How Barack Obama will affect the US hotel industry

Economic woes in 2009: Managing in a downturn

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2009 is going to be a year of challenges without easy fixes, writes ALLEN TOMAN, Como-based consultant with REALITY ADVISORS, and the Hobbesian quote he selected aptly describes the unpleasantness ahead, as hotels must come to terms with a number of negative factors that can each have an impact on the health of their business. Here he looks in detail at the implications for real estate, finance and hotel operators. Grim reading.

« Capitalism is the astounding belief that the most wickedest of men will do the most wickedest of things for the greatest good of everyone. »
- John Maynard Keynes, economist.

« History has not dealt kindly with the aftermath of protracted periods of low risk premiums. »
- Alan Greenspan, former Chairman of the United States Federal Reserve.

As this is written, the world stock markets continue to shed value as the probability of a serious global recession increases. The European nations have discovered their financial institutions and systems are not immune from the meltdown – and, to their great dismay, that their own banks were both active participants in the practices, and suppliers of the products that resulted in a global capital market crisis.

By the time this is being read, the capital markets may once again be operating with greater liquidity and less volatility. However, in 2009 things will not return to « normal » for the hotel industry, either in terms of real estate or operations. It will be a period of adjustment and re-adjustment as circumstances unfold.

At present, the erosion in the capital markets (debt and equity) continues, despite the commitment of governments across the world to inject massive, and historic, amounts of capital directly and indirectly into the financial markets. Commitments already made by governments, if fully drawn upon, could total some 15% of the world’s GDP. It is not yet clear that this will be enough. In effect, governments have been putting up a series of financial fences. With each new fence, they are hoping to halt the massive financial avalanche that is being driven by investor sentiment (i.e. fear), as well as the growing realization of the seriousness and extent of the damage done to the world financial system. To date, each successive fence has increased future risk while slowing, but not halting, the downward momentum.

With a primary focus on Europe, the following is a brief surmise as to some of the ways these events may translate into the hotel industry for 2009, for both the asset (real estate) and the services (operations) components of the industry.

Clearly, it will be a year of challenges without easy fixes. At best, it will be a year when the markets bottom out and the ground work is laid for an economic recovery that will take years to accomplish. Some have termed this a period of « de-leveraging » when consumer and industry debt levels rebalance to more supportable levels. But this period also represents a fundamental re-pricing of risk and a new resolve by governments to better regulate risk taking. This realignment is likely to impact the capital market landscape for at least a generation and to have far reaching effects on the hotel industry.

A bit of macro-economic perspective
Before looking at possible impacts, it may help to put to rest an idea forwarded by some analysts that the EU may fare better in the coming downturn or that the downturn may be less serious than it appears to some.

The first idea is that the fast-growing economies of China and India may be able to use their stock of foreign reserves to continue growth and thus « rescue » the world economy, and that this will have a favorable impact on the EU. The accompanying chart provides a snapshot of the GDP, personal consumption expenditures and population for some of the larger economies in the world. While the double digit growth of the economies of China and India have contributed over 50% of the increase in the world GDP over the past year, their relatively modest size and dependence on the more developed economies will not make up for the low growth experienced next year by the « Big Three » (the USA, the EU and Japan), where forecasts range from less than 1% to negative growth. And, given the large negative trade balance the EU has with China – the EU imports from China nearly 3 times the amount it exports to China – further strengthening in the Chinese economy is unlikely to translate into gains for the EU. (China is prepared to commit a substantial portion of their current account balance – some $1.4 trillion – to prop up their economy; however, it is likely that much of this money will go to multiple-year housing and infrastructure investments which will have few positive « spillover » effects for the EU.)
The second chart recasts this information in terms of personal consumption per capita and level of personal consumption as a percentage of GDP. Despite years of double digit growth, the economies of India and China remain relatively small on a per capita basis. Even if India and China were by some miracle able to increase their GDPs next year in line with revised growth estimates (8%-9%), avoid a real estate « crash » and boost personal consumption to levels more in line with the developed economies (say 60%), this would only add some $1 trillion to the world economy – i.e. less than 2%. Not enough to offset the amount of capital being poured directly, and indirectly, into the capital markets by governments around the world.

