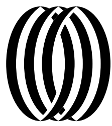
Issue 14 - July 2003



Jones Lang LaSalle Hotels℠

A Global Comparison of Hotel and Office Real Estate

In this issue

Trading Performance Relationship	1
Investor Insights - Part 1	8
Investment Performance Relationship	9
Investor Insights - Part 2	14
Hotels' Role in an Investment Portfolio	15

Foreword

As the hotel market matures and investment vehicles become more sophisticated, there is an increasing level of interest from non-traditional hotel investors. Furthermore, the popularity of property during uncertain economic times, a growing pool of institutional funds and the diminishing supply of quality investment grade real estate provide real opportunities for hotels to enter the mainstream investment sphere.

However, one impediment to institutional hotel investment is a lack of global investment data to enable prospective investors to compare hotels with other forms of real estate, such as office, retail and industrial segments with which they are more comfortable.

This edition of Hotel Topics takes steps to rectify this by comparing hotels to office real estate in terms of trading and investment performance.

Our first article examines the relationship between supply, demand and rentals for hotels and offices across key markets around the globe. Our analysis shows that hotels react more quickly to external events however they have the benefit of recovering more quickly than their office counterparts. In this way, hotels can be seen as a predictor for office performance. We also confirm that as they are tenanted daily, hotel occupancies are more volatile than office vacancy rates.

This trading fluctuation has pricing implications, and in our second article, we compare the investment yields of offices and hotels. As expected, the inherent volatility of hotel returns justifies higher return expectations, but where hotels are leased, hotel investment yields are more closely aligned with the commercial sector.

Given these relationships, we suggest there is a place for hotels alongside offices in an investment portfolio. The final article compares the cycles of hotels and office sectors and identifies the risks that need to be managed in order to maximise returns of diversified portfolios.

We trust you find this edition of Hotel Topics informative and thought-provoking. If you have any comments, please forward them to me or Michelle Webb (michelle.webb@ap.joneslanglasalle.com)

Arthur de Haast
CEO
Jones Lang LaSalle Hotels

Trading Performance Relationship

Chee Hok Yean, Senior Vice President, Singapore.
Michelle Webb, Vice President, Sydney.

As the hotel market matures and investment vehicles become more sophisticated, there is an increasing level of interest in the sector from non traditional hotel investors. These investors are quite often institutions which are familiar with the performance of office and retail sectors, but unfamiliar with hotel market behaviour.

This article aims to determine the existence and form of the relationship between the performance of the hotel and office sectors. Identification of the relationship could assist experienced as well as new investors to pre-empt the behaviour of these sectors in the future.

In order to determine whether there is a logical link between the performance of hotels and office real estate, we need to examine the drivers of demand for both sectors.

The office market is impacted by the growth of the local economy and corporate profitability, which can be measured in terms of GDP, white collar employment rates and business sentiment, whereas in addition to these influences, hotel markets rely on a variety of factors depending on their location and business mix. For example, international hotels are also influenced by the economic conditions of their inbound source markets and domestic leisure hotels are affected by the level of disposable income and consumer sentiment in the home market. In resort areas, extraneous variables such as access, airline capacity and infrastructure greatly affect the performance and growth of the local hotel market.

"We would expect a positive correlation between the performance of office real estate and hotels in CBD areas."

Given these factors and our focus on CBD markets in each region, we would expect a positive correlation between the performance of office real estate and hotels in these areas. As we have restricted our scope to four to five markets in each region, this paper represents preliminary rather than comprehensive analysis.

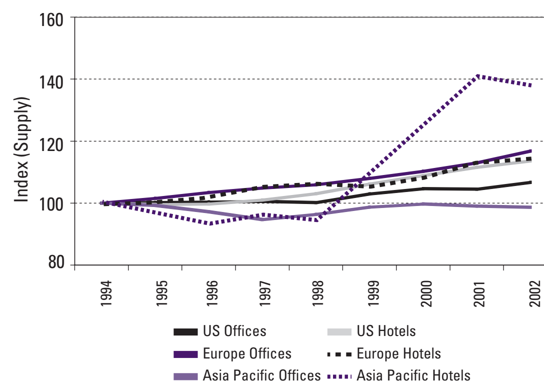
Global Overview

Supply

In both the US and European markets, hotel supply has increased at a greater rate than office supply over the same period, with the European markets expanding more than the mature US markets. We have not been able to analyse the Asia Pacific supply due to lack of available data, but analysis of the major Australian markets show similar trends as witnessed in Europe and the US, up until the influx of hotel rooms hit the market leading up to the Olympics in Sydney.

In general, office and hotel supply increases move in tandem with each other and the fact that office buildings can be converted into hotels and vice versa intrinsically links the supply of these asset classes. It is difficult to determine whether hotel development has lagged or led the office market on an annual basis. However, in the US, it appears that hotel development phases have started earlier and lasted longer than their office counterparts.

Supply Index by Region and Asset Class



Source: ABS; Deloitte & Touche; Jones Lang LaSalle; Jones Lang LaSalle Hotels; Smith Travel Research; Torto Wheaton

Vacancy / Occupancy*

Hotel and office occupancies generally move in the same direction at the same time, but hotels experience greater peaks and troughs. Hotel occupancies are generally more affected by demand shocks in the short term, but in most instances recover before offices. This is because most demand for hotel rooms reacts to market conditions on a daily basis whilst office space is locked in for a specific term.

"Hotel occupancies are more affected by demand shocks in the short term, but recover before offices."

In the US and Europe, occupancies for hotels and vacancies for offices were on a positive trend respectively up until 2001. The pattern in Asia Pacific was affected by the Asian economic downturn in 1997/98,

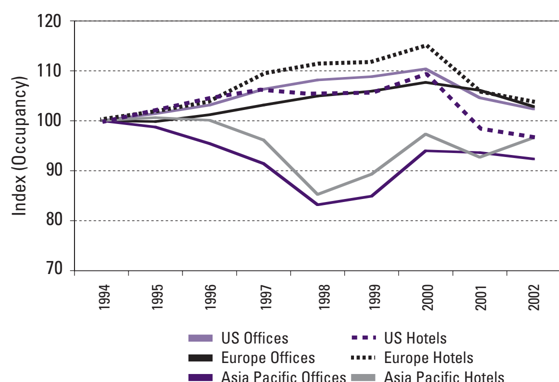
* For the purposes of comparison we have calculated the occupancy of offices as one less the published vacancy rate. For example a 7% vacancy rate becomes a 93% occupancy rate. More detail on the methodology is found on page 19.

which adversely affected both hotels and office buildings. Around mid 1999, the Asia Pacific markets recovered slightly from the Asian financial crisis until 2001. In keeping with the trend, the recovery of the Asian hotel markets outpaced the office market during 1999.

In general during 2001, hotels across all regions recorded a sharp decline as an immediate result of the impact of September 11 and the global economic slowdown, before recovering slightly during 2002. Office markets were not as adversely affected during 2001, but, unlike the hotel sector, their negative performance continued into 2002 as corporate profitability and economic growth prospects languished.

Further analysis is found in the regional overviews.

Occupancy Index by Region and Asset Class



Source: ABS; Deloitte & Touche; Jones Lang LaSalle; Jones Lang LaSalle Hotels; Smith Travel Research; Torto Wheaton

Income

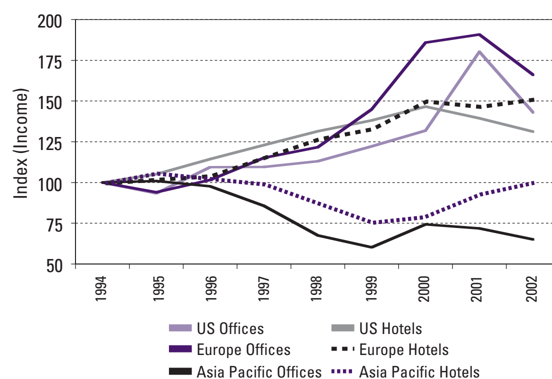
At the outset we should make it clear that hotels' average daily rate (ADR) is computed on a daily basis whereas office rent is based on the prevailing market conditions at the time of signing the contract and consequent rental reviews. Rather than being calculated on a daily basis, the terms of these office contracts are usually 2-3 years in Asia, 5 years in Australia and significantly longer in Europe. Although a certain proportion of hotel room nights are charged at a rate based on corporate or air crew annual contracts, there remains a significant portion of hotel business with shorter lead times and negotiable rates.

"Office rentals across the board fluctuate more significantly than hotels' ADRs."

In contrast to the occupancy relationship, office rentals across the board fluctuate more significantly than hotels' ADRs. This is perhaps due to the fact that hotel rates are generally priced to the market each day and therefore do not witness a major correction each year when new leases are signed. This explains why the fluctuations in office rent over the long term are more significant in Europe where longer office leases are more common than in the other regions.

Apart from these consistent observations, the regions vary in terms of the correlation between revenue generated by their office and hotel real estate markets. Further detail can be found in the regional overviews.

ADR / Rent Index by Region and Asset Class



Source: ABS; Deloitte & Touche; Jones Lang LaSalle; Jones Lang LaSalle Hotels; Smith Travel Research; Torto Wheaton

Revenue by Available Space

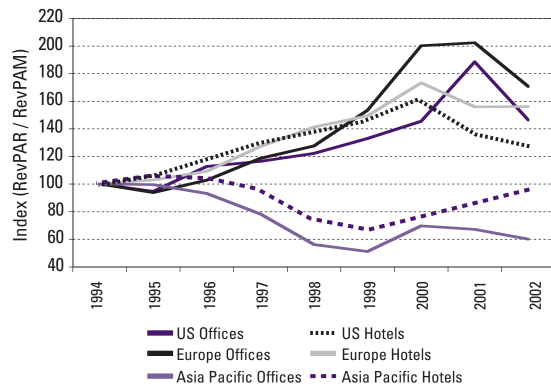
We have examined the performance of hotels and offices in terms of two measures – demand relative to supply (occupancy or its inverse – vacancy) and the revenue generated by this demand (ADR or rent). Taking these in combination, we can look at an overall profitability measure – revenue per available hotel room (RevPAR) and the revenue generated by offices per available square metre (RevPAM).

Obviously, the relationship between hotels and offices in this measure depends on the relationship between occupancy / vacancy and rate / rent. In that way, it is an interesting measure to decipher the overall net relationship between these asset classes over the period studied.

"Results demonstrate the benefits of geographic diversification rather than sector diversification."

