DISPELLING THE MYTHS ABOUT HOTEL INVESTMENT

Glen Boultwood looks at some of the long-held preconceptions about investment in hotels and aims to test whether or not they hold true.

Many of the preconceptions about investment in hotels have been formed on the basis of their relativity to the traditional core property asset classes of office, retail and industrial.

The discussion around hotels in this paper refers solely to what I term 'institutional grade hotels'. That is, hotels that are predominantly corporate-focused and located in major CBDs. These hotels are not dependent on only one or two demand sources. They also do not incorporate leisure assets, such as resorts or islands, as I do not consider these institutional grade assets as they are higher risk assets due to their reliance on only one or two demand sources. The definition is very similar to that used by Investment Property Databank (IPD) in the traditional core property sectors.

1 HOTELS ARE HIGHLY SENSITIVE TO INCREASES IN THE AUSTRALIAN DOLLAR

There has been a long-term misconception that inbound arrivals are particularly sensitive to increases in the Australian dollar. This belief is still prevalent today, even within the hotel industry.

However, the majority of demand for hotels in corporate CBDs is domestic-based – only 25% of stays in Sydney are driven by international sources. This reduces in Melbourne and Brisbane to 19% and 10% respectively (Tourism Research Australia – National Visitor Survey, 2012).

Increases in the Australian dollar are actually negatively correlated to a reduction in inbound arrivals, contrary to popular opinion.

Six preconceptions about hotel investment

This paper covers off six preconceptions about hotel investment, including:

1. Hotels are highly sensitive to increases in the Australian dollar
2. Hotels are more susceptible to supply shocks than office spaces
3. Hotels have significantly more volatile returns than other traditional core property markets
4. Hotels are more capital intensive
5. Hotels have demand levels that are extremely volatile and sensitive to one off events
6. Hotels are valued at similar capitalisation rates to office properties but carry greater risk

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2 HOTELS ARE MORE SUSCEPTIBLE TO SUPPLY SHOCKS THAN OFFICE BUILDINGS

History is not always a precursor to the future, but what history has shown us is that office markets are more susceptible to supply stocks than hotels (see graph 1).

So what does the immediate future look like for office and hotel markets? It is expected that increases in the supply of office buildings will gain momentum in a few years' time due to the release of government land for redevelopment in major CBDs such as Barangaroo in Sydney, Southbank Brisbane and Perth; and the retreat to prime office property by A-REITS, Australian superannuation Funds and offshore investors post the GFC.

It is extremely difficult to acquire prime quality office stock in major CBDs at present and many of these investors are now starting to develop prime stock to meet their allocation requirements. This is expected to lead to an increase in office stock.

On the flipside, despite close to record occupancy levels in most major CBDs, hotel supply is unlikely to gain traction due to:

- a lack of feasibility – the majority of hotels are currently worth significantly less than replacement value. Across Eureka's hotel portfolio, the market value of combined hotels is 71% of the replacement value. This excludes the cost of land, which can be quite expensive in major CBDs
- hotels don't come close on a highest and best-use basis. As an example,

for a prime hotel asset in the core Sydney CBD with water views, the value represents about $5,000 to $6,000 per sq. m of gross building area. Compared to a premium office at $10,000 to $13,000 per sq. m and residential at $21,000 to $25,000 per sq. m, it becomes quite apparent that hotels are less favorable from a development perspective

