ERNST & YOUNG’S HOSPITALITY ADVISORY SERVICES GROUP recently conducted the 2007 Hospitality Investment Survey of professionals within the US hospitality industry to gauge overall sentiments regarding future industry dynamics. The survey targeted key decision-makers, focusing on major trends related to hospitality investment both in the US and internationally. Approximately 300 respondents participated in the survey. Respondents were comprised of senior management in all facets of the hospitality investment community, including management company executives (25%), developers (15%), consultants/advisors (14%), private investors/private equity firms (10%), brokers (9%), lenders (6%), REITs (5%), investment bankers (4%), and others (12%), including owners, operators, franchisors, asset managers, analysts, academics, institutional investors, and government representatives.

Upon analysis of the survey results, key highlights, reflective of overall views on the hospitality industry, include the following:

**Domestic**
- Hospitality investment activity anticipated to remain strong to at least mid 2008
- Perception of hospitality real estate as being generally overvalued, highlighting the importance of more comprehensive due diligence
- Capitalization rates anticipated to stabilize or increase over the short to medium term
- Investment strategies transitioning from acquisitions to developments
- Strongest interest over the medium term anticipated in luxury, midscale without food and beverage, and upper-upscale segments, respectively
- High-performing markets generally continue to attract highest levels of investment

**International**
- More interest in deals outside the US over near to medium term as investment opportunities are difficult to source domestically
- While the established economies of Europe have previously been the main focus of the investment strategy, respondents clearly favor the emerging markets of Asia as providing the greatest potential in the future
- Strongest interest over the short term will be in luxury, upper-upscale, and upscale segments, respectively
- The biggest risk factor to international hospitality investments is political and economic instability, and the greatest upside is the growth potential
US Lodging Market Investment Environment

While hotels were historically viewed as one of the riskier asset classes since profits fluctuate based on changes in daily demand that directly impact revenues and expenses, this notion has changed. The change has been supported by the resurgence of demand, which has outperformed supply, along with stronger rate growth in light of stabilizing occupancy levels. Aside from unforeseen economic changes, demand outlook is anticipated to continue to improve, helping to increase the overall transparency of the hotel industry and to encourage further investments.

According to Jones Lang LaSalle, the US lodging transaction market for 2006 reached a record high of $34.8 billion, an increase of 7.6% compared to 2005. This can be attributed to investor strategies geared toward upside potential achieved through developing new brands or repositioning existing assets, resulting in record prices in single-asset and portfolio transactions. In particular, international investors are considered to be major investors in large US-based transactions over the near term. The focus on this asset class is expected to continue until at least the middle of 2008, as more than 80% of the survey respondents anticipate their investment activity in hospitality will remain the same or increase over the next 12 months.

The National Council of Real Estate Investment Fiduciaries stated that hotels outperformed all other sectors during the first half of 2006, with annualized returns of 20.8%. Over the last few years, these high returns were a result of the combination of historically low capitalization rates, improved operating performance, and a favorable capital market environment. As demand continues to outpace supply, competition for the limited number of existing assets is anticipated to increase hotel pricing through the end of 2007 in specific primary markets.

Despite the continued interest in the hospitality industry, the majority of survey respondents (59%) believe that hospitality assets are currently overvalued. Indeed, recent transaction prices have hit record highs, fueled until recently by the abundance of available capital including an active debt market. Only 4% of those surveyed consider hotel assets to be undervalued, indicating that sourcing new investment opportunities may be difficult going forward as investors see limited potential for upside. Respondents overall perceive that hotel values are near their peak, with 68% anticipating values to remain stagnant or decline over the next year. This sentiment is further echoed as a majority (88%) anticipate capitalization rates to remain at current levels and even increase over the next 12 months.

In terms of investment strategy, within the US, a clear shift has begun toward development projects (52% of respondents) and away from acquisitions (48% of respondents), anticipated to continue over the next two to three years. It has becoming increasingly apparent over the last two years that in certain markets, despite rising construction costs, building a new hotel may be more feasible than buying an existing hotel as demand outpaces supply and values soar. Overall, changes in the debt market are clearly visible, not only through increases in interest rates, which were previously at such lows, causing a buying spree in all real estate sectors, but also through a shift to more conservative underwriting guidelines.
US Chainscale Segments

In 2006, revenue per available room (RevPAR) continued to grow across all segments in the US lodging industry, resulting in an overall growth rate of 7.6% compared to 2005. These record highs were primarily driven by the 7.2% increase in average daily rate (ADR). Growth in all segments is expected to originate from increases in ADR as occupancy stabilizes due to monthly and daily patterns of demand and additions to supply. RevPAR is anticipated to continue increasing in 2007, although at a slower growth rate of 5.8%. According to Smith Travel Research, as of year-to-date June 2007, RevPAR for the US lodging industry increased by 5.5%.