A second idea has been that trade with Russia and emerging markets, other than India and China, could provide a « soft landing » for the EU in the event of a global recession. Unfortunately, this is unlikely as the EU remains a net importer, and its only significant positive trade balance is with the USA. A significant recession in the USA, even with the currency adjustment that is currently underway, will only serve to increase the EU’s growing trade imbalance. (The Euro has appreciated over 20% versus the US$ in the past twelve months. Unfortunately, this has not been driven by the strengthening of the US economy, but by the perceived erosion of the EU’s economic prospects.) For 2007, the net trade balance approached -15%.

A third idea has been that the hotel industry might be immune, or less impacted, by the current downturn. One of the more interesting illusions of the past decade has been that commercial real estate, and in particular hotels, had somehow lost both their cyclical and unique risk components while retaining the positive attribute as an inflation hedge. For hotels this « illusion » was fueled, in part, by over seven years of ever-increasing profitability, quick recoveries from both terrorist incidents in various parts of the world and less serious economic downturns, copious amounts of new capital directed to the industry, the expansion of discount air service to both major and secondary markets, and moderate increases in rooms supply. (At least the EU will not have a similar problem that faces the US hotel industry where a large increase in supply is due to enter the market over the next two years).

These factors contributed to a reduction in the cost of financing (both debt and equity) and translated into a significant increase both in asset prices and the amount of debt...
financing. The chart below provides some evidence that banks and investors are quickly recovering from this illusion. The chart uses July 2007 as a base. This was the time when values approached a peak. The chart then provides a comparison of both the recent stock price and the price in July 2004 in relation to that base, or peak. July 2004 represents the start of the extended «rally» that led to the peak prices in mid-2007. In July 2007, the Dow Jones Industrial Average reached a record high from which it has retreated. To clarify: between July 2005 and July 2007, Marriott’s share price increased over 50%.

Between July 2007 and October 2008, it has decreased 62%. In the financial press, such an advance followed by a large retreat in price is often loosely referred to as a «bubble» or a «speculative bubble.»

At this time, the Dow is down some 40% from the record high achieved in mid-2007. Strategic Hotel & Resort (BEE), representing the real estate/asset side of the hotel business is down some 87% and Marriott International, representing services/operations, is down 62%. Accor, which represents a mix of real estate and operations is also down 62%. While the illustration is confined to a few examples, the overall results for the industry follow the same pattern: the stocks reaching a higher peak (from 2004 to 2007) are now are experiencing a more severe retrenching (2007 to 2008).

**Real estate / asset impacts**

Over the past decade, investors and lenders came to correctly realize that hotel real estate is another investment class with similarities to other asset classes such as stocks, bonds and commodities. As such, capital flows to the industry when investors perceive they can achieve superior risk adjusted returns. This awareness came to Europe when funds such as Blackstone, Colony Capital, and others began purchasing hundreds of hotels. Investors made the implicit argument that hotel ownership and hotel operations were separate enterprises with separate risk characteristics. Further, they argued that it was more efficient for the hotel companies to focus on operations while real estate specialists assumed ownership risk. (A less flattering version of this argument is that the hotel companies were simply inefficient owners of hotel assets.)

However, what was forgotten (or not mentioned) is that this asset class is subject to a variety of specific risks that tend to magnify the results in the overall economy, i.e. it tends to be cyclical. This is especially true in much of the EU where a larger proportion of the industry is geared to «cross-border» (international) demand, the meetings segment tends to be less fully developed, and leisure and tourism are more important market segments. As lenders discovered in the early 1990s, and are rediscovering now, industry fundamentals and individual property results can deteriorate rapidly when the economic prospects dim, leading to the deterioration of operating results, sharp declines in asset prices and the inability to support contracted levels of debt.

