Global Hospitality Insights

Top thoughts for 2013

Ernst & Young
Quality In Everything We Do

At the onset of 2012, the global hospitality sector faced a year of significant uncertainty ahead. The threat of the fiscal cliff in the US, economic and political instability in Europe and the Middle East, and slowed growth in prominent Asian economies threatened performance across the globe. Throughout the year, the hospitality industry continually faced pressure from external events; while some forces have stabilized, concerns of economic uncertainty persisted through the close of the year.

However, even in volatile environments, signs of renewed vigor emerged in 2012. Owners, investors and managers of hospitality assets who sufficiently addressed their capital needs and the changing preferences of guests witnessed an improvement in operating fundamentals over the course of the year. A growing number of transactions, often at the portfolio level, heightened investor sentiment for deals, though most property trades continued to occur in major international cities. Access to financing remained constrained in some regions; however, the lodging sector continued expansion into new international markets in 2012, often financed through a platform of creative capital and growing investment from private real estate funds.

While the recovery from the global recession has varied by region, traction gained in 2012 has positioned the hospitality industry for near-term sustainable growth. In 2013, the management and optimization of capital will remain top of mind for industry players. Owners will continue to assess deferred maintenance spending at the property level, while changes in governmental regulations will present hotel companies with new restructuring and tax considerations. Across the globe, an increase in tourism is anticipated over the next 12 months, resulting from the renewed efforts of destination marketing organizations, the increased use of technology and a growing interest in travel among the middle class of various emerging economies. The role of infrastructure will also gain prominence in 2013, as major cities continue to invest public funds to improve the movement of travelers from the airport to tourist attractions. Furthermore, investor demand in the capital markets will continue to rise; however, signs of a full recovery, including the IPOs of hotel companies and significant new loan origination, may require additional time to materialize, as markets slowly move towards a new equilibrium.

As globalization among all industry stakeholders and participants has become the standard, it is ever more critical to be aware of the changing transactional, developmental and operational landscape to be best positioned for success and to maximize value.

We are excited to present this year's edition of *Global Hospitality Insights: top thoughts for 2013*. The report reveals key issues and trends we believe will be the primary areas of focus in the global hospitality industry in the upcoming year.

Contents

Where we are now, and where we are going

Even in volatile environments, signs of growth and strengthening lodging fundamentals are present, positioning the global lodging sector for imminent and sustainable recovery going forward.

The outlook for the global lodging industry continues to be in flux; the influence of political and economic events, including the recent US presidential election, European sovereign debt crisis, ongoing conflict in the Middle East and the economic slowdown in Asia, has cast uncertainty on both developed and emerging markets worldwide. However, despite looming uncertainty, hotels worldwide have witnessed rising demand and improved lodging fundamentals in 2012; while performance will vary by region, the effects of a slow and stubborn recovery are positioned to materialize in 2013.

The US hospitality sector, most notably New York, San Francisco, Chicago and Los Angeles, continues to display signs of expansion and growth. Driven by gains in occupancy and average daily rate (ADR), it is anticipated that 2012 revenue per available room (RevPAR) averages in the US will return to 2007 levels. While US hotels overall have experienced improved operating fundamentals, upper-tier lodging segments are expected to achieve the highest RevPAR gains in 2012, as occupancy levels in these segments have already met or exceeded pre-recession levels.

Many factors, including strong barriers to entry, longer hotel development periods and decreased dependence on third-party wholesalers have positioned luxury, upper-upscale and upscale segments to achieve the highest RevPAR gains in 2012.[1] Overall, growth in both occupancy and rate is forecasted across all US hotel segments over the next few years, driven by a lack of significant new lodging supply, a recovery in leisure and corporate demand and effective hotel management. Positive lodging fundamentals, including a projected RevPAR compound annual growth rate (CAGR) of 7.2% through 2016, is anticipated to strengthen the US lodging market going forward.[2]

Economic uncertainty in international markets has infiltrated the Asia-Pacific region, with major economies in the region experiencing a slowdown after several years of strong growth. However, while the level of international traffic has slowed, regional demand remains strong. With the exception of India and New Zealand, all major Asia-Pacific countries are forecast to achieve RevPAR growth in 2012, with Japan and Thailand leading the performance in the region.[3] Increased tourism from China is anticipated to benefit the regional lodging market, with approximately 100 million Chinese leisure tourists projected to travel abroad in 2013. In Hong Kong, heighted tourism from China has led to increased room rates, as a growing Chinese middle class seeks travel for both leisure and business purposes. An increase in business travel is also anticipated for the Asia-Pacific region; as seen in Singapore, business travel remains strong, given a shortage of lodging supply in the region.[4]

The instability resulting from various conflicts has produced mixed results among lodging markets in the Middle East and Africa (MENA). Continued unrest in countries such as Egypt, Libya and Syria has enabled leisure destinations, such as Dubai, to benefit from the redirected lodging demand. ADR is anticipated to remain stagnant in the MENA region, as key lodging markets in the region, including Abu Dhabi, continue to recover from oversupply in the short-term. However, occupancy metrics are forecasted to improve from prior year levels as political forces slowly stabilize.[5] Going forward, increases in rate are anticipated for key MENA lodging markets; while much of the region experienced a decline in ADR following the recession, an increase in tourism from Chinese leisure travelers is anticipated to boost room rates in popular tourist destinations, such as Dubai, in 2013.[6]

European countries continue to face economic challenges, with Greece, Spain, Portugal and Italy among some of those most affected. Currently, gains in ADR have driven RevPAR growth across Europe, as flat occupancy growth is anticipated for the region in 2013.[7] As a result of continued economic uncertainty, lodging performance will vary by market in 2013. In the UK, lower demand and room rates are anticipated in the short-term, as the region adjusts from an influx of lodging supply created for the 2012 Summer Olympics games. Looking to Germany and France, modest increases in ADR are expected; despite positive economic performance in Germany and strong hospitality demand in France, particularly Paris, the outlook remains cautious in light of uncertainty in the greater European region. The economic struggles of Greece and Italy are anticipated to have an adverse impact on lodging demand, with declines in ADR forecast in the short-term. However, strong performance is anticipated for the Russian lodging sector; driven by upcoming mega-events, including the 2014 Winter Olympics and the 2018 FIFA World Cup, RevPAR growth and a significant increase in the supply pipeline is expected over the next few years.[8]

The outlook for 2013 is one of cautious optimism amid the European economic uncertainty, decelerated growth in Asia and slowed growth in many emerging markets.[9] Lodging markets across the globe continue to face constant economic, political and technological change. Yet even in volatile environments, signs of growth and strengthening lodging fundamentals are present, positioning the global lodging sector for imminent and sustainable recovery going forward.

1 *US Hotel Review*, Smith Travel Research, November 2012.

2 "US hotel market set to prosper through 2016: PKF," *Hotels Magazine* (accessed via www.hotelsmag.com/Industry/News/Details/3841113, December 2012).

3 *Global Hotel Review*, Smith Travel Research, November 2012.

4 *2013 Travel Price Forecast*, CWT Solutions Group, July 2012.

5 *Global Hotel Review*, Smith Travel Research, November 2012.

6 *European Hotel Review*, Smith Travel Research, November 2012.

7 "STR Global: Europe hotel results for September 2012," Hospitality Net website (accessed via www.hospitalitynet.org, 18 December 2012).

8 *2013 Travel Price Forecast*, CWT Solutions Group, July 2012.

9 "IMF Sees Heightened Risks Sapping Slower Global Recovery," International Monetary Fund, 9 October 2012 (accessed via www.imf.org, December 2012).

Understanding your capital needs

Companies that focus on optimizing capital will be best positioned when economic confidence improves.

In October 2012, Ernst & Young's Capital Confidence Barometer revealed that confidence in the global economy, the expectations of pursuing an acquisition and the focus on growth was low across all sectors, including the real estate, hospitality and construction sectors. However, after a closer review of key metrics and leading indicators, the hospitality sector appears to be pushing through global headwinds in search of renewed growth and investment activity.

Ernst & Young's Capital Confidence Barometer is a biannual survey of senior executives from large companies around the world conducted by the Economist Intelligence Unit (EIU). The respondent community is comprised of an independent EIU panel of senior executives and selected Ernst & Young clients and contacts. The survey gauges corporate confidence in the overall economic outlook and identifies boardroom trends and practices in the way companies manage their capital agenda — or how they preserve, optimize, raise and invest capital. Ernst & Young performs an in-depth analysis of the survey results, specifically focusing on responses from real estate, hospitality and construction (REHC) companies, among other sectors.

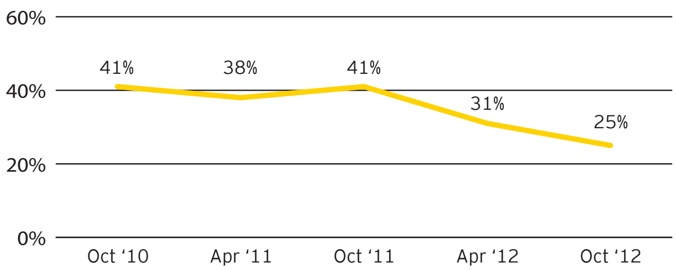
The survey revealed that from a macro standpoint, levels of optimism remain weak. Seventy-six percent of REHC respondents feel the global economy is showing no sign of improvement. The Eurozone crisis and slowing growth in emerging markets, such as China and India, have dampened global economic confidence and expectations around corporate earnings. Compounding this sentiment is the decline in confidence around short-term market stability and the stock market outlook compared with one year ago.