Figure 1: RevPAR Growth by Segment

<table>
<thead>
<tr>
<th>Segment</th>
<th>YTD August 2006 (STR)</th>
<th>YTD August 2007 (STR)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Luxury</td>
<td>11.5%</td>
<td>11.5%</td>
</tr>
<tr>
<td>Upper Upscale</td>
<td>7.1%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Upscale</td>
<td>8.1%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Midscale with F&amp;B</td>
<td>9.8%</td>
<td>8.3%</td>
</tr>
<tr>
<td>Midscale without F&amp;B</td>
<td>6.0%</td>
<td>3.9%</td>
</tr>
<tr>
<td>Economy</td>
<td>9.8%</td>
<td>6.3%</td>
</tr>
</tbody>
</table>

Source: Smith Travel Research

Figure 2 illustrates respondents’ anticipated investment strategy by hotel chain scale segment (excluding the extended stay segment) by comparing investment strategy for the next 12 months against outlook for the next two to three years. Although luxury, midscale without food and beverage (F&B), and upper-upscale segments remain the most popular segments in terms of RevPAR outlook, supported by actual and projected RevPAR performance, investment strategy over the next 12 months shows the strongest preference for the upper-upscale segment (30%) over the other two. This suggests that next year, industry participants believe the upper-upscale segment will greatly benefit from continued increases in corporate, convention, and leisure demand levels. However, in the longer term, hotel professionals appear to change the order of their preference to mirror each segment’s historical and anticipated RevPAR performance (Figure 1), indicating that investment preference is based primarily on segments that have proven strong fundamentals.

The luxury segment continues to outperform the other segments due to its ability to leverage robust ADR growth caused by high barriers to entry for this segment and increases in disposable income and personal consumption expenditures. The other distinguished segment is midscale without food and beverage, which benefits from relatively low construction costs, accessibility to a wide franchise market, and higher operating margins with comparatively lower execution risk.
**US Geography**

According to Smith Travel Research, the top RevPAR growth markets in 2006 were Chicago, Manhattan, San Francisco, and Dallas due to factors such as increases in corporate demand and higher ADRs from new luxury supply. Many of the other markets that continue to attract investors are those with high barriers to entry, such as Washington, D.C., and Los Angeles, mainly attributed to limited supply growth, a solid demand base, and elasticity.

**Fig. 3: 2006 PevPAR Performance by Market**

Source: Smith Travel Research
High-performing markets have historically attracted investors and are further confirmed to be popular from the results of the investment survey. The cities in which the respondents are most likely to invest within the next 12 months are Washington, D.C. (9.5%), New York City/Manhattan (9.5%), Los Angeles (9.0%), Chicago (8.7%) and San Francisco (8.4%), a majority of which are shown as high performers based on RevPar growth in the chart above. This trend is likely to continue going forward.

While the majority of these markets support the theory that high performance results in high investment interest, there are a couple of exceptions worth noting. Washington, D.C., (9.5%) is the city in which respondents are most likely to invest even though it was not a top-performing lodging market in 2006.
Occupancy rates in 2006 decreased 3.0 percentage points, which is mainly attributed to the 2005 presidential inauguration, thereby enhancing performance in 2005. Many neighborhoods in the area are undergoing revitalization and emerging as viable lodging markets, which is anticipated to increase overall demand. Additionally, the federal government, the most stable sponsor of lodging demand in Washington, has created a market less susceptible to economic downturn and geopolitical instability, thus mitigating investment risk. In contrast, Dallas was a top-performing lodging market in 2006, yet very few respondents indicated they would likely invest in this market (3.2%) within the next 12 months. In 2006, overall occupancy in Dallas increased by 1.2 percentage points and ADR increased by 10.3%, resulting in a RevPAR increase of 12.5%. Since 2005, Dallas has dramatically increased hotel property tax rates. Additionally, recent and upcoming supply increases make sustained strong market performance uncertain. This combination of significant increases in property taxes and the potential of over-supply in the Dallas lodging market has contributed to investors’ hesitation to enter the market within the next 12 months.