So what are some of the implications in 2009 for the real estate & finance aspects of the industry?

**Less complicated to predict:**

1. Transactions: a steep decrease in transaction volume, with the majority of transactions that do occur being «less than voluntary.» (However, individual governments may try to...
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mitigate damage in the hotel & real estate sector by extending the «good asset, bad asset» machinery that is already in use to stabilize the banking industry. In this case, several of the EU countries – particularly Spain and Germany – might try to stabilize falling asset prices by having the public sector absorb some of the losses.

2. Prices: down at least 20% from 2007 record levels and possibly as much as 30%. Based on the evidence from the public markets, investors are anticipating significant downward adjustments in asset prices. Recent downgrades by analysts from Goldman Sachs and Morgan Stanley suggest that a 20% downward adjustment is a minimum. The price reduction should be less in the «trophy»/luxury segment and greater in the regular, full-service and limited-service segments. However, if the investment funds are faced with redemptions requests, they could be forced to divest of assets and this could lead to the type of downward pressure on prices being experienced in the mortgage backed securities industry.

3. Supply: the pipeline in Europe will virtually stop except for extraordinary projects (i.e. those backed by sovereign wealth funds or with significant equity investment) or projects already underway.

4. Debt financing terms: a return to levels and terms last seen in the early 1990s, or before. These are likely to include:
   - 65%-70% loan-to-value ratios (or 30% to 35% of owner equity based on conservative valuations);
   - Lending spreads increasing above 250 basis points;
   - Annual debt coverage requirements rising to between 1.4 and 1.5, or more;
   - A shift from fixed to variable-rate loans with shortened (real) amortization terms.

5. Vacation ownership: a steep decline in new units, coupled with an increase in defaults on existing units. This is already showing up in the USA, where default levels on existing units have exceeded those in the residential housing market and several companies have indicated they are «rethinking» their investments and programs.

More difficult to predict:
1. Debt financing availability: much lower, but how much lower is unclear. The combined impacts of new regulations; recalibration of Basel II risk models; and greater tier 1 reserve requirements will make credit for hotel assets more expensive than other asset classes, and less available. This will be particularly evident in the EU-15 where government officials are using the threat of additional regulation to «suggest» that tier 1 capital reserves should be raised significantly which, in turn, raises the return requirements of lenders.

2. Leaseback transactions: renegotiation of terms and/or lessees looking for legal relief. (In cases where the security for the lease payment is property-specific, lessees may threaten default if terms are not renegotiated. However, where the security for the lease is not property specific but tied to the balance sheet of the company, the legal options of the lessee are fewer and more complicated.) This form of transaction represents a significant part of the major transaction activity for the past 3 to 5 years. Excepting the Accor transaction with Foncière des Murs (the transaction for 128 Accor hotels was based on a flat percentage of revenue; in effect, the buyers agreed not only to take on 100% of the ownership risk but also to share in the operating risk), the vast majority of these leases were structured based on a percentage of the transaction price. For 2009, this means that while operating profits decline sharply, the required lease payments remain fixed.

3. Investment fund model: no longer viable for 2009 and significantly revised thereafter. The current model was based on high levels of leverage (80% or more), an anticipation that net income could be improved by at least 10% within a three-year period through a combination of cost cuts, strategic investments and increasing rates, and that exit multiples would either improve or remain constant. With few exceptions, the assumptions underlying this investment model no longer apply. If net income remains flat (an optimistic assumption for 2009 and 2010) and exit multiples reflect the revised capital structure and costs of capital, then the 20%+ rate of return that investors anticipated would shift to a negative return. How institutional investors will react is difficult to assess.
They may have little choice but to accept the results as many of the funds «locked in» the investors by providing no, or limited, redemptions during the life of the fund.

