



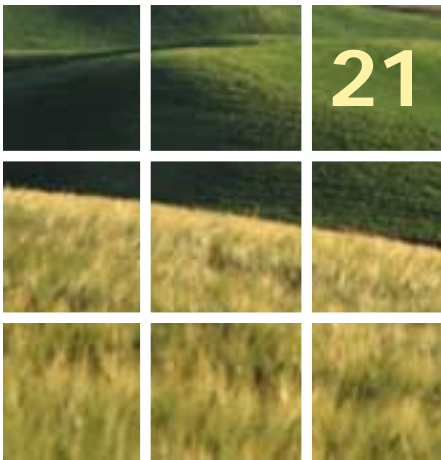
The hospitality industry has always been a house divided. Hospitality companies act as both real estate owners and managers of enterprises, seeking capital to support both the property and operational sides of the business. At the same time, management must allocate capital between physical assets (the hotels they own and operate) and intangible assets

property brokerage firms and investment banks; and the users of capital, including developers and hotel companies. Our goal for Hospitality 2000: The Capital — identify those factors that will contribute to success in securing capital, making optimal use of it and rewarding those who provide it. The following article offers a snapshot of findings from the study.

Hospitality 2000: The Capital

Global survey profiles industry's sources and uses of funds

BY
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(customers, the brands they own, the people they employ, the technology they use and the alliances they form).

Hospitality 2000: The Capital, as a result, spans two critical arenas in the capital markets: the property markets and financing available for hospitality enterprises. This fourth study in the Hospitality 2000 series offers a global view of the financial resources required for hotel property development and acquisition, as well as for creating and expanding hospitality enterprises. And this year's survey is set within a volatile and fast-paced capital markets environment.

Change is accelerating as the dynamics of the New Economy affect the investment and lending decisions of traditional providers of capital. And as new investment opportunities generate attractive comparative rates of return, the hospitality sector must find innovative ways to compete among capital sources.

Knowledge and insight about this swiftly changing landscape, of course, is essential. To gain breadth and depth in our study, we surveyed three separate groups — the providers of capital; intermediaries, such as international

Business or real estate?

The complex nature of hospitality organizations has tended to create hurdles for accessing capital. For those with interests in the hospitality sector, the general lack of appreciation for the complexities of the operational side of the business remains a source of considerable frustration. It has generally been easier to secure financing in the

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property markets, and opinions expressed by our respondents reflect that historical fact.

Investor attitudes to hotel property are currently more positive (52 percent) than negative (44 percent), while in the future, the positives are expected to increase to 66 percent. On the enterprise side, the



negatives for investors are currently marginally higher than that for property (47 percent versus 44 percent). And in the future, this is expected to worsen (50 percent versus 23 percent). It appears that investors have a better feeling for the prospect of investing in hotel property than in hospitality enterprises. (See Figure 1.)

Both investors and lenders to hospitality enterprises exhibit a current preference for international hotel chains and this is likely to continue in the future across all regions. And both groups also have a strong preference for property acquisition, as opposed to new property development, which they tend to view somewhat negatively. (See Figure 4.)

Sources of equity and debt capital

Private financing for both property and enterprises has historically dominated the international hospitality industry. And despite the trend toward securitization of real estate in countries like the United States, our respondents not surprisingly rank private investment and venture capital funds as the most significant

source of equity capital on the property front today globally. Capital invested by hotel companies, both public and private, was cited in second place. In contrast, our respondents cited the top source of equity capital for hotel enterprises as public markets. (See Figure 2.)

Predictably, commercial banks take the lead on providing property level debt financing around the globe, and respon-

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dents see no change in that role in the future. (See Figure 3.)

Debt financing: Property or enterprise

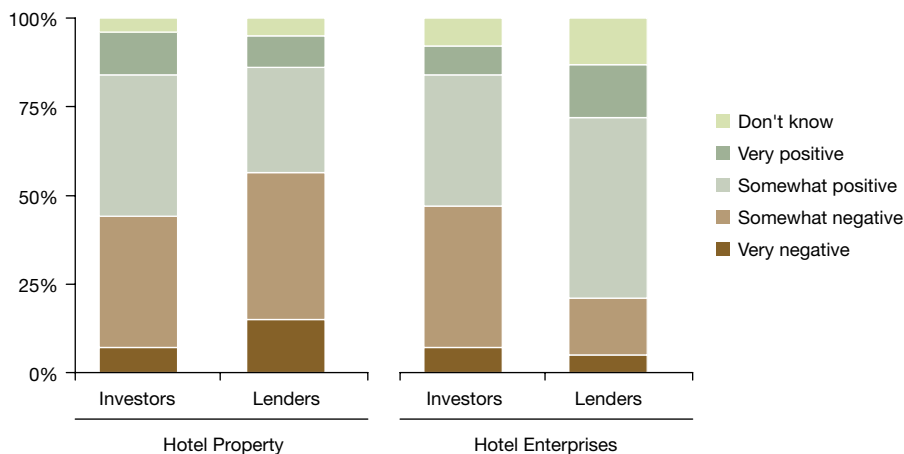
Lenders make distinctions between opportunities to lend against hotel property and those associated with loans to hospitality enterprises involved in