International Lodging Market Investment Environment

Finding it progressively more difficult to source investment opportunities to fit their return profiles, investors are increasingly looking outside the domestic market for cross-border investment opportunities. According to Jones Lang LaSalle, global hotel investment in 2006 reached $72.5 billion, which was 62.9% higher than 2005’s hotel transaction volume. Approximately half, or $35 billion, was placed in investments outside of the US. This trend is expected to continue, as evidenced by significant portfolio transactions that occurred in the first half of 2007.

Currently, only one-third (37%) of the respondents invest in hospitality internationally. However, this portion is anticipated to increase in the near to medium term as almost 46.1% of respondents anticipate focusing more on international opportunities.

International Regions

While investors have increasingly turned their focus outside of the US to global markets, a few regions have demonstrated their propensity for growth more quickly than others. Europe and Asia continue to have a stronghold on investor interests due to strong ADR and RevPAR growth rates and high barriers to entry. Twenty-two percent of those surveyed are currently investing in Europe, and 15% believe Europe to have the greatest potential for hospitality investment. As indicated by survey respondents, 41% believe that Asia has the greatest potential for hospitality investment, while 19% are currently invested there. With China and India having opened their markets to international investors, a record level of transaction volume was recorded in 2006. Several major markets have experienced double-digit growth in the past few years, and the amount of capital that is seeking investment outweighs the number of assets that are available in the market. According to Jones Lang LaSalle, in 2006, $26.8 billion was invested in European hotel real estate, and total transaction volume reached $4.25 billion in Asia-Pacific.

Despite obstacles such as local legislation and development laws, both Latin America and the Caribbean remain high on the investment radar. Stabilizing economies and politics in countries such as Mexico further support foreign investment initiatives. Approximately 15% and 14%, respectively,
of survey respondents currently invest in the Caribbean and Latin America. Investment in the Middle East continues to grow as well, most notably developments in the luxury segment and those with mixed-use components, especially in areas such as Dubai and Abu Dhabi, as tourist arrivals and RevPAR growth reach record levels and returns remain high. Approximately 13% of survey respondents indicated that they believe the Middle East to have the greatest potential on a relative basis for hospitality investment.

Fig. 6: Current Hospitality Investments vs. Greatest Potential for Hospitality Investment

![Graph showing current investment vs. greatest potential investment by region.]

Source: EY Hospitality Investment Survey

This comparison illustrates the enormous investment potential that hospitality professionals see in Asia, particularly compared to their existing investments in Latin America and the Middle East.

**International Chainscale Segments**

While the survey respondents indicate greater interest in higher-rated segments for both domestic and international investments, their interest is skewed towards the luxury segment, with a preference of 37% internationally versus 23% domestically. Thirty-three percent of respondents who indicate an interest in international markets would seek opportunities in the economy to upscale segments compared to 46% of domestic investors. Investors appear to be more comfortable investing in high-end properties, which tend to attract more international travelers and rely less on the local markets. Also, luxury properties typically allow for placing more capital for a single asset than the lower-rated segments do.
International Risks and Upside

One of the main reasons that investment activity by most US-based hospitality companies is relatively lower internationally than domestically is the perception of greater risks. According to the respondents, among the greatest risk factors to international hospitality investments are political instability (27%), economic instability (22%), currency risk/inflation (19%), prohibitive and unclear local legislation (15%), and terrorism (15%). Regions that have political instability have more of a tendency to drive away potential investors, explaining the relatively low current investment (8% of respondents) in the Middle East.
However, some of these risk factors are mitigated by the potential upside that international hospitality investments offer, such as growth potential (38%), abundance of opportunity (24%), higher returns on investment (23%), and risk diversification (14%). Many of these provide the rationale for Asia being perceived as offering the greatest potential for international hotel investments, given China and India’s rapid economic expansion, increased transparency, and easing of restrictions on international investment.

Fig. 9: What Do You View as the Biggest Upside to International Hospitality Investment?

Source: EY Hospitality Investment Survey
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