This graph demonstrates the divergence of the performance by regions and the benefits of geographic diversification rather than sector diversification. For instance, both the hotel and office sectors in Asia Pacific were hit by the isolated economic downturn of 1997/98, while the European office and hotel markets boomed until 2000.

RevPAR / RevPAM Index by Region and Asset Class



Source: ABS; Deloitte & Touche; Jones Lang LaSalle; Jones Lang LaSalle Hotels; Smith Travel Research; Torto Wheaton

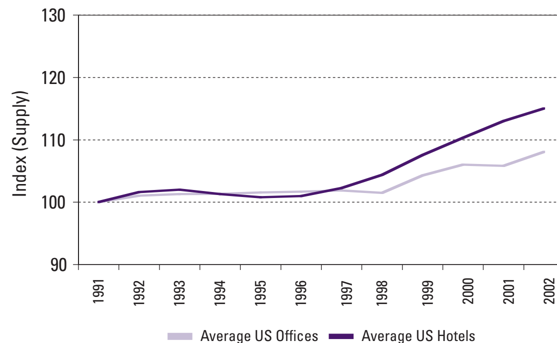
We will now examine each region in depth, offering explanations for the relationships we have seen.

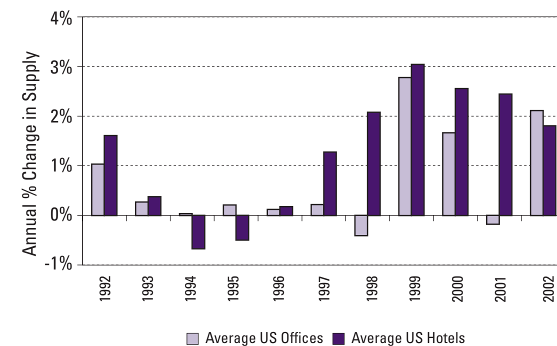
The US

Supply

- Hotel supply fluctuates more significantly than office supply.
- Hotel and office supply moved in tandem until 1993 when hotel supply declined slightly across the markets studied. It is perhaps easier for hotels to be converted into residential use than office buildings, meaning that hotel supply can be more responsive to the changing trading environment. Thereafter, both sectors increased.
- Over the 11 years studied, hotel supply has grown at a higher rate than office supply, particularly between 1996 and 2002. This follows on from the recession years of the early 1990s where there were no net additions of hotel rooms. Between 1991 and 2002, office space increased by 8.1%, while hotel rooms grew by 15.0%.
- Hotels' development phase commences earlier and lasts longer. The development phase for hotels commenced during 1997 and peaked at an average of a 3.0% increase during 1999. Office supply development peaked in 1999 with an average growth of 2.8% and continued during 2000.
- The influx of supply for hotels lasted longer (five years) than the flood of office development (two years). Hotels need to be fitted with furniture and fittings and operations need to go through extensive dry runs before the hotels can be fully operational. In contrast, the respective tenants fit out the interiors of the offices.

Average Supply Growth – Major US Markets





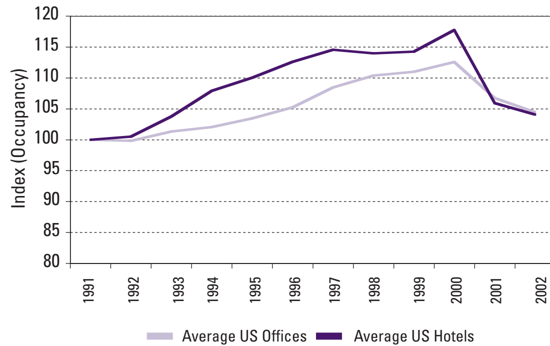
Source: Jones Lang LaSalle Hotels; Smith Travel Research; Torto Wheaton

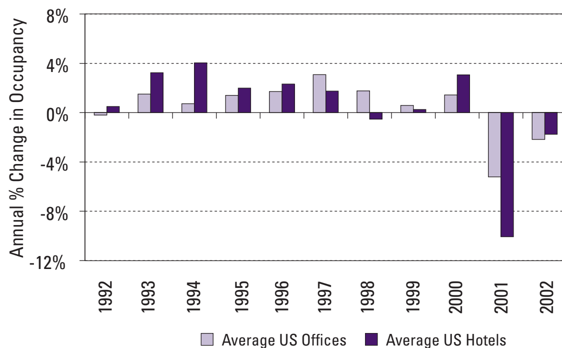
- Overall, the US markets are relatively mature. Supply growth of 0.7% pa (office) and 1.3% pa (hotels) between 1991 and 2002 is in reality, quite modest.

Occupancy

- Hotels and office occupancies generally move in tandem, with hotels experiencing greater peaks and troughs. As mentioned previously, this is likely due to the fact that hotel occupancies react to market demand on a daily basis whereas office occupancy is tied to longer term lease periods. Occupancy growth for hotels peaked at 4.0% in 1994 and 3.1% during 2000, whereas office vacancies fell by 20.3% to reach 10.5% during 1997 and fell 15.5% to record 7.1% during 2000.
- The impact of September 11, 2001 and the general global economic slowdown had a more profound impact on the occupancy of hotels than offices. This is likely due to the daily tenanting issue as well as the impact of these events on travel specifically. That is to say that people stopped travelling immediately, whereas corporations did not relocate immediately as was initially anticipated. During 2002, growth in hotel occupancy outstripped the decline in office vacancy.

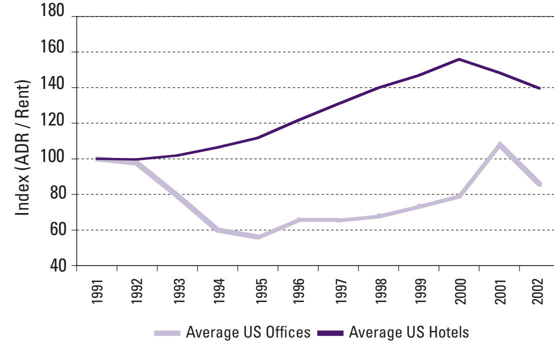
Average Occupancy – Major US Markets

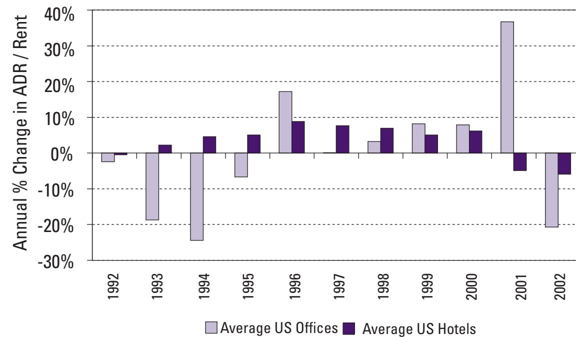




Source: Jones Lang LaSalle Hotels; Smith Travel Research; Torto Wheaton

Average Rent / Rates – Major US Markets





Source: Jones Lang LaSalle Hotels; Smith Travel Research; Torto Wheaton

Income

"Hotels can alter their rentals each day and therefore do not suffer the significant annual correction experienced by offices."

- Unlike the trends witnessed in occupancy and supply measures, in terms of rent, it is the US office market which has experienced more significant fluctuations than hotels. As mentioned in the global summary this is likely to be due to the fact that hotels can alter their rentals each day and therefore do not suffer the significant annual correction experienced by offices.
- Hotel rates grew between 1993 and 2000, before declining during 2001 and 2002 due to the challenging tourism and economic environment.
- In contrast, office rents declined between 1993 and 1995, as the market suffered from overbuilding due to the tax incentives available during the mid 1980s and the fallout from the economic downturn of 1990. Rents then recovered until 2001 when they posted strong growth. There was a surge in demand during 2001 following the terrorist attacks in New York and the Pentagon as firms across the nation reassessed their office requirements in the major cities. During 2002 rents declined in light of the corporate collapses and lower corporate profitability as economic growth continued to be lacklustre.
- Over this 10 year period, the office market rents declined by 14.3%, compared to hotels' rate growth of 39.5%.

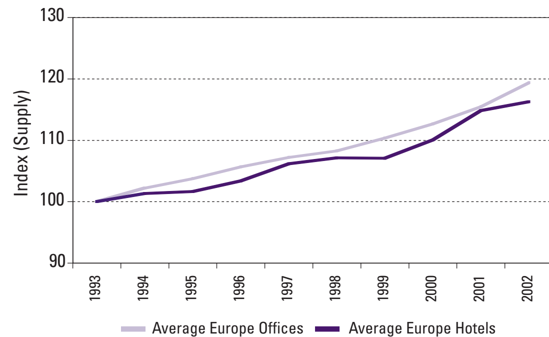
EUROPE

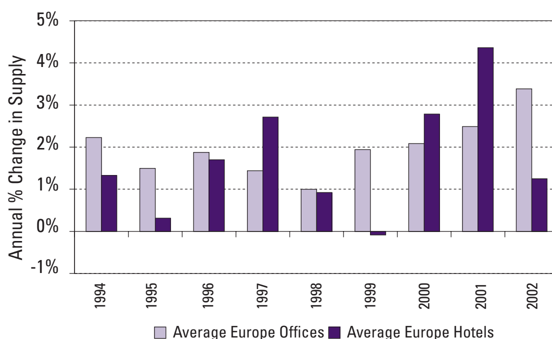
Supply

"Both segments were subject to similar development issues and supply constraints and were in a state of relative equilibrium at the start of the 1990s."