management and marketing. Twenty-three percent of our respondents report providing debt financing to the industry. Of these, 88 percent offer financing for hotel property, while considerably less — 42 percent — provide financing for hospitality enterprises.

For borrowers seeking debt capital for hotel property acquisition or development, the question of security is of

paramount importance. In the United States, the concept of nonrecourse mortgage financing represents the vast majority of hotel property lending reported by Americas' respondents (79 percent). By sharp contrast, only 2 percent of property lending in Asia Pacific is reported as nonrecourse, while 76 percent is guaranteed by the borrower.

1 Current Investor and Lender Attitudes to Providing Capital to Hotel Property and Hospitality Enterprises



2 Top Five Sources of Equity Capital

Hotel Property	Hotel Enterprises
• Private Investment/Venture Capital Funds	• Public (Stock) Markets
• Public Hotel Companies	• Private Investment/Venture Capital Funds
• Private Hotel Companies	• Financial Institutions
• Pension Funds	• Individual Investors
• Individual Investors	• Pension Funds



The balance (22 percent) is a combination of the two. In the region comprising Europe, the Middle East, India and Africa (EMEIA), the distribution is more even with 44 percent of property lending reported as nonrecourse, 40 percent guaranteed and the balance (16 percent) a combination of the two. These relationships are set to change in the future, however. (See Figure 5.)

Of all respondents, 42 percent project an increase in the availability of attractive lending opportunities, this ranging from 50 to 51 percent of respondents in Asia Pacific and EMEIA, respectively, to 36 percent of respondents in the Americas. By contrast, 31 percent of all respondents indicated they saw no change in the future, while a minority (23 percent) projected a decline.

In tracking the performance of hotel property lending, we inquired about default rates on hotel property loans. On an overall basis, 11 percent of respondents cite the rate as either significant (8 percent) or very significant (3 percent), while one in four claim it is moderate.

The urge to merge

Consolidation is clearly seen as one of the most important forces in the industry today, even though our respondents

believe that mergers and acquisitions often do not produce the benefits sought. Noteworthy is the fact that the need to improve access to capital was selected as the least significant driver to further consolidation of the hospitality industry in the future. The top ranked factors were focused on market share, distribution and brand acquisition. (See Figure 6.)

Executives in the Americas and EMEIA (93 and 94 percent respectively) over-

In the future, large hospitality enterprises are projected to benefit most from consolidation, while small businesses can be expected to be negatively affected as capital providers look for scale, branding, technology and global presence in the businesses they finance.

Only 49 percent of respondents believe that the results projected of a merger will actually be delivered currently, although in the future they believe this may