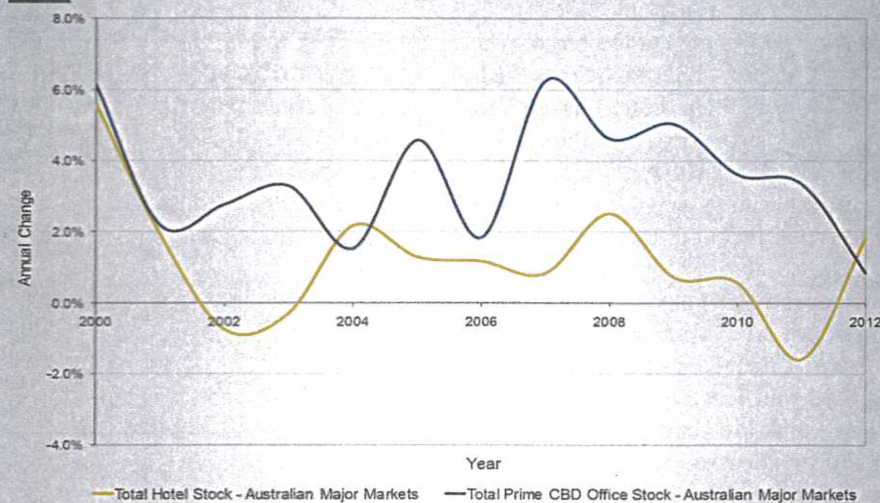
- historic spikes in hotel supply have typically been as a result of one-off events, such as the Sydney Olympics, or retail investor interest in serviced apartments. The latter of these one-off events is a model that no longer works as purchasers were buying these properties on residential prices, but the resale value was significantly less
- banks have been burnt numerous times through financing hotel developments. Due to the difficulty of obtaining pre-commitments for hotels due to their nature, obtaining development finance for hotels is extremely difficult to come by

3 HOTEL RETURNS ARE SIGNIFICANTLY MORE VOLATILE THAN OTHER TRADITIONAL CORE PROPERTY MARKETS

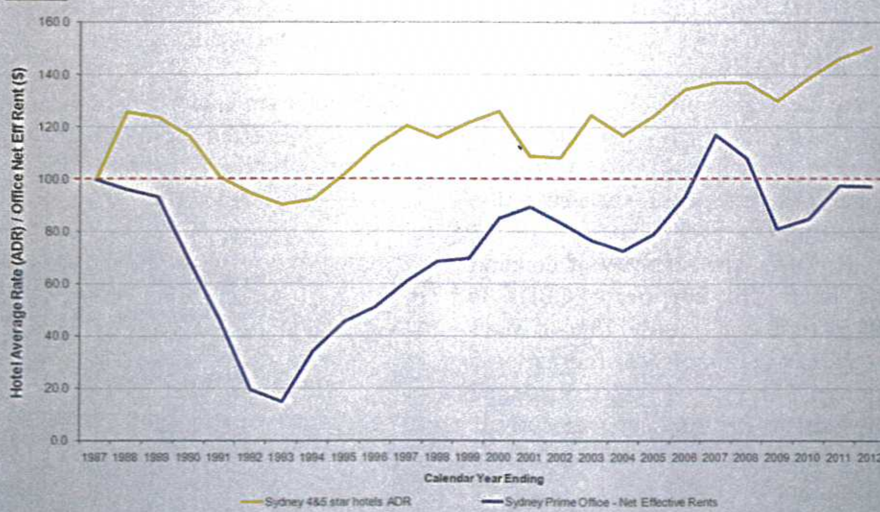
There is a perception that hotel average room rates are more volatile than office rents due to the fact that hotels are considered to be priced on a daily basis, as opposed to office rents, which are under long-term leases.

It should be noted that a significant proportion of room nights in a hotel and their associated room rate is actually locked down under one-year contracts with corporate clients, air crews and wholesalers. Therefore the volatility of average room rates is not as high as is generally perceived.

Graph 2 indexes hotel average room rates for 4 and 5 star hotels in the



(Source: Jones Lang LaSalle Hotels and Jones Lang LaSalle REIS)



(Source: BIS Shrapnel and Jones Lang LaSalle REIS)

Sydney CBD against effective rents for prime office space since 1987.

There are two key messages that are portrayed by this graph.

Office effective rents have been more volatile than hotel average room rates. It could be argued that the early 1990s was an exception for office buildings due to a massive glut of office space combining with a significant economic downturn. At the time office deals were being agreed at Governor Phillip Tower, which had been built speculatively, with no rent and purely outgoings recovery. The same can't be said about the global financial crisis in 2008 and 2009. However, it is clear that office effective rents decreased at a much faster rate than hotel room rates.

The second important insight that can be gleaned from this graph is that hotel room rates have performed much better over the past 26 years than office effective rents, resulting in around a 50% growth differential. In fact, office effective rents have barely changed over this period of time. The question is, is this purely a Sydney phenomenon or does the same trend hold true in other markets?