- Across the European cities analysed within this study, hotel and office supply generally increased in tandem between 1993 and 2002.
- The level of congruence is higher than for the two other global regions, which suggests that both markets were subject to similar development issues and supply constraints and were in a state of relative equilibrium at the start of the 1990s.
- Hotel and office supply have grown by similarly robust levels. Between 1993 and 2002, office space increased by 19.4%, while hotel rooms grew by 16.3%. Both rates are significantly higher than the supply growth experienced by the US sample and are testament to the strength of the local economies, particularly in Continental Europe after the recessionary conditions of the early 1990s.
- Although not as obvious as the US experience, hotel supply growth in Europe has fluctuated more significantly than office supply, from –0.1% in 1999 to 4.4% in 2001 This is also due to the longer construction period required for the completion of hotels.
- It is difficult to determine whether hotels and offices lead or lag each other in terms of development. Hotel supply

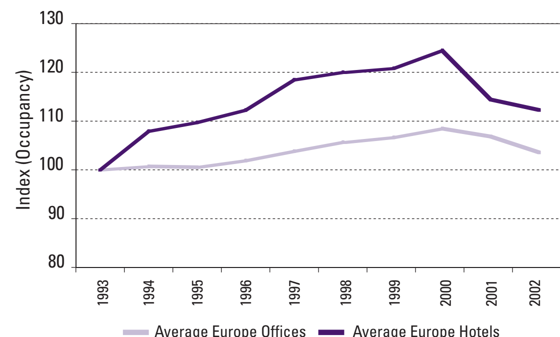
Average Supply Growth – Major European Markets

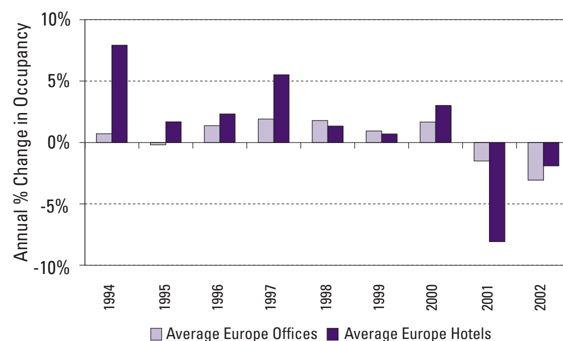




Source: Deloitte & Touche; Jones Lang LaSalle; Jones Lang LaSalle Hotels

Average Occupancy Growth – Major European Markets





Source: Deloitte & Touche; Jones Lang LaSalle; Jones Lang LaSalle Hotels

increases demonstrate obvious peaks during 1997 and 2001, while office supply growth has been more consistent across the period, building up to a peak during 2002.

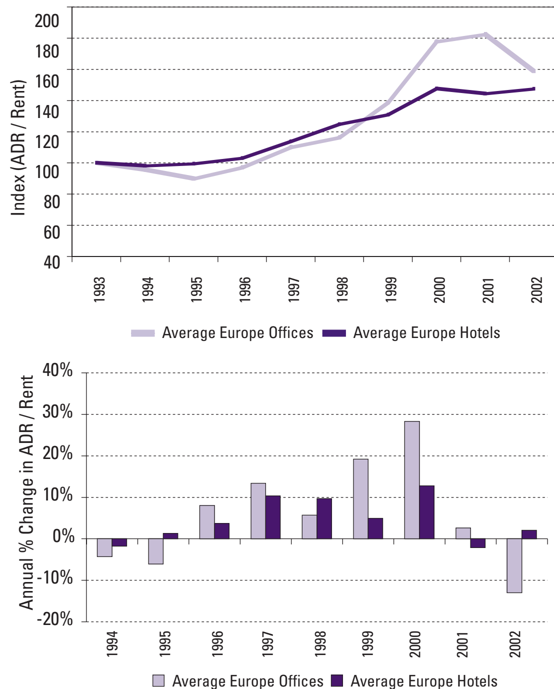
Occupancy

- European hotel and office occupancies have demonstrated a similar trend to their US counterparts. The more acute volatility shown in hotel occupancy rates is replicated in Europe, mostly as a result of the global tourism downturn in 2001.
- As can be seen by the sharp drop in occupancies during 2001, the adverse economic conditions impacted the hotel sector more immediately than the office sector. However, the hotel sector began its recovery during 2002 when the office market showed its largest decline to date.
- With the exception of 1994 and 2001, average annual occupancy growth in both sectors was broadly similar. The reasons behind 2001 are well documented, but it is also fair to suggest that in 1993, due to economic recession in many European markets, was also a particularly weak year for the hotel market, which perhaps exaggerated the 1994 recovery.
- Solid demand growth generated by the mature regional economies managed to absorb the significant supply increases up until 2001. Consequently, the growth in European occupancies for both office and hotels has been superior to the US.

Income

- As witnessed in the American markets, the European office market has experienced more significant fluctuations in rent than hotels.
- However, unlike the American experience, hotels and offices have generally moved in tandem, with office market rents growing by 58.8% over the period studied, compared to hotels' rate growth of 47.4%.
- After ongoing stagnation until the mid 1990s, the economic growth of the region meant that both hotel and office revenues were on an upward trend between 1993 and 2000, although hotels could not increase average room rates to the same extent as office rents increased during 1999 and 2000. After peaking in 2000, both asset classes recorded a decline during 2001.
- The easing of demand in both sectors during 2001 had an inevitable impact on rents and rates, though the internationally vulnerable hotel sector again demonstrated the immediate impact of external influences, recording negative performance. As witnessed in the occupancy analysis, the hotel market was quicker to recover from the events of 2001 and posted modest growth during 2002. In contrast, European office rents were stable during 2001 before falling significantly during 2002.

Average Rent / Rates Growth – Major European Markets



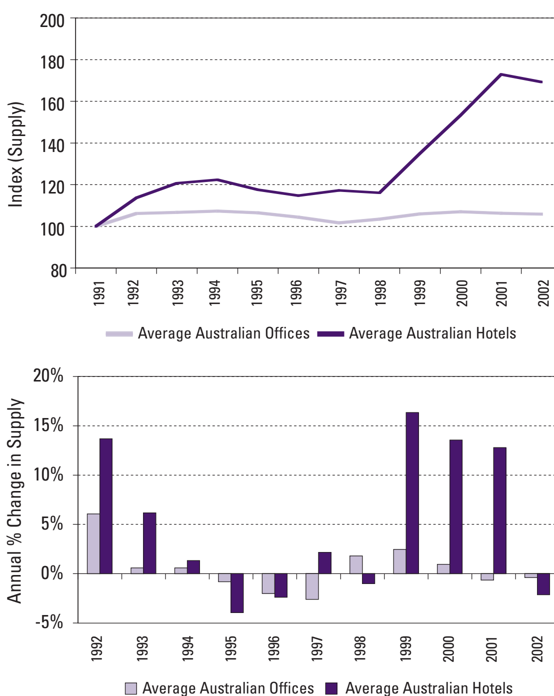
Source: Deloitte & Touche; Jones Lang LaSalle; Jones Lang LaSalle Hotels

Asia Pacific

Supply

- Looking at the Australian markets (the only market data available), it would appear that the hotel development

Average Supply Growth – Major Australian Markets



Source: Deloitte & Touche; Jones Lang LaSalle; Jones Lang LaSalle Hotels

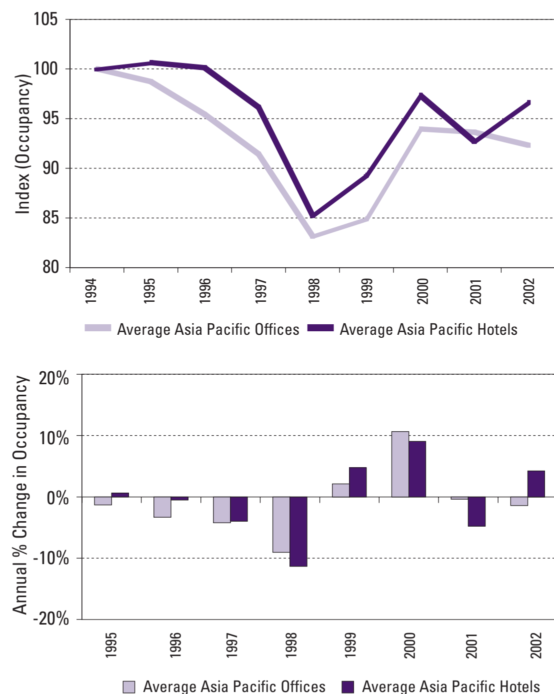
cycle is more significant than office supply additions. This is largely due to the influx of hotel development before the 2000 Olympics which continued to be absorbed into the market during 2001.

- Given their relatively small size, the impact of hotel supply additions is more pronounced in these Australian hotel markets than other global markets.

Occupancy

- Unlike the supply analysis, the occupancy analysis pertains to several key Asia Pacific cities.
- Of all the regions, hotels and offices experience the most similar occupancy movements in Asia Pacific. Furthermore, hotels and offices have experienced similar peaks and troughs in terms of their magnitude and timing as the Asian economic crisis had a similarly significant impact on both travel and leisure business.
- With the onset of the Asian economic crisis in 1997, hotel and office occupancies registered sharp declines until mid 1998. Occupancy improved from mid 1998 onwards, with hotels achieving a faster recovery. During 2001, hotels were more affected by the fall out from September 11, but, once again, recovered quickly during 2002. We expect a similar pattern in 2003, with hotels being more affected by the outbreak of SARS.
- Occupancy growth for hotels and offices peaked in 2000, at 9.0% and 10.6% respectively. Similarly, occupancy growth experienced a trough during 1998 at –9.0% for offices and –11.3% for hotels. Unlike the US, there is no apparent lag.

Average Occupancy Growth – Major Asia Pacific Markets



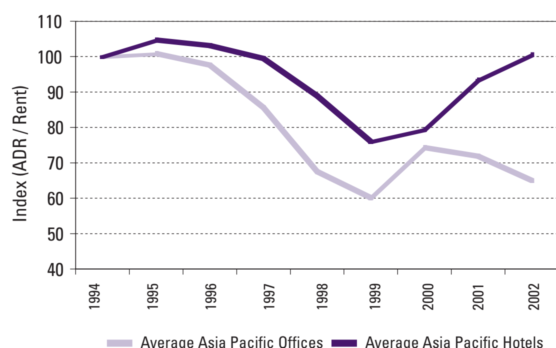
Source: Deloitte & Touche; Jones Lang LaSalle; Jones Lang LaSalle Hotels

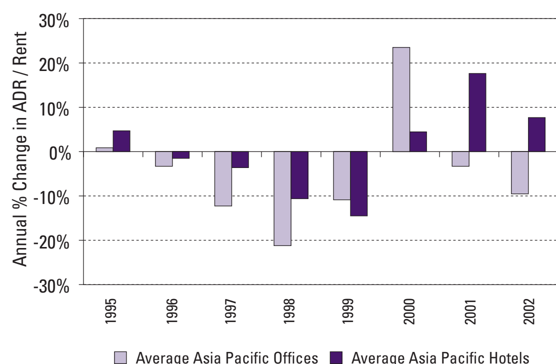
Income

"Given its geographic isolation and strong intra-regional demand, the impact of September 11 was less obvious in Asia Pacific than in the other regions."

