

May 2010

## Background note to property investment markets – May 2010

With specific focus on the hotel and leisure sector, and fractional ownership concept

### \* 1. COMMERCIAL PROPERTY – OVERVIEW

Mixed signals have emerged from the commercial property sector over recent months, particularly in the UK, but also in various other regions around the world. The massive problems in Dubai, for example – where some US\$323 billion worth of construction projects are now reckoned to be on hold – hit the headlines in late 2009 and have since sent shock waves through bond and equity markets around the world.

The situation in Dubai appears now to have stabilised, after the state-owned Dubai World reached a repayment agreement with creditors on US\$23.5 billion of debt. Also, Meed Projects (which tracks the construction industry in the Middle East) says around US\$114 billion of new projects will be awarded in 2010.

However, there are still plenty of uncertainties in regard to values. Last month Landmark

Advisory (another tracker of property in the region) said that rental values in both residential and commercial property in Dubai are likely to continue falling in coming months, especially for lower quality buildings in the least developed and integrated communities. Nevertheless, Landmark also suggested that certain residential units in key locations and within high quality developments should see stable prices.

There was some good news from the US property market in early May. The Investment Property Databank (IPD) Index showed the first positive return in more than 18 months, with the US quarterly Index showing a 1.2% total return for Q1-10; within that figure there was a 0.5% decline in capital values in the quarter.

Sector figures from the US, however, showed that commercial property in the region is still in trouble, with capital values

across retail, office and industrial still falling. Only residential US property showed gains in both capital and income (rental) returns.

In the UK, there have been signs that the London office market is improving. Property giants British Land and Land Securities both reported stronger full year numbers, in late May, and both issued positive statements on recovery after better conditions became apparent in the second half of 2009/10.

Land Securities, for example, reported a pre-tax profit of over £1 billion, against the £4.8 billion loss declared for the year to 31st March 2009; most of the 2010 'profit', however, came from a valuation surplus of over £860 million. Revenues actually fell 20% to £251.8 million. British Land reported a return to profit, with its portfolio valuation rising 13.5% against the prior year, and NAV up 27% to 504p.

Yet the optimism from these commercial

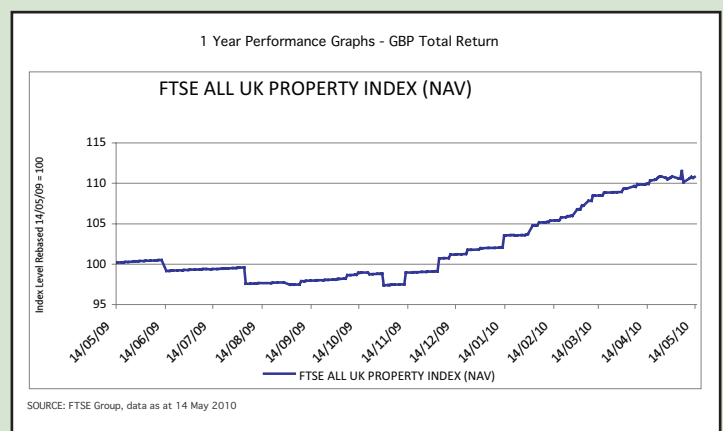
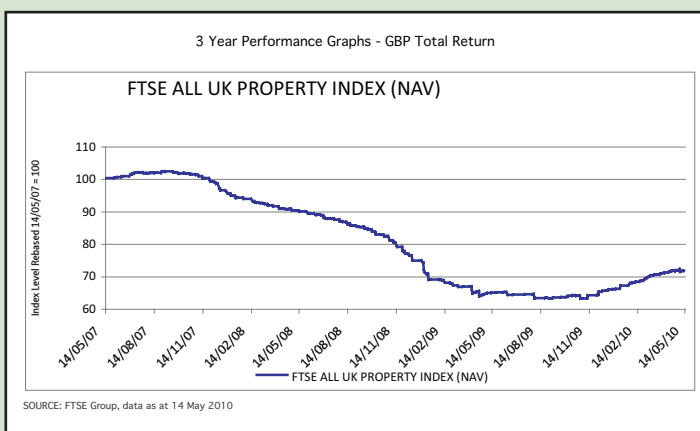


Figure 1.

property leaders was largely focused on the office market in central London. While British Land's statement talked about its £475 million commitment to re-starting new office developments in the city, it also referred to "modest recovery" overall this year amidst a "fragile" economic recovery.

The Q1-10 report at the end of April from the Royal Institution of Chartered Surveyors (RICS) gives a clearer picture of the current state of commercial property markets. The report said that available space in central London had declined for the second successive quarter, so that rental expectations have moved "above zero" for the first time since the last quarter of 2007.