On a more positive note, however, the lack of new supply, particularly in the US hospitality sector, is contributing to higher RevPAR for hotels. Demand growth outpaced supply growth in 2010, 2011 and 2012 and is expected to outpace it in 2013. In 2012, the US hotel development pipeline experienced minimal growth (0.7%), and the total number of projects in the pipeline was down 6.6% compared with the same period in the previous year. Increased demand and lack of supply have had a positive impact on key hospitality metrics: in 2012, national lodging fundamentals experienced positive growth in all three primary performance metrics — occupancy, ADR and RevPAR. The luxury, upscale and independent segments led the US lodging industry in RevPAR growth.

Although lodging fundamentals are strengthening, the number of REHC companies focused on growth declined from 43.0% a year ago to 27.0% today. Companies are refocusing on the basics: stability, operational efficiency and cost reduction initiatives are expected to dominate the boardroom

Do you expect your company to pursue acquisitions in the next 12 months?

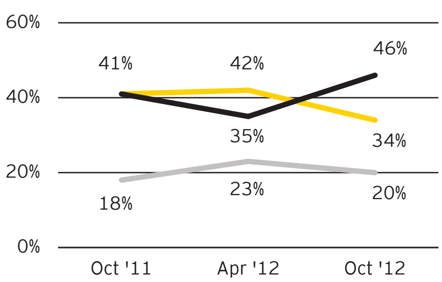
Percentage of respondents who expect to pursue acquisitions



Source: Ernst & Young LLP

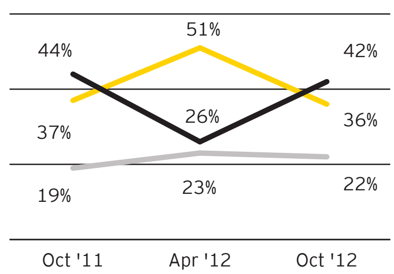
Concerning M&A activity in the next 12 months, how confident are you in the:

Number of deals



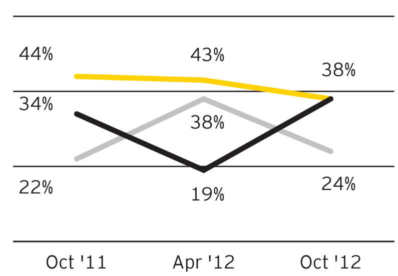
Source: Ernst & Young LLP

Quality of deals



Source: Ernst & Young LLP

Likelihood of closing deals



Source: Ernst & Young LLP

agenda. The slow growth is contributing to the aforementioned limited supply additions.

Despite strengthening fundamentals for deals, including rising cash balances and improving credit availability, there is a smaller appetite for acquisitions than in any previous edition of the Capital Confidence Barometer (which dates back to October 2010). The absence of confidence around merger and acquisition (M&A) activity is elevated further by the valuation gap between buyers and sellers. Furthermore, 80.0% of REHC companies surveyed expect that valuation gap to remain unchanged in the next 12 months. However, there is a silver lining as 41.0% of the participants believe the valuation gap is less than 10.0% in value — meaning we may be approaching a more robust transaction environment.

While the expectation of pursuing acquisitions in the next 12 months continues to decline, the confidence of REHC respondents around the quality and likelihood of closing deals increased.

As of Q3 2012, transaction volume in the US hospitality sector was recorded at US$4.7 billion, according to Real Capital Analytics. It was down 25.0% from a year earlier versus the same period in 2011 due to fewer portfolio transactions. The majority of deal activity was supported by investment banks and their refinancing activities as a result of improving financial conditions and a recent decline in mortgage rates.

While recovery is taking longer than expected and acquisition appetite remains relatively small, REHC companies are pursuing organic growth by focusing their efforts primarily on the changing mix of existing products and services. Among the examples in the hospitality sector are reducing guest services that do not provide high-value propositions to customers, catering to specific guest segments and increasing distribution channels through mobile applications.

Given the lack of a more favorable environment for M&A, companies will have to focus on optimizing capital by controlling costs, improving performance and focusing on bottom-line improvements. Those who execute in a disciplined way will be best positioned when economic confidence improves.

Capital markets: mixed signs

In the wake of continued economic and political uncertainty, real estate capital markets have displayed mixed results, and there are signs of pent-up investor demand. While expectations for returns have decreased, investors continue to seek high-quality assets with higher yields in stable gateway cities with consistent cash flows.[1] However, a significant increase in transaction activity is not anticipated until there is greater constancy in the credit markets. And without any clear market direction, the current sell versus hold sentiment is expected to last. If an asset does not have to be sold, it appears to be better to hold off until another time and, without pressure from lenders, owners will keep waiting for top-dollar prices while investors are still looking for bargains.[2] The ongoing deleveraging of commercial real estate is also expected to change leveraged yield expectations.

There is a notable divergence in markets, with investors first targeting investment in global gateway cities with major urban centers and next, everywhere else. According to Jones Lang LaSalle, as of Q3 2012, the 10 largest countries in the world accounted for 82.0% of all commercial real estate transaction activity, with more than 50.0% of all activity concentrated in just 30 cities globally.[3] Although hotels continue to attract considerable investor interest, the economic uncertainty has shaped how investors target their investments, as they focus on cities with strong leisure and corporate demand drivers. As of October 2012, one-third of all hotel transactions were completed in just 10 gateway cities. Of these, half are located within the US, representing approximately 19.1% of all global hotel investments.[4] London remains the most attractive city in the world for cross-border commercial real estate investment, and inter-regional commercial real estate transaction activity has continued to be characterized by larger portfolio deals involving pension funds and sovereign wealth funds.[5]

In the EMEA region — Europe, the Middle East and Africa — hotels remain an attractive alternative investment, while in the Asia-Pacific region, there have been fewer transactions in key gateway cities compared with last year and, instead, greater activity in the resort and destination markets.[6] As of September 2012, the top three countries for hotel investment in EMEA were the United Kingdom, France and Germany, while the top three countries for hotel investment in the Asia-Pacific region were Australia, China and Thailand. In keeping with the trend of investors focusing on global gateway cites, London, Paris, Sydney and Hong Kong have been the cities in their respective regions with the most hotel transaction activity in this same period.[7] While international investor demand for hotels in key European cities remains, as of September 2012, actual transaction activity was below 2011 levels, likely due to international investors' concerns regarding investment in the Eurozone.[8] In contrast, the Asia-Pacific region, Australia in particular, experienced several record-breaking deals and has seen considerable transaction volume, comparable to peak 2007 levels.[9] In fact, investment funds and private equity groups are currently raising additional capital in view of the strong growth outlook for the region.

As the real estate markets recover, capital is expected to return to riskier markets and poorer-performing assets, as investors look for additional opportunities to maximize returns and diversify holdings. According to a recent Urban Land Institute report, an estimated US$300 billion of refinancing of maturing loans over each of the next three years will affect lenders' ability to originate new loans.[10] With stringent underwriting standards anticipated to remain in effect in 2013, a gap in financing is expected to be partially filled by non-traditional lenders, such as private equity funds or insurance companies expanding into secondary debt positions. Hospitality-focused public real estate investment trusts (REITs) will likely continue to benefit, as investors look for alternative places to put capital while maintaining certain yield levels. These REITs are also likely to continue acquiring high-quality, stabilized hotels with a competitive edge in strong markets, due to a lower cost of capital. Finally, initial public offerings are still seen by some real estate companies as a growth strategy and an alternative method of accessing low-cost debt through the corporate bond markets.

During all phases of the real estate cycle, real estate as an asset class is anticipated to keep attracting investors' attention and capital, which will ultimately help the underlying markets continue to recover and move toward a new equilibrium. Investor frustration about opportunities and lower levels of return will potentially be offset by the attractiveness of the asset class as an income generator and a potential inflation hedge.[11]

1 *Emerging Trends in Real Estate 2013*, Urban Land Institute and PwC, 2012.

2 Ibid.

3 *Global Capital Flows in Q3 2012*, Jones Lang LaSalle, 24 October 2012.

4 *Global Market Perspective*, Jones Lang LaSalle, Fourth Quarter 2012.

5 *Global Capital Flows in Q3 2012*, Jones Lang LaSalle, 24 October 2012.

6 *Asia Pacific Hotel Investment Highlights*, Jones Lang LaSalle Hotels, September 2012.

7 *Hotel Investment Highlights*, Jones Lang LaSalle Hotels, September 2012.

8 Ibid.

9 *Asia Pacific Hotel Investment Highlights*, Jones Lang LaSalle Hotels, September 2012.

10 *Emerging Trends in Real Estate 2013*, Urban Land Institute and PwC, 2012.