- In Asia Pacific, both sectors generally moved in tandem until 2000/01 when they diverged.
- The office and hotel markets peaked in 1996 before registering a sharp decline with the onset of the Asian economic crisis in 1997. In mid 1999, the markets bottomed out to record a recovery until mid 2000.
- During 2000/01, the weakening global economy resulted in many multinational companies rationalising their operations to one regional office which led to a drop in demand for offices in some cities. This slowdown continued into 2002.
- In contrast, the hotel market stayed firm during 2001 and 2002. Given its geographic isolation and strong intra-regional demand, the impact of September 11 was less obvious in Asia Pacific than in the other regions. This is particularly the case in Shanghai, which continued to post strong growth in hotel rates during 2001 and 2002. Both sectors were more obviously affected by the regional economic downturn in 1997/98 than the terrorist activity in the US.

Average Rent / Rate Growth – Major Asia Pacific Markets





Source: ABS; Jones Lang LaSalle; Jones Lang LaSalle Hotels

- Over the period studied, office rents declined by 35.0% while a recovery in hotel performance during 2002 resulted in a decline of only 0.5% in hotel rates over the eight years. This has, in part compensated for the higher level of risk inherent in hotel investments.
- As witnessed in all other regions, the Asia Pacific office market has experienced a larger range of rental fluctuations than hotels.

Conclusion

Our analysis has uncovered a number of common themes:

- The annual supply movements of hotels and office space generally move in the same direction.
- No definitive lagging or leading indicator is apparent when analysing annual supply data. However, further analysis on a quarter by quarter basis could uncover a pattern.
- **Occupancy / vacancy and ADR / rent of hotels and offices in the same region have generally demonstrated similar movements over the period studied.** The relationship was more obvious before 2001 when the shock of September 11 and the global economic slowdown took its toll on the sectors.
- There is generally more positive correlation between hotels and offices in the same regions than the same sector across the globe. Therefore, **regional factors such as GDP and employment have more of an impact on the performance of hotels or office real estate than sector specific factors,** assuming the market is not significantly oversupplied (as was the reason for the decline in rate in the US office sector in the early 1990s).
- **Hotels react more quickly to external events and recover more quickly than their office counterparts.** In the face of a demand shock, hotels' ADR and demand generally decline before and increase earlier than office markets. This is due to the shorter tenanting term of hotels.
- On an annual basis, **hotel occupancies are more volatile** due to this factor, but ADRs fluctuate less than offices. This is because a significant portion of hotel rooms are priced to the market on a daily basis and therefore do not face such a major correction at the end of each year.

Therefore, hotels appeal to investors seeking a pre-emptive measure for office investment and a potential for strong upside. These investors should focus on geographic diversification and counter cyclical timing when making investment decisions.

Investor Insights - Part 1

Investor: Jonathan D. Gray, Senior Managing Director, Blackstone Real Estate Advisors

What is your experience in investing in hotels and office real estate?

Blackstone has had significant exposure in both asset classes over the last ten years, with over US$10 billion in hotels and office buildings acquired during this period.

What made your company invest in both asset classes?

Initially, attractive pricing. During the early 1990s, hotels and office buildings faced significant distress due to overbuilding. We had the opportunity to acquire such assets at a sizable discount to replacement cost. Over time, we have developed core competencies and relationships in these areas which has given us greater confidence in buying hotels and office buildings.

How successful has it been and how is that success measured?

Both our office and hotel investments have been quite successful. We measure success through two return criteria: 1) IRR; and 2) multiple of equity. We have definitely exceeded our targets, with returns in office and hotels actually pricing out fairly close.

Have you noticed any diversification benefits by including hotels with any other property types?

Our investment philosophy is not to over-weight in one particular asset type, so investing in a variety of property types underscores that risk diversification. But in terms of urban hotels and office buildings, there is little diversification benefit given that the primary demand for these hotels is drawn from the corporate market. Blackstone looks to diversify away from 'corporate spend' via assets that rely more on consumer spending, such as resort hotels and retail properties.

Have you noticed a definite relationship in trading or investment performance between hotels and office real estate? Which one moves first?

Yes. Hotels' 'rent' is marked to market every day and therefore reacts immediately to occupancy pressures. Since office buildings are structured around leases, it takes longer for distress to show-up and conversely for upturns to materialise. Hotels are likely to catch the recovery sooner and should trend upward before offices.

What is your preferred hotel versus office asset allocation and why?

Historically, the portfolio has been split approximately 45% office, 33% hotels and 22% other real estate. The weighting to hotels reflects both our desire to enjoy premium returns but manage risk by not being over-exposed to this volatile sector.

What are the different criteria for investing in hotels and office?

To get comfortable with the additional risk of hotel investment, we assign a greater weighting to current income during underwriting. As a result, cash on cash returns for hotels must be significantly higher than office because of the volatility of the income stream. Office returns are generally derived more from capital appreciation.

How does your short-term outlook for hotels compare to offices? How does the long term outlook compare?

The short-term outlook for hotels appears better than for office buildings. It is hard to imagine conditions will get much worse in the lodging sector. In contrast, offices may continue to experience a decline in rents over the near term. In addition, the hotel income that we are underwriting reflects current market conditions, while office rents in place are often significantly above prevailing market rents. The consequence is that today it seems relatively easier to buy hotels. Over the long-term, supply will be the wildcard as demand for both office and hotels are highly correlated to GDP. The good news is that the supply pipeline in both sectors is narrowing.

Is the additional risk of investing in hotels worth the added return?

We believe so. Generally there are fewer competitors because many investors are concerned about the inherent risk in the hotel industry. But hotel investment offers two important upside plays:

1) hotels are often operationally inefficient so a new owner can bring management expertise to bear;
2) cycles play a significant role and allows opportunistic investors the ability to take advantage of 'distress points'.

Investment Performance Relationship

Ian Chappell, Senior Vice President, London

The global hotel investment arena has widened considerably over recent years. The adoption of new financing structures, ongoing separation of bricks and business by operators and the growth of cross border investment have all had an impact on the hotel real estate investment market and are well documented in earlier editions of Hotel Topics.

This article looks into some of the rationale behind hotel real estate investment and compares and contrasts the key structural components of the hotel sector with the office investment market. We will discuss whether there are any meaningful trends between both sectors and whether the hotel market can replicate the performance and liquidity characteristics of the office investment sector.

As there is arguably better congruence between the office and hotel sectors within Europe due to the prevalence of leases in European hotels, our analysis focuses principally on the European region, though we provide insight across the Asia Pacific and Americas markets, comparing structural and performance characteristics, trends and outlook.

Hotel and Office Investment Characteristics

Across Asia Pacific and the Americas, hotels are generally operated under management agreements, resulting in investment returns that fluctuate according to the daily or monthly cashflow. In Europe, the management contract model is also very common, however the region also has the most established hotel leasing sector which spans the key country markets of Italy, Germany, France, the UK, and Spain.

"Across Asia Pacific and the Americas, hotels are generally operated under management agreements, resulting in investment returns that fluctuate."

To set the context we have defined and contrasted the key investment characteristics of the office and hotel real estate sectors in Table 1 below. The information below is considered as generally representative rather than definitive.

Table 1 – Global Comparison of Typical Office and Hotel Investment Characteristics

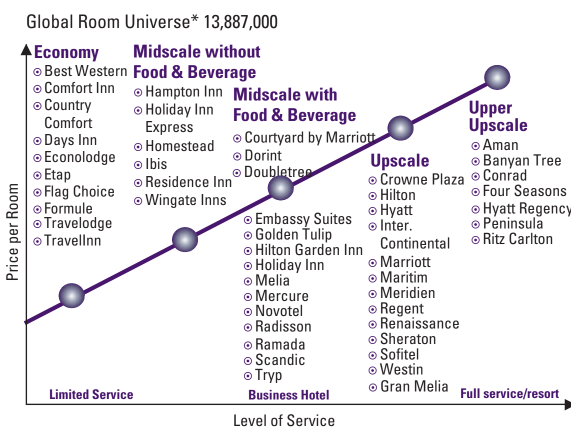
	Office	Hotel
Location	Usually CBD, or decentralised office / campus parks	Classic distinction is between city and resort sectors.
Product Homogeneity	Strong. Limited variation in product, other than age and location.	Heterogeneous and influenced by operator brand standards, range of facilities and grade.
Grade Classification	Grade A – New, purpose built, maximum specification. Grade B – Older, usually renovated, may not have air conditioning. Grade C – Oldest, unrenovated, limited facilities	Luxury / Upscale – Upper four star to six star. Mid to upscale – Three and four star, full service. Limited Service – Modern branded hotels usually at two to three star level. Economy - One and two star hotels, predominantly room only operations. Boutique – Can be ungraded but offer upper tier service in contemporary select product.
Investment Medium	Leased to tenant at guaranteed, certain rent, either reviewed to market levels or linked to cost of living index.	Lease – More common in Europe. Mostly fixed rents with indexation, some with turnover tranche. Market based periodic reviews cause uncertainty and difficult to assess. Management Contract – Investor owns real estate and business. Employs manager who guarantees performance and receives fee. Franchise – Owner operated with licensing agreement / franchise to brand.
Investment Return	Rent	Either; - Rent - Profit underpinned by guarantee - Variable Profit
Investment Return Volatility	Low to Medium. Either indexed or based to market levels. Stable cashflow.	Rent – Low to Medium as with offices. Profit – Medium to high, depending on extent of operator guarantee and branding.
Investor Universe	Wide across all investment sectors. Grade A and B market dominated by financial institutions and leveraged equity buyers. Owner occupation rare in US and increasingly so in most European countries.	Historically owner occupied but evolving. German funds dominant in Germany. Financially orientated buyers prevail in US. High net worth owners common amongst trophy hotels globally.
Trends	Mature investment market.	Developing investment market. Higher investor participation. Rents / fees increasingly turnover linked.

Hotels Offer a Variety of Investment Options

The hotel sector offers a variety of investment options. Throughout nearly 14 million rooms worldwide, investors can choose from economy to luxury standards and city to resort locations. An additional layer to this mix includes the brand and management company, which act as a point of differentiation between asset types and will dictate their performance. The following diagram exhibits 50 of the largest hotel brands throughout the world, reflecting the wide variety of choice open to investors.

Similar to office real estate, hotels can be offered under a variety of investment structures. These include direct ownership, joint ventures, special purpose vehicles, subordinated debt positions and lease backed investment interests.

The Hotel Investment Universe



Source: Jones Lang LaSalle Hotels
*WTO data
The hotel brands have been broadly segmented into five categories based on their general characteristics around the world, yet please recognise some regional variations exists in these classifications.