**Service or operations impacts**

An apt summary of what individual hotels will face during 2009 is provided by the English philosopher Thomas Hobbes: «The condition of man… is a condition of war of everyone against everyone.» The next year will present numerous challenges to hotel management companies and to the on-site management staff. Hotels will face the combined impacts of business headcount reductions; business travel restrictions; further consolidation and route rationalization in the airline industry; decreases in public sector funding of events and location marketing; and a drop in overall travel. For newer entrants into the industry, this will be the first time they have faced prolonged decreases in occupancy and rate.

The majority of hotels in Europe are operated independently or loosely affiliated with marketing associations. These hotels will be faced with pressure to increase their marketing spend while trimming other operating expenses in an attempt to offset operating revenue declines. The chain hotels will face a similar dilemma. The international and regional chains have already started their initial corporate staff reductions. The first phase involved staff working in the areas of new management or franchise agreements. The next phase will involve marketing, reservations and revenue management staff. Operators of these hotels will be faced with fewer corporate resources during a very difficult period. This could well be the period when the gains the chain operators have made in Europe over the past five years are severely put to the test.

So what are some of the implications in 2009 for the service/operations aspects of the industry?»
Less complicated to predict:

1. Expenses: anticipated to increase 3-4%. Throughout much of Europe, the real danger is the potential that workers demand wage increases to offset real, or perceived, consumer price increases. The chains are already looking for ways to reduce expenses by a combination of curtailing services, staff reductions and pooling orders.

2. Owner & asset managers: increased presence and pressure on management, especially for hotels owned by investment funds. A number of asset management/advisory firms are setting up or expanding in Europe anticipating growing demand from hotel owners. (As the transactions firms downsize or shift their business focus, asset management becomes an attractive alternative. It will be interesting to see if owners with underperforming assets will choose to be represented by those who sold them those assets.)

3. Marketing: the initial reaction in a downturn is to hope it will be short. As demand weakens, the better operators will increase and target their marketing dollars in an attempt to capture incremental business.

More complicated to predict:

1. Rates, occupancy & RevPAR: across Europe, all are likely to be down significantly from 2008 results. The high estimate is that RevPAR increases by 2 to 3%; however, a decrease of 3% to 5% seems more probable.
   - Business sector: down as companies curtail travel and general economic activity lowers.
   - Tourism: down both on an intra-regional and an international basis. This will be driven largely by shifts underway in the airline industry as consolidation and adjustment to increased costs are accelerated by economic conditions. Consolidation and retrenchment within the travel companies, including a reduction in inventory, will also contribute to a weakening in the tourist segment.

2. Industry profitability: down. The issue is not whether, but by how much. Several industry analysts have recently revised their 2009 earning expectations for publicly traded firms downward by 30% or more.

A closing thought. The impact of the massive infusion of liquidity into the capital markets that is currently underway will be felt as necessary and, one hopes, a positive in 2009. It should provide the basis for lending and the stabilization of values. This will have a cost that will be paid by the various economies in the future: inflation. It will be nearly impossible to « de-lever » the world economy, foster economic growth and control inflation. That will be a challenge and a price paid by those still standing after 2009. As noted by John Maynard Keynes: « The best way to destroy the capitalist system is to debase the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens ».

For the hotel industry, there are three pieces of good news. First, once an economic recovery takes hold, inflation tends to feed through to hotel revenues at a greater rate than it does to operating expenses. So, in the longer run, the current fiscal adjustments should result in greater industry profitability.

Second, for the next three to five years, lenders will be more cautious about funding additions to supply which should, in the longer run, enhance the performance and the value of existing hotels.

And third, as the high-leverage investment funds exit the industry, or transform their investment model, in the long run the industry should be on more solid financial footing with less emphasis on short-term financial results. Of course, as John Maynard Keynes aptly noted, « In the long run, we’re all dead. »