The RICS figures in fact showed the biggest jump on record in expectations for central London office rents, resulting in a boost to the national average rental expectation. Away from London, available office space continues to rise "at a broadly similar pace to Q4", the report said.

Letting activity for both office and industrial space rose for the second consecutive quarter nationally, although RICS reported that investment demand outside of the capital was less buoyant. Indeed, some surveyors in the RICS report were voicing concerns at the end of Q1-10 about prospective demand for office space, given the likelihood of cuts in public sector spending. Several UK regions have become very dependent on government spending, so that UK budget cuts will be scrutinised closely for potentially positive and negative impacts on commercial property markets.

As RICS members in Barnsley put, it "Very much a static market with a lot of people waiting for the next announcements on government action".

The continued difficulties for the Euro and for sovereign debt levels generally must also hamper investment confidence across Europe, and it is clear that small towns across the UK and the Continent are the ones bearing the brunt of the economic slowdown and property slump.

Although many observers fear major negatives because of public sector job cuts, there are some UK property pundits who are already looking for the opportunities. Just before the General election, Sir Stuart Lipton (former boss of property group Stanhope, and now working again with Elliott Bernerd) urged any new administration to undertake a full audit of publicly-owned property with a view to identifying asset sales. With central and local government owning an estimated £370 billion of property and land, Sir Stuart suggested that there is bound to be some "low-hanging fruit" to be harvested to help repay Britain's debts.

There is some hope that the Tory-LibDem budget will show progress on such asset sales;

this view is bolstered by the fact that former Ernst & Young star John McCready remains a property 'tsar', and he is being urged to initiate £40 billion of public property sales over five years, instead of the '£20 billion over 10 years' already outlined.

## \* 2. HOTEL AND LEISURE PROPERTY

**Analysis from Deloitte, the accountants and business advisory firm, said earlier this year that recovery in European hotel performance may be on the horizon: "Demand has experienced an upturn since October 2009, before pushing into positive territory in December 2009 - up 4.2%. STR Global results for January 2010 also show a healthy 3.3% increase in the region against January 2009".**

Alex Kyriakidis, Global Managing Partner of Tourism Hospitality & Leisure at Deloitte, added: "No strong rebound in European tourism and hotel performance is expected in 2010, but further declines will now be city specific rather than the norm. Demand should continue to return as more people travel to and within Europe. This will give hoteliers an opportunity to grow occupancy and then average room rates and revenue per available room (revPAR). However, it will be difficult to surpass pre-recessionary levels this year.

"Hotels in London however, are an exception. The capital had the advantage of an inexpensive currency compared to the US dollar and euro throughout the downturn along with limited new supply, and did not experience the massive drop off in tourism that some European cities did. Increases in leisure visits from international and domestic tourists counterbalanced a 20% drop in business travel. Combined with strong revenue management, London is leading European hotels out of the recession. Hoteliers there have been able to push up average room rates since November 2009 and could possibly achieve double-digit revPAR growth this year."

As Marvin Rust, Global Managing Partner of Hospitality at Deloitte pointed out alongside the report: "As a general rule, hotel performance will be closely tied to trends in consumer confidence and GDP growth. With the US dollar strengthening further we could see a welcome return of the American tourists to the UK towards the back end of this year. This remains our most important source market and one that tends to spend well when they are here. On the other hand, corporate travel budgets continue to be scrutinised in cost cutting programmes, and while some rebound will occur, demand will remain weaker than normal."

Clearly, Mr Rust's comments will also apply to European venues, including his remarks

about the importance of American tourists. The relative weakness of all European currencies against the US dollar and Japanese Yen is likely to stimulate tourism across the region; other visitors from Asia, and from BRIC countries, are also likely to be encouraged by the change in relative currency values.

Indeed, hotel and tourism could prove to be one of the few bright spots across European economies in the current year. Whether international visitors will be able to counterbalance likely poorer domestic demand is hard to judge. Also, the STR Global results to which Deloitte refers, pre-date the € crisis, which, at time of writing, appears ongoing.

For March 2010 the STR Global Hotel Index showed hotel occupancy in Europe averaging 55.0% on a 'year-to-date' (YTD) basis. That represents a rise of 4% against the March 2009 YTD number. In the whole of 2009 occupancy levels averaged 60.6%, 6.4% down on 2008.

Demand in the 12 months to March also recovered, rising 5.3% across the region, and revenues rose 10.5%. RevPAR also rose strongly, by 9.2% YTD to March – this compares to a 21.1% fall in revPAR across Europe in the whole of 2009.