Distinction Between Office and Hotel Investment

Arguably the most apparent distinction between the office and hotel investment sectors is that of the owner occupier relationship. As with the wider commercial real estate sector, offices are either owner occupied or leased to a tenant, the latter at a rent secured by contract for a known term of years. The tenant has exclusive occupation rights to the property and is usually responsible (either directly or indirectly) for repairs and maintenance.

"Arguably the most apparent distinction between the office and hotel investment sectors is that of the owner occupier relationship."

The rent is based at a market level at the commencement of the lease term and is subsequently reviewed on a periodic basis, either to revised market levels, or by reference to indexation. Most markets incorporate a level of protection to the landlord by a ratchet mechanism, whereby the rent can rise, but cannot fall. This 'upwards only' clause is a fundamental criteria for most landlords across the mature investment markets and is an important risk mitigator.

This type of leasing structure is required by the relatively risk averse financial institutions that form the backbone of the prime real estate investment market, and as such, is known as the "institutional lease". It fosters the safe haven status of commercial real estate investment and underpins market liquidity.

Conversely, hotel management contracts only grant the operator a right of management, with the owner retaining ownership of the business and most of the staff at the hotel. Unlike a lease, the income return to the owner will therefore comprise the business profit from the hotel, which will vary in line with market conditions. Some certainty can be incorporated through an operator guarantee, though this is usually finite, capped, and therefore does not insulate the owner from downside risk. However, strategic acquisitions which are cyclically timed can provide excellent upside potential.

Hotel Lease Trends

As we have indicated above, the leasing model has become widely established in the European hotel investment market, and is the predominant operating model in Germany, where open and closed ended funds are significant investors. Whilst these particular lease structures provide low unleveraged returns, they satisfy the conservative investment criteria of these substantial investor groups.

A very successful variation of the lease is the turnover rent provision which allows a greater share of risk and reward between owner and operator. These have been widely used in the various sale and leaseback portfolios across Europe since 2000, and will tend to attract more entrepreneurial investor groups.

"A more recent trend within the hotel leasing market has been the separation of rental income into separate risk tranches."

A more recent trend within the hotel leasing market has been the separation of rental income into separate risk tranches. The first tranche, or base rent, is fixed, certain and indexed on an annual basis. The second tranche is geared to trading performance or profitability. The advantage of this structure is that the investor has a known downside risk and a rental profile which offers better growth prospects (through the "top slice") in line with trading performance. The advantage to the operator is twofold; firstly, there is some protection to profit in leaner periods, when the rental commitment reduces; and secondly there may be a more favourable treatment of the contingent rent within the tenant's balance sheet.

Across Europe, the portfolio structure of operators such as Accor, Hilton International, Le Meridien and Rezidor SAS include up to 50% of assets which are leased, demonstrating their popularity. The portfolio sale and leasebacks of hotel real estate by these and other operators since 2000 have focused attention on the hotel sector, providing encouragement to the investment community that the market is ripe for new players.

Hotel Real Estate Investment Market Structure

The hotel sector is a small slice of the wider real estate investment cake. In 2002, only 4% of all US real estate investment transactions by value were hotels. In Europe, the hotel sector accounted for less than 2.5% of real estate sales and in Asia it is estimated to be even less. In general, hotels represent a tiny share of institutional investment across the globe. Mixed asset portfolio investors typically allocate 5-10% of their fund to real estate.

The prime hotel investment market is characterised by a more diversified ownership base than the office markets. Across many European markets, a large proportion of the quality hotel supply was traditionally owner occupied, though as noted, third party ownership is becoming more prevalent. As a result, participation within the sector by financial institutions, the predominant owner of prime commercial real estate, is growing, particularly where hotel leases are being chosen as the primary operating model.

Within Europe, institutional interest remains strongest in Germany, as a result of the more conservative lease structures that prevail. In the UK, investment by pension funds and other financial institutions remains very low, with only a handful of hotels owned by funds such as Norwich Union, Standard Life and Scottish Widows. This is primarily a result of imperfect knowledge of the sector, which compares poorly with the widely tracked and highly transparent commercial sector.

Private equity groups are well immersed into the sector, again mostly as an extension to existing real estate operations. These groups, together with property companies and high net worth individuals remain extremely active and will be attracted by operating structures that share risk or which encourage owner and operator dialogue; vital components for high leveraged returns. A recent investment initiative was the BAA Hotels Partnership sponsored by Jones Lang LaSalle Hotels. This indirect investment vehicle comprises eight airport hotels generating a fund value of close to £200 million. Equity partners included UK financial institutions previously not represented in the sector.

The hotel investment market in Asia Pacific is quite different. Whilst there is a high level of owner operation and partnership / joint venture structures, management contracts tend to dominate. In the more liquid market of Australia, we have witnessed institutional investors acquiring hotels and structuring leases with operators. However, these are still in the minority and there remains growth potential in this market for lease expansion.

The Americas has perhaps the most established separation between ownership and operation. Management contracts rather than leases are a dominant operating model, with the ownership vehicle commonly a Real Estate Investment Trust (REIT), Partnership, C Corporation or Limited Liability Company. The hotel sector has a strong investment ownership base and is therefore the most transparent sector of the three regions. The accounting treatment of leases, and the favoured management contract / franchise suggest that the opportunities for leasing are fewer than elsewhere but the existing level of investor activity should not adversely impact the potential for the sector.

"An important distinction between the office and hotel sectors is that of transparency."

An important distinction between the office and hotel sectors is that of transparency. Within the office investment sector there is a plethora of performance analysis data, sourced from organisations such as Investment Property Databank (IPD), CoStar, Jones Lang LaSalle and Property Council of Australia. The size of the global real estate market together with the high volume of investment sales and the openness of reporting facilitates detailed transaction analysis, performance measurement and predictive forecasting.

However, within the hotel sector, whilst there are ample trading performance and benchmark indices, there is no currently acceptable and consistent investment measurement tool. As a result, and on the whole, the availability and quality of hotel investment information is vastly inferior to other investment classes. The reporting of investment transactions is itself somewhat irregular, with analysis often restricted by confidentiality and the absence of full financial information.

In Australia, the Property Council has published a hotel valuation index since 1995, however, this is based on hypothetical, rather than real data and is restricted to a four star hotel in one city.

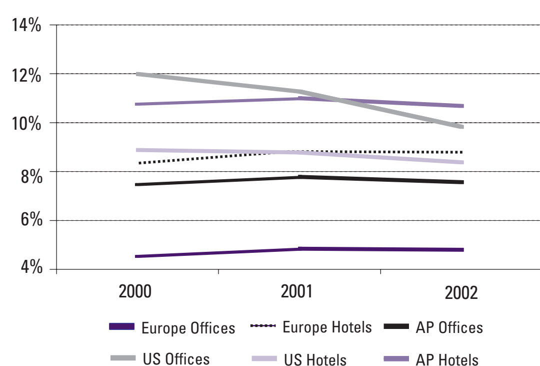
In the UK, Jones Lang LaSalle Hotels, in conjunction with IPD, hotel operators and advisors are currently discussing a pilot investment performance benchmark index, which will be the first step in reducing the uncertainties currently attached to the market.

Investment Performance Analysis

What evidence on the sector does exist? Jones Lang LaSalle Hotels has analysed the evolution of office and hotel investment performance for 19 cities globally. As a result of the paucity of data available in respect of hotel investment performance we have taken results from Jones Lang LaSalle Hotels' Hotel Investor Sentiment Survey (HISS) which has tracked hotel investment market sentiment across key global markets since 2000.

Our results, which have been collected in identical cities are presented in the chart below and illustrate the trend in average investment yield requirements for both sectors.

Prime Office Yields Versus HISS Returns 2000-02



Source: Jones Lang LaSalle Hotels

We can see that the graph illustrates three clear trends;

- There remains a noticeable yield gap across all regions between prime offices and hotels, with hotel yields consistently higher than prime office yields of the same region;
- Despite signs of a widening investor universe for the hotel investment market, it is too early to yet identify any yield convergence between the two sectors;
- Yields of hotels and offices of the same region tend to move in the same direction. For instance, US hotel and office yields have both declined since 2000, whereas the segments in Europe and Asia Pacific increased during 2001 before remaining stable.

Not surprisingly, the inherent volatility of income returns to a hotel investor justifies the relatively higher return expectations. In the case of the US, hotels' income returns ranged between 7.8%-14.3% (637 basis points), as compared with office which had a range of between 8.1%-9.7% (160 basis points) over the decade to first quarter 2003. Conversely, the office market is considered to be far less volatile, given its more homogeneous structure, wider transparency and predictable income returns.

However, this analysis needs to be qualified. Firstly, as the HISS sourced yields reflect yield requirements rather than yields paid, they tend to overstate yields that would be acceptable in market transactions. This is certainly true in the case of sale and leaseback and leased hotel transactions (see below) and from Jones Lang LaSalle Hotels' experience with assets which under current trading conditions can attract pricing which reflects comparatively low initial income returns.

In addition, the above figures are aggregated and tend to smooth over individual city investment characteristics. As an example actual average hotel yields for Sydney compared to the HISS and office investment data are set out in Table 2 below:

Table 2 – Comparative Office and Hotel Yield Data, Sydney

	HISS Hotel Yield Requirement	Actual Average Hotel Yield	Prime Office Yield
2000	9.0%	9.2%	6.25%
2001	9.6%	5.9%	6.50%
2002	8.9%	6.8%	6.50%

Source; Jones Lang LaSalle Hotels; Jones Lang LaSalle

Arguably a more relevant comparison is between leased hotels and leased offices. Table 3 below highlights four significant sale and leaseback transactions in the UK between 2001/2002, compared to HISS hotel requirements and prime office yields for London over the same period;

Table 3 – Achieved Hotel Investment Yields 2001/2002

Transaction	Estimated Yield
Hilton 2001	7.1%
Hilton 2002	7.0%
Jarvis	7.3%
Thistle	7.5%
HISS Yield	9.0%*
Prime Offices	5.25%*

* Averaged for 2001/2002. Both figures are for Central London.

It is apparent that when measuring performance and expectations on a more level basis, yield requirements between offices and hotels are noticeably closer.

The lower level of yields paid by investors for leased assets is also supported by empirical evidence throughout Europe where prices of prime single asset hotels also reflect investment yields more closely aligned to the commercial sector.

Offices and Hotels – Convergence?