11 Ibid.

Tax and restructuring considerations

Globally, tax trends are a common focal point for investors. Various tax and structuring issues that affect the lodging sector are driven by changes in operating models and transaction trends, as investors seek both traditional and innovative ways to navigate a fluid business environment.

Around the globe, major hotel brands continue to move to an "asset-light" model. This ongoing trend involves a number of key tax and structuring initiatives for brand owners. Taxable or tax-deferred sales of hotel properties can provide cash or deferred types of compensation, such as buyer equity in the form of shares or "operating partnership" units, notes or earn-outs. The movement to an asset-light model is increasingly seen in the transfer of unwanted hotel properties to pension funds, sovereign wealth funds, opportunity funds, real estate investment trusts (REIT) or high net worth investors by means of taxable or tax-deferred joint ventures. In addition, some hoteliers have been exploring the acquisition of brands and management contracts, which involves a tax amortization of the cost to purchase the brands and existing contracts.

The uncertainty in the economic and business environment globally, along with the anticipated long-term growth in Asia, is prompting market participants to revisit their strategies and core competencies. Aside from traditional sales of business segments and large-scale restructuring by owners and/or operators, nontraditional transaction structures have emerged worldwide. These include "REIT conversions" — the restructuring and conversion of a corporation to a real estate investment trust; "Opco-propco" spinoffs — the distribution to shareholders of a property company by an entity that retains the operating assets and brands; joint ventures; and other types of spinoffs, such as distributions or initial public offerings (IPOs) of "non-core" assets. These nontraditional structures present investors with a myriad of tax issues, including the taxation of legal entities, capital structure, or tax status changes; structuring divestitures (the sale of assets versus the sale of shares); tax deductibility of executive compensation and other costs; and deferred tax-related accounting matters.

Tax matters are taking on a more significant role in hospitality transactions, even in so-called "simple" outright asset purchases and sales. The complexity of the hospitality-related business and operating models directly affects the complexity of the tax situation. A number of key tax issues have dampened a strengthening appetite among buyers of both single asset and portfolio hotel real estate. They include traditional property-related tax due diligence matters, such as property taxes, transfer taxes and other "indirect" taxes. Less traditional, but increasingly common entity tax due diligence matters, include the acquisition of REIT or corporation shares from sellers unwilling to sell assets, requiring the buyer to inherit potential entity-level income tax liabilities, along with property-level tax liabilities.

Another concern relates to the acquisition of international tax structures from sellers unwilling to sell a local country asset or entity. Lodging investors must balance how best to perform diligence and structure both the legal entity and financing aspects of cross-border asset or entity acquisitions, particularly in emerging markets. The repatriation of cash in cross-border structures, including withholding tax implications, is also a consideration, as is transfer pricing, which has come under increasing scrutiny worldwide for hospitality sector owners. To fully understand the complexity of tax implications in a transaction, hospitality companies and investors should model tax data and implications into their financial models and include tax functions as part of any negotiation or transaction process.

More broadly, tactical tax trends are also gaining prominence in the international hospitality community. One such trend is a reduction in the corporate tax rate. Around the globe, countries strive to maintain international competitiveness, and, typically, rate reduction carries with it a closing of so-called "loopholes" and results in the widening of the corporate tax base. A very difficult question in this regard involves the taxation of foreign income and the optimal way to provide additional tax revenue to the home country without harming its competitiveness in a global, interconnected market.

Another global tax consideration involves the tax deductibility of interest on debt as the tax deductibility of interest favors borrowing by taxpayers. In light of the over-leveraged nature of many companies and countries in the developed markets and the need in many jurisdictions for additional revenue, lawmakers are starting to seriously examine the tax subsidy provided for debt over equity. This question, like so many in the tax arena, is fraught with complexity as holders of debt are often subject to greater tax costs than holders of equity. Accordingly, a change to one set of rules may require a change to another as countries also look to apply "fairness" to the tax law where possible.

Further, there has been an increased focus on tax enforcement across countries for individuals and corporations. A particular area of scrutiny is transfer pricing, especially given the increasingly global nature of business and supply chains. As previously mentioned, this is highly relevant to the hospitality sector, in which cross-border intellectual property migration and licensing, cross-border services, cross-border transactions and related-party leases are widely employed. Additionally, there has been a sharper focus on value-added tax (VAT) topics in tax field audits related to cross-border transactions and to day-to-day hotel business issues (e.g., VAT and pay television, VAT and barter transactions).

The hospitality sector has a long-standing tradition of innovation in its business and its financing and legal-entity structuring. Without doubt, this spirit of innovation will continue to prevail as it applies to tax and structuring matters, its global footprint and continuing changes in tax law and enforcement mechanisms.

Addressing deferred capex

The physical condition of a hotel property is one of the most important drivers of operating performance. A deteriorating property, whether on the exterior, in common areas, rooms, ancillary facilities or back-of-house, can be a significant challenge for investors and owners. In recent years, stagnant lodging fundamentals and capital constraints, exacerbated by slow economic growth in many parts of the world, have had a negative impact on the ability and/or willingness of hotel companies and owners to address portfolio capital expenditure needs. Today, in light of recovering industry fundamentals, hotel companies and owners are once again assessing the need for capital expenditure investments.

In the wake of the global recession, declining property performance and relatively high leverage often resulted in little excess capital for property expenditures, despite low interest rates. Hoteliers that failed to reinvest cash generated during prior periods of stronger growth were particularly affected. Recognizing the challenges confronting owners without adequate capital, hotel operators generally agreed to temporarily reduce capital expenditure reserves and delay necessary capital investments. Hotel brands relaxed property-improvement plan (PIP) requirements, allowing owners to defer or obtain waivers of certain system-wide brand-standard improvements, as well as repair and maintenance items. However, as global lodging sector competition continues to increase in the coming years, hoteliers can no longer rely on once-flexible brand refresh policies.

Going forward, hoteliers are expected to face stricter requirements from both brands and lenders to refresh properties so they can maintain a competitive market position in this new environment. Capital events, such as a transaction or recapitalization, may trigger PIPs for branded properties that have not made any recent major capital expenditures. Investors evaluating acquisitions, or even refinancing opportunities, should carefully evaluate potential PIP requirements that may be set off. It is imperative that investors analyze historical capital expenditures, as well as future needs as an integral part of their due diligence.

As the global lodging sector recovers, hoteliers have begun to address deferred capital expenditures in the face of heightened competition. According to a study published by New York University, an estimated US$5.0 billion in capital improvements in the US is expected to be spent in 2012, a 33.0% increase over the US$3.8 billion in expenditures in 2011. International hotel companies have also committed additional funds to upcoming capital refreshes at their properties. In addition, major hoteliers across Europe and Asia pledged billions in capital expenditures in 2012.

Around the globe, today's traveler is presented with a multitude of state-of-the-art lodging amenities, including Internet access, flat-screen televisions and high-quality bathroom fixtures and case goods. To remain competitive, some hotel owners have initially been focusing on small-scale room refreshes, such as new carpeting, furniture, lighting fixtures, drapery and wall coverings. However, hoteliers with well-funded capital reserves have increasingly shifted focus to larger-scale projects, such as full-brand refreshes and redesign of lobbies, restaurants, bars and fitness facilities, in view of their positive impact on operating efficiency and the ability to roll out changes incrementally to minimize downtime.

While many larger projects are financed through property capital reserve funds, some owners are obtaining debt financing from lenders, particularly in cases where a property requires extensive renovation work. Before deploying capital for property expenditures, owners must carefully evaluate return on investment by taking into account reduced occupancy, construction contingencies, impacts to room rates and current and planned facilities at competitive properties, along with the anticipated upside associated with a renovated asset.

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1 "Brands again bear down on refreshes," *Hotel News Now*, (accessed via www.hotelnewsnow.com/Articles.aspx/9039/Brands-again-bear-down-on-refreshes, 15 December 2012).

2 "U.S. Lodging Industry Capital Expenditures Continue to Accelerate in 2012," Preston Robert Tisch Center for Hospitality, Tourism, and Sports Management, NYU School of Continuing and Professional Studies, 24 September 2012.

3 "Alliance Global plans bigger capex," *Business World Online* (accessed via www.bworldonline.com/content.php?section=Corporate&title=Alliance-Global-plans-bigger-capex&id=62439, 15 December 2012).

4 "Designing in a Recovering Hotel Market," *Hotel News Now* (accessed via www.hotelnewsnow.com/articles.aspx/5758/Designing-in-a-recovering-hotel-market, 14 December 2012).

5 "Maximising Capex Spend to Impact Hotel Value," Jones Lang LaSalle, March 2012.

6 "Hotel buyers looking for debt post-deal," *Hotel News Now* (accessed via www.hotelnewsnow.com/Articles.aspx/9435/Hotel-buyers-looking-for-debt-post-deal, 15 December 2012).

Private real estate funds: gaining global traction

Although economic uncertainty continues to have a negative impact on investor confidence, fund-raising remains active in the real estate investment market, including the hospitality sector. A traditional source of equity capital for hotel investment is real estate private equity funds. While some real estate fund platforms have dedicated hotel investment strategies, most often, hotel investments are part of the broader investment mix involving multiple property types.