There were similar signs of recovery in the Middle East and North Africa regions: occupancy rose 3.3% to 64.7% in the year to March, having averaged 62.9% in 2009, which was 10.9% down on 2008 averages. Demand rose 9.6% and revenues by 3.4% in the 12 months to March, although revPAR slipped back 2.5% in the period, presumably because much of the 2008/9 revPAR number was accounted for by pre-booked winter holidays.

Other recent statistics for hotels offer some further hopeful signs of stabilisation. The worldwide Hotel Price Index showed that the average price of a hotel room in 2009 was 14% lower than in 2008. In fact, 2009 prices were lower than those prevailing in 2004, when the HPI began. However, in Europe the fall in room costs was better than the average, at -13%, and the average rate of fall was clearly slowing in the fourth quarter. For example, the year-on-year fall in room prices averaged just 7% in Q4, against a fall of 14% in Q3, minus 17% in Q2 and minus 16% in Q1.

With occupancy levels and room rates clearly still depressed, valuations for hotels around the world are similarly well below their peak. The still subdued outlook for GDP growth across Europe, for example, suggests that valuations will remain relatively low throughout the rest of this year at least. Nevertheless, as long as there is no further serious deterioration in economic performance – no 'double dip' recession – then it looks reasonable to assume that hotel values generally

are now at or near the bottom. Individual locations, however, will always produce significant variations and defy the averages, both in terms of occupancy, room rates and revPAR.

### \* 3. HOTELS AS ASSETS AND OPERATING BUSINESSES

One of the principle difficulties in evaluating hotels arises in identifying the worth of the physical property and, separately, of the operating business. Most analysts agree that it is the operating business which matters most in terms of valuation, and, for the big hotel chains and brands, this is always true. So much of the operating efficiency and profitability (reservation systems, staff training, group marketing) is tied into the brand or any franchise agreement. As one leading industry commentator has said (Jim Butler, of JMBM), “what is the value of the underlying real property of a Marriott, Holiday Inn, Hilton, Hyatt or Four Seasons if it loses the brand and professional management? It becomes just a big box hotel with no name, no reservation system and no professionally run staff”. For this reason, evaluating big hotels or big brands is particularly complex.

For privately run, generally smaller hotels the task of ascribing value is somewhat simpler, but even here the questions of location and management experience and reputation are tricky areas to assess. However, they are always relevant and have an impact on the basic financials of the business – occupancy and room rates, operating margins and cash flow requirements.

Arriving at an actual value per room for any hotel, therefore, is not an easy or even clear formula. In fact, per room values could well be described as having more to do with art than science, which is why hotel asset sale prices can surprise heavily one way or another. At the time of writing, there are press reports that Royal Bank of Scotland is expected to sell the Grosvenor House Hotel (in London’s Park Lane) for around £500 million. That figure can only be ‘ball-park’, since RBS now has a short-list of five potential purchasers apparently, and the sale process still has some way to run. Given the variables of valuation – even for such a prestigious venue – the followers of RBS’ fortunes could easily end up being shocked by the outcome.

Of course, apart from direct investment in a hotel there is the opportunity to invest in the shares of quoted companies, assessing these businesses by the usual measures of share price, ROCE, EPS, dividend yield and so on. However, the purpose of this note is directed at making some assessment of the background to ‘alternative’ investments in the hotel and leisure industry, rather than any sector-specific equity evaluation.

### \* 4. TIMESHARES AND FRACTIONAL OWNERSHIP

The timeshare industry around the world – in which rights at particular resorts or locations are purchased - is now well established and very large. According to the UK-based Timeshare Consumers’ Association (TCA), six million families now own a timeshare, and there are generally well-regulated ways of buying, selling and exchanging any timeshare rights.

All timeshare is self-catering, and there are two basic forms of timeshare ownership – ‘fixed week’ and ‘floating system’. In the first, owners have the right to spend a fixed amount of time in a specific apartment or villa, which may or may not have accompanying leisure facilities. Owners can choose to stick with spending the same week or fortnight in the same place each year, or use one of several exchange systems to swap their ‘rights’, changing time period as well as location.

In the second, you own a time period within a seasonal band of time, and each year you have to book the week you want; this will be subject to availability. This floating timeshare right can also be exchanged, and where the timeshare is a “club points” purchase owners can accumulate points, or use only part of them each year.

US group Wyndham Worldwide Corporation is NYSE-quoted and probably the largest provider of ‘vacation exchange’ services (it owns the RCI brand), and its ‘Wyndham Exchange & Rentals’ division, “offers leisure travellers, including its 3.8 million members, access to over 65,000 vacation properties located in approximately 100 countries”. ‘Wyndham Vacation Ownership’, “Develops, markets and sells vacation ownership interests and provides consumer financing to owners through a network of over 155 vacation ownership resorts serving over 820,000 owners throughout North America, the Caribbean and the South Pacific”.

