acquire assets and then recycling capital through a subsequent sale-leaseback. Hotel operators are under pressure from their stockholders who demand constant growth. Debt alone cannot finance this growth and, therefore, operators are facing the need for financing without loading their balance sheets with debt. The sale-leaseback structure meets this need successfully.

Increasingly, investors are recognising the potential of the hotel industry and are eager to invest their capital. However, they do not always understand the hospitality business and do not want to be burdened with the risk of the hotel operation. Again, and mainly for those more conservative investors, the sale-leaseback structure uses a base structure that can accommodate a number of innovative rent flow clauses enabling investors to tap into the growth of the individual assets.

The toughening conditions of the debt markets, worsened by the events of September 11 and the relatively poor performance of hotel shares in the stock markets, again point to the increasing viability of this structure in the future.

Recently, European hotel stocks have not performed at the expected levels. In fact, many hotel companies, like Thistle and Sol Meliá, have traded at a discount to their stated net asset value. Sale-leaseback deals release the value inherent in a hotel company's asset base, which has not been recognised by the equity markets - another reason why we expect to see more of these deals in the coming months.

Additionally, the use of sale-leaseback structures reduces the size of the assets on the balance sheet, enhancing financial ratios such as return on assets (ROA), return on equity (ROE) and the debt-to-equity (D/E) ratio in the process. This has an impact on the operators' rating and, consequently, may also have an impact on the stock market's perception of the operator. This may imply an increasing interest on the part of investors and, thus, a raise in market values.

Conclusion

The hotel sale-leaseback structure is mainly a European off-balance financing structure, and will probably remain most popular in that region. This structure satisfies the growth needs of operators, principally those listed, when debt markets are tough and equity markets do not recognise the value of the owned asset. Equally, it provides a secured vehicle for hotel investment to those conservative investors willing to benefit from the growing hotel industry.

Interview with Desmond Taljaard, Director & Senior Vice President — Real Estate, Hilton International Co.

In 2001, Hilton Group plc (the UK listed parent of Hilton International) announced a major sale and turnover (revenue)-based leaseback transaction for 11 hotels in the United Kingdom to the Royal Bank of Scotland (RBS). Described by industry observers as "ground-breaking" and by one stock analyst as the most significant hotel real estate transaction in the UK for the last three decades, the transaction raised £312m (U.S.$454 million) cash. Here we interview Desmond Taljaard, responsible for the transaction, about Hilton's perspective on the deal.

A) What was the strategic rationale for such a deal?

Hilton had been looking for a number of years at ways of recycling the significant capital tied up in its UK real estate. There were a number of drivers which led ultimately to Hilton's transaction with RBS in March 2001:

- Following the acquisition of Stakis plc (a UK 4-star hotel chain) in 1999, Hilton Group held nearly £3billion (U.S.$4.3 billion) in hotel real estate, with over 70% located in the UK.
- Hilton had aspirations to expand the brand in Europe, and the rest of the world, but limited capital resources to do this.
- We did not want to borrow excessively to finance our expansion if this would threaten our valuable BBB Investment Grade credit rating.
- Fundamentally, Hilton did NOT want to dispose outright of its core UK real estate which generates very profitable returns.

B) How did this strategic analysis translate into action?

The solution was the creation of a turnover lease instrument whereby the investor's primary return is a percentage of turnover, but a guaranteed base rent is offered to improve the investor's leveraged equity IRR.

Hilton offered the portfolio of 11 hotels to a variety of investors, including pension funds, privately held property companies, and private equity arms of banks, such as the RBS. Crucially, the results of the bidding process had to meet our primary objective: could we recycle the capital tied up in the core UK real estate portfolio, but at the same time retain the maximum freedom to operate these key assets?

RBS clearly understood our objectives and demonstrated great enthusiasm for the potential of the hotel sector. We closed the deal within 23 days of signing an exclusivity agreement.

The deal with RBS enabled us to achieve our objectives:

- Sold 11 assets for £312million (U.S.$454 million) at full vacant possession value.
- Retained long term operating agreements on core assets for up to 40 years.
- Turnover rent means we have a rental substantially linked to operational performance.
- Minimised guaranteed rent component which was covered 3 times by the hotel EBITDA.
- No capital gains arose on disposal.
- Positive impact on Hilton's gearing and fixed charge cover ratio.

C) Are you just replacing interest with rent?

That is a view some have, but we are realising the full value of the real estate today; we are not exposed to the property investment market on these assets. Furthermore, the rent is much more commercially palatable as it is performance related.

Critical to the attractiveness of this transaction is the fact that the guaranteed level of rent is below interest cost, so that borrowing capacity is actually improved.

D) How did the deal create value?

Beyond the financial aspects of the transaction, this was the question we had to keep asking ourselves — have we created shareholder value? I am happy to say the answer is 'yes'.