According to Preqin, a research firm covering the alternative asset industry, there are currently 463 funds in the market aiming to raise, in aggregate, US$165.0 billion.[1] In addition to fund-raising, the global real estate funds sector currently has substantial capital to deploy and, as a result of the financial crisis, opportunity funds are in a unique position to acquire challenged properties at attractive prices.

Investors remain cautious and have been the key drivers of consolidation among fund managers. Investors with proven track records and the ability to source off-market deals and obtain commitments have been the winners in the present environment. This investment strategy of sourcing off-market deals bodes well for the hotel sector as the competitive landscape is not what it was just a few years ago.

While there has been a slowdown in both global lodging transactions and capital-raising in general, the new normal for annual fund-raising seems to be averaging approximately US$50.0 billion a year for new money to invest in the sector.[2] There is also a large gap between who has been successful in fund-raising and who has not, as only a small number of the large global real estate private equity firms have received significant capital commitments and are still able to raise mega-sized funds. These large global players are still well placed to be active investors for the foreseeable future.

According to Real Capital Analytics, hotel transactions have made up just 4.7%, or US$25.9 billion, of the total global real estate transactions year-to-date to December 2012.[3] Almost half of that amount comes from transactions in the US market, which remains the most liquid real estate transaction market in the world. Real estate funds comprise about one-third of the transaction market for hotels in terms of buyers and sellers and, over the past year, have been the three top buyers in the sector.

Around the globe, the story remains split between the global gateway cities that have active transaction markets with a large amount of interested institutional capital, and everywhere else, where deal flow remains suppressed. For the gateway cities, the institutional and foreign capital chasing hospitality opportunities have driven yield for prime assets up to the level they were prior to the financial crisis and, in some regions, just below peak rates. Bank financing is available for investors in prime hotel properties with loan-to-value ratio generally between 60% and 70%.

The rebound in the availability of lending sources should increase transaction volume for hotels, sparked by improving financing conditions and more favorable underwriting criteria. Efforts to drive capital appreciation are being directed toward effective asset management, capital expenditures and a focus on top-line performance at the individual hotel property level, rather than holding out for improvement in the overall macro-economy. Hotels with long, stable performance records, located in major cities around the globe, all reflect the core risk-averse investment strategies preferred by the institutional investors that have placed and are now placing capital in real estate funds.

Joining the buyer mix are sovereign wealth funds (SWF) that typically take a long-term view and make strategic hotel acquisitions globally and have become key players with rising interest in the sector. In addition to direct investments, many SWFs continue to choose funds as a channel for placing capital. But consistent with the global trend, most are opting for separate accounts with fund managers, rather than the blind pool arrangements common before the financial crisis. In part, many continue to prefer the control and focus to the non-discretionary nature of commingled funds, but many also have more capital to place than today's fund-raising climate can accommodate. In addition, they may have a longer-term outlook and desire to hold hotel properties for a period that is more suited to joint venture structures.

Although media headlines continue to emphasize a global uncertainty, considering that consumer debt levels are subsiding and corporate balance sheets remain strong, a good case can be made for growth.

Naturally, not all businesses will emerge at the other end of this transitional period unscathed. Difficulty in fund-raising, increased business costs and widespread market consolidation will continue to claim casualties in the funds sector. This corrective phase is necessary for the sector's overall quality and credibility, rewarding those able to bring creative solutions to the recovery process and helping to rebuild investor confidence in the real estate fund space over the long term.

With considerable buying power and risk tolerance in a volatile environment, opportunistic real estate funds are in a position to achieve outsized returns, since many investors are instead focused on core strategies and may shy away from challenging, yet lucrative deals. Notwithstanding, the absence of sellers actively marketing assets continues to constrain market activity. Still, opportunities in secondary locations on the peripheries of major cities, as well as some distressed or non-performing assets, should widen the scope of available investment options.

1 *Real Estate Online.* Preqin (accessed via www.prequin.com, November 2012).

2 Ibid.

3 "Global Capital Trends: Q3 2012 Review," Real Capital Analytics (accessed via www.rcanalytics.com/landing.aspx, 17 December 2012).

Development in a new global economy

Hotel development statistics suggest that the US economy has entered a new real estate cycle. Investors are slowly regaining their lost confidence in the economy's ability to recover, in light of improving job market trends; however, despite rising eagerness, investor action to capitalize on new hotel investment opportunities remains subject to credit availability. Driven by returning leisure and business travel, as well as limited supply growth during the past four years (1.4% CAGR since 2008 versus a 20-year historical CAGR of 1.8%[1]), year-to-date RevPAR for the top 25 US markets grew by 7.8% over the previous year as of October 2012, according to Smith Travel Research.[2] The RevPAR growth has prompted renewed interest in development and consequently caused an uptick in domestic pipeline statistics. According to Lodging Econometrics, new hotels under construction in June 2012 represented 66,917 rooms,[3] an increase of 29.6% relative to the prior year.[4] In addition, new project announcements, a good indicator of future pipeline growth, have reached the equivalent of 147,447 rooms on a four-quarter aggregate basis, representing the highest level since March 2011,[5] albeit still 63.5% below the February 2008 peak.[6]

While it is evident that interest in hospitality development is growing in the US, the distance from the 2008 peak room announcements is a strong reminder that development in today's market continues to be capital-constrained. Although hotel lending volume as of June 2012 increased by 22.0% compared with that seen three months prior, financing generally remains limited to projects with low loan-to-value ratios (i.e., approximately 50.0%[7]) that adhere to stringent underwriting standards, such as elevated credit rating requirements,[8] as well as rigorous pre-development due diligence procedures. In fact, lending origination for hotels remains 91.9% below the June 2007 peak.[9]

As a result of continued capital constraints, hotel owners have found creative ways to finance and invest in this asset class. One creative source capital developers are utilizing is the EB-5 program, an immigrant investor visa category created for foreign nationals who invest in a business that creates at least 10 permanent domestic jobs per investor.[10] One project financed via this model includes two proposed branded hotel properties adjacent to L.A. Live, and is receiving approximately US$175.0 million from foreign investors, primarily originating in China and Asia-Pacific.[11] Other participants employing this strategy include real estate investment trusts, one of which recently secured US$45.0 million via EB-5 for a planned US$230.0 million redevelopment of a hotel located in Times Square in New York City.[12]

Developers in the US are also tapping international sources through sovereign wealth funds, generating a number of joint ventures between real estate investment funds and Middle Eastern funds. One such initiative resulted in the development of the Washington, D.C., City Center, which was equity-financed by a Qatari bank and is slated to include a hotel within its mixed-use complex.[13] Meanwhile, the land purchase for a potential mega resort and commercial complex to be built on a waterfront site in downtown Miami was funded through an all-cash purchase in 2011, giving the developer maximum flexibility in project decisions.

In contrast to the development trends in the US, numerous emerging markets are experiencing an unprecedented level of hotel development activity, especially in the midscale segment.

RevPAR growth has prompted renewed interest in development and consequently caused an uptick in domestic pipeline statistics.

This has resulted in US developers chasing down local developers in hopes of creating strategic partnerships and securing a piece of the regions' growing pie. Specifically, markets such as China, Colombia, India and Mexico, where strong gross domestic product growth and an emerging middle class are fueling opportunities for development, have seen an increase in high net-worth individuals or well-capitalized multi-industry conglomerates providing infusions of equity into development companies that are driving supply growth. In particular, in India and China, a combined total of more than 850 branded hotels with more than 225,000 rooms were under construction as of May 2012.[14] Furthermore, the local developers and multinational partnerships are seizing the opportunity to pair with internationally recognized brands that are sought after by local lending institutions to provide credit enhancement. This strategy is also aimed at filling a void for what is perceived as a growing need for brand recognition among business travelers in markets typically dominated by unbranded operators. Internationally recognized operators are eager to sustain their rapid growth in emerging markets, even adapting their service strategies to local preferences. For instance, one local developer paired with an international brand to launch a new select-service property adjacent to Bogota's international airport, adding a more formal food and beverage outlet in lieu of the typical grab-and-go snack bar seen at the same brand's properties in US locations.

Overall, a constrained capital environment, combined with high barriers to entry in sought-after gateway markets, should ensure a few years of growth in lodging fundamentals for existing supply as the development cycle ramps up. As the demand and supply gap nears equilibrium due to increasing activity and economic feasibility, capital will again seek out secondary and tertiary markets for development opportunities.

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2 "U.S. Hotel Industry Performance for the Month of October 2012," *STR Monthly Hotel Review*, 19 November 2012.

3 "Q2 U.S. Lodging Report Reveals Development Trends Are On The Rise With 1,180 New Project Announcements in the Pipeline," Lodging Econometrics, 20 September 2012.

4 "Projects Build Up In Early Planning as Developers Schedule Market Entry For 2014 Or Later," Hotel Online, November 2011 (accessed via www.hotel-online.com, November 2012).

5 "Q2 U.S. Lodging Report Reveals Development Trends Are On The Rise With 1,180 New Project Announcements in the Pipeline," Lodging Econometrics, 20 September 2012.