In Q1-10 financial results from Wyndham beat analysts’ estimates, and even reported slight growth in diluted EPS. It also reported a 7% increase in free cash flow in the quarter, to US\$166 million versus US\$155 million in Q109, and Wyndham has been able to triple its quarterly dividend. Thus, the timeshare market appears to have been very much more resilient than other segments of the leisure industry.

Whilst corporations such as Wyndham, and many other holiday companies and property developers, are still making good money out of timeshare, a spokesman for the TCA states that, “timeshare is not a financial investment and never has been” for individual owners. Very few timeshares, if any, ever actually

sell even for as much as the original purchase price, let alone for more.

Having said that, most buyers do not take on a timeshare with investment intentions – they are looking only for a reliable annual holiday in places they like and with accommodation standards they know and trust. The structure of timeshare is that buyers pay a one-off payment for the ‘right to use’ and an annual management fee (covering cleaning, maintenance etc of the accommodation). The management fee is always payable, even if you do not visit.

According to the TCA, the best resorts and locations are run by the owners, through a timeshare club and committee. Certainly, you are less likely to encounter problems with timeshare clubs, and buyers need to be aware that there are still unscrupulous developers around exploiting the timeshare system, even though the industry has become better regulated and more respectable than, say, 20 years ago.

There are scams affecting European resorts right now, and the TCA in fact is preparing court cases against a handful of developers and their banks and credit card companies on a variety of grounds, and seeking compensation for many consumers. These cases are likely to hit the headlines in the coming months.

Also, some of the current scams in timeshare are using different terms in their sales pitch – anything from ‘vacation club’ to ‘holiday club’ and even ‘fractional ownership’. “Some dishonest traders are using the ‘fractional ownership’ phrase to avoid the loss of credibility which has hit the timeshare industry because of previous scams”, says the TCA.

Real fractional ownership schemes focus on investment returns, rather than holiday and leisure rights, and offer both a share of the underlying asset and a proportion of income derived from the asset. Any leisure or usage rights (certainly in regard to property assets) are an extra benefit, rather than a part of the underlying returns. Room To Invest (RTI), for example, which has been offering fractional ownership in European hotels for the past three years, says that only around 10% of its investors actually make use of their usage rights.

The concept of fractional ownership is not new; fractional ownership of aircraft leases, for example, has been around for many years (appealing to wealthy individuals and business people who put in a lot of flying time each year). All such schemes also tend to include management agreements (someone has to ‘run’ the asset) and annual management fees.

In property, fractional ownership is reckoned to have really got going in the 1990s when ski resorts in Colorado were developed

on a fractional ownership basis. According to US property consultants Ragatz Associates, there were more than 250 fractional developments in North America by 2006, and the TCA says this is clearly the most developed market: "there are few, if any, successful fractional ownership schemes in Europe".

Any fractional ownership scheme can have problems. There have been disputes as to initial valuations, sale values and structures, and management charges. As the TCA warns, you have to assess the reasonableness of the price you are paying for your asset. As stated earlier, assessing the value of hotel assets is complex, particularly where major brands or any kind of rebranding is involved.

In the UK we have had an example of these pitfalls in the collapse of GuestInvest two years ago. In that fractional ownership scheme investors paid as much £400,000 for ownership of a room in high profile and fashionable hotels in central London. The management company had borrowed around £500 million from HBOS to purchase the hotels, before selling them in the fractional ownership scheme. With the near-collapse of HBOS and credit crisis of 2008, GuestInvest was unable to continue, despite having attracted around 250 private investors.

Reported comment from Savills, the property advisors, at the time of the GuestInvest collapse highlighted the weaknesses of that particular scheme. "The concept of hotel room investment works, but the GuestInvest model is all wrong. The model was destined to fail... Firstly, with the backing of HBOS, GuestInvest paid far too much for the hotel assets as they stood. Then, having bought the hotels as trading concerns, they closed the businesses down and ripped the hotels apart. Finally, they overspent on the refurbishment. It all adds up to lots of capital expenditure, and no cashflow."

The risks are clearly greater where expen-

sive or trophy assets are involved; how much of the initial valuation relates to 'prestige'? HBOS has lost a great deal of money by lending on high profile, prestige assets; apart from GuestInvest two years ago, the troubled bank is also expected to face a 90% loss on around US\$1 billion of loans it made for development of a resort in Hawaii, which was also part of a fractional ownership scheme.