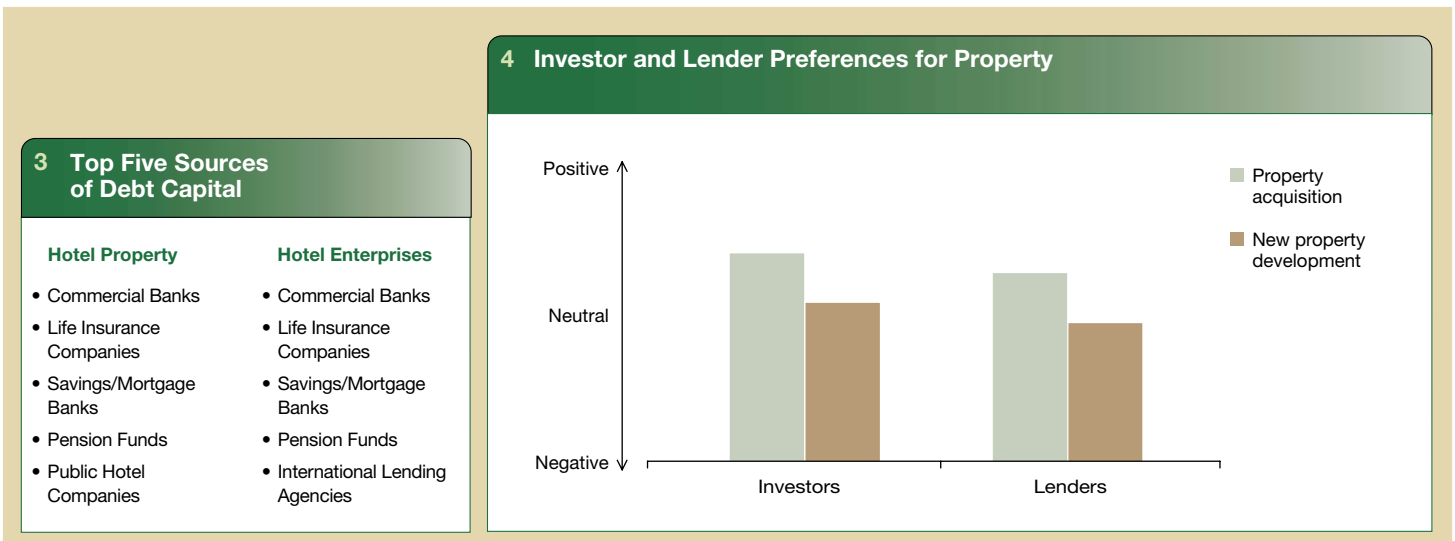
In a significant number of cases, the combination of two organizations does not always produce the intended benefits of the merger or acquisition.

whelmingly report that the industry is consolidating in their areas. That stands in sharp contrast to Asia Pacific, where this rate falls to 79 percent. As to the pace of this consolidation, respondents overall consider it to be generally moderate (59 percent), while 28 percent believe the pace is actually fast. As to the prospect for future consolidation, close to one-half of our respondents believe the pace of consolidation will increase during the next three years.

improve — but only marginally. This reflects a reality facing hospitality managers as they consider mergers and acquisitions in the future. In a significant number of cases, the combination of two organizations does not always produce the intended benefits of the merger or acquisition.

Tangible assets vs. intangibles

Tangible assets, including the hotel properties themselves, have long been





considered the backbone of the industry. Intangible assets, however, increasingly dominate in providing competitive advantage, including customer information, brands, human capital, technology and strategic alliances.

Not surprisingly, given the industry’s historical value proposition, the preference for investing in hotel property remains strong among the executives we polled, but there appears to be some acknowledgment of the value of intangible assets. Our respondents rank physical hotel property as their current investment preference, but other types of assets come next, including brands, human capital, technology, customer information and strategic alliances.

Companies generally manage best what they also measure. As a result, it is of some note that our respondents say measuring the return on investment in intangible assets is important. Two-thirds believe that taking such measures is important today, and 77 percent believe it will be so in the future.

In measuring the performance of hospitality enterprises, respondents report using a variety of measures, the most popular of which are growth in earnings before interest, taxes, depreciation and amortization (EBITDA) and

growth in revenue per available room (RevPAR).

**Underwriting practices:
Location reigns**

Over the years, we have witnessed a “cycle of attention” paid to underwriting in general. In times of rapid expansion and capital availability, underwriting standards have a tendency to weaken, whereas in softer periods, when earnings are under pressure, they invariably

lenders will be far more focused on historical performance and in-place earnings in evaluating transactions or property portfolios.

Aside from the variability in underwriting standards, the age-old adage of location, location, location appears to ring true for respondents across the board. Location is consistently ranked as the number one factor affecting investment and lending decisions.

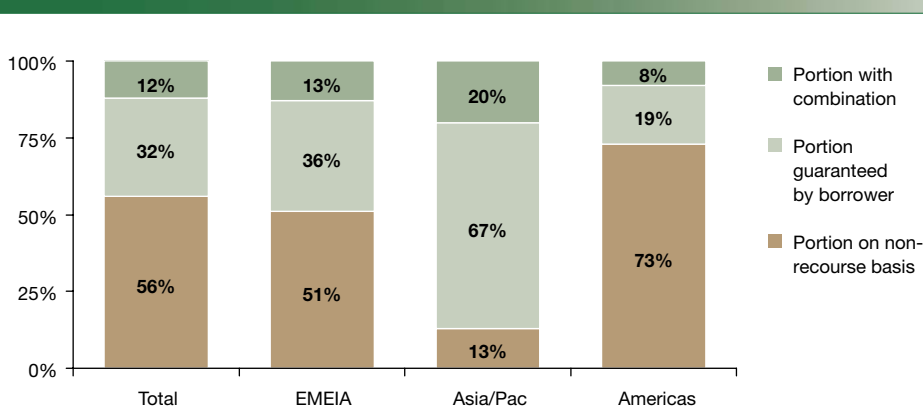
In ranking the various measurements

In ranking the various measurements used to evaluate property investments, respondents overall rate the internal rate of return as the most important. Cash-on-cash returns using stabilized earnings follow with payback periods and per-room costs relative to comparables sharing third and fourth rankings.