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7 "Lenders Should Raise Hotel Loan-to-Value Mortgages," HotelManagement, 30 August 2012 (accessed via www.hotelmanagement.net, November 2012).

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9 *Quarterly Survey of Commercial/Multifamily Mortgage Bankers Originations*, Mortgage Bankers Association, Q3 2012.

10 "EB-5 Immigrant Investor," US Citizenship and Immigration Services (accessed via www.uscis.gov, November 2012).

11 "Green Card Means 'Go' to Investors," *Los Angeles Business Journal*, 5 December 2011.

12 Butler,Jim, "EB-5 Financing For Hotels Is Now Mainstream Institutional," ehotelier.com, 13 September 2012 (accessed via www.ehotelier.com, November 2012).

13 "Qatari Diar Makes First Move Into US Property," *Financial Times*, 4 April 2011 (accessed via www.financialtimes.com, November 2012).

14 "Big Hotel Chains Still Focus Strongly on Project Development in East Asia," Hospitality Net, 22 May 2012.

Public-sector infrastructure investments are prime enablers of private real estate development opportunities.

Infrastructure as a catalyst for lodging development

From the moment a flight departs to arrive at the ultimate destination, the impressions made at the onset of a trip contribute to the overall evaluation of a travel experience. The initial trip can either be a smooth and pleasant journey, or a confusing struggle to understand the various transportation options and connections required to reach the final destination. The impact of infrastructure on the business traveler or tourist can be significant. To enhance the overall travel experience, cities and regions globally should ensure that their infrastructure offers a user-friendly and efficient gateway for visitors.

Despite the global economic slowdown that has forced both mature economies and emerging ones to re-focus priorities, governments around the globe continue to recognize the direct correlation of infrastructure investment and positive economic impact. The move toward austerity has led to a more careful approach to investment and the need to calculate accurately anticipated gains from an infrastructure investment.[1] This summer's Olympic Games in London highlighted more than US$4.3 billion in infrastructure improvements, delivered on time and under budget, that will continue to provide critical utilities, housing, roads and transport for the UK citizens long after the Games are over.[2] This approach has had the dual benefit of providing high-quality infrastructure that enhanced the visitor experience, while leaving a wide-ranging legacy of improvements for residents and future visitors.

Public-sector infrastructure investments are prime enablers of private real estate development opportunities — projects and improvements that can drive increased economic activity. While cities and regions have long understood this connection, the global financial crisis has forced municipalities to critically evaluate and prioritize any investment in rail or air infrastructure. Nonetheless, several major cities around the globe have committed to large-scale airport and rail projects as a way to improve travelers' connections to city business centers and tourist zones. In Miami, Florida, for example, the US$2.0 billion Miami Intermodal Center features a 6,550-vehicle auto rental facility, a people mover connecting the facility to Miami International Airport, and Miami Central Station, a multimodal facility incorporating commuter rail, intercity rail and heavy rail transit, buses, taxis and shuttles.[3] A major goal of the project is to improve the clarity and efficiency of the user experience in reaching Miami while providing multiple ways to do so. Air travelers can now travel by train directly to downtown Miami.

Around the globe, many areas struggle to move visitors easily from the airport to the heart of the city. In 1995, for example, the city and county of Denver, Colorado, opened an expanded and relocated airport situated 25 miles east of the city center. Although it offered ample room to grow, the airport's location made for a lengthy trip into central Denver. To address the issue, the airport is currently planning the US$500.0 million South Terminal Redevelopment Program. This project involves the construction of a public transit center that will provide access to the East Rail Line, a light rail line with a direct link to downtown Denver that is now being built. A 500-room hotel and conference center, which aims to create a destination at the airport itself, is also a component of the project. Slated for completion in 2015, these improvements, along with the new light rail line, are being made to improve the traveler experience into and out of the Denver area and to act as a catalyst for further economic growth in the Denver market.[4]

In 2012, the Hartsfield-Jackson International Airport, in Atlanta, Georgia, the world's busiest airport expanded through the construction of the US$1.4 billion Maynard H. Jackson International Terminal.[5] Adding 12 new gates, the terminal was constructed with room to grow and an eye toward increased international economic activity flowing through Atlanta.[6] The airport improvements have already provided a more pleasant traveler experience, which will be further upgraded by another major transportation investment, now in the planning stages. In conjunction with the airport renovation, the city of Atlanta has also launched a US$1.2 billion project, the Georgia Multimodal Passenger Terminal (MMPT), to connect existing public infrastructure in Atlanta. The MMPT is anticipated to become the new ground transportation hub for the city, linking heavy rail rapid transit service, intercity, regional and local buses and allowing for future streetcar, commuter rail, Amtrak and high speed rail service.[7] Structured as a public-private partnership, the project also includes considerable commercial real estate development in and around the station. When completed, the terminal will become a second gateway into the Atlanta area, smoothing the way for air travelers to reach major activity centers within the city. Also included in the MMPT venture is the reconstruction of the main heavy rail rapid transit station, Five Points. Improvements to the station will provide an access point for travelers and commuters in the heart of downtown Atlanta. The MMPT project and related development are expected to have a significant economic impact — US$5.2 billion by 2040 — as well as to provide an indelible positive experience.[8]

The connection between reliable infrastructure, the traveler's experience, and the potential economic impact to a city/region is clear. When executed properly, investment in infrastructure has proven beneficial to the current and future interests of both the visitor and the area economy.

1 *Infrastructure 2012: Spotlight on Leadership,* Urban Land Institute and Ernst & Young, 2012.

2 "London Olympics 2012: where does the money come from — and where's it being spent?" *The Guardian*, 26 July 2012 (accessed via www.guardian.co.uk/sport/datablog/2012/jul/26/london-2012-olympics-money, 6 December 2012).

3 Miami Intermodal Center website (accessed via www.micdot.com, 6 December 2012).

4 Denver International Airport website (accessed via www.flydenver.com 6 December 2012).

5 Hartsfield-Jackson International Airport website (accessed via www.atlanta-airport.com/internationalterminal 6 December 2012).

6 "Up in the air: A new billion-dollar terminal aims to boost the world's busiest airport," *The Economist*, 2 June 2012.

7 Georgia Multimodal Passenger Terminal website (accessed via www. dot.ga.gov/informationcenter/p3/projects/mmpt/Pages/default.aspx, 6 December 2012).

8 "Economic Impact Analysis of the Green Line vision plan and Georgia Multi-modal Passenger Terminal Completed and Released," Central Atlanta Progress website, 27 January 2012 (accessed via www.atlantadowntown.com/initiatives/green-line-plan/economic-impact-analysis, 6 December 2012).

Hybrid contracts: weighing risks vs. rewards

Traditionally, the operation of a hotel was governed by one of two contract types: a lease agreement or a management contract. However, in today's business environment, traditional operating agreements do not always meet the changing needs of the owning and operating parties. The hybrid contract has emerged in response, offering elements of leasing, ownership, franchising and management contracts to properties globally to enhance the flexibility of contracts. However, while the hybrid contract presents great opportunities for the lodging sector, it also increases the complexity of contractual relationships.

Around the globe, standard management contracts have dominated contractual hotel property relations. In their simplest form, such agreements govern the relationship between the hotel operator, who manages the property, and the owner, who pays a fee to the management company for its services. Aside from a base management fee, management companies are often provided with incentives to generate additional income based on meeting or exceeding annual operating performance thresholds. Given the international reach of most major hotel players, the management agreement is often used to govern property management because of the comparatively low risk for the operator. Even at lower-occupancy properties, operators are protected under the management agreement as the increased location risk is compensated for by the lower-risk contractual structure.

The European hotel market, on the other hand, has largely been shaped by the classic lease agreement. Under that operating structure, the owner receives a steady stream of lease payments (often fixed) for the duration of the agreement. The owner is not affected by fluctuations in the hotel's operating performance as long as the operator is able to meet its payment obligations. The leasing model has posed challenges for developers, particularly those from abroad looking to invest in the markets dominated by that operating structure. In Germany, for example, any departure from the classic lease agreement could result in difficulty for an investor to obtain financing; similarly, in much of Europe, domestic investors and lenders expect the hotel management company also to assume the business risk of operating the hotel.

Today, traditional forms of hotel management have increased in complexity, as both owners and operators seek to share the risks and rewards of hotel management. The hybrid agreement, which combines components of the classic lease and the pure management agreement, has started to gain more prominence on an international level. The contract can be structured in various ways and is often customized to help align the interests of owner and operator more equitably. For example, instead of the owner receiving solely an agreed-upon, fixed payment as is common in a lease arrangement, the hotel may also share in the upside by remitting variable payments based on operating performance to the owner. A similar structure could be employed, in which the operator receives a minimum guaranteed fee before additional profit-sharing arrangements take effect. In other types of hybrid contracts, performance clauses that benefit the operator are only available after the owner has met debt service requirements and paid other fees due. Further, in the case of fixed-payment leases, some hybrid contracts call for a cap on the operator's losses if a weak external business environment inhibits the operator's ability to generate enough cash flow to make the lease payment.