To refresh the numbers; the estimated turnover rent absorbed EBITDA of £22.5m (U.S.$32.7 million) sold for £312M (U.S.$454 million).

At an EBITDA multiple of 8.5 times, our shareholders expected £190M (U.S.$276 million) versus the £312M (U.S.$454 million) raised — ie: over £120M (U.S.$174 million) in shareholder value was added. On a practical level, the stock went up 7% within an hour of the deal being announced.

E) For such a good deal, why only 11 hotels?

This was driven by tax shelter — Hilton Group brought forward capital losses covered by any taxable gain. We are now in a position to do circa £300m (U.S.$436 million) efficiently.

F) What are the investment characteristics of the 11 hotels?

Remember, we have to operate these hotels as core brand "Hiltons" for the term of the lease. We very much share the same asset criteria as the investor; we both emphasise the asset's location and product quality. For the investor, brand and covenant are also critical.

G) Is there a future for these transactions?

Yes, we will be selling more real estate. We are currently exploring opportunities for the next two years in Euro-land, Australia and Canada. Hilton will always own real estate — it makes money. The split between ownership versus sale and turnover-based leaseback will be dictated by financial capability and the success of these first portfolios. We need to see first generation investors make a decent return, though, to entice wider participation.

The Potential for Sale-Leaseback Transactions in the United States

By Anwar Elgonemy

At present, sale-leaseback transactions are rarely used in the United States in third party hotel transactions, due to their often-required bondable guarantees and their long term, reduced flexibility. This article examines the viability of sale-leaseback transactions in the U.S. hotel sector.

Introduction

For hotel sale-leasebacks to be successful in the United States without substantial covenants, higher lease rates (or reversionary upside) may create a new segment of buyers, fueled by the consent that most markets are now poised for growth and the dearth of available hotel investments.

Accounting for Leases

Sale-leaseback deals have been part of the property markets since the early 1970s but are less common in the United States where only 33% of corporate real estate is owner-occupied, compared with approximately 40% in Latin America and 60% in Europe.

In the United States, there are two methods used to account for leasing by a lessee (the tenant): the operating method and the capitalised lease method. From a U.S. accounting perspective, an operating lease is one that has the characteristics of a usage agreement and that meets certain criteria established by the U.S. Financial Accounting Standards Board (FASB), resulting in off-balance sheet treatment.

The operating method requires no balance sheet disclosure of the future lease payments. Instead, the lease payments are recognised only on the income statement as a lease expense, when paid. Current standards require, however, that the minimum future lease payments be disclosed in the company's footnotes.

The capital method, on the other hand, treats the lease as if it were an asset being purchased on credit. Lease payments are treated as payments on an installment debt, while the value of the lease, which is recorded as an intangible limited-life asset on the balance sheet, is amortised over its legal life.

In the United States, sale-leasebacks with publicly traded companies (as tenants) are motivated to structure a lease under the operating method. An operating lease is advantageous when a company wants to keep debt off its balance sheet because indentured covenants require low debt-to-equity ratios and/or high interest coverage ratios.

Conditions Required to Qualify as an Operating Lease
(From the Lessee/Tenant Perspective)

1.	The present value of the minimum lease payments must be less than 90% of the fair market value of the property.
2.	The term of the lease must be less than 75% of the usable life of the property.
3.	The Tenant may not purchase the leased property at below its fair market value, during or at the end of the term of the lease.
4.	The Tenant may not receive a "bargain" purchase price for acquiring the property at the end of the lease term.

Current Sale-Leaseback Trends in the U.S.

The current sale-leaseback market in the United States is primarily being driven by office product. The typical criteria for sale-leaseback investments are summarised in the following table.

Real Estate Sale-Leaseback Typical Deal Structure and Criteria

Purpose	To liquidate long-term assets, thus improving the balance sheet while retaining control of the property.
Tenant	Usually strong middle-market to investment-grade corporate ownership or corporate holding companies. Lease is triple net bondable (lessee pays all costs associated with operation of the property).
Rental Rates	Calculated as a percentage of the purchase price, usually with embedded escalations throughout the lease term.
Term	15- to 20-year lease terms, with options to include up to four 5-year renewal periods.
Advance	100% of fair market value, usually $2.0 million and above.
Property	Conveyed via Warranty Deed; must have fee simple ownership interest in property; ground leases as exception only.
Preferred Properties	Office, industrial (distribution, warehouse, manufacturing and R&D), medical and retail.

The traditional sale-leaseback buyer in the U.S. likes the security of the "A" tenant, combined with a return spread over Treasuries, or other secure investments. If the guarantee is capped under the lease (common in Europe), some investors

in the U.S. might not be interested. CNL and Marriott have such capped guarantee arrangements where Marriott guarantees a fixed return — around 5% to 7%. With today's low interest rates, one could speculate that private placements (private REITs) may be able to use this mechanism, but the institutions would not.