It is clear therefore that for now, the office and hotel real estate investment sectors offer different structural characteristics. Outside of Europe, the hotel sector remains a structurally different asset class with a strong focus on operational / proactive management. Whilst this philosophy continues and whilst leases have their own balance sheet implications, the hotel sector is unlikely to replicate the characteristics of the office market.

But neither should it. We see significant opportunity for the informed investor seeking growth outside of the traditional commercial real estate arena. With high barriers to entry in key locations, particularly in Europe and ongoing operator review we see excellent growth prospects for the supply of investment grade hotel property, whether this is leased or management contract based.

Internationally branded hotel assets continue to offer investors with lower obsolescence, higher residual values, and a measure of downside risk protection through lease or guarantee mechanisms. As such, they have a rightful place as part of a portfolio diversification strategy.

We are also confident that as sector transparency increases, and the investor universe widens, pricing will improve with this liquidity. By way of comparison, we need only to look at the improvement in prime yields on retail warehousing and leisure properties in the UK, which decreased by more than 300 basis points during the 1990s.

As we know, pricing is driven as much by demand as location. In the current market, leased hotel investments that are adequately rented to proven operator covenants are undoubtedly popular. A flight to quality is particularly apparent in uncertain economic times. This in itself is an encouraging feature of the near term hotel investment landscape.

Conclusion

So what of the future? We believe the case for hotel investment globally is compelling. We believe the variety of hotel ownership structures will appeal to a widening investor universe and reduce the perception of risk to the sector.

We expect most growth in the sector from the risk aware investor, willing to accept measurable downside risk in return for a share in upside potential and consider that such an approach can be incorporated into both management contracts and leases. Consequently, current unfamiliarity with the sector, concerns over transparency and operator aversion to fixed rent leases are all barriers that we view as being overcome by the canny investor.

“We expect growth from the risk aware investor, willing to accept measurable downside risk in return for a share in upside potential.”

Indeed with the global hospitality market due to initiate a recovery phase, and with the investment community seeking growth, this may be a unique opportunity for one giant leap.

Investor Insights - Part 2

Investor: Sandy Calder, CEO, Australia, Principal Real Estate Investors

What is your experience in investing in hotels and office real estate?

Principal Global Investors' Australian business manages around $A2 billion in local real estate assets through the Principal Office Fund and the Principal Hotel Group. Principal Office Fund (POF) comprises total property assets of $1.8 billion, spread predominantly across 12 premium and A grade office properties situated in Sydney, Melbourne and Perth. Principal Hotel Group comprises a portfolio of four hotel properties comprising 1,434 rooms situated in Brisbane, Melbourne, Sydney and Hayman Island.

What made your company invest in both asset classes?

Principal manages in excess of US$20 billion in global real estate and is quite comfortable with real estate as an asset class. With the Principal Office Fund, we created the vehicle from its inception and have developed many of the assets that now form part of its portfolio. We acquired Principal Hotel Group in an on market transaction shortly after Principal set up shop in Australia. Since that time we have substantially refurbished and upgraded the portfolio as well as having divested one asset that was not considered a core property.

How successful has it been and how is that success measured?

Success is measured by return on equity, return on investment, total return ratios. The hotel fund gave unit holders a good outcome for a number of years following its introduction. In recent years, world events have made it difficult for hotels to perform. Our hurdle rate for the vehicle going forward is a 15% return on equity and despite global events we are well on the way to achieving that target.

Have you noticed a relationship in trading or investment performance between hotels and office real estate?

Yes, I think overall there is a high correlation. The hotel sector is more volatile. Daily tenanting and rates means that the sector reacts more quickly to upturns and downturns, plus the sector can be hit very sharply by one off shocks, such as September 11 and SARS. The office sector takes a longer time to hit the bottom given its rental cash flows are underpinned by lease agreements with varying durations. The hotel sector should recover quickly also.

What is your preferred hotel versus office asset allocation?

At the moment we do not have a preferred allocation. Instead, we house each class in separate fund products and allow the market to decide where it will place its investments. We like and have expertise in both the office and hotel sectors.

What are the different criteria for investing in hotels and offices?

Offices are a commodity style of investment. The objective is to buy at the right price with a yield to compensate for any risk. The owner aims for high occupancy with tenants paying market driven rates as much as possible and staggered lease expiry dates to average out risk of renegotiating rates at the bottom of the cycle. Key investment criteria for the office sector are the tenancy schedule, average lease duration, the quality of tenants, current rents versus passing rent in the market, value of building per square metre versus replacement cost, land value per square metre, location, amenity, quality of technical services, scale and size and restrictions on the covenants of title.

Hotels are not a commodity style of investment; rather you are investing in a business. There is a share of profit and risk between the operator and owner. Hotels have a volatile revenue stream and are subject to supply and demand, the global environment and the nature of the operating agreement entered into between the operator and owner. Key investment criteria for the hotel sector is geographical location, price point (5 star versus motel) and business mix. A diversification of both property type as well as branding is the best hotel investment model.

How does your outlook of hotels compare to offices? How does the long-term outlook compare?

In the short term, both look positive. Both sectors are near or at the bottom of their cycles and due to the factors of correlation discussed earlier, both look set for an upturn (barring one off events).

In the long term, the office sector looks more positive due to the current holding structure of hotel & office investments. When compared to the office sector, I think many hotel assets are currently overpriced and overvalued, relative to their risk and underlying cash yield. Hotel owners experience downside in the way operating agreements are structured at the moment, compared to the lease agreements offered by the office sector.

What is your future strategy regarding hotel investment?

We will continue to invest in hotels. If an asset is correctly priced, it can make money. If the asset is not correctly structured, then profit is difficult.

Is the added risk of investing in hotels worth the added return?

Yes, everything has its price but an investor expects to get a higher return for higher risk.

Hotels' Role in an Investment Portfolio

Melinda McKay, Senior Vice President, Chicago

The case for adding hotels to a mixed-asset portfolio has never been more compelling or complex. In response to a downturn in office markets and an unexpected decline in capitalisation rates, investors are questioning just where they can source high growth returns. While hotels offer the allure of high returns, demand shocks such as SARS underscore the sensitivity of the market and challenge the more risk-sensitive investors' opportunistic strategies.

The second article summarised the universe of hotel investment opportunities and discussed hotels' risk return profile. This article compares the cycles of hotel and office segments, outlines risk considerations, suggested portfolio mixes and discusses the future role of hotels in an investment portfolio.

Hotels are Like a Crème Brulee

Rich, delicious, but not everyone likes them. Hotels remain distinct from the four other main 'food groups' of real estate: office, retail, industrial and residential. Like a crème brulee, hotels have the potential to enhance the 'meal' (portfolio) or make a person (investor) sick. For non-dedicated hotel investors, getting it right comes down to understanding the unique fundamentals of the hotel industry and recognising the importance of timing and cyclicality.

Hotels are not just about owning a piece of real estate. As mentioned previously, the sector has a heavy serving of business flavour, thereby sending it up the investment risk curve. Operational performance is marked to market daily by economic, social and geopolictical movements and unlike other real estate sectors, in most cases a third party entirely manage its operations. These two factors underscore the importance of management company and flag selection, as well as structuring the management agreement to link the return of the operator and investor.

"Cyclicality dictates that hotels will not be an 'always and everywhere' approach for investors who are not solely focused on the industry."

Cyclicality dictates that hotels will not be an 'always and everywhere' approach for investors who are not solely focused on the industry. Volatility in earnings underscores the significant opportunistic play available to investors at certain points in the cycle. Thus knowledge of when to enter and exit hotel investments is perhaps more critical than for any other type of real estate. Risk can be further lessened by understanding how to underwrite hotels, including the value on higher cash-on-cash return requirements (than compared with offices). It is knowledge such as this, which allows certain investors to enjoy tremendous success in the hotel arena.

Are Hotels a Predictor of Office Market Cycle Positions?

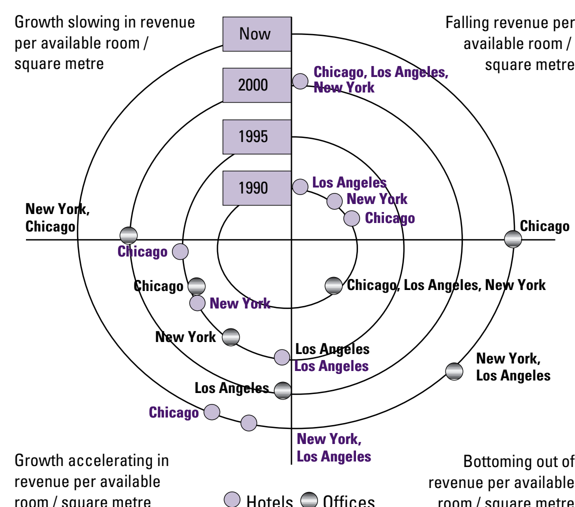
Cycles are critically important in the real estate investing business. In the majority of cases, the point at which one buys (and sells) in the cycle dictates the degree of profitability (or loss). Hotels are rarely a 'stabilised' asset – they are either on their way up or way down. While in a broad operational sense, offices and hotels differ due to rate variations, there appears a causal link in their respective cycle positions. This suggests that hotels can act as a barometer of office market performance, given their quick reaction to economic climate, as determined from the first article. It also serves to demonstrate that hotels play an important role in balancing investment performance in a mixed real estate portfolio.

"Hotels can act as a barometer of office market performance."

Americas

More recently, hotels appear to have assumed a 'leader' effect in relation to the office cycle position. Using three of the largest US hotel markets: Chicago, Los Angeles and New York

Hotel versus Office Cycle Positions – Americas



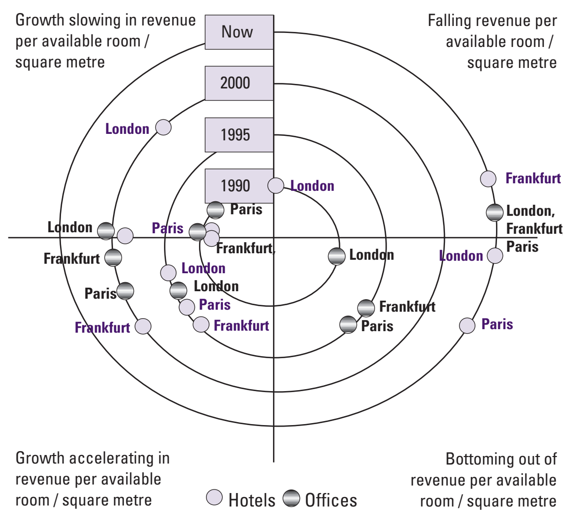
Source: Jones Lang LaSalle Hotels; LaSalle Investment Management
Note: the allocation of the office and hotel positions were derived from separate groups within the firm and as a result, there was no collusion on their locations

as a proxy; we identified that hotels exhibited a 'lagged' cycle position as compared to offices in 1990. However, this pattern began to change in 1995 when the markets appeared closely aligned. As we approached the new millennium, the 'leader' effect of hotels became evident, with 2000 indicating an earlier peak than offices. This was reaffirmed in the current position (2003), with hotels demonstrating an advanced trough to offices.