While hybrid agreements have gained popularity, owners and operators must recognize the pivotal difference between a lease and a management agreement. The impact of the regulatory environment on lease and management agreements varies widely in many countries. In many European countries, for example, hotels owned by real estate investment trusts are legally unable to operate under management agreements or are able to operate only under very strict conditions. Additionally, as previously mentioned, financing options may become more limited, depending on the requirements of the lender.

To distribute the risk and reward of hotel operators, hoteliers and property managers increasingly seek to align common interests under a hybrid contract. While the demands of the contracting parties often escalate under a hybrid agreement, hybrid contracts promote transparency between the owner and operator and help to foster a long-term business relationship. For instance, properties encumbered by classic leases offer little information to owners on the operations of the hotel. Yet when risk and reward are shared under a hybrid contract, property owners are given access to the details of daily operations. Use of such contracts to foster business relationships and increase transparency is seen at both the individual asset and portfolio level.

Despite its inherent complexity, the hybrid contract has proved useful for many owners and operators globally. Yet, due to the additional intricacies, it is even more important for both parties to seek the appropriate advice to understand fully the impact of the envisioned structure. By appropriately aligning common interests, hybrid contracts enhance transparency, and help to balance and share the risks and rewards between the owner and the operator.

Destination marketing strategies

Amid fierce global competition, destination marketing organizations (DMO) are looking at innovative ways to put their destinations back on the map after the recent years of constrained budgets and fluctuations in visitation levels. According to the 2012 Portrait of American Travelers, published by MMGY Global,[1] 19.0% of active travelers in the US plan to take more leisure trips in 2013, while 13.0% expect to travel less. In view of improving consumer travel trends, destinations are dusting off and rethinking their tourism strategies to maximize demand capture.

As explained further in "New ways of reaching guests" (see page 20), social media is a driving force in today's hospitality sector. While hoteliers are leveraging these technologies to better their service and raise their standards, tourism boards are leveraging them to attract potential visitors to particular destinations. With more than 75 million reviews generated by 32 million online users on TripAdvisor,[2] research from Cornell University indicates that social media and user-generated content undoubtedly affect a hotel's profitability and, to a broader extent, a destination. For example, in the aftermath of Hurricane Katrina, the New Orleans Convention and Visitors Bureau (CVB) developed an emergency-preparedness plan and proactive marketing strategy that helped restore the confidence of travelers and local stakeholders through the use of social media. The CVB's website offered live Twitter feeds updating travelers on airport operations, and its Facebook page highlighted reviews from satisfied guests. The creative use of social media helped minimize negative perceptions and fostered a positive brand image.

The widespread use of social media has also led to the development of user-friendly mobile applications featuring a city's local hot spots. Such applications enable tech-savvy travelers to navigate their way around a new city. For instance, NYCgo, the tourism authority in New York City, has launched a free mobile application and site (nycgo.com) that offer customizable city maps and links to attraction guides and dining menus.[3] And in tech-centric Austin, Texas, the local CVB offers locals and visitors an online platform (Austin Social Media Lounge),[4] where users can upload pictures of their trip experience and provide live updates on citywide events. DMOs around the globe value the ability to keep content fresh and relevant, in addition to the possibility of casting their net over like-minded individuals and potential visitors by leveraging such real-time, user-generated content.

Some DMOs target nontraditional forms of marketing to encourage tourism. Flash mobs, scavenger hunts and public stunts are memorable, cost-effective examples of "guerilla marketing" that has helped promote destination awareness. For an investment of less than US$200,000, for example, the Las Vegas CVB released an ad campaign centered on the breach of the Las Vegas code "What happens in Vegas, stays in Vegas" following the publicity scandal regarding Britain's Prince Harry, dubbed "Harry's Naked Romp." The campaign used various marketing media to portray the destination's "Sin City" appeal and generated public interest with more than 7,800 likes and 1,800 shares on Facebook.[5] And London & Partners kicked off its "Imagine London" campaign with a scavenger hunt that challenged visitors to navigate their way around major landmarks and venues across London; winners were offered tourist vacation packages and limited-edition gifts.[6]

DMOs are also forming strategic partnerships with local public and private entities across diverse sectors to capture and cultivate demand from niche and/or new markets. For instance, in an effort to sustain international tourism growth in Miami, the Greater Miami CVB partnered with American Airlines to market the destination in key feeder markets across Mexico, the Caribbean and Latin America, which resulted in more than 53 familiarization tours and 72,000 client contacts. Orlando adopted a similar strategy and partnered with the Colombian airline Avianca, as well as Disney, SeaWorld and Universal Studios, to drive visitation from Colombia, which resulted in more than US$3.0 million in visitor spend.[7]

Similar to hotels, many convention centers have been capital-constrained and are in need of renovations as an important part of destination infrastructure. Thus, DMOs are advocating for government agencies to partner with private developers to modernize, expand and/or renovate outdated convention facilities to attract groups

In view of improving consumer travel trends, destinations are dusting off and rethinking their tourism strategies to maximize demand capture.

and fill weaker demand periods. Destinations such as Boston, MA; Toronto, Canada; and Hawaii have either released or are planning to release requests for proposals (RFP) centered on the expansion or renovation of existing convention and meeting space or the development and operation of hotels adjacent to their convention centers. Furthermore, several localities, such as Alberta and Vancouver, Canada; Cape Town, South Africa; Trinidad and Tobago and India released RFPs seeking help in developing tourism infrastructure and strategic positioning analyses.

Marketing destinations is no easy feat, and repositioning in a growth phase in tourism even less so. DMOs are asking how the view of their market has evolved in light of changing consumer preferences, where their marketing dollars should be deployed, and which consumers they should target. DMOs are quickly realizing they need a team of experienced partners to assess opportunity gaps in view of increased competition. The development of innovative marketing strategies, thorough competitive destination analyses and the identification of critical success factors (e.g., market image, price/value and quality of tourism infrastructure) are keys in keeping destinations ahead of the competition.

1 "2012 Portrait of American Traveler," *MMGY Global*, 2012.

2 Chris K. Anderson, Ph.D., "The Impact of Social Media on Lodging Performance," *Cornell Hospitality Report*, *Vol. 12, No. 15*, November 2012.

3 "Nycgo.com," NYCgo website (accessed via www.nycgo.com/articles/best-nyc-smartphone-apps, 28 November 2012).

4 "Austin Social Media Lounge," Austin Convention & Visitors Bureau website (accessed via www.austintexas.org/visit/plan-your-trip/social-media-lounge/?socialTab=facebook, 28 November 2012).

5 Laura Carroll, "Harry's naked romp fires publicity machine at Las Vegas Convention and Visitors Authority," *Las Vegas Review Journal* (accessed via www.lvrj.com/business/-harry-s-naked-romp-fires-publicity-machine-at-las-vegas-convention-and-visitors-authority-167654805.html, 18 September 2012).

6 "London & Partners puts London on the map with a stack of prize packages for savvy visitors to EIBTM," London & Partners website (accessed via www.londonandpartners.com/pdf/media-centre/press-releases/2012/121116-london-partners-put-london-on-the-map-with-a-stack-of-prize-packages-for-savvy-visitors-to-eibtm, 16 November 2012).

7 *2011 Annual Report*, VisitOrlando website, 2012 (accessed via www.visitorlando.com, 12 Novmber 2012).

International brand, local market

Competition in the international hotel market is strong, as hotel companies strive to penetrate new markets and expand their portfolios around the globe. The establishment of international brands in new markets globally, both emerging and mature, is continuing. Building a local brand presence involves myriad considerations from both an operative and an ownership standpoint.

In emerging markets, such as China and India, international hotel companies are focusing on customizing their international standards to the needs of the areas. Many hotel companies have aggressive plans to expand quickly into these geographies, doubling or tripling their presence in the next couple of years. In order to prepare for rapid and successful expansion, brand standards are being adapted to local customer preferences in terms of hotel room design, service standards and food and beverage choices. "Glocalization," or the combination of globalization and localization, is a leading principle for international hotel companies striving to succeed in new markets and compete with local, domestic brands. Some of the top-tier luxury brands are even providing "lifestyle managers" to ensure that guests' needs and demands are met during their stay.

While many companies are concentrating on customizing their brands for the host countries, the outbound traveler has also received considerable attention, with international hotel companies creating specific programs tailored to appeal to specific desires of their clientele. One major international company has developed a welcome program specifically for Chinese travelers, leveraging its experience in mainland China. Guests are able to request special amenities and services at participating hotels outside of China and can be assured that the hotel will meet their specific needs and expectations.

While international tourists and business travelers are key demand generators for hotels, companies must consider the significant rise in domestic travel, particularly in Brazil, Russia, India and China (BRIC). In some emerging countries, the numbers of domestic travelers far exceed international arrivals. In order to capture the domestic market and alter the propensity of domestic travelers for staying at unbranded guesthouses and hotels, international companies are taking customization even further and ensuring product competitiveness by creating specific brands for particular markets. In addition to the independent hotels, international brands are meeting lively competition from local brands in some markets in the mid-scale and budget sectors.