The Enron Contagion

Off-balance sheet financing for publicly traded companies is likely to come under rigorous scrutiny in the United States as a result of the role that such financing played in veiling Enron's highly vulnerable financial formation. Because of its notorious profile as the largest bankruptcy in corporate history, the U.S. Congress is focusing on changes to laws governing off-balance sheet structures, the recording of subsidiaries' and/or limited partnerships' financial conditions, and any other forms of creative financial structuring. However, it is premature to speculate as to the breadth and depth of these potential underlying changes.

Implicit in the issue of off-balance sheet financing is the belief that if substantial quantities of debt can be kept off-balance sheet, then a company can be leveraged to a greater extent than would otherwise be possible. Whether this notion is valid or not is a fundamentally empirical question. In other words, can it be argued (after the Enron collapse) that since the stock market is supposedly information-efficient, investors will still be "confused" by the use of operating leases or other forms of off-balance sheet debt?

A similar argument might be made by lenders because operating lease payments are reflected in the income statement as a lease expense, and thus on any cash flow analysis prepared there from. If an investment (or lending decision) is being made on the basis of unadjusted debt ratios, then that decision is being made without an explicit consideration of the off-balance sheet debt. These are elements that will certainly be closely scrutinised by the U.S. Congress.

Lodging Sector Leases

Hotel leases in the U.S. basically appear in two forms: (1) Operating leases and (2) Lease arrangements required for REIT ownership. In either case, the lease payment is dependent on the hotel's operations and is rarely guaranteed.

Among the most active buyers of hotels in 2001 were REITs that maintain third-party (unaffiliated) relationships with their operator/tenants, namely CNL and Hospitality Properties Trust (HPT). The larger of the two, HPT, owns 224 hotels with some 30,400 rooms in 36 states that are operated by Marriott, Wyndham, Prime and Candlewood. HPT has made $2.5 billion in investments over the past seven years, collecting $240 million in security deposits and $260 million annually in minimum rents. In addition to the minimum rents, the REIT collects percentage rents (over a base year) that average 7.5% of total revenues. Initial lease terms range from 10 to 12 years, and typically permit one or two renewal options for similar terms.

The Negotiation Table

Since traditional sale-leaseback investors want security first and upside second, the key issues in negotiating a sale-lease back of a hotel between unrelated parties in the United States are as follows:

Key U.S. Hotel Sale-Leaseback Negotiation Issues

- The security of the cash flow is paramount; investors do not want the burden of operating risk.
- Investors will want rents set at fixed amounts that escalate at 2% to 3% percent to keep pace with inflation.
- Sale-leaseback investors often value the reversion at less than 100% of the current value; often times, the landlord is tax-motivated and is recognising significant levels of depreciation.
- With a U.S. publicly traded tenant, the lease may not involve any pre-determined sales prices at which the tenant is obligated to buy (or has an option to buy) without voiding the opportunity for off-balance sheet financing.
- The landlord will most likely obtain financing that matches the term and figure of the rent amounts (less their annual return); early termination provisions will be substantial, which reduces flexibility.
- The sale price at the end of the lease can vary drastically (10%-20%) if the property is sold encumbered or unencumbered by management. Accordingly, investors will want the assets to be sold unencumbered.
- Investors will want to monitor not only the financial viability of the asset but of the entity that provides the guarantees.

Innovative Structuring

Since traditional sale-leaseback investors require security first, the form and type of guarantee for the lease payment is the most critical issue in negotiating such agreements for hotels. For a seller/tenant that does not want to provide a traditional bondable guarantee of payment, the following is a list of possible alternatives. A bondable guarantee, essentially a form of financial security, is a burden on the lessee/seller required by the lessor/buyer in the form of a letter or credit or deposit to ensure that the lessee is credit-worthy.

Higher returns might prove to be sufficiently attractive to offset the lack of a guaranteed payment, although to date, investors seem unwilling to trade security for a higher yield.

However, currently in the United States the overall equity capital market outlook is quite strong for lodging investments, with investors indicating that they see various opportunities, particularly in 24-hour cities. At the same time, there is a lack of quality product being floated,

Seller and Buyer Negotiation Issues

Variable	Seller's Issue	Buyer's Issue
Escrow a percentage of the purchase price/escrow a set number of rental payments as a security deposit	Limits exposure Limits proceeds Higher price = higher deposit	Not bondable
Segregate rental payments into a more secure base amount and a higher risk percentage amount	Rent payments are reduced during downturns	Investor is able to participate in upside
Fixed charge covenants	Requires entity level reporting	Provides entity level security
Provide easily assumed vacant possession in the event of default	Potential loss of management	Greater control Higher proceeds upon sale
Credit insurance/enhancement by third party	No liability Additional cost	Provides unconditional guarantee

particularly in the upscale and luxury tiers. This strong buy-side sentiment, accompanied by a lack of hotel product, will cause investors to broaden their investment radar screens, potentially bringing new buyers of sale-leaseback positions into the market.