Despite such high profile, high cost failures, fractional ownership schemes can and do work. Room To Invest, for example, has attracted investment and functioned successfully for three years now, as part of a wider offering of alternative investments. But it contrasts strongly to the GuestInvest model – the TCA, by the way, examined the RTI brochure and concluded that RTI is similar to GuestInvest only because it is an investment/returns, rather than holiday/leisure, focused scheme.

RTI's hotels are in selected locations which have limited development scope, so that these established venues are unlikely to see growing competition (the Medina within Marrakech, and a mountain resort in Slovenia). They are also hotels which function on what can be described as 'core demand', rather than as fashionable venues, such as the Blake's Hotel in the GuestInvest portfolio.

The asset valuations and projected returns also appear much more realistic and likely to be fulfilled, especially against the background of continued tourism development in both Slovenia and Morocco and the shortage of hotel room supply for both countries. Morocco saw GDP growth of 5.4% in 2009 and is forecast to achieve 5.1% growth this year, and whilst Slovenia has seen its economy shrink in the past two years, it is still rated as one of the more successful economies in central Europe. Budget deficit and government debt levels (at 5.5% and roughly 37% of GDP,

respectively) put Slovenia in the 'safe' category of national economies.

Also, in general, the STR and other industry research suggests that destinations which have not had mass appeal in the past are suffering relatively less in the global recession, thus underpinning hotel values and viability at such non-mainstream locations.

Indeed, the key factor for any particular destination appears to be its place in the development cycle, and the amount of available hotel space. Many destinations in developing economies are still 'early stage' in their development, so that investment selections in such locations are proving resilient. RTI's approach, therefore, looks appropriate.

Another significant advantage to the RTI scheme is that it allows relatively low entry costs, varying from £2,000 for a low season room in Slovenia up to £7,250 for a suite in Morocco, which has little seasonal variation. There is also no annual service charge, just annual management fees that are deducted as a percentage of room revenues. Whilst there is no commission charged on initial purchases, there is a 6% commission payable when investors decide to sell via RTI; again, this does not look unreasonable in comparison to other asset sale commissions.

## \* 5. CONCLUSION

Fractional ownership of any asset can work, but the structure of the scheme needs to contain reasonable assumptions on initial valuations, likely revenues – against both bad and good economic backdrops – and reasonable management charges. Where hotels or resort properties are concerned, investors should also consider whether the amount of usage rights attaching to any investment is so big as to be detrimental to cash flow for the property – another of the big problems which GuestInvest faced.

RTI appears to have come up with the right balance in its business model; certainly it has significant advantages over the failed GuestInvest structure. It is also, clearly and as the TCA concluded, a real fractional ownership scheme, and not a timeshare in disguise. For investors, the core questions must be about initial valuations and ease of exit, as is the case with all investments, particularly in the 'alternative' category. ●

**BY: Pam Spooner, Editor, Investing for Growth**

*Pam has been a financial journalist for more than 20 years, with national publications such as The Times, Mail on Sunday, Evening Standard and Investors Chronicle. She also edited Quest, the CFROI-based research weekly for institutional investors published by stockbroker Collins Stewart, between 2002 and 2004.*

## Europe

| Date         | Occupancy |       | RevPar    |       | Revenue         |       |
|--------------|-----------|-------|-----------|-------|-----------------|-------|
|              | This Year | % Chg | This Year | % Chg | This Year       | % Chg |
| Total 2007   | 67.6      |       | 101.16    |       | 131,770,964,671 |       |
| Total 2008   | 64.8      | -4.3  | 101.90    | 0.7   | 134,265,698,165 | 1.9   |
| Total 2009   | 60.6      | -6.4  | 80.41     | -21.1 | 107,226,399,623 | -20.1 |
| Mar YTD 2010 | 55.0      | 4.0   | 69.48     | 9.2   | 23,000,282,444  | 10.5  |

## Middle East & North Africa

| Date         | Occupancy |       | RevPar    |       | Revenue        |       |
|--------------|-----------|-------|-----------|-------|----------------|-------|
|              | This Year | % Chg | This Year | % Chg | This Year      | % Chg |
| Total 2007   | 69.0      |       | 98.03     |       | 14,198,653,904 |       |
| Total 2008   | 70.6      | 2.4   | 119.46    | 21.9  | 17,890,851,279 | 26.0  |
| Total 2009   | 62.9      | -10.9 | 103.03    | -13.8 | 16,107,987,824 | -10.0 |
| Mar YTD 2010 | 64.7      | 3.3   | 111.57    | -2.5  | 4,462,978,719  | 3.4   |

Data: STR Global

Figure 2.