Jones Lang LaSalle Hotels undertook a study in 2003 whereby it looked at a comparison between office and hotel markets around the globe for the period between 1994 and 2002. The findings of this report were that the same trend was evident. European hotel room rates had outperformed European office rental growth; US hotel room rates had outperformed US office rental growth; and Asia Pacific room rates had outperformed Asia Pacific rental growth (Jones Lang LaSalle Hotels, *A Global Comparison of Hotel and Office Real Estate*, July 2003).

One argument that is constantly raised against a chart like this is that office buildings have long-term leases and therefore can ride through these

THERE HAS BEEN A LONG-TERM MISCONCEPTION THAT INBOUND ARRIVALS ARE SENSITIVE TO INCREASES IN THE AUSTRALIAN DOLLAR. THIS BELIEF IS STILL PREVALENT TODAY, EVEN WITHIN THE HOTEL INDUSTRY

downturns. To an extent that is true, however, if a major tenancy becomes vacant during a downturn period, rents will revert.

More importantly, due to the long-term nature of leases, locking in leases during a downturn also prevents the ability in many cases to benefit from the subsequent improvement in market rents. With a hotel, there is the ability to quickly recover from a downturn. This has been evidenced post-GFC whereby hotels in Sydney, for instance, are trading well above their 2007 peak trading levels.

This paper is not advocating that hotels are less risky. It is purely designed to encourage the thought that all property classes have different risks and each risk has to be considered in context.

Graph 3, produced by IPD, measures the annual return over a seven-year period to September 2012 for the traditional core property sectors and hotels.

What it demonstrates is that over the past seven years hotels have not only provided the best absolute return at 12%, but they have also provided the best volatility adjusted return, with IPD measuring volatility based on quarterly rolls (IPD Research, 2012).

Many will argue that seven years is not a long enough timeframe to accurately measure this and that the results should be measured over a minimum 10 years to produce statistically reliable results. However, I would argue that we have just gone through one of the most volatile periods in history, being the GFC. If the perception that hotels are significantly more volatile than offices and other property assets classes were to be true, it would have surely played out during this period.

Interestingly, when IPD first launched the hotel returns index in February 2011, hotel returns had the exact same volatility as office returns. The reason for the slightly increased volatility in graph 3 is due to the fact that hotels have significantly outperformed other property asset classes over the past two years, reflecting positive volatility.

4 HOTELS ARE SIGNIFICANTLY MORE CAPITAL INTENSIVE THAN OTHER PROPERTY ASSET CLASSES

One of the biggest deterrents to investment in hotels is the perception that they are significantly more capital intensive than other property asset classes, such as office and retail. Graph 4 has been compiled by IPD detailing the capital expenditure of the traditional core property sectors and hotels as a percentage of capital value.

The graph demonstrates on the surface that hotels have in fact been marginally more capital intensive over a one-, three- and five-year period. However, it is important to understand some major influences of this.

Firstly, the five-year period coincided with the acquisition

of a significant number of hotel properties by Eureka Funds Management and Mirvac, which were long overdue for refurbishment. These were all refurbished shortly after acquisition, which has inflated, to some degree, the five-year capital expenditure number. As such, anecdotally I would suggest that the one-year and three-year numbers are more towards the norm.

Secondly, during the GFC most major real estate fund managers were required to reduce their debt levels. As a result, incentives paid on office and retail space moved from historically being largely provided as fitout incentives (and therefore included in the above capital expenditure amounts) to rent abatements or rent frees (which are not included). In addition, significant capital expenditure upgrades have been deferred to improve balance sheets and hold up distribution amounts. This has skewed the office and retail capital expenditure numbers.

ONE ARGUMENT THAT IS CONSTANTLY RAISED IS THAT OFFICE BUILDINGS HAVE LONG-TERM LEASES AND THEREFORE CAN RIDE THROUGH THESE DOWNTURNS. TO AN EXTENT THAT IS TRUE, HOWEVER, IF A MAJOR TENANCY BECOMES VACANT DURING A DOWNTURN PERIOD, RENTS WILL REVERT

5 HOTELS ARE EXTREMELY SENSITIVE TO DEMAND SHOCKS

One of the largest misconceptions around hotel investment is that hotels are subject to the vagaries of major demand shocks such as epidemics, economic downturns and terrorism events. Graph 5 shows that demand for Australia's nine major CBD hotel markets has only declined once in the past 23 years. This was during the GFC where it declined a mere 1.4%, significantly less than the increase in sub-lease space across these office markets (Jones Lang LaSalle Hotels Research, 2012).