Europe

In most cases throughout almost a decade, the position of hotels on the market cycle has pre-empted that of offices for Europe, when using London, Frankfurt and Paris as samples. Relative positions in 1990 indicated hotels lagged offices (similar to the US pattern), as the hotel market continued to grow in the face of a widespread real estate downturn. After the demand shock of the Gulf War, hotels recovered quicker and led the office sector by 1995, and generally remained in this predictor position in both 2000 and 2003. Frankfurt's predominantly corporate based guest mix has perhaps contributed to the city's lagged position relative to offices, since this sector will often be slower to react than tourist and leisure based demand.

Hotel versus Office Cycle Positions – Europe



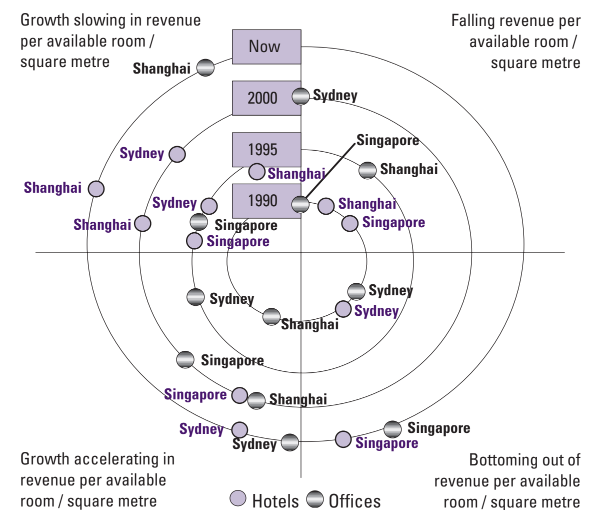
Source: Jones Lang LaSalle Hotels; Jones Lang LaSalle
Note: the allocation of the office and hotel positions were derived from separate groups within the firm and as a result, there was no collusion on their locations.

Asia Pacific

Looking at the current cycle positions of the mature Sydney and Singapore markets it would appear that hotels act as a barometer of the market as they are at slightly advanced positions compared to office. Shanghai is contrary to this trend as we have used the Puxi area for our analysis, which is closer to its office development peak than the newer commercial area of Pudong which is the centre of Shanghai's strong growth.

However, over the last 13 years, there appears no consistent trend in the comparison of hotels and office on the market cycle. Over the years, hotels have shifted from a leader to a lagger position across the three Asia Pacific proxy cities reflecting the findings of the first article. This surmised a departure in rent / rate movements between the two sectors in this region (in contrast to Europe and United States) that in turn materially impacted the yield curve. As such, while Europe and United States demonstrate consistency, whereby hotels act as a leader in comparative cycle positions, Asia Pacific will remain contrary until there is convergence in rentals / rate patterns.

Hotel versus Office Cycle Positions – Asia Pacific



Source: Jones Lang LaSalle Hotels; Jones Lang LaSalle
Note: the allocation of the office and hotel positions were derived from separate groups within the firm and therefore there was no collusion on their locations.

Property and Operating Risks

There are two core areas of risk in hotel investment: property risk and operating risk. Property-specific risks include due diligence risk, functional obsolescence, legal liability and management company default. Operational or market risk incorporates economic cycles, demand shocks, excessive new construction and liquidity.

Importantly, these risks can be managed and experienced investment advisors can identify and mitigate these risks. In private hotel ownership, an investment manager and asset manager acts as an owner's representative. The skill of this manager, both at the investment selection stage and in the oversight of the hotel operations, is key to managing risk. A brief exploration of these mitigating factors is provided in the following table.

"The skill of this manager is key to managing risk."

Hotel Investment Risk Mitigation

Risks	Example	Mitigating Factors
Property		
Due diligence	Missing a systemic problem with the HVAC (Heating Venting Air Conditioning) units which will require a large capital expenditure to remedy.	Formulate a rigorous due diligence list and employ the services of hotel specialists in economic, environmental, physical and legal due diligence matters. If underwriting is done internally seek an independent check of assumptions.
Functional obsolescence	Small bathrooms which do not meet brand standards of many management / franchise companies.	Ensure investment management team is knowledgeable and experienced with trends in hotel demand. Hotels are a capital intensive asset and investors wishing to avoid such liability will need to make careful selections and receive intuitive advice from specialists.
Legal liability	Physical harm from inadequate lighting in stairway areas.	Appoint investment managers with specialised hotel experience at the acquisition stage and also throughout operations. A sophisticated approach to insurance management is also important, particularly as costs have escalated significantly.
Operational / Market		
Demand shocks	A San Francisco hotel that primarily relied on a few key group accounts which were high tech firms.	Diversify demand sources to smooth volatility and potential exposure to significant performance hits. The sales and marketing team should continue to nurture key accounts but also broaden the demand base to include an adequate weighting of leisure, group, corporate, conference (if relevant), FIT (free independent traveller) and discount (eg. air crew, internet) business.
Excessive new construction	Four new limited service properties open within two blocks of your business hotel.	Seek markets that offer high barriers to entry. At the time of investment, excessive future competition should be reasonably assessed. If an excessive (unforeseen) pipeline exists during in the investment period, the investment manager can be proactive through repositioning to focus on key differentiating factors, or recommending a sell strategy.
Management default	Hotel performance falls well below competitive set levels.	Install protection measures in the management contract which allow for management termination or 'payback' provisions if performance falls below an agreed metric. In turn, alignment of interests should be facilitated whereby management shares in the upside of a hotel's performance above an agreed metric.
Liquidity	Nobody wants to buy your hotel.	Focus on "generic" full-service hotels in top markets which can be sold free and clear of management / brand as this will provide a deep universe of buyers. Experienced investment managers can take advantage of market mis-pricing to time buying or selling decisions, thereby capitalising on hotels' limited liquidity in comparison to stocks and bonds.

Source: Jones Lang LaSalle Hotels

Portfolio Risks

"Investors must also deal with portfolio risk, which includes portfolio concentration, management exposure and financial structure."

Investors must also deal with portfolio risk, which includes portfolio concentration, management exposure and financial structure. In addition to managing property-specific risk, an investor can diversify risk away by holding a well-balanced hotel portfolio that invests in multiple property types and geographic areas.

The risk of portfolio concentration results from too heavy a weighting in either a geographic area or a property type. Geographic diversification allows for differentiated exposure to the economic cycle, while property type diversification allows for broader demand exposure. Portfolio-balancing techniques incorporate the development of short, mid and long-term strategies for each asset in the portfolio, culminating into either a buy, sell or hold recommendation by the investment advisor. Furthermore, an effective advisor should be able to identify portfolio over-weights where expected incremental returns outweigh the risks.

Management and brand exposure risk is not such a large issue since partnering with one or a small number of management companies often create synergies. An added complexity to this issue is radius restrictions, which potentially limit an investor's options. However, in most cases these issues are resolved at the acquisition stage and therefore should not present ongoing problems for an investor, assuming portfolio-balancing strategies are implemented.

Risks from the financial structure can be managed effectively at the portfolio level, while they may not be manageable at the asset level. Often buildings are sold with a financial structure in place (i.e. to buy the building, an existing mortgage must be assumed) that may not be consistent with the investor's targeted leverage risk. By mixing assets with above targeted risk with unleveraged

assets, the desired level of mortgage debt can be achieved on a portfolio basis.

Hotels' Role in a Diversified Real Estate Portfolio

Hotels play an important yield-rich role in a diversified real estate portfolio. Given the risk factors mentioned previously, for investors who are not solely focused on the lodging sector, hotels traditionally fit into an 'opportunistic' investment strategy, where there are no set expectations on income, but the total return on the investment would be in the upper teens or above. For a more opportunistic strategy in North America and Europe, LaSalle Investment Management suggests up to a 10% portfolio weighting to hotels, with a smaller percentage for Asia Pacific. The design behind such a strategy is that hotels offer, in most cases around the world, a counter-cyclical play, where there is real potential for significant capital appreciation.

Hotels and wider real estate also play an important role in a mixed-asset portfolio. Analysis of asset performance over the past twenty years indicates that an optimal portfolio mix would include a 10% to 30% allocation to real estate, when considering a portfolio return of up to 14%. Based on an opportunistic strategy therefore, hotels would have a 1% to 3% role in a mixed asset portfolio, comprising stocks, bonds and other real estate. However, this allocation would optimally be higher if the return requirements for the portfolio were higher than 14%. While this allocation for hotels might seem an insignificant amount, in the case of say CALPERS (largest US pension system) it would equate to $1.4 billion to $4.1 billion.

In all reality, no institutional quality investor currently allocates 30% of their portfolio to real estate, let alone 3% to hotels. However, several large government pension plans have an 8% or greater real estate allocation and are increasingly looking at hotels to provide additional yield lifts to their portfolios. In Germany, certain open-ended funds are understood to have between 4% and 8% of their real estate portfolio in hotels and are known to be acquisitive.

The Future Role of Hotels

Since 2001, hotel real estate markets have weakened given the synchronised slowdown in national economies around the world. However, in many markets this softening has occurred from historically high levels of performance. The combination of weakening hotel markets, low inflation and plentiful capital means that unleveraged real returns from hotels will likely fall below levels achieved in the late 1990s.

New acquisitions of high quality, well located, unencumbered assets purchased this year at lower prices can be expected to generate initial yields of 6% to 12% and unleveraged IRRs of 12% to 16%. While these percentages might not seem as compelling as in the late 1990s, adding hotels to a real estate based or institutional portfolio still makes sense given:

- Low inflation, and with rates expected to remain low, real rates of return are likely to register at or above historical averages.
- Low borrowing rates on an historical basis and relative to initial yields, meaning leveraged returns will stay relatively high.
- Fair valuation by historical standards.
- Out-performance (potentially) against other asset classes, including offices.
- Over-compensation of risk, which becomes apparent when analysing past risk-adjusted returns and yield premiums against office and treasuries.
- The hotel market and the economy are near cyclical lows. As both recover, returns could be higher than currently anticipated.