tighten. In an expansive hotel property market, for example, investors will frequently look to long-term projections of future earnings and embrace assumptions of continuous increases in pricing and room occupancy. And their lenders, under pressure to put money out to the market, will frequently do the same. During the inevitable contraction, however, these same investors and

used to evaluate property investments, respondents overall rate the internal rate of return as the most important. Cash-on-cash returns using stabilized earnings follow with payback periods and per-room costs relative to comparables sharing third and fourth rankings. Lenders have these same rankings. We also asked our respondents about assumptions used for debt in underwriting. They reported a

5 Portion of Lending on Non-Recourse Basis



6 Drivers of Industry Consolidation (Ranking)

- Increase market share
- Expand distribution system
- Reduce costs
- Diversify geographically
- Acquisition of additional brand(s)
- Desire to “globalize”
- Extend product line
- Improve ability to source capital



mean average debt-to-total-capitalization ratio of 61 percent overall for a standard three- to four-star commercial hotel in the respondent's local market. (See Figure 7.)

Debt service coverage ratios average 1.5 times in the Americas, but a significantly more conservative ratio of 2.1 times in EMEIA and 2.4 times in Asia Pacific, these differences partially attributable to the different degrees of leverage assumed in each region.

For a forecast period, underwriters select from six to 11 years. Residual capitalization rates used to capitalize the last year's earnings of a projection to arrive at residual value range from 9 to 11 percent. The discount rate used to discount a future stream of "free and clear" hotel property income (before interest, taxes, depreciation and amortization) back to the present, along with the net residual value to arrive at a present valuation, ranges from 10 to 13 percent. (See Figure 8.)

Property returns by region

Our research queried respondents by region on hotel property returns. EMEIA respondents indicate they believe that

satisfactory hotel property returns can be found today in the United Kingdom, France, the United States, Scandinavia, the Middle East, Canada, South America and Italy. And in the future EMEIA respondents include Southeast Asia. Executives in Asia Pacific believe that satisfactory returns may be found in the United States, the United Kingdom, France and Scandinavia, but not in Asia Pacific itself. But in the future — apparently believing the industry is on the

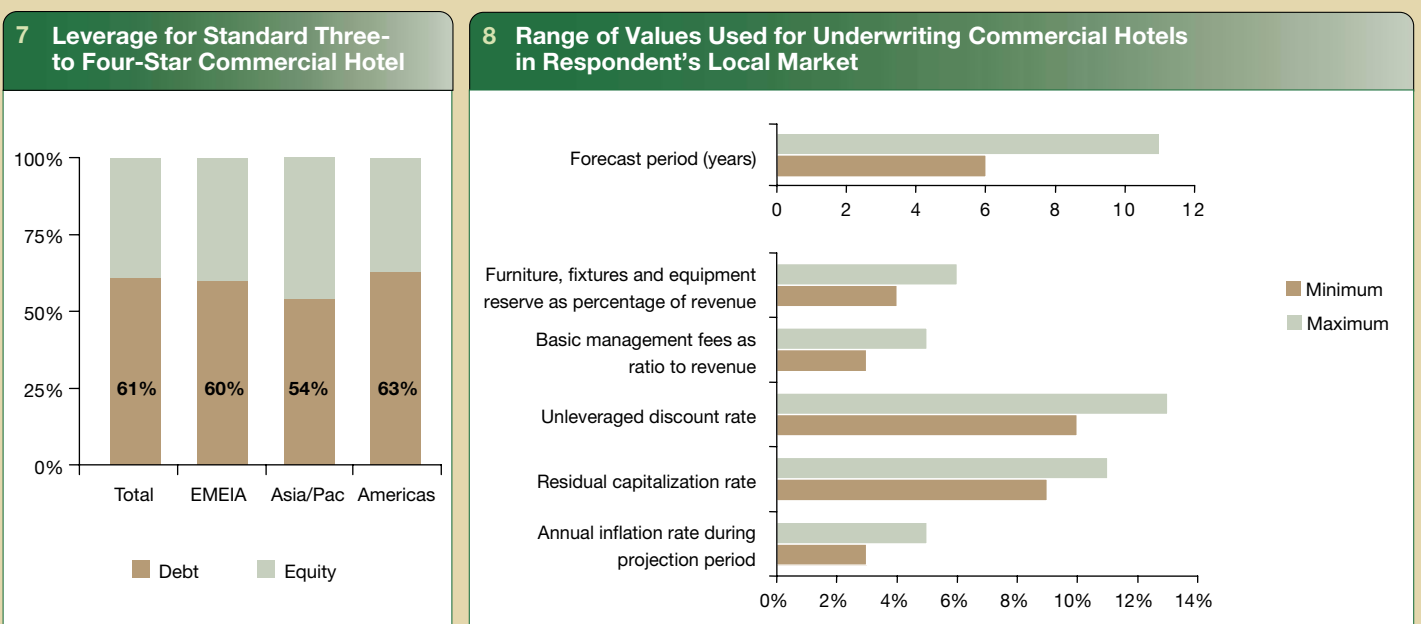
For investors in hotel property, expectations for rate of return on invested capital change inversely by property classification — the higher the quality of the property, the lower the return. At the luxury five-star level, overall returns are expected at about 14 percent, increasing 100 basis points at the four- and three-star levels, to 15 and 16 percent respectively, and then 200 basis points to about 18 percent at the one- and two-star levels. (See Figure 9.)