While hotel companies face many challenges to establishing international brands successfully from an operational standpoint, the initial task of developing or converting the hotel is the first major hurdle they encounter. In the past, international brands have been reluctant to invest directly in projects in emerging markets, preferring instead to enter into lower-risk management or franchise arrangements. There are a number of risks, such as those related to local legislation and land ownership, for hotel companies wishing to invest in international markets, especially in emerging geographies.

Therefore, in order to minimize risk, navigate local investment environments and tap growth potential, liaisons have been developing between international and domestic hotel players; such associations also help international hotel companies to understand local customer requirements. To be successful, brands generally must work with local partners and, particularly in the most attractive markets, such as key gateway cities, those local partners can often bargain from a position of strength in negotiating deal terms for a favorable transaction. It has become increasingly critical for hotel companies to invest in the country in order to establish a presence; investment may come in the development of assets, key money for management contracts or in the build-out of a more robust infrastructure to support the value of their brands in the local market. The local companies, in turn, benefit from the international company's global infrastructure and experience, from both a customer and employee standpoint.

In addition to direct management of or investment in hotels, some hotel companies have been navigating the challenges of penetrating new markets by forming alliances with local hotel chains.[1] For example, one international European hotel company formed a partnership with a Chinese hotel company that enables each company's guests to make reservations in the other's country; the reservation process is facilitated by an alliance of the websites of the two trade names and the sharing of reservation channels.

Despite global economic challenges, emerging markets similar to those in the BRIC countries present significant opportunities for hotel companies to grow, expand and invent new brands in markets around the globe. The world continues to become increasingly globalized, and millions of tastes and preferences are changing as a result of shifts in class and rapidly growing population with increasing amounts of disposable income. International hotel companies must be prepared to invest, as entrance into and success in new markets may require capital partnerships and the customization of global brand standards or, in some cases, the creation of an entirely new brand to suit particular markets.

1 "Louvres global expansion kicks into high gear," *Hotel News Now*, 12 July 2012.

Shifting segments: responding to changing preferences

Despite lingering concerns about the prospects for economic growth in many of the major developed economies around the globe, the increased availability of capital and building optimism in the lodging sector is leading many hotel companies to refocus on the changing preferences of business and leisure travelers. After the proliferation of boutique "lifestyle" brands during the last decade, industry pacesetters are pursuing new responses to new demand trends in the post-recession environment. From multigenerational travel to wellness to the psychographics of today's urban traveler, the ongoing segmentation of hotel demand is likely to shape the sector for years to come.

Although high-end vacation clubs have existed for years, familiarity with this niche hospitality product among luxury travelers has risen considerably in the last five years.[1] Luxury travelers, often traveling as multigenerational families, are increasingly choosing destination and residence clubs that offer exclusive access to luxury accommodations in prestigious locations as an alternative to vacation home ownership. Compared with traditional hotels and vacation homes, these clubs are generally associated with up-front membership fees (or equity investments) and annual dues. As a result of fast-growing demand from new members, the club segment is rapidly consolidating, as the largest club managers seek to broaden property portfolios through the acquisition of smaller clubs.

A rapidly growing substitute for destination clubs is online vacation rental marketplaces. These websites connect homeowners and property managers globally with travelers seeking vacation home rentals with either no or minimal membership fee required. Building on travelers' increasing familiarity with online hotel booking and their desire for value-based lodging alternatives, vacation home rental sites are simplifying the highly fragmented and unbranded vacation home market.

Driven by greater health consciousness among aging consumers, demand for hotels that promote health and personal well-being is increasing. According to one major lodging brand, 17 million people, or 40.0% of all US travelers, are considered "health-conscious" and prioritize personal well-being while traveling.[2] In a recent survey conducted by one major brand in China, 9 out of 10 Chinese travelers report that fitness and a healthy lifestyle are key priorities in their lives. Hotels around the globe are quickly adapting to this wellness trend in a variety of ways, including larger and more accessible fitness gyms, room features that improve air quality and in-room amenities such as resistance bands and exercise equipment. Other wellness-oriented strategies include concierge-led group jogging (with loans of workout clothes and shoes) and additional yoga offerings.

More than a decade since the mainstream adoption of boutique and lifestyle hotels, psychographic segmentation of the urban traveler is again driving change in the boutique segment. In the pursuit of hipness and individuality, "creative" industry travelers are opting for unique alternatives to established branded boutique properties. Often independent or affiliated with new entrepreneurial brands, these new hotels, unburdened by stringent brand design standards, are frequently repositioned properties with historical or cultural significance. Oddly configured room layouts and design elements informed by the property's locale create a sense of place that appeals to the "creative-class" traveler. The immediate future of these smaller brands may be tested by the absence of guest loyalty programs and global reservation systems and the rapid expansion of the new boutique brands announced in the past several years. Several of the new brands have also announced plans to expand to emerging markets such as China, India and Brazil.

In the post-recession economy, many travelers continue to prefer select service-type accommodations that offer a strong value proposition by providing full-service amenities at a lower price than traditional hotels. Select-service hotels are similar to limited-service properties but have features such as meeting spaces and casual dining outlets that are more traditionally identified with full-service properties. Select-

From multigenerational travel to wellness to the psychographics of today's urban traveler, the ongoing segmentation of hotel demand is likely to shape the industry for years to come.

service properties also offer owners and investors higher profit margins due to lower construction and operating costs and higher room rates than those achieved in limited-service properties. Compared with average full-service profit margins of approximately 20.0% in the US, select-service hotels can achieve margins ranging from 35.0% to 40.0%[3] Most of the leading select-service brands are planning aggressive expansions in Europe, Latin America and emerging Asian countries despite the fact that select service is a new concept in many international markets.

As the global economy and tourism recover from the downturn, lodging brands are anticipated to continue adapting to changing travel trends and economic forces. Going forward, hotel companies with adaptive amenity offerings and innovative marketing initiatives will be well-positioned to create value from the increasing specialization of traveler demand.

1 "Increasing Interest in Purchasing Access to a Shared Vacation Home," *Sherpa Report*, 6 June 2011.

2 "Brands target guests with fitness programs," *Hotel News Now*, 4 September 2012.

3 "Our Approach to Hospitality Properties," *Moody National REIT I, Inc*. (accessed via www.moodynationalreit.com/investment-philosophy/hospitality-study.aspx, 27 November 2012).

Valuation: recovery amid uncertainty

The uncertainty surrounding the European debt crisis, slowing growth in China and India and geopolitical unrest in the Middle East resulted in a significant decrease in hotel investment volume in 2012,[1] leading to a lack of market data on which to base hotel valuation assumptions. Given this uncertainty, hotel valuations are expected to remain a challenge in the near- to mid-term.

Globally, investors have traditionally relied on a discounted cash flow (DCF) or a sales comparison approach for investment analysis. Both approaches can indicate a hotel's market value, provided the valuation assumptions reflect the present operating and capital markets environment. However, current investment parameters and other valuation assumptions may be difficult to estimate due to considerably fewer transactions and the resulting limitations in available supporting data. Therefore, selection of the most appropriate valuation methodologies and assumptions should be made on an asset-by-asset basis.

Hotel values in the US generally improved in 2012 due to improved operating fundamentals. Throughout the year, cap rates continued to contract from historical 2009 and 2010 highs. Though highly dependent upon location, quality, brand and management, market fundamentals are anticipated to continue improving and cap rates to remain low because of the Federal Reserve Bank's efforts to keep interest rates down. As a result, the average price per key has nearly doubled from 2009 lows.[2] Investors' continuing difficulty achieving desired leverage and navigating economic uncertainty remains a primary valuation concern. Thus, many investors continue to gravitate toward stability of cash flow and proven track record, preferring trophy assets in key gateway cities such as New York, San Francisco and Washington, D.C. With investor focus moving away from compressed cap rates, alternative "per pound" metrics, such as value per key and value per square foot, have become increasingly common methodologies.

In Europe, the Middle East and Africa, estimating hotel values became increasingly difficult in 2012 due to continued economic and political turbulence and a lack of market activity. The European debt crisis has clouded valuation estimates across the region. Although overall investment volume in Europe decreased in 2012, there were some signs of value stabilization and even increases in the most stable markets, such as the UK and Germany. Hotel values in the Middle East remained relatively stable throughout the year and are anticipated to remain stable in the near term as a result of limited available financing, high interest rates and limited development interest in markets outside of Dubai. Africa is showing signs of improvement from a hotel valuation standpoint, with key fundamentals, such as international visitation, increasing at rates exceeding global averages. Even with improving fundamentals, however, transaction activity in the Middle East and Africa remained weak in 2012. This resulted in a greater focus on the DCF valuation method, the judgment of valuation experts and the input of management when estimating key valuation assumptions.

Growth in several of the world's emerging economies began to slow in 2012, increasing the uncertainty in hotel valuations, particularly when estimating future property performance under a DCF analysis. The outlook for hotel values in China, Hong Kong and Taiwan have softened because of slowing visitor and economic growth. Given the recent flurry of hotel construction throughout China, many cities are now oversupplied with hotel rooms, particularly in the upper-upscale and luxury segments. This led to year-over-year decreases in occupancy levels in 8 of the 10 major Chinese hotel markets and challenges in achieving projected levels of ADR. In India, declines in gross domestic product, an increase in the fiscal deficit, substantial hotel supply growth and inflation have weakened the outlook for hotel value growth there.