As the larger and more conventionally risk-adverse investors such as pension funds and institutions cast a wider net in search of higher returns, they are likely to challenge the traditional "no-bed" rule to real estate investment. And with good reason. Hotel investment no longer sits on the fringes of the investment domain, an asset class once only for the venture-capitalists or highly specialised outfits. Accelerated maturation has formed a central component of this sea-change, as investors become more experienced, capital markets more disciplined and the demand supply balance less unbalanced. There still remains a higher component of risk, with the hotel sector vulnerable to demand shocks such as terrorist attacks. Yet with a disciplined and specialised investment and / or asset manager, the impacts of such risks can be mitigated and returns maximised.

We gratefully acknowledge the input of LaSalle Investment Management in the development of this article.

Methodology for Trading Performance Relationship - pages 1-7

Sample

The analysis focused on the major CBD market in the following cities:

US	Europe	Asia Pacific
• Chicago	• Amsterdam	• Kuala Lumpur
• New York	• Frankfurt	• Shanghai
• Los Angeles	• London	• Singapore
• Washington DC	• Madrid	• Sydney
	• Paris	

We used comparable samples for hotels and office space depending on the data available. In Asia, we compared 4 & 5 star hotels with prime office space, whereas in the US and Europe, we compared the total hotel market with the total office market.

Occupancy

Occupancy for hotels was calculated as room nights demanded divided by room nights available. The occupancy factor for office space was calculated as one less the vacancy factor.

Rent / Rate

We compared hotels' average daily rate (ADR) with office net rents, which take into account incentive payments and the like. As we were comparing the annual change in rents and rates, we used the currency in which the local market deals, that is the local currency in all markets except for China where US dollars are the quoted currency for office rents.

RevPAR / RevPAM

This measure was calculated as the occupancy rate multiplied by the net rent or ADR of each asset class.

Biographies of Guest Contributors

Jonathan D. Gray, Senior Managing Director, Blackstone Real Estate Advisors

Jonathan D. Gray is a Senior Managing Director in the real estate group and joined Blackstone in 1992. Mr. Gray has played a leading role in Blackstone's lodging related investment activities, where it has acquired more than 25,000 rooms, including The Savoy Group in London and Homestead Studio Suites in the US. In addition, Mr. Gray has overseen the acquisition of nearly 7 million sq. ft. of office, multi-family and retail properties, including Rincon Center in San Francisco and 609 Fifth Avenue in New York City. Mr. Gray also formed a series a successful joint ventures with Glenborough Realty Trust, a publicly traded real estate investment trust.

Prior to joining the real estate group in 1994, Mr. Gray worked in the Mergers & Acquisitions Advisory group and the Private Equity group at Blackstone. Mr. Gray received a B.S. in Economics from the Wharton School, as well as a B.A. in English from the College of Arts & Sciences of the University of Pennsylvania, where he graduated magna cum laude and was elected to Phi Beta Kappa. He currently serves on the Board of Directors of The Savoy Group and Homestead Studio Suites.

Sandy Calder, Chief Executive Officer of Principal Real Estate Investors

Sandy has been Chief Executive Officer of Principal Real Estate Investors (Australia) Limited since April 2001. His role is to oversee the strategic and operational matters that affect Principal Office Fund and Principal Real Estate Investors Australia as a whole.

He has extensive experience in this role from his previous positions as head of property securities and head of listed property at Colonial First State Investment Managers. During his five years there he managed the growth of the Property Securities Fund from $49 million to $1.2 billion. He also managed the merger of four smaller funds to form their $1.7 billion diversified listed property trust.

Sandy was admitted to the Supreme Court of South Africa as an attorney before gaining 13 years experience in funds management, 11 of these being in property investment. He has a number of qualifications including a BA LLB MSc (in building) and a diploma in financial management. He is a Fellow of the Australian Property Institute and serves on the Capital Markets Committee of the Property Council of Australia.

Biographies of Jones Lang LaSalle Hotels' Contributors

Ian Chappell, Senior Vice President, London

Ian Chappell joined Jones Lang LaSalle Hotels in February 2000 after several years working in Jones Lang LaSalle's commercial real-estate advisory group. He is engaged in a diverse range of sales, leasing and advisory mandates, with a particular focus on the UK and resort markets. Recent achievements include acting on behalf of InterContinental Hotels in the acquisition of the Posthouse portfolio, and advising a major international operator to identify expansion options to meet their EMEA development strategy.

Prior to joining the hotels team, Ian's principal skills were gained in an international real-estate arena, where he developed expertise on other specialist real-estate trading assets, including advising Investcorp on their acquisition of the Welcome Break portfolio of motorway service areas.

Ian has a Bachelor of Science in Estate Management and a Master of Arts from the University of Newcastle Upon Tyne. He is a Member of the Royal Institution of Chartered Surveyors.

Hok Yean Chee, Senior Vice President, Singapore

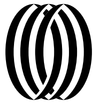
After 16 years in the Advisory unit in Jones Lang LaSalle, Hok Yean joined Jones Lang LaSalle Hotels in 2002. In her new role, Hok Yean undertakes valuation and advisory assignments within Asia and supports the brokerage area of Jones Lang LaSalle Hotels. Hok Yean has carried out valuation and advisory assignments in Bangkok, Batam, Bali, Beijing, Cambodia, Hanoi, Ho Chi Min, Hong Kong, Jakarta, Macau, Mauritius, Myanmar, Shanghai, Singapore and Suzhou. She has also co-ordinated valuation assignments for major corporate clients in Australia, China, Hong Kong, Indonesia, Korea, Malaysia, Myanmar, New Zealand, Philippines, South Africa, Taiwan, Thailand, United Kingdom and Vietnam. Hok Yean is a licensed appraiser with a Bachelor of Science (Honours) in Estate Management from the National University of Singapore. She is also a Member of the Singapore Institute of Surveyors & Valuers.

Melinda McKay, Senior Vice President, Chicago

Melinda is responsible for strategic investment advisory consulting for Jones Lang LaSalle Hotels and has over ten years experience in the lodging industry. Current assignments include assisting LaSalle Investment Management in the development of its opportunistic hotel program and the World Bank in global portfolio balancing and investment strategy execution. Recent examples of Melinda's buy side and underwriting advisory include advice to Rockwood Capital on the fair market prices for the Starwood portfolio of 14 hotels and value considerations on a 10-hotel portfolio for a major private equity firm. Melinda graduated with Merit from the University of NSW with a Bachelor of Commerce (Marketing / Hospitality) degree and is a member of Jones Lang LaSalle's Global Research Board.

Michelle Webb, Vice President, Sydney

Michelle is responsible for the coordination of hotel investment research for Asia Pacific and is also involved in various consultancy assignments for key hotel and tourism clients. She has undertaken assignments for government agencies, lobbying bodies and leading private institutions including supply and demand forecasts, the identification of hotel investment impediments, analysis of accommodation needs, feasibility studies and key note speeches. Michelle also assumes responsibility for the regional marketing of Jones Lang LaSalle Hotels. Michelle has a Bachelor of Commerce (Marketing / Hospitality) from the University of NSW.



Jones Lang LaSalle Hotels™

Dedicated Hotel Offices

New York
153 E. 53rd Street, 33rd Floor
New York NY 10022
tel: +1 212 812 5700
fax: +1 212 421 5640

Los Angeles
Suite 4280
355 South Grand Ave
Los Angeles CA 90071
tel: +1 213 680 7900
fax: +1 213 680 7933

Chicago
200 Randolph Drive
Chicago IL 60601
tel: +1 312 782 5800
fax: + 1 312 782 4339

Miami
Gables International Plaza
Suite 1004, 2655 Le Jeune Road
Coral Gables FL 33134
tel: +1 305 779 3060
fax: +1 305 779 3063

London
22 Hanover Square
London W1A 2BN
tel: +44 20 7493 6040
fax: +44 20 7399 5694

Paris
58/60, Avenue
Grande Armee
75017 Paris
tel: +33 1 4055 1530
fax: +33 1 4055 1868

Barcelona
Passeig de Gracia 11
4a Planta, Esc. A
08007 Barcelona
tel: +34 93 318 5353
fax: +34 93 301 2999

Madrid
Paseo de la Castellana 33
Edificio Fenix Planta 14
28046 Madrid
tel: +3491 789 1100
fax: +3491 789 1200

Frankfurt
Platz der Einheit 2
60327 Frankfurt am Main
tel: +49 69 7543 1041
fax: +49 69 7543 1040

Munich
Maximilian Strasse 52
80538 München
tel: +49 89 212 6800
fax: +49 89 212 68010

Jakarta
Jakarta Stock Exchange
Building Tower 1, 17th Floor
Suite #1701, Sudirman Central
Business District
Jl. Jend Sudirman Kav 52-53
Jakarta 12190
tel: +62 21 515 5665
fax: +62 21 515 5666

Tokyo
3F, ATT New Tower
2-11-7 Akasaka
Minato-ku
Tokyo 107-0052
tel: +81 3 3568 1066
fax: +81 3 3568 3356

Singapore
9 Raffles Place
#38-01 Republic Plaza
Singapore 048619
tel: +65 6536 0606
fax: +65 6533 2107

Sydney
Level 18
400 George Street
Sydney NSW 2000
tel: +61 2 9220 8777
fax: +61 2 9220 8765

Brisbane
Level 33, Central Plaza One
345 Queen Street
Brisbane QLD 4000
tel: +61 7 3231 1400
fax: +61 7 3231 1411

Jones Lang LaSalle Hotels is the largest and most qualified specialist hotel investment services group in the world.

Through our 15 dedicated offices and the global Jones Lang LaSalle network of 7,000 professionals across more than 100 key markets on five continents, we are able to provide clients with value added investment opportunities and advice.

Our recent track record for the last year alone included the sale of 6,747 hotel rooms to the value of US$862 million in 36 cities and advisory expertise for 116,877 rooms to the value of US$17.8 billion across 170 cities.

Disclaimer Copyright - All material in this publications is the property of Jones Lang LaSalle Hotels (NSW) Pty. Ltd. (ABN 65 075 217 462). No part of this publication may be reproduced or copied without written permission. The information in this publication should be regarded solely as a general guide. While care has been taken in it's preparation, no representation is made nor responsibility accepted for the accuracy of the whole or any part. This publication is not part of any contract and parties seeking further details should contact the author.