Technology investments will drive capital needs in the future as the hospitality industry updates legacy systems and adopts eBusiness strategies. The choices that hospitality companies make in the technology realm will have a significant impact on competitiveness and on return to investors.

upswing — they add Southeast Asia and South America. Finally, respondents from the Americas believe that satisfactory returns can be found in the United States, Canada, France and the United Kingdom currently. For the future, they add Southeast Asia and Germany.

Investing in technology

Technology investments will drive capital needs in the future as the hospitality industry updates legacy systems and adopts eBusiness strategies. The choices that hospitality companies make in the technology realm will have a significant





impact on competitiveness and on return to investors.

Respondents to Hospitality 2000: The Capital report varied processes for making those investments. Forty percent of these senior executives have some responsibility for investing in technology, but the approach varies. And 57 percent of these executives report that their companies have a formal annual IT budgeting process involving the senior management team. (See Figure 10.)

Once capital is invested in IT, it is frequently forgotten as suggested by the 61 percent of respondents who report having no formal measurement system in place to monitor IT investment performance. This is somewhat akin to investing in hotel property and then never receiving or reviewing the property's financial statements. But respondents appear to recognize the problem — 63 percent report plans for such a system to be deployed over the next three years.

Conclusion

Hospitality 2000: The Capital offers a positive profile as capital providers indicate a willingness to finance the industry, albeit with relatively strong underwriting standards. As hospitality companies grow into this networked global economy, they will clearly need to look to global capital markets for support. Companies that wish to attract investors will need to demonstrate that they can offer better returns and performance than in the past. And at least in the eyes of the world's financial markets, they will need to demonstrate their viability as companies in a global marketplace. Accessing capital will be a driver of industry transformation as hospitality organizations embrace new ways of doing business and serving the customer in the years ahead.

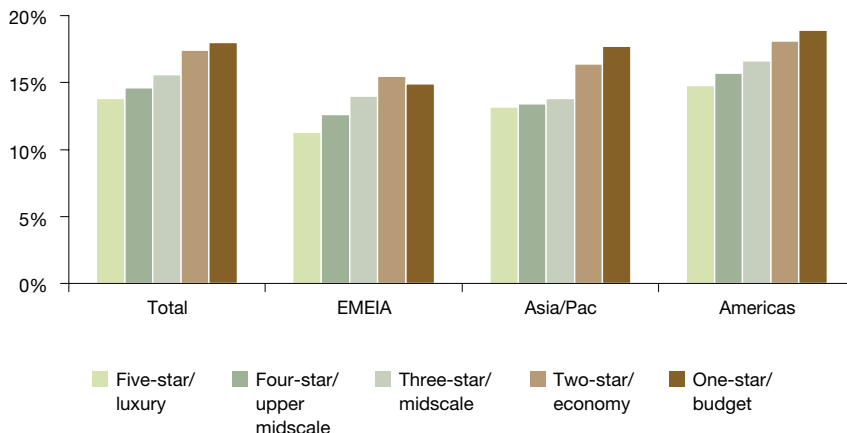


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9 Average Return on Equity Requirements



10 Approach to IT Investment Decision-Making