Combined with record low interest rates, the equity capital markets now favor hotel investments. Investor objectives could be provided through permitting the investors to participate in the appreciation of the asset through a "put" (sell) option, at which time the landlord could compel the tenant to purchase the asset at a pre-determined price on a pre-determined date.

An alternative to a sale-leaseback with an unaffiliated third party would be to set up a private REIT, structuring the ownership as a REIT and Tenant entity. Equity and debt could be raised offshore, and as most REITs in the United States are related parties, the process of raising capital would be somewhat facilitated. In addition to transactions with third-party landlords, Marriott has its own in-house REIT. Host Marriott enters (as owner) into a management agreement with its operating company, Marriott International.

U.S. Lessors/Landlords

The most active buyers/landlords in the hotel arena today are CNL, a private REIT headquartered in Orlando Florida; FFI, a private investment fund based in Dallas, Texas; and the previously mentioned HPT, a publicly traded REIT in Newton, Massachusetts.

HPT's portfolio is comprised mainly of limited-service Marriott brands such as Courtyard, Residence Inn, Fairfield Inn, SpringHill Suites and TownPlace Suites with a small number of AmeriSuites (Prime) Summerfield Suites (Wyndham) and Candlewood Suites, as well.

Candlewood Hotel Company recently completed a $145-million sale-leaseback transaction with HPT. The deal represents the sale of 21 Candlewood properties with a total of nearly 2,600 suites. The 21 hotels purchased have been added to an existing pooled lease of 36 Candlewood hotels, which HPT already owns and leases to Wichita-based Candlewood, creating one lease for all 57 hotels, representing close to 6,900 suites. The 57 hotels included in this combined lease are spread among 27 states, with an average age of 3.6 years. The proceeds of the transaction were used to repay a portion of the company's mortgage debt, repay unsecured corporate financing with Hilton Hotels Corp. and provide working capital. Additionally, Candlewood refinanced its remaining short-term mortgage debt with a new $55-million note provided by GMAC Commercial Mortgage. The new note is for three years, with a one-year extension.

CNL has invested $1.75 billion in hotels since 1998, and also deals with household brands such as Marriott and Hilton. CNL, which owns some 12,400 rooms, is proactive in the monitoring of its hotel investments, and maintains an asset management department that routinely inspects properties, reviews budgets, capital expenditures and monthly operating statements.

Term Renewals and Exit Strategy

In general, initial terms and renewals are set by the remaining life of the asset; with a publicly traded tenant, the deal must not be set up to exceed 75% of the remaining asset life. Thus, for a 10-year-old suburban hotel, the maximum term might be 25 years, whereas for a steel-frame city center hotel the initial term and extension might go to 30 years.

As mentioned earlier, the typical exit strategy of an arms-length investor presumes the appreciation of an asset, rather than its depreciation. If the tenant is not a publicly traded entity in the United States, the door is opened for pre-determined sale prices at which the tenant may be compelled to buy-back the asset, or at which it may compel the seller to sell back the property. This feature may be used to increase the yields to the landlord.

The REIT as an Alternative Structure

All variables considered, the formation of a sale-leaseback transaction for a hotel in the United States without significant guarantees could be challenging. Nonetheless, another

structure that unlocks real estate value (while maintaining control) is the establishment of a private or public REIT.

And what is the outlook for the REIT market? Currently, earnings growth has slowed, but remains surprisingly stalwart despite rising basic insurance rates combined with a lack of affordable terrorism insurance. On average, REIT shares are up about 8% this year compared with a 6% loss for the Standard & Poor's 500.

Real Estate Investment Trusts
Daily All REITs Price Index (December 1998 to May 2002)

Source: National Association of Real Estate Investment Trusts (1971 = 100)

Investors are attracted by the high yields of REITS, their annual dividend payouts and earnings visibility. REIT valuations remain generally attractive with relative multiples near their all time lows, and share prices below Net Asset Value (total asset value + cash – net debt). For the most part, real estate markets are still in reasonably good condition despite the impact of the economic slowdown on real estate fundamentals, and should be muted by the absence of oversupply.

As the returns on REITs compare favorably to the S&P 500 in terms of the relatively low interest rates offered by other fixed income vehicles, and as investor fears are assuaged over the next two quarters, the outlook for raising equity for REITs looks upbeat.

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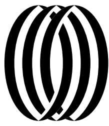

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