A few bright spots still remain in the world in terms of hotel values. In South America, increased liquidity, favorable financing conditions and strong

Despite global economic uncertainties, lodging fundamentals in much of the world continue to strengthen, and many investors anticipate hotel values will either remain stable or increase.

domestic demand, combined with the upcoming 2014 FIFA World Cup and 2016 Summer Olympic Games, have fueled international investment, resulting in increases in hotel values. However, whether these increases will be long-lived remains to be seen. Additionally, the hotel sector in Russia has steadily recovered since 2009, with fundamentals expected to continue improving and hotel values estimated to increase at a compound annual rate of 5.7% from 2013 to 2017.[3]

Despite global economic uncertainties, lodging fundamentals in much of the world continue to strengthen, and many investors anticipate hotel values will either remain stable or increase. However, significant economic growth is not expected to occur until late 2013 or early 2014.

As the global economy regains its footing, hotel owners, operators, investors, lenders and appraisers should remain cognizant of current and future global and local market conditions that could influence valuation.

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Emerging markets: spotlight on Africa

Historically, hotel investment in Africa has largely been confined to South Africa and the leisure tourism destinations on the continent's north coast, namely Morocco, Algeria, Tunisia and Egypt. However, several other African countries have recently experienced an increase in hotel investment activity, and the continent is slowly emerging from the shadows of Brazil, Russia, India and China as a target market for international hotel developers and investors. In particular, the coastal regions of Sub-Saharan Africa currently stand out as a focal point in Africa's hotel investment landscape.

As investors stream to Sub-Saharan Africa in search of natural resources, the region has become the second fastest-growing economic region in the world, reports the World Bank.[1] Hotel development has followed economic growth, as Sub-Saharan Africa saw a 54% year-on-year increase in the number of hotel developments in 2012.[2] Nigeria, one of the world's top ten petroleum exporting countries, has become the hotspot in the region, with 26 hotels currently under construction and a further 17 being planned in 2012 alone.[3] Other Sub-Saharan countries with abundant natural resources, such as Ghana and Gabon, are also seeing a considerable increase in hotel investment. At this stage in the economic development cycle, hotel development activity has generally appeared to follow growth in activity related to the region's natural resources; given this trend, it is likely that a surge in hotel investments in resource-rich countries, such as Mozambique and Angola, will ensue.

Nonetheless, South Africa has experienced the greatest hotel investment activity on the continent, accounting for approximately 45.0% of the total annual transaction volume in Africa over the past six years.[4] However, the hotel market has suffered from over-supply since the FIFA Football World Cup in 2010.[5] While average occupancy remained stable at around 55%, ADR decreased by 10.0% to US$95.0 in 2011.[6] Consequently, little new hotel development is planned in the region in the near- to mid-term.

In North Africa, a dynamic environment for hotel transactions before the global economic downturn, activity has not yet fully recovered, mainly due to political uncertainty caused by the recent "Arab Spring." As a result of the regional conflict and instability, foreign investors have become cautious about hotel investment in North Africa. Nevertheless, the pipeline of planned hotels still increased by 4.0% to 75 new properties in 2012.[7]

Despite the recent surge in hotel investment in Sub-Saharan Africa, certain barriers to entry remain. Even with sporadic improvements, the continent's overall infrastructure remains a challenge, often adding 10.0% to 15.0% (or more) to a hotel's development cost budget. This added increase often makes stand-alone hotel development financially unfeasible, as developers are often required to install power stations, generators, water/sewer systems and so forth, as well as build roads to the development. Further, depending on the location, fraud, visa restrictions, malaria, security concerns and slow implementation of reforms can be seen as key impediments to further growth in most African countries.

However, despite such barriers, investors continue to look to Africa for opportunities. According to official figures, approximately US$3.2 billion has been invested in hospitality real estate transactions in Africa in the last six years.[8] While this volume appears negligible compared with the estimated US$95.0 billion that transacted in the entire EMEA region over the same period,[9] true transaction volume may be considerably higher since many deals are not officially recorded. The most active investor segments in recent hotel transactions in Africa appear to be South Africa-based institutional investors, sovereign wealth funds from the Middle East and international hotel companies expanding their portfolios through direct acquisitions of hotels for renovation and rebranding. Additionally, there has been a significant inflow of Chinese investment into the African hospitality sector.

As investment interest in Africa rises, international hotel companies have turned their focus to Sub-Saharan Africa for their expansion plans on the continent. The companies that have a minimal presence, as well as those that already have a sizable number of hotels there, have robust pipelines and are actively expanding their footprints. One major international hotel company with a presence in Africa has a portfolio of 113 hotels and currently boasts a pipeline of 36 hotels in various stages of planning and development in Sub-Saharan Africa alone.[10] Another large international hotel company that was not active in the region until recently now has a pipeline of nine hotels under construction and another five in the planning stages in Sub-Saharan Africa. Local companies also have ambitious plans to expand their hotel portfolios across the area; two of the most established local hotel brands, the bulk of whose hotels is located in South Africa, are now looking toward Sub-Saharan Africa to achieve their lofty expansion plans.

While opportunities for hotel investments in Africa seem abundant, and interest from international and local investors is high, the key to success for international investors, as in many emerging markets, appears to be thorough due diligence and a trustworthy local partner.

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New ways of reaching guests

Technology has revolutionized the way customers interact with each other, as well as with brands, products and services. Social media and mobile technology are at the forefront of this revolution, and many different sectors are evaluating the application of these technology trends and cultural shifts for their businesses. In the lodging sector, participants also face the strategic assessment of technology implementation to enhance the way they market themselves, sell inventory and service their guests.

On the spectrum of "high tech" versus "high touch" technology and service philosophies across the lodging sector, common practices for the application of emerging technologies have evolved, with a focus on sales and marketing, distribution and guest services via social media, mobile applications and in-room technology.

Social media has provided hotel companies with new marketing tools to build customer relationships and deepen engagement. A survey of social media platforms conducted by Ernst & Young shows that all major global hotel brands use Facebook, TripAdvisor, Twitter and LinkedIn to communicate with consumers and guests.[1] Hotels are integrating social media into hotel operations to enhance customer relationships and to analyze guest satisfaction and brand reputation by tracking and resolving guest complaints presented on social media outlets. Some hoteliers are also combining the power of social media sites with customer relationship management (CRM) technology to develop guest profiles that are used to provide enhanced service to customers.[2]

Hotel companies also measure consumers' social media influence to identify influential customers. Some hotels engage guests to conduct word-of-mouth marketing, providing incentives such as upgrades upon check-in.[3] Other hotel brands have integrated social media into their rewards programs, awarding hotel loyalty points to guests who check into a hotel via Facebook or Foursquare.[4]

A recent study by Cornell University identified a material correlation between the social media reputation and pricing power of hotels, particularly as it relates to the popular hotel review site, TripAdvisor. According to the Cornell Hospitality Report,[5] if a hotel enhances its review score by one point on TripAdvisor's five-point scale, it can increase its rate by 11.2%, while maintaining the same occupancy or market share. Not surprisingly, a different study, conducted by PhoCusWright, found that 53% of respondents would not book a hotel if it did not have any TripAdvisor reviews, and 87% agreed that TripAdvisor reviews increased their confidence in the selection of a property.[6]

Mobile technology is also transforming the way hotels interact with guests, given the fact that global smartphone ownership exceeded one billion in 2012.[7] Major hotel companies have demonstrated a commitment to enhancing their mobile presence; in the survey conducted by Ernst & Young, most large hotel brands offered mobile websites and dedicated mobile applications.[8] One international hotel brand, for example, offers an application allowing guests to view or cancel existing reservations, check in, use location-based technology to find and book rooms, download directions to its branded properties and collect information about a destination, including local time, weather and area maps. As an example of inventory distribution via mobile technology, some hotels offer a mobile booking application, providing discounts and promotions exclusive to mobile bookers, a strategy aimed at capturing incremental demand while avoiding cannibalization of other distribution channels.

In hotels, technologies across lobbies and guestrooms are expanding further, often to shorten the service time required for seasoned travelers via automation while freeing up hotel staff to answer travelers' questions. Tablets have been launched as standard tools at the properties of major hotel brands, allowing guests to check in, check out and interact with room service, housekeeping and concierge services. Tablets have also been utilized by guests to research area attractions, make dining reservations and print boarding passes.[9]

Social media, mobile distribution and in-hotel service technology have been shown to affect guest satisfaction, guest loyalty, brand value and, thus, financial performance. However, the impact of these technologies is not universal across chain scales or hotel brands and properties. Instead of adopting a more-is-better mentality, hotel companies may benefit from a careful review of their technology tactics to assess investment parameters, return metrics and benefits. If implemented strategically into the lodging-business architecture, technology has the potential to materially enhance the value pathway for hotel brands, operators and properties.

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