At the time, occupancy levels in the Sydney CBD fell from a record of 82% to 80%, the previous highest occupancy level recorded for the Sydney CBD office market (Jones Lang LaSalle Research, 2012).

Demand in hotels has continued to sustain continuous annual growth, despite the short-term impact of one-off events like SARS, the Asian Economic Crisis in 2007 and the September 11 terrorism attacks. This would arguably place hotels as having a much more stable demand base than any of the other traditional core property sectors.

6 HOTELS SHOULD HAVE HIGHER CAPITALISATION RATES THAN OFFICE BUILDINGS

One of the things that confound many investors that invest in the office sector and not the hotel sector is why hotel capitalisation rates for prime hotels mirror that for prime office buildings. The reality is that hotels are valued differently to office buildings.

With office buildings, the net operating income of the asset is capitalised. Under the capitalisation rate approach the present value of the first couple of years of capital expenditure is then deducted from the resulting value.

Conversely, with a hotel it is actually the net operating income (profit) less typically 3% of revenue (a proxy for capital expenditure), which is capitalised. This gives a very different result than taking the present value of the first couple of years' capital expenditure and arguably deflates the real capitalisation rate on a hotel.

Office buildings are capitalised on a face market rent basis. Technically, office buildings never receive that rent as they pay incentives to generate that level of rent. Over the past 10 years incentive levels in the Sydney CBD have averaged 24.2% (Jones Lang LaSalle REIS). In effect, the capitalisation rate on office buildings is inflated by the fact that market rents, excluding the impact of incentives, are being capitalised. With a hotel capitalisation rate, the real income you receive is being capitalised.

Office capitalisation rates also don't take into account leasing fees or vacancy allowance. Again, this arguably inflates the capitalisation rate on office buildings.

CONCLUSION

If the gap between the capital expenditure on hotels and office and retail closes over time, which I expect it will, then why should hotel valuers treat capital expenditure differently to retail and office valuers? Instead of capitalising net property income less furniture, fixtures and fittings reserve (capital reserve), should they be adopting the same approach as office and retail valuers? For example, capitalising the net property income and then taking the present value of future capital expenditure. This would create a more consistent approach across the property industry.

Further, in calculating interest cover ratio covenants for finance purposes, office, retail and hotels should use the same methodology. Banks should not deduct the capital reserve from the net property income in calculating the interest cover ratio.

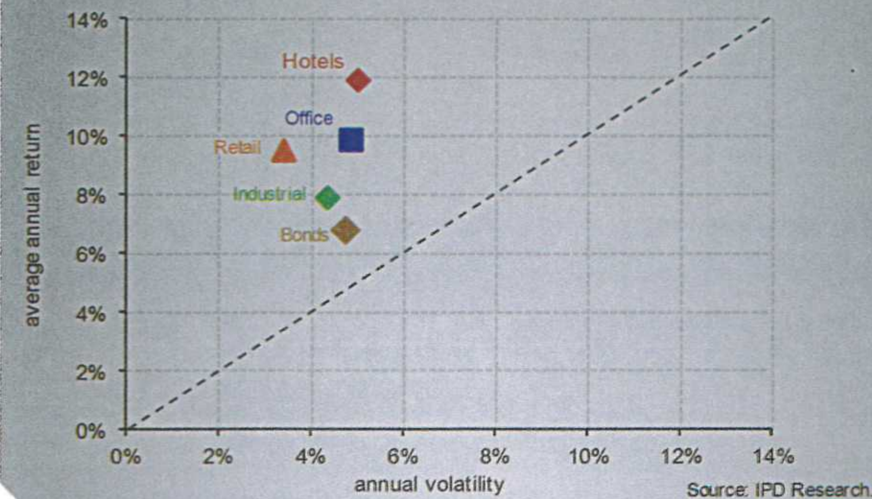
Given hotels have provided the best volatility adjusted returns over the past seven years, has there been a mispricing of hotel investment risk relative to the other traditional core property sectors? If they have, it means banks have charged too high a margin on hotel debt due to misunderstanding their inherent risk profile.

Also, has the treatment of incentives in office, retail and industrial property valuations artificially reduced the volatility of returns across these property sectors? If instead of capitalising face rents and then deducting the present value of incentives and effective rents were capitalised, it would likely result in a much greater volatility of returns. Should the valuation industry adopt a consistent approach to valuing hotel assets and the traditional core property sectors?

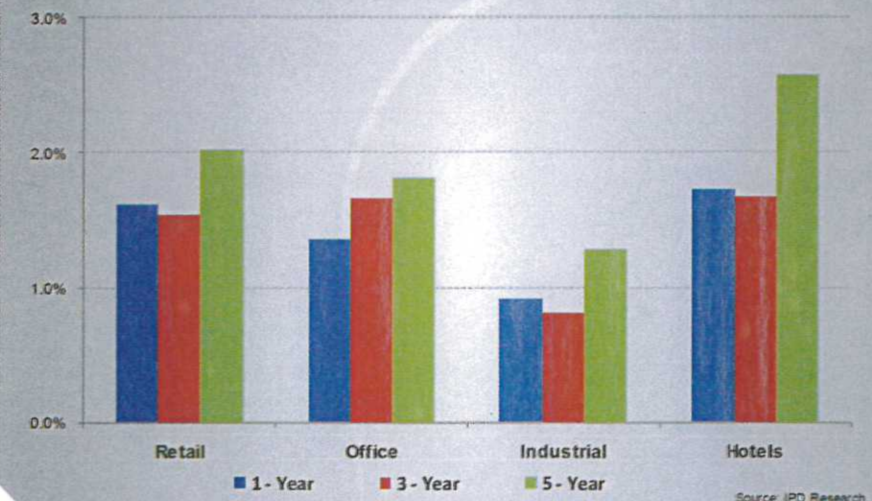
The majority of institutional investors in property have been deterred from investing in hotels because of long held misconceptions around hotel investment.

However, these preconceptions don't always hold true. I do not suggest that hotels should take precedent over investment in the traditional core property assets classes of office, retail and industrial. Instead, hotels should secure a place in an institutional investor's portfolio ahead of riskier strategies, such as development or offshore investments. ■

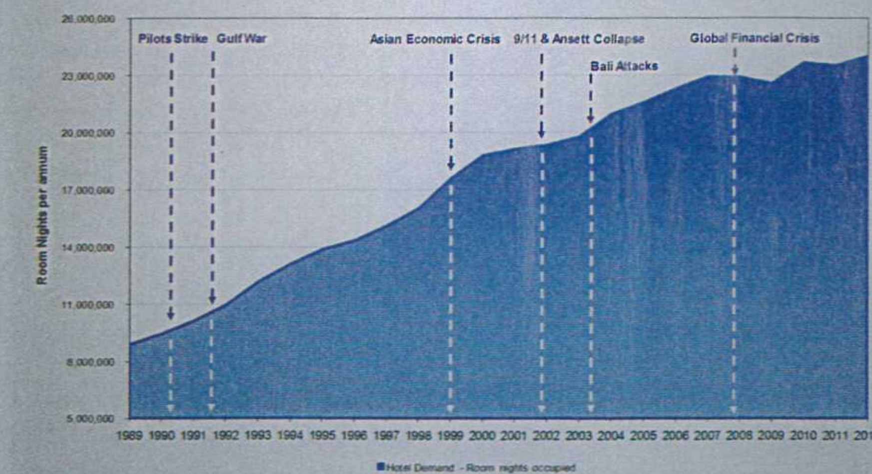
3 Australian risk-reward trade-off for property
Quaterly observations on a seven-year period ending June 2012



4 Capex (incl development) across property sectors
Average as a share of capital value to June 2012



5 Australian Major Markets - Hotel Demand



(Source: Jones Lang LaSalle Hotels